Audit and Accounting Quarterly Update – July 2024

Contents Page

Publication date: **June 2024**

1 FRC periodic review 2024 – overview (Lecture A858 – 13.55 minutes)

Unsurprisingly, this quarter's Audit and Accounting update is dominated by the FRC's periodic review of UK and Ireland GAAP.

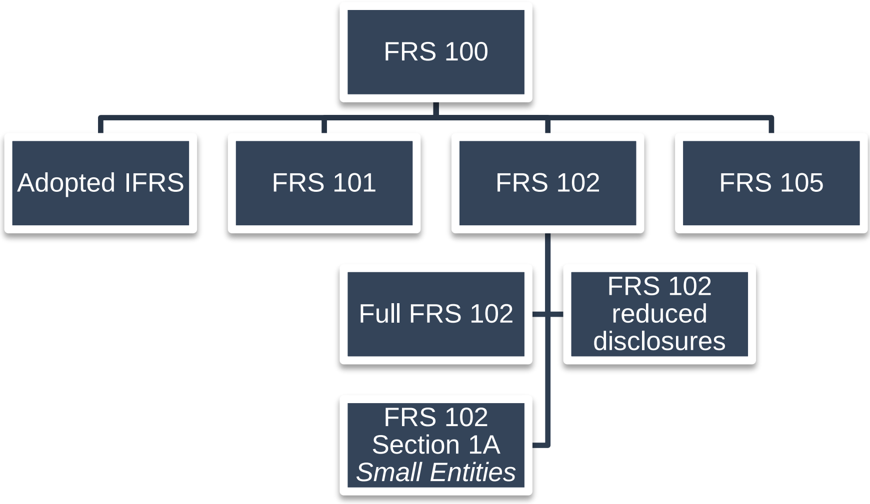
This quarter will look at the periodic review from a 'high level' approach and examine some of the key changes that have been introduced from the review as well as looking at what practitioners should be thinking about now in preparation for transitions to the new requirements. Over the course of the forthcoming quarters, we will be looking in more detail at some of the technical accounting requirements to enable transitions to be carried out as well as some of the additional disclosure requirements that will be needed. However, this quarter, we will be examining the additional disclosure requirements that will become mandatory for small entities in the UK preparing financial statements under FRS 102, Section 1A *Small Entities* (see **Section 5**).

1.1 Overview of UK and Ireland GAAP

UK and Ireland GAAP is split into six FRSs as follows (note – the current editions of the FRSs is the January 2022 edition, with the exception of FRS 100 which was re-issued in November 2022 following an Exposure Draft to update the equivalence guidance):

- FRS 100 (November 2022) *Application of Financial Reporting Requirements*
- FRS 101 (January 2022) *Reduced Disclosure Framework*[1]
- FRS 102 (January 2022) *The Financial Reporting Standard applicable in the UK and Republic of Ireland*
- FRS 103 (January 2022) *Insurance Contracts*
- FRS 104 (January 2022) *Interim Financial Reporting*
- FRS 105 (January 2022) *The Financial Reporting Standard applicable to the Micro-entities Regime*

[1] The FRC carry out annual reviews of FRS 101 to ensure that applicable disclosure exemptions are provided following developments in IFRS® Accounting Standards.



FRS 100 outlines the applicable financial reporting framework for entities which prepare financial statements in accordance with legislation, regulation or accounting standards applicable in the UK and Republic of Ireland. FRS 100 also requires that where an entity is subject to a Statement of Recommended Practice (SORP), the relevant SORP will apply in the circumstances set out in the FRS. In addition, if an entity (other than a small entity) follows a SORP, it must state in its financial statements the title of the relevant SORP followed and whether the financial statements have been prepared in accordance with the SORP's provisions.

FRS 100 also requires that entities preparing financial statements under FRS 101 or FRS 102 include a statement of compliance in the notes to the financial statements. Small companies applying FRS 102, Section 1A are encouraged to include a statement of compliance (though this will change for UK-based small entities when the periodic review amendments take effect – see **5.2**).

FRS 101 sets out a reduced disclosure framework which allows a qualifying entity to take advantage of certain disclosure exemptions as well as setting out the financial reporting requirements of the qualifying entity. The term 'qualifying entity' for the purposes of FRS 101 is:

A member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation[2]*.*

The following are not qualifying entities:

(a) charities;

---

[2] As set out in section 474(1) of the Act.

(b) *entities that are both required to apply Schedule 3 to the **Regulations** and have contracts that are within the scope of IFRS 17 Insurance Contracts; and*

(c) *entities that are not companies but are both required to apply requirements similar to those in Schedule 3 to the Regulations*[3] *and have contracts that are within the scope of IFRS 17.*

The qualifying entity must prepare its financial statements under IFRS.

FRS 101 allows qualifying entities to take advantage of certain disclosure exemptions in the individual financial statements, but **not** in the consolidated financial statements. This prohibition also extends to small groups that voluntarily prepare group accounts.

Financial institutions are also unable to apply the exemption from the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*, IFRS 13 *Fair Value Measurement* (to the extent that they apply to financial instruments) and the disclosure exemptions in IAS® 1 *Presentation of Financial Statements*, paras 134 to 136 which outline the disclosure requirements in respect of the entity's capital.

FRS 102 is the 'backbone' of UK and Ireland GAAP and outlines the recognition, measurement and disclosure requirements for financial statements. The latest edition of FRS 102 is the January 2022 and was the primary focus of the FRC's periodic review.

FRS 102 is applicable to private entities and is based on the principles in the IASB® *IFRS for SMEs Accounting Standard*, albeit with amendments to allow FRS 102 to be consistent with UK and Irish company law requirements and accounting practices.

FRS 103 is an industry-specific standard which outlines the reporting requirements for entities applying FRS 102 in the preparation of financial statements which issue insurance contracts or reinsurance contracts.

FRS 104 outlines the reporting requirements for entities applying UK and Ireland GAAP which prepare interim financial statements. An important point to emphasise is that FRS

---

[3] Requirements that are similar to those in Schedule 3 to the Regulations include:

(a) Schedules 1 and 2 to *The Friendly Societies (Accounts and Related Provisions) Regulations 1994* (SI 1994/1983);

(b) Schedule 1 to the *Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008* (SI 2008/1950);

(c) *Syndicate Accounting Byelaw* (No. 8 of 2005); and

(d) *The Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 2008* (SI 2008/565).

104 does not make any obligation for entities to produce interim financial reports (and hence FRS 104 is not regarded as an accounting standard).

FRS 105 provides an accounting framework for micro-entities, including limited liability partnerships that qualify as such. FRS 105 provides no accounting policy options (other than some limited options on first-time adoption of the standard) and has a vastly reduced disclosure regime and simpler accounting treatments that are proportionate to its target audience.

1.2 What is the periodic review?

The FRC is required to review (and potentially) amend the suite of UK and Ireland accounting standards at least every five years. Maintaining consistency with international accounting standards is a long-standing policy that has been developed through consultations, and reflects the wider approach taken by the FRC. The pace of change in IFRS Accounting Standards is fast and consequently the FRC must consider whether UK and Ireland accounting standards must be aligned together with the consideration of other emerging issues and simplifications/clarifications as part of the FRC's review.

The periodic review of UK and Ireland GAAP supports the FRC's overriding objective in standard-setting, which is to enable users of the accounts to receive high-quality, understandable financial reporting that is proportionate to the size and complexity of both the entity and users' information needs. In achieving this primary objective, the FRC develop accounting standards that:

FRS 102 Basis for Conclusions, Part A – Development and overarching issues, A.2(a) to (e)

(a) *have consistency with global accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective;*

(b) *balance improvement, through reflecting up-to-date thinking and developments in the way businesses operate and the transactions they undertake, with stability;*

(c) *balance consistent principles for accounting by all UK and Republic of Ireland entities with proportionate and practical solutions, based on size, complexity, public interest and users' information needs;*

(d) *promote efficiency within groups; and*

(e) *are cost-effective to apply.*

It should be noted that while the FRC carry out periodic reviews at least every five years, there may be changes to accounting standards outside of the periodic review cycle where the FRC judges this necessary.

1.3 Additional change that was subject to a separate Exposure Draft

In September 2023, the FRC issued FRED 84 *Draft amendments to FRS 102 – Supplier finance arrangements*. This FRED proposed to introduce new disclosure requirements in the cash flow statement to provide users with additional information concerning the entity's use of supplier finance arrangements and the effect of such arrangements on the entity's balance sheet and cash flows.

The FRC finalised these amendments at the same time as finalising the periodic review amendments on 27 March 2024. This has resulted in additional paragraphs 7.20B and 7.20C being included in FRS 102, Section 7 *Statement of Cash Flows.* FRS 102, para 7.20B clarifies what a supplier finance arrangement is; and para 7.20C set out the disclosure requirements where an entity has entered into such arrangements.

1.4 What has NOT changed in the periodic review 2024?

There was some debate in the very early stages of the periodic review concerning the introduction of an expected credit loss model in respect of the impairment of financial assets (as found in IFRS 9 *Financial Instruments*). The FRC decided not to introduce such a model in this periodic review. The FRC have intimated that it may revisit this issue in a future project.

In addition, the FRC has not introduced any amendments arising from IFRS 17 *Insurance Contracts*. Implementation experience from IFRS 17 users will be needed and it is expected that the FRC will consider this implementation experience in the future.

1.5 Staff factsheets

The FRC has previously published some staff factsheets (see www.frc.org.uk) which are freely available. There are currently eight of these as follows:

- Factsheet 1: FRS 102: Triennial Review 2017 Amendments
- Factsheet 2: FRS 102: Triennial Review 2017 Transition
- Factsheet 3: FRS 102: Illustrative Statement of Cash Flows
- Factsheet 4: FRS 102: Financial Instruments
- Factsheet 5: FRS 102: Property: Fair Value Measurement
- Factsheet 6: FRS 102: Business Combinations
- Factsheet 7: FRS 102: Transition to FRS 102
- Factsheet 8: FRS 102: Climate-related matters (amended March 2024)

The FRC have stated they will be publishing new factsheets and amending existing ones, where necessary. Additional factsheets are expected in the autumn of 2024, the content of which is currently unknown.

1.6 Effective date

The amendments arising from the periodic review come into mandatory effect for accounting periods commencing on or after 1 January 2026. Early adoption is permissible provided that all the amendments are applied at the same time.

The amendment in respect of supplier finance arrangements (see **1.3** above) has an earlier effective from date. The additional disclosure requirements in respect of supplier finance arrangements apply for accounting periods commencing on or after 1 January 2025, again with early adoption permissible.

1.7 What should practitioners be doing now?

The FRC had stated in September 2023 that it would require the amendments arising from the periodic review to be effective for accounting periods commencing on or after 1 January 2026. This means December 2026 year ends and entities with short periods will be affected first.

While this may seem a long time away, practitioners are strongly advised to gain a sound understanding of the technical accounting requirements of the periodic review amendments because there will be some significant changes made to the financial statements of clients (especially where leasing is concerned). Impact assessments are advisable in some circumstances to enable the practitioner and the client to see how the amendments will affect profit and loss and the balance sheet position. Debt covenants (where applicable) may also need to be renegotiated due to additional assets and liabilities being recognised on-balance sheet.

HMRC is expected to issue guidance in the coming months on the tax treatment of the new lease accounting requirements.

In addition, it is also worthwhile notifying clients of other changes on the horizon, such as the new filing requirements at Companies House and the possibility that the profit and loss account may be available for inspection on the public record with more detail filed at Companies House.

As noted earlier, we will be examining the detailed technical accounting issues over the course of the next few quarters, and it is also expected that professional bodies will be publishing guidance in due course.

1.8 New editions of the standards

The FRC has published the amendments arising from the periodic review on its website and these amendments cover all the FRSs. It has confirmed that new editions of the standards will be published that will consolidate all amendments made so everything is in one document. We can expect new editions of the suite of UK and Ireland GAAP to be published in the summer of 2024.

2 Lease accounting (Lecture A859 – 15.44 minutes)

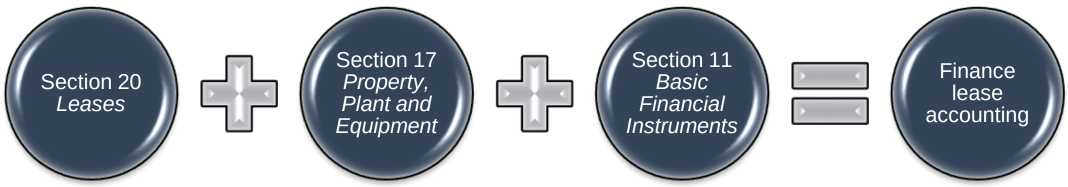
One of the most significant changes brought about by the FRC's periodic review is in respect of lease accounting (for lessees).

At the outset, it is worth emphasising that the lease accounting requirements have only changed in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. There have been no changes made to the lease accounting provisions in FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Hence, micro-entities preparing accounts under FRS 105 will continue to account for leases on a risks and rewards basis and will continue to distinguish between a finance and an operating lease.

2.1 Current requirements

FRS 102 (January 2022) works on a 'risks and rewards' approach. If the risks and rewards incidental to ownership of the leased asset remain with the lessor, the lease is, in substance, an operating lease and hence is not recognised on the balance sheet. Lease rentals are recognised in profit or loss on a straight-line basis over the lease term (or on another systematic basis if this is appropriate).

Where the risks and rewards incidental to ownership of the leased asset pass from the lessor to the lessee, the lease is, in substance, a finance lease. In other words, the entity has acquired an asset for use in its business that has been financed by way of a leasing transaction. Finance leases are recognised on-balance sheet with a corresponding finance lease payable. There is then interaction with other areas of FRS 102:



Initial recognition of the lease is dealt with in FRS 102, Section 20. The asset subject to the finance lease is then measured in accordance with Section 17 (or Section 18 *Intangible Assets other than Goodwill* if an intangible asset) for initial cost recognition and subsequent depreciation, and Section 27 *Impairment of Assets* for consideration of impairment. The finance lease obligation is measured under Section 11 using the amortised cost method which uses an effective interest rate.

Correct classification of a lease as either finance or operating is critical because getting this wrong (or deliberately engineering a lease to achieve a desired outcome) will present a misleading picture in the financial statements.

These existing requirements will continue for micro-entities preparing financial statements under FRS 105. In addition, there is no change to the way in which lessors account for their leases (the new accounting treatments affect lessees).

2.2 New requirements

The new lease accounting treatments remove the distinction between a finance lease and an operating lease for lessees.

With only a couple of exceptions, lessees will generally be required to bring all leased assets onto the balance sheet.

This means that lessees will have to bring more of their current operating leases onto the balance sheet under the new requirements.

To sum up the new requirements in a very small nutshell, there will be far more finance leases hence capitalisation of leased assets and recognition of finance lease obligations.

Discount rate to be used

The lease payments contained in the lease agreement will be discounted to essentially arrive at the value of the leased asset and corresponding finance lease liability.

In other words, at initial recognition, the entity measures the lease liability at the present value of the lease payments that are not paid at that date.

FRS 102, para 20.49 states that the interest rate to be used in discounting the lease payments will be the interest rate implicit in the lease (where this can be readily determined). The 'interest rate implicit in the lease' is defined as:

*The rate of interest that causes the **present value** of:*

*(a) the **lease payments**; and*

*(b) the unguaranteed **residual value** to equal the sum of:*

*(i) the **fair value** of the **underlying asset**; and*

(ii) any initial direct costs of the lessor.

*Amendments to FRS 102 and other FRSs (March 2024) Glossary: **interest rate implicit in the lease***

If the interest rate implicit in the lease cannot be determined reliably, the entity can choose (on a lease-by-lease basis) to apply either the lessee's incremental borrowing rate or the lessee's obtainable borrowing rate. For clarity, these terms are defined as follows:

*The rate of interest a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.*

*Amendments to FRS 102 and other FRSs (March 2024) Glossary: **lessee's incremental borrowing rate***

*The rate of interest a lessee would have to pay to borrow, over a similar term, an amount similar to the total undiscounted value of **lease payments** to be included in the measurement of the lease liability.*

*Amendments to FRS 102 and other FRSs (March 2024) Glossary: **lessee's obtainable borrowing rate***

FRS 102, para 20.51 then goes on to clarify that the lease payments included in the measurement of the lease liability (i.e., those not paid at the commencement date of the lease) comprise the following:

(a) *fixed payments (including in-substance fixed lease payments as described in paragraph 20.52), less any lease incentives receivable;*

(b) *variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraphs 20.53 and 20.54);*

(c) *amounts expected to be payable by the lessee under **residual value guarantees**;*

(d) *the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraphs 20.41 to 20.44); and*

(e) *payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.*

Amendments to FRS 102 and other FRSs (March 2024), para 20.51.

The key message the FRC is keen to get out there is that this should not be over-complicated. Getting the obtainable borrowing rate, for example, could be as easy as picking up the 'phone to the bank and asking them at what rate could the business borrow money at?

In the Exposure Draft, a 'publicly available rate' (i.e. a gilt rate) was also suggested. It is worth noting that the finalised amendments have removed this option.

2.3 Exemptions from on-balance sheet recognition

There are two situations when a lease need not be recognised on-balance sheet:

Short-term lease

A **short-term** lease is a lease which, at the commencement date, has 12 months or less to run. Keep in mind that a lease which contains a purchase option is **not** a short-term lease.

Low-value assets

In the Exposure Draft, the FRC chose to provide a list of examples of assets that the standard would consider as being of low value (computers, printers, tablets etc).

In the final amendments, this list has been removed and, instead, the standard provides a list of assets that would **NOT** be low value as follows:

Amendments to FRS 102 and other FRSs, para 20.11

- Cars, vans, buses, coaches, trams, trucks and lorries
- Cranes, excavators, loaders and bulldozers
- Telehandlers and forklifts
- Tractors, harvesters and related attachments
- Boats and ships
- Railway rolling stock
- Aircraft and aero engines
- Land and buildings
- Production line equipment

In developing the revised FRS 102, Section 20, the FRC deliberately did not include monetary amount for low value. In contrast, the Basis for Conclusions in IFRS 16 does indicate an amount of US$5,000 which the IASB had in mind when they were developing IFRS 16. This number seems to be the number that IFRS reporters have 'clung onto' when dealing with the low value assets issue.

The updated lease accounting treatments are more permissive than IFRS 16 – and that is a key difference and is one of the reasons why the FRC have not included a monetary amount for low value. This means that preparers should ensure that for leases of assets that are not low value, these should be recognised on-balance sheet (for example, if you can climb into the asset, then recognise it on-balance sheet). If the entity has smaller things, the standard is happy to leave the treatment to professional judgement and an entity can go as small as it likes in terms of determining low value. In developing this section of FRS 102, the FRC decided to enable it to be proportionate to reflect the size of the task that entities are being asked to take on.

Guidance on key technical areas such as the low value issue and discount rate is expected to be published, certainly by the professional bodies, and we will examine these issues in further detail next quarter.

2.4 Expected impact on financial statements

The lessee capitalises the 'right-of-use' asset with a corresponding lease liability in a similar way as current finance lease accounting works in FRS 102 (January 2022).

Balance sheet

On the balance sheet, the lessee recognises a new asset at the present value of the future lease payments together with any directly attributable costs of obtaining the lease (e.g. legal fees) and a corresponding finance lease liability.

If applying the cost model, the subsequent measurement basis for the asset in Section 20 will apply, but the entity looks to Section 17 for depreciation only and Section 27 for impairment. If applying other measurement models, the entity looks at Section 16 *Investment Property* for investment properties (unless the entity is applying the intra-group exemption); or Section 17 for the revaluation model.

The lease liability is measured using the amortised cost method which uses an effective interest rate. The derecognition requirements of FRS 102, paras 11.36 to 11.38 apply to lease liabilities.

The lease liability is split between current and non-current liabilities to comply with the statutory formats of the balance sheet.

Profit and loss account

The current operating lease rental expense is replaced with depreciation, any applicable impairment and a finance cost (see above) for the unwinding of the lease liability.

Impact on KPIs/key figures

The following KPIs/key figures are likely to be impacted as a result of the new lease accounting treatment, and hence it is important that issues such as existing debt covenants are considered to see the impact on these:

- EBITDA will increase by the value of the operating lease expense that is removed.
- Finance and depreciation charges will be higher (which could affect lending covenants).
- The gross assets (balance sheet total) test may be breached due to additional right-of-use assets being recognised, although the government have announced an intention to increase the company size thresholds – see **Section 7** of these notes.
- Net current assets will be decreased due to the current lease liability.
- Gearing ratios will increase, depending on the definitions of debt.

3 Revenue recognition (Lecture A860 – 10.48 minutes)

The next 'headline' change is in respect of revenue recognition. This affects both 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*.

3.1 Current requirements

Revenue is dealt with in FRS 102, Section 23 *Revenue* and in FRS 105, Section 18 *Revenue*. Both standards deal with revenue from:

While the current requirements are straightforward to apply, there has been criticism of the revenue recognition sections of UK and Ireland GAAP for being 'clumsy' and quite difficult to apply in certain situations. In recognition of this, the FRC took the decision to delete the entire sections of FRS 102, Section 23 and FRS 105, Section 18 and redraft the revenue recognition requirements.

3.2 New revenue recognition requirements

There is a single comprehensive five-step model for revenue recognition for all contracts with customers, based on identifying the distinct goods or services promised to the customer and the amount of consideration to which the entity will be entitled to in exchange (see **3.3** below).

The FRC believes this will make it easier for entities to account for revenue transactions correctly and consistently across all sizes of entity and all contract types. In addition, the FRC believes:

- There will be more reliable and useful information in the financial statements concerning the nature, amount and timing of revenue and cash flows arising from contracts with customers.

- High quality financial information supports a range of broader effects, potentially including improved access to capital.

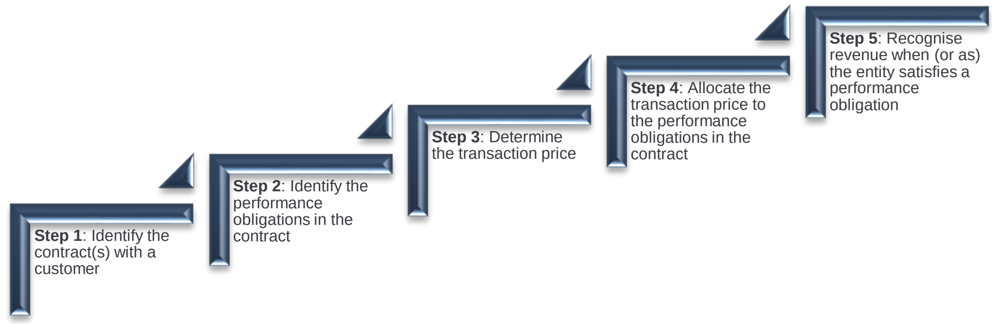
- Consistency with international accounting principles is re-established, improving comparability and reducing 'GAAP differences'.

The first thing to note about FRS 102, Section 23 and FRS 105, Section 18 is that the title of the sections has been changed from *Revenue* to *Revenue from Contracts with*

Customers. For those preparers familiar with IFRS 15 *Revenue from Contracts with Customers*, it will be obvious which direction UK and Ireland GAAP is going in where this change is concerned and how revenue will be determined when the new requirements become mandatory.

Five-step model approach

As noted in **3.2** above, there is a comprehensive five-step model approach to recognising revenue as follows:



The term 'performance obligations' features a lot in the above process and is defined as:

*A promise in a **contract** with a **customer** to transfer to the customer either:*

*Amendments to FRS 102 and other FRSs (March 2024) Glossary: **performance obligation***

(a) a distinct good or service (or a distinct bundle of goods or services); or

(b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

It should be noted that (b) is not included in the definition contained in FRS 105.

Revenue will still be recognised at a point in time or over time, but the new requirements are more prescriptive on how different elements of a customer contract are disaggregated or combined and taken into account.

Steps 1 to 4 in the five-step model may, on the face of it, be straightforward to apply and the reality is that in practice these steps are generally applied across the board. Step 5, however, uses a single approach rather than the current approach of determining when the significant risks and rewards of ownership of the goods are transferred and the stage of completion for service contracts.

However, the tricky part will be identifying an appropriate policy in the absence of current guidance to some of the difficult aspects of applying this five-step model, such as the prescriptive requirements for:

- identifying performance obligations in a contract;
- licensing and royalty revenue;
- non-refundable upfront fees;
- variable consideration, including customer refunds; and
- warranties, rights of return and customer acceptable clauses, and options.

We will consider some of the technical accounting issues relating to these in future quarterly updates.

3.3 Practical considerations

Clients will need to carefully assess their revenue recognition accounting policies to ensure they are compliant with the new requirements in FRS 102 and FRS 105. There could be potential amendments to the timing of revenue recognition under the revised accounting treatments.

Entities will need to review their customer contracts in detail to apply the guidance and this may not be as simple as it first appears at first glance.

There are enhanced disclosure requirements which relate to classes of revenue; how and when revenue has been recognised; and unsatisfied performance obligations. In addition, if the entity has applied significant judgements in recognising revenue, these will also require disclosure. Accounting policies should also describe the point at which revenue is recognised (e.g. on dispatch of goods or when a customer receives those goods).

In terms of first-time application of the new requirements, FRS 102 allows an entity to choose either to amend its comparatives and apply the new five-step model to all customer contracts; or to apply the model to incomplete contracts at the start of the current period and adjust equity for the cumulative effect at that date. FRS 105 only allows the micro-entity to apply the revised Section 18 prospectively to contracts that begin after the date it first applies the periodic review amendments. Therefore, the micro-entity does not change its accounting policy for any contracts in progress at that date.

4 Concepts and Pervasive Principles

Another notable change in 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* is the new Section 2 *Concepts and Pervasive Principles*.

The *Concepts and Pervasive Principles* found in extant FRS 102 (January 2022) and FRS 105 (January 2022) has been completely deleted and replaced with a new set of *Concepts and Pervasive Principles*. The FRC have taken the decision to create a new *Concepts and Pervasive Principles* section so that UK and Ireland GAAP is aligned to the latest *Conceptual Framework for Financial Reporting* as issued by the IASB.

4.1 Structure of the revised Concepts and Pervasive Principles

The structure of the revised FRS 102, Section 2 is as follows:

Scope

The scope section describes the objective of financial statements and sets out the concepts and basic principles that underpin the financial statements of entities within the scope of the FRS. It also explains the process that must be followed if FRS 102 does not deal with a transaction, event or condition.

It should be emphasised that if there are any inconsistencies between Section 2 and the requirements in any other section of FRS 102, the other section prevails. This approach is consistent with the approach in the IASB's *Conceptual Framework for Financial Reporting* ('the Framework') which would not prevail over the requirement of an IAS or IFRS Accounting Standard as the Framework does not have the force of a standard.

Objective of financial statements

This section clarifies that the objective of general purpose financial statements is to provide information about the entity that is useful for decision-making by a wide range of users who are not in a position to demand reports tailored to meet their particular information needs. This section then goes on to describe the types of information users are particularly interested in when it comes to the financial statements.

Qualitative characteristics of useful financial information

These are split between:

- Fundamental qualitative characteristics; and
- Enhancing qualitative characteristics.

The **fundamental** qualitative characteristics are **relevance** and **faithful representation**. A sub-set of 'relevance' is 'materiality'.

Paragraph 2.11 clarifies that information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the users of the accounts make on the basis of those financial statements.

Relevance

Information contained in the financial statements must be relevant. Information is said to be relevant when it has the capability of influencing the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations.

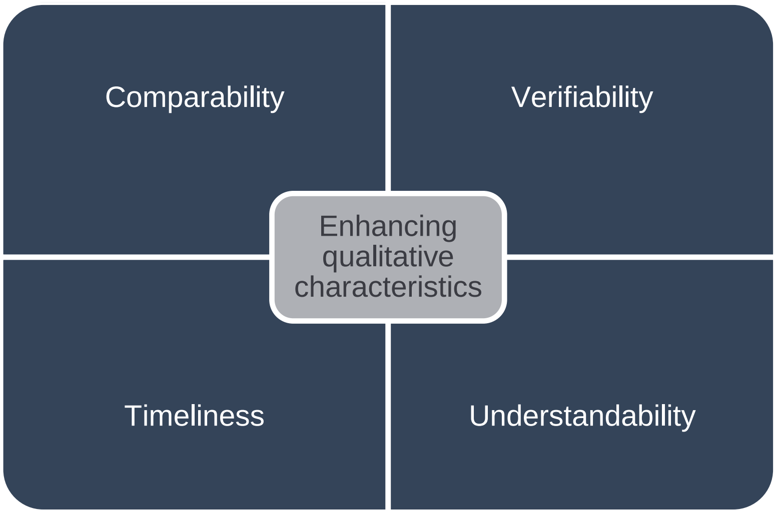
These types of characteristics are often referred to as ‘predictive’ values (i.e. information can be used to predict future outcomes) or ‘confirmatory’ values (i.e. information provides feedback about previous evaluations).

Faithful representation

Faithful representation means that the financial statements are accurately presented and reflect the condition of a business. Faithful representation should extend to all parts of the financial statements, including the results of operations, financial position and cash flows of the entity. Financial statements that faithfully represent these aspects are said to be:

- Complete
- Neutral (i.e. free from bias)
- Free from error

The **enhancing** qualitative characteristics are:



Comparability

Users must be able to compare the financial statements of an entity through time to identify trends in its financial position and performance. In addition, users must also be able to compare the financial statements of different entities to evaluate their relative financial position, performance and cash flows.

Comparability allows users to identify and understand variations in, and among, items. For example, an investor looking to invest in one of two companies will inevitably want to see which entity can provide a return on their investment the fastest. Comparing the liquidity and profitability of both entities will enable the potential investor to arrive at that conclusion.

Verifiability

Verifiability allows different knowledgeable and independent users to reach consensus, albeit not necessarily complete agreement, that a particular depiction is a faithful representation. Verifiability means that information can be verified either directly or indirectly. Direct verification means verifying an amount or other representation through direct observation such as counting cash. Indirect verification means checking the inputs to a model, formula or other technique and performing a recalculation using the same techniques (for example, recalculating inventory valued on a first-in, first-out cost methodology).

Timeliness

To be relevant, financial information must be able to influence the economic decisions of users. This involves providing the information within the decision timeframe.

Where undue delays are encountered, this could impact on the relevance of the financial information. However, it may be that some financial information continues to be timely long after the balance sheet date has passed as many users, for example, need to identify and assess trends.

There is no specific time limit expressed in FRS 102 for this concept. However, in the UK, private entities have nine months from the year end to file accounts at Companies House (longer for some newly established entities) and six months for entities which are listed. Hence, entities are constrained by other legal requirements to prepare and issue financial statements within certain timescales. The Listing Rules of the London Stock Exchange also specify certain deadlines that must be met for listed entities (e.g. the requirement to issue half-yearly financial statements to shareholders).

Understandability

This concept requires financial information to be presented in a way that makes it comprehensible by users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. The need for understandability does not allow relevant information to be omitted on the grounds that it may be too difficult for some users to understand.

For example, the disclosures in respect of a defined benefit pension plan and certain financial instruments are inherently complex but this must not be a reason to preclude such information in the notes to the accounts. Where additional guidance is required in respect of complex disclosures, professional advice should be sought by the user.

Users are therefore required to have some degree of knowledge of the business to which the financial statements relate, and an understanding of the information contained in those financial statements. If information were omitted on the basis of its complexity, the financial statements would be incomplete hence the economic decision-making process would be impaired.

Cost constraint

There is a cost to providing financial information which must be justified by the benefits of reporting that information and this will involve judgement. The *Concepts and Pervasive Principles* recognises that the costs are not necessarily borne by those users who enjoy the benefits, and often the benefits are enjoyed by a broad range of external users.

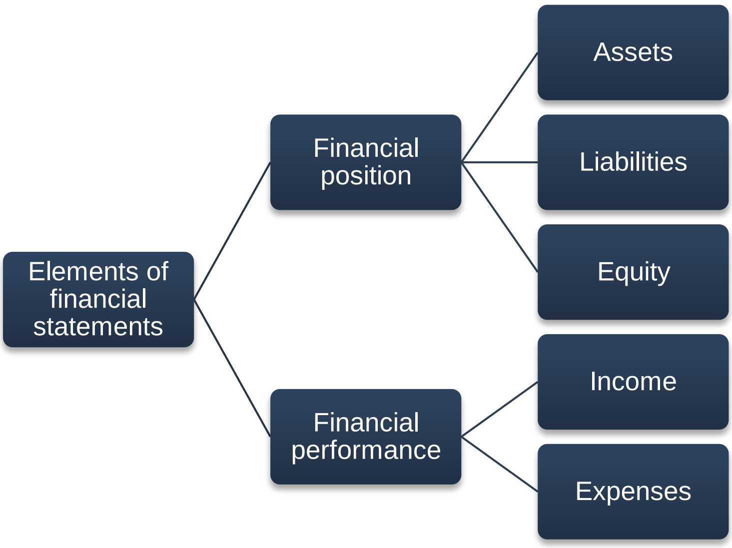
Financial statements and the reporting entity

This section deals with:

- The reporting period.
- The perspective adopted in financial statements (i.e. the provision of information concerning transactions and other events from the perspective of the reporting entity as a whole).
- The going concern assumption.
- The reporting entity – either a single entity or a portion of an entity or more than one entity. Where the reporting entity comprises a parent and its subsidiary, the reporting entity's financial statements are referred to as consolidated financial statements.

Elements of financial statements

These comprise:



This section of the *Concepts and Pervasive Principles* also provides the definition of 'asset' and 'liability'.

Unit of account

This is the right(s) or obligation(s) to which recognition criteria and measurement concepts are applied.

Income and expenses

The *Concepts and Pervasive Principles* recognises that users require information concerning an entity's financial position (balance sheet) and financial performance (profit and loss account/other comprehensive income). Although income (which includes revenue and gains) and expenses are defined in terms of changes in assets and liabilities, information concerning income and expenses is just as important as information concerning assets and liabilities.

This section of the *Concepts and Pervasive Principles* requires the entity to prepare its financial statements on an accruals basis (with the exception of the cash flow statement).

Recognition and derecognition

This section describes the recognition process and recognition criteria. Only items that meet the definition of an asset, liability or equity are recognised in the balance sheet (referred to as the 'statement of financial position' in FRS 102). Similarly, only items that meet the definition of income or expenses are recognised in the profit and loss account (referred to as the 'statement of financial performance' in FRS 102).

With regards to the recognition criteria, the *Concepts and Pervasive Principles* also clarifies the following points:

- Relevance (para 2.56)

- Existence uncertainty (para 2.57)
- Low probability of an inflow or outflow of economic benefits (para 2.58)
- Faithful representation (para 2.59)
- Measurement uncertainty and outcome uncertainty (paras 2.60 and 2.61)

This section also describes the **derecognition** process for assets and liabilities in paras 2.62 to 2.64.

Measurement

Measurement refers to the measurement bases such as historical cost, current value (fair value, value in use for assets and fulfilment value for liabilities) and current cost.

This section also describes factors that should be considered by the entity in selecting a specific measurement basis (i.e. relevance and faithful representation) and provides a link to the enhancing qualitative characteristics of comparability, understandability and verifiability.

The measurement of equity is not measured directly. The *Concepts and Pervasive Principles* recognises that the carrying amounts of all recognised assets less the total of the carrying amounts of all recognised liabilities equals total equity. However, it recognises that it may be appropriate to measure directly the carrying amount of some individual classes of equity and some components of equity.

Presentation and disclosure

This section of the *Concepts and Pervasive Principles* deals with the following:

- Classification (sorting of assets, liabilities, equity, income or expenses on the basis of shared characteristics).
- Offsetting (when the entity recognises and measures both an asset and liability as separate units of account, but groups them into a single net amount on the balance sheet). Generally, offsetting is not permissible unless specifically allowed by the FRS. However, measuring assets net of allowances (e.g. net of a bad debt provision or stock provision) is not offsetting.
- Classification of equity – it may be necessary to separately classify equity to comply with company law requirements (e.g. share capital and share premium).

Paragraphs 2.100 to 2.101 deal with aggregation. These paragraphs recognise that aggregation makes information more useful by summarising a large volume of detail but also recognises that aggregation conceals some of that detail. To that end, the entity must strike a balance so that relevant information is not obscured by a large amount of insignificant detail or by excessive aggregation.

4.2 Fair value measurement

The fair value measurement guidance is contained in an Appendix to Section 2 *Fair Value Measurement* which is an integral part of Section 2.

The FRC have renamed the fair value guidance 'Section 2A' as opposed to it being an Appendix. Section 2A has been updated to align definitions with the latest international standards and provide additional guidance. This additional guidance was deemed to be necessary because fair value measurement is fundamental to the accounting for some transactions (e.g. financial instruments) but can be subject to significant judgement. This additional guidance should enable preparers to arrive at appropriate conclusions consistently.

5 Small entities (Lecture A861 – 11.21 minutes)

Many small entities choose to apply the presentation and disclosure requirements of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Section 1A *Small Entities*. Section 1A provides a reduced level of disclosure which complies with the requirements of company law.

There are two specific Appendices which are relevant to the small company disclosure requirements in FRS 102 (January 2022), Section 1A:

- Appendix C: Disclosure requirements for small entities in the UK
- Appendix D: Disclosure requirements for small entities in the Republic of Ireland

There is then Appendix E *Additional disclosures encouraged for small entities*.

5.1 Encouraged disclosures

Company law requires the financial statements of a small entity to give a true and fair view. The mere application of appendices C and D may not achieve that, and it will require the professional judgement on the part of the directors (often in conjunction with their professional accountant) to determine which, if any, additional disclosures should be made in the small entity's financial statements to achieve a true and fair view. Remember, under FRS 102 (January 2022), potentially anything outside Section 1A (i.e. full FRS 102) is disclosable if making such a disclosure enables a true and fair view to be presented.

The FRC included Appendix E to encourage small entities to provide the following disclosures in the financial statements to enable a true and fair view to be achieved. The encouraged disclosures are as follows:

FRS 102 (January 2022), para 1AE.1 (a) to (e)

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

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

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

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

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

5.2 Changes to the disclosure requirements for small entities in the UK

Following the UK's departure from the EU, the FRC is now able to require more disclosure for small companies in the UK. Prior to Brexit, the FRC had stated that it was constrained by the requirements of the EU Accounting Directive, but this is no longer the case.

The FRC has made amendments to FRS 102, Section 1A, Appendix C by requiring more disclosures to be made for small entities.

The FRC are of the view that this will be helpful to small entities as there will not be as much reliance needed on professional judgement to enable a true and fair view to be presented in the financial statements; although there will be some element of this required and additional disclosures may still be required to achieve a true and fair view.

The amendments to FRS 102, Section 1A, Appendix C are as follows:

General

FRS 102, para 1AC.1 has been amended to clarify that a small entity need not provide a specific disclosure set out in Appendix C if the information resulting from that disclosure is not material. The exception to this rule would be where the disclosure is required by company law.

This additional clarification has been included because the revised Appendix C mandates disclosure information that may not necessarily be required by law. If that disclosure information *is* required by law, it must be made regardless of materiality.

Statement of compliance

A small entity must make an explicit and unreserved statement of compliance with FRS 102 (adapted to refer to Section 1A) in the notes to the financial statements.

Keep in mind that a small entity will **not** be able to make such an explicit and unreserved statement of compliance unless the financial statements comply with **all** the requirements of FRS 102 (including Section 1A).

Public benefit entities that apply the 'PBE' prefixed paragraphs must also make an explicit and unreserved statement of compliance that it is a public benefit entity.

Going concern

A new paragraph 1AC.2C is included which requires a small entity to provide the disclosures set out in paragraphs 3.8A and 3.9. For clarity, paragraphs 3.8A and 3.9 are reproduced as follows:

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

Amendments to FRS 102 and other FRSs (March 2024), para 3.8A

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

Amendments to FRS 102 and other FRSs (March 2024), para 3.9

To a certain extent, this will help to 'mop up' a problem that became particularly prevalent during the Covid-19 pandemic where some small entities did not include disclosures about material uncertainties relating to going concern. This was often on the grounds that there was no legal requirement to do so.

While this is true, the fact that they are **material** uncertainties means that a small entity should include such disclosures in the financial statements to achieve a true and fair view (remember, there is a legal requirement to ensure the financial statements for a small entity present a true and fair view).

ACCA and ICAEW issued guidance to member firms in this respect stating that while the accounts were legally 'correct', the fact that they may omit a material disclosure means that they are materially misleading hence do not present a true and fair view.

The professional bodies also reminded member firms that they are not allowed to have their names associated with accounts that are misleading so any reluctance by the small company's directors to include disclosures about material uncertainties relating to going concern would mean the firm may have to resign from the client.

Making material uncertainties relating to going concern mandatory for small entities will reduce this happening.

Current and deferred tax

Small entities are required to provide the disclosures relating to deferred tax set out in paragraph 29.27(e). For clarity, this paragraph is reproduced as follows:

The amount of deferred tax liabilities and deferred tax assets at the end of the reporting period for each type of timing difference and the amount of unused tax losses and tax credits.

FRS 102, para 29.27(e)

In addition, FRS 102, para 1AC.32C requires a small entity to provide information relating to **current tax** and **deferred tax** as set out in paras 29.26 and 29.27(b). Paragraphs 29.26 and 29.27(b) are reproduced as follows:

An entity shall disclose separately the major components of tax expense (income). Such components of tax expense (income) may include: *FRS 102, para 29.26*

(a) current tax expense (income);

(b) any adjustments recognised in the period for current tax of prior periods;

(c) the amount of deferred tax expense (income) relating to origination and reversal of timing differences;

(d) the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;

(e) adjustments to deferred tax expense (income) arising from a change in the tax status of the entity or its shareholders; and

(f) the amount of tax expense (income) relating to changes in ***accounting policies*** *and material* ***errors*** *(see Section 10 Accounting Policies, Estimates and Errors).*

A reconciliation between: *FRS 102, para 29.27(b)*

(i) the tax expense (income) included in profit or loss; and

(ii) the profit or loss on ordinary activities before tax multiplied by the applicable tax rate.

Leasing

Given the significant changes to lease accounting in FRS 102, it was unsurprising that the FRC include additional disclosure requirements for small entities in the UK concerning a small entity's leasing arrangements as follows:

(a) Where the small entity is a lessee, a general description of its significant leasing arrangements must be made. There is a similar disclosure requirement in FRS 102, para 20.76.

(b) Where necessary to enable users to understand the small entity's significant leasing arrangement, a lessee must provide additional qualitative and quantitative information. There is a similar disclosure requirement in FRS 102, para 20.77, which requires the following minimum information:

    (i) information concerning future cash flows to which the lessee is potentially exposed that are not reflected in the measurement of the lease liability;

    (ii) information concerning restrictions or covenants imposed by leases;

    (iii) the type of discount rate used in the calculation of lease liabilities; and

    (iv) specific information concerning sale and leaseback transactions.

(c) A small entity must provide the disclosures concerning short-term leases, leases of low-value assets and variable lease payments as set out in paragraphs 20.80(b) to 20.80(d).

For clarity paragraphs 20.80(b) to 20.80(d) are reproduced as follows:

The expense relating to short-term leases accounted for applying paragraph 20.6. This expense need not include the expense relating to leases with a lease term of one month or less.

Amendments to FRS 102 and other FRSs (March 2024), para 20.80(b)

The expense relating to leases of low-value assets accounted for applying paragraph 20.6. This expense shall not include the expense relating to short-term leases of low-value assets included in paragraph 20.80(b).

Amendments to FRS 102 and other FRSs (March 2024), para 20.80(c)

The expense relating to variable lease payments not included in the measurement of lease liabilities.

Amendments to FRS 102 and other FRSs (March 2024), para 20.80(d)

Provisions and contingencies

A small entity is required to provide the disclosures concerning provisions and contingencies as set out in paragraphs 21.14 to 21.17A. For clarity, these paragraphs are reproduced below:

<u>Disclosures about provisions</u>

For each class of provision, an entity shall disclose the following:

FRS 102, para 21.14

(a) a reconciliation showing:

(i) the carrying amount at the beginning and end of the period;

(ii) additions during the period, including adjustments that result from changes in measuring the discounted amount;

(iii) amounts charged against the provision during the period; and

(iv) unused amounts reversed during the period.

(b) a brief description of the nature of the obligation and the expected amount and timing of any resulting payments;

(c) an indication of the uncertainties about the amount or timing of those outflows; and

(d) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Comparative information for prior periods is not required.

<u>Disclosures about contingent liabilities</u>

Unless the possibility of any outflow of resources in settlement is remote, an entity shall disclose, for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, when practicable: *FRS 102, para 21.15*

(a) an estimate of its financial effect, measured in accordance with paragraphs 21.7 to 21.11;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.

If it is ***impracticable*** *to make one or more of these disclosures, that fact shall be stated.*

<u>Disclosures about contingent assets</u>

If an inflow of economic benefits is probable (more likely than not) but not virtually certain, an entity shall disclose a description of the nature of the contingent assets at the end of the reporting period, and, when practicable, an estimate of their financial effect, measured using the principles set out in paragraphs 21.7 to 21.11. If it is impracticable to make this disclosure, that fact shall be stated. *FRS 102, para 21.16*

<u>Prejudicial disclosures</u>

FRS 102, para 21.17

In extremely rare cases, disclosure of some or all of the information required by paragraphs 21.14 to 21.16 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose all of the information required by those paragraphs insofar as it relates to the dispute, but shall disclose at least the following:

In relation to provisions, the following information shall be given:

(a) a table showing the reconciliation required by paragraph 21.14(a) in aggregate, including the source and application of any amounts transferred to or from provisions during the reporting period;

(b) particulars of each provision in any case where the amount of the provision is material; and

(c) the fact that, and reason why, the information required by paragraph 21.14 has not been disclosed.

In relation to contingent liabilities, the following information shall be given:

(a) particulars and the total amount of any contingent liabilities (excluding those which arise out of insurance contracts) that are not included in the statement of financial position;

(b) the total amount of contingent liabilities which are undertaken on behalf of or for the benefit of:

*(i) any **parent** or fellow **subsidiary** of the entity;*

(ii) any subsidiary of the entity; or

(iii) any entity in which the reporting entity has a participating interest,

shall each be stated separately; and

(c) the fact that, and reason why, the information required by paragraph 21.15 has not been disclosed.

In relation to contingent assets, the entity shall disclose the general nature of the dispute, together with the fact that, and reason why, the information required by paragraph 21.16 has not been disclosed.

Disclosure about financial guarantee contracts

An entity shall disclose the nature and business purpose of the financial guarantee contracts it has issued. If applicable, an entity shall also provide the disclosures required by paragraphs 21.14 and 21.15. *FRS 102, para 21.17A*

Share-based payment transactions

The small entity must make disclosures in connection with any share-based payment arrangements it undertakes as set out in paragraphs 26.18(a), 26.18(b)(i), 26.18(b)(vi), 26.18(b)(vii) and 26.23.

These paragraphs are reproduced as follows (although only the disclosure information that will be required by small entities in the UK is reproduced):

A description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement, such as vesting requirements, the maximum term of options granted, and the method of settlement (eg whether in cash or equity). An entity with substantially similar types of share-based payment arrangements may aggregate this information. *FRS 102, para 26.18(a)*

The number and weighted average exercise prices of share options for each of the following groups of options: *FRS 102, para 26.18(b) (i), (vi) and v(ii)*

(i) outstanding at the beginning of the period;

(vi) outstanding at the end of the period; and

(vii) exercisable at the end of the period.

*An entity shall disclose the following information about the effect of share-based payment transactions on the entity's profit or loss for the period and on its **financial position**:*

FRS 102, para 26.23

(a) the total expense recognised in profit or loss for the period; and

*(b) the total **carrying amount** at the end of the period for liabilities arising from share-based payment transactions.*

Revenue recognition

A small entity is required to provide the disclosures relating to its performance obligations in contracts with customers – specifically the information required by paragraphs 23.135(a) to 23.135(c). The required information from these paragraphs is reproduced as follows:

An entity shall disclose information about its performance obligations in contracts with customers, including a description of:

Amendments to FRS 102 and other FRSs (March 2024), paras 23.135(a) to 23.135(c)

(a) when the entity typically satisfies its performance obligations (eg upon shipment, upon delivery, as services are rendered or upon completion of service);

(b) the significant payment terms (eg when payment is typically due, whether the contract includes a financing transaction, and whether the consideration amount is variable);

(c) the nature of the goods or services that the entity has promised to transfer, highlighting any promises to arrange for another party to transfer goods or services (ie if the entity is acting as an agent).

Related parties

In contrast to the current (limited) disclosure requirements of FRS 102 (January 2022), para 1AC.35, the FRC have redrafted this entire paragraph and instead require a small entity to provide the disclosures required by paragraphs 33.9 and 33.14 (subject to the provisions of paragraphs 33.1A and 33.11). Much more comprehensive disclosures will be required by small entities in the UK in respect of related parties and transactions with related parties. Paragraphs 33.9 and 33.14 are reproduced as follows:

If an entity has related party transactions, it shall disclose the nature of the related party relationship as well as information about the transactions, outstanding balances and commitments necessary for an understanding of the potential effect of the relationship on the financial statements.

Amendments to FRS 102 and other FRSs (March 2024), para 33.9

Those disclosure requirements are in addition to the requirements in paragraph 33.7 to disclose key management personnel compensation.

At a minimum, disclosures shall include:

(a) The amount of the transactions.

(b) The amount of outstanding balances and commitments, and:

(i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and

(ii) details of any guarantees given or received.

(c) Provisions for uncollectible receivables related to the amount of outstanding balances.

(d) The expense recognised during the period in respect of bad or doubtful debts due from related parties.

Such transactions could include purchases, sales, or transfers of goods or services, ***leases****, guarantees and settlements by the entity on behalf of the related party or vice versa.*

An entity may disclose items of a similar nature in the aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

FRS 102, para 33.14

As noted above, FRS 102 provides an exemption from disclosing transactions entered into between two or more wholly owned members of a group and the small entity can take advantage of this disclosure exemption. For clarity, FRS 102 para 33.1A is reproduced as follows:

Disclosures required by paragraph 33.9 need not be given of transactions entered into between two or more members of a ***group****, provided that any* ***subsidiary*** *which is a party to the transaction is wholly owned by such a member.*

Amendments to FRS 102 and other FRSs (March 2024), para 33.1A

Paragraph 33.11 also provides an exemption as follows:

An entity is exempt from the disclosure requirements of paragraph 33.9 in relation to related party transactions, outstanding balances, and commitments, with:

Amendments to FRS 102 and other FRSs (March 2024), para 33.11

(a) government that has control, joint control or significant influence over the reporting entity; and

(b) another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity.

However, the entity must still disclose a controlling party relationship as required by paragraph 33.5.

Dividends declared and paid or payable

A small entity must disclose dividends paid or payable during the reporting period.

Transition information

On first-time adoption of FRS 102 (e.g. when the entity transitions from FRS 105 to FRS 102, including those that choose to apply the presentation and disclosure requirements of Section 1A), the small entity must provide an explanation of how the transition has affected its financial position and performance as required by paragraph 35.13. For clarity, paragraph 35.13 is reproduced as follows:

To comply with paragraph 35.12, an entity's first financial statements prepared using this FRS shall include: *FRS 102, para 35.13*

(a) A description of the nature of each change in accounting policy.

(b) Reconciliations of its equity determined in accordance with its previous financial reporting framework to its equity determined in accordance with this FRS for both of the following dates:

(i) the date of transition to this FRS; and

(ii) the end of the latest period presented in the entity's most recent annual financial statements determined in accordance with its previous financial reporting framework.

(c) A reconciliation of the profit or loss determined in accordance with its previous financial reporting framework for the latest period in the entity's most recent annual financial statements to its profit or loss determined in accordance with this FRS for the same period.

5.3 Impact of the additional disclosure requirements

The FRC have moved all the encouraged disclosure requirements from Appendix E to Appendix C and included additional disclosures relating to:

- Leasing
- Provisions and contingencies
- Share-based payment arrangements
- Taxation
- Revenue recognition

On first-time adoption of the periodic review amendments, UK-based small entities are encouraged to ensure the disclosures comply with the new requirements and not simply rely on accounts production software as this could result in errors or omissions. The consequences could be the financial statements are misleading and do not present a true and fair view. Where appropriate, it may be advisable to use an up to date disclosure checklist to ensure the completeness and accuracy of disclosure information.

6 Other changes (Lecture A862 – 6.50 minutes)

While not necessarily 'headline' changes, some of the other changes made by the FRC's periodic review to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* are as follows:

6.1 Share-based payments

There is additional guidance in Section 26 *Share-based Payment* to clarify that equity instruments issued in a business combination (i.e. where a parent acquires a subsidiary) in exchange for control are not within the scope of Section 26. However, equity instruments granted to employees of the acquiree in their capacity as employees (e.g. in return for continued service) are within the scope. The cancellation, replacement or other modification of share-based payment arrangements arising as a consequence of the business combination, or other equity restructuring, must be accounted for in accordance with Section 26.

There is also additional clarification on the use of the term 'fair value' because Section 26 uses the term differently in some respects.

For the purposes of Section 26, fair value is the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

Section 26 sets out specific guidance for measuring fair value for certain share-based payment transactions.

For example, new paragraph 26.14A which deals with the measurement of cash-settled share-based payment transactions states:

The fair value of the liability shall be measured by reference to the fair value of the cash-settled share-based payment transaction. For example, share appreciation rights are measured by reference to the fair value of the underlying equity instruments measured in accordance with paragraphs 26.10 and 26.11.

Amendments to FRS 102 and other FRSs (March 2024), para 26.14A

Cash-settled share-based payment transactions

In addition to paragraph 26.14A above, there are additional paragraphs 26.14B and 26.14C which relate to vesting conditions. Paragraph 26.14B clarifies that a cash-settled share-based payment transaction may be conditional upon satisfying specified vesting conditions which relate to service or performance. The paragraph then goes on to specify how these conditions are accounted for as follows:

Amendments to FRS 102 and other FRSs (March 2024), para 26.14B (extract)

(a) Vesting conditions, other than market vesting conditions, shall not be taken into account when estimating the fair value of the cash-settled share-based payment as at the measurement date. Instead, such vesting conditions shall be taken into account in estimating the number of awards expected to vest. The entity shall revise that estimate, if necessary, if subsequent information indicates that the number of awards that are expected to vest differs from previous estimates. On the vesting date, the entity shall revise the estimate to equal the number of awards that ultimately vest.

(b) All market vesting conditions and conditions that are not vesting conditions shall be taken into account when estimating the fair value of the cash-settled share-based payment at each reporting date and at the date of settlement.

New paragraph 26.14C then goes on to clarify that as a result of applying paragraphs 26.14 to 26.14B, the cumulative amount ultimately recognised for goods or services received as consideration for the cash-settled share-based payment is equal to the cash that is paid.

Counterparty has a choice of settlement

Where the counterparty has a choice of settlement (i.e. in cash or in equity), paragraph 26.15B states that the share-based payment transaction is accounted for as a wholly cash-settled share-based payment transaction. However, this paragraph has now been expanded to include two exceptions as follows:

(a) the choice of settlement in cash (or other assets) has no commercial substance because the cash settlement amount (or value of the other assets) bears no relationship to, and is likely to be lower in value than, the fair value of the equity instruments; or

(b) the choice of settlement relates only to a net settlement feature and there is an obligation on the entity under tax laws or regulations to withhold an amount for an employee's tax obligation associated with that share-based payment.

In the above situations, the entity accounts for the transaction as a wholly equity-settled transaction.

However, if the entity withholds an amount of shares that exceeds the monetary value of the employee's tax obligation in (b) above, the entity accounts for the excess shares withheld as a cash-settled share-based payment when this amount is paid in cash or other assets to the employee.

6.2 Uncertain tax positions

FRS 102, Section 29 *Income Tax* did not deal with uncertain tax treatments prior to the periodic review. The term 'uncertain tax treatment' is defined as:

A tax treatment for which there is uncertainty over whether the relevant taxation authority will accept the tax treatment under tax law. For example, a tax treatment that relies on an interpretation of the law that is not in accordance with the way in which the taxation authority is known to interpret the law.

New paragraphs 29.17A to 29.17C have been included in FRS 102 which deal specifically with uncertain tax treatments. An entity must determine whether to consider each uncertain tax treatment separately or together with one or more other uncertain tax treatments. In applying this requirement, the entity uses the approach which better predicts the resolution of the uncertainty.

Paragraph 29.17B states that the entity assumes a tax authority will examine amounts that it has a right to examine and have full knowledge of all related information when making those examinations.

Entity concludes it is probable the tax authority will accept an uncertain tax treatment

Where the entity concludes it is probable (i.e. more likely than not) that the tax authority will accept an uncertain tax treatment, the entity determines the taxable profit (loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used or planned to be used in its tax filings.

Entity concludes it is not probable that the tax authority will accept an uncertain tax treatment

Conversely, where the entity concludes it is not probable that the tax authority will accept an uncertain tax treatment, the entity must reflect the effect of uncertainty in determining the related taxable profit (loss), tax bases, unused tax losses, unused tax credits or tax rates by using either of the following methods, depending on which better predicts the outcome:

(a) the most likely amount – the single most likely amount in a range of possible outcomes; or

(b) the expected value – the sum of the probability-weighted amounts in range of possible outcomes.

Going forward, the entity treats a change in relevant facts and circumstances as a change in accounting estimate (i.e. the changes are reflected prospectively – no retrospective restatement is carried out).

6.3 Future planning

The FRC do not have many upcoming projects on the horizon as the periodic review has clearly taken several years to complete and has been a huge piece of work for it. The FRC may start preliminary work on some areas for the next periodic review – for example, the expected credit loss model that did not get included in FRS 102 in this review but may end up being exposed for public comment in the next periodic review (or as a separate project).

Some calls have been made to the FRC to look at specific areas such as group reconstructions, changing the definition of 'business' and business combinations. However, the scope of this work and, indeed, whether the FRC will embark on projects in these areas remains to be seen.

Keep in mind that the FRC can still amend accounting standards outside of the periodic review cycle if it considers an issue to be important to warrant a change. Such changes will be dealt with as ad-hoc projects.

There will be some narrow-scope amendments made to accounting standards prior to the next periodic review. For example, the planned changes to the UK company size thresholds will need to be reflected once they have been enshrined into law; and changes to company size thresholds made by the EU which are applicable to Ireland (although Ireland have not yet enshrined the increased company size thresholds into legislation as yet) will need to be reflected in the standards.

The Economic Crime and Corporate Transparency Act 2023 will also result in changes being made to UK and Ireland accounting standards once secondary legislation has been issued.

SORP-making bodies will also need to carry out reviews of their SORPs to ensure they cater for the periodic review changes, where applicable. We have already seen changes to the LLP SORP being consulted upon towards the end of 2023. Given that the periodic review was finalised on 27 March 2024, it is likely that the CCAB will delay issuing an updated SORP as it would be sensible for them to include the periodic review changes in the SORP (as far as the periodic review affects the LLP SORP) prior to finalising it.

In May 2023, the IASB published IFRS 19 *Subsidiaries without Public Accountability: Disclosures*. IFRS 19 permits eligible subsidiaries to use IFRS Accounting Standards with reduced disclosures. This is similar to FRS 101. The UK Endorsement Board (which is responsible for endorsing IFRS Accounting Standards for use in the UK) will need to endorse IFRS 19 for use in the UK and the FRC are looking at the principles in IFRS 19 to see if any of those principles could be used in FRS 101.

FRS 101 will continue to be updated on an annual basis to cater for changes in IFRS Accounting Standards so those practitioners with clients that use FRS 101 are advised to keep abreast of developments in this area. There may also be a project in the future that looks at whether FRS 101 should be overhauled entirely to ensure it remains fit for purpose, but at the present time no details have been released about any potential project in this respect.

7 Change in company size thresholds (Lecture A863 – 12.40 minutes)

On 18 March 2024, the government announced its first set of planned regulatory changes that are designed to ease the burdens placed on businesses in respect of non-financial reporting.

Many would agree that regulation over financial reporting and auditing has increased significantly over the last few years. The government are conscious that increased regulation has a cost to it and given the challenging economic climate, increased costs are something which businesses are actively trying to avoid where possible.

The government intend to lay legislation in the summer of 2024 to increase the size thresholds which determine the size of a company. The 50% increase in the monetary thresholds aim to cut complexity and burden from legislative reporting requirements and it is expected that:

- 5,000 large companies will be reclassified as medium-sized to access more proportionate reporting;
- 13,000 medium-sized companies will fall into the small companies' regime enabling them to benefit from potential audit exemption and filing simpler accounts (see **7.3** below); and
- 113,000 small companies will fall into the micro-entities' regime to allow them to prepare simpler accounts.

If the new measures contained in The Companies (Non-financial Reporting) (Amendment) Regulations 2024 are implemented, the table below outlines the revised thresholds:

Two out of three of:	Micro		Small		Medium		Large	
	Old	**New**	**Old**	**New**	**Old**	**New**	**Old**	**New**
Annual turnover	Not more than £632k	**Not more than £1m**	Not more than £10.2m	**Not more than £15m**	Not more than £36m	**Not more than £54m**	£36m+	**£54m+**
Balance sheet total	Not more than	**Not more than**	Not more than	**Not more than**	Not more than	**Not more than**	£18m+	**£27m+**

	£316k	**£500k**	£5.1m	**£7.5m**	£18m	**£27m**	
Average number of employees	Not more than 10		Not more than 50		Not more than 250		251+

There are some technical points that are worth recapping on where these thresholds are concerned:

- Turnover is pro-rata'd for a short accounting period.
- Balance sheet total is fixed assets plus current assets (it is not net assets). This is a common misconception and the source of the authority clarifying this is found in the Companies Act 2006, s382(5).
- Employee headcount is based on the **average** number of employees employed under contracts of service by the company in that month (whether throughout the month or not).

Remember, a company's size is determined if it satisfies at least two out of the above three criteria. The thresholds above must be breached for two consecutive years for the classification to be applied.

7.1 Impact on audit exemption thresholds

The audit exemption thresholds track the small companies' thresholds and have done so since 2012 when they were both aligned. Hence, if there is a change to the small companies' thresholds, the audit exemption thresholds will automatically change as well.

7.2 Further consultation issued by the Department for Business and Trade

On 16 May 2024, the government issued a further Press Release titled *Brexit freedoms used to slash red tape for businesses*.

In that Press Release, the government confirmed that they will consult on raising the employee headcount threshold for medium-sized businesses from 250 to 500. In addition, the government is also consulting on providing an exemption from preparing a strategic report for medium-size companies, which is expected to be welcome.

If the proposals go through as planned, the only primary differences between a medium-sized company and a small company will be audit exemption (which can only be claimed by small companies); and the availability of a less onerous disclosure regime in FRS 102, Section 1A *Small Entities* (which, of course, would not be available to medium-sized entities).

7.3 Impact on filing requirements

As noted above, the government estimates that some 13,000 medium-sized companies will fall into the small companies' regime which will enable them to benefit from potential audit exemption and filing simpler accounts.

The filing requirements for small and micro-entities are, of course, going to change following the enactment of the Economic Crime and Corporate Transparency Act 2023 (ECCTA). Small companies will be required to file a directors' report and a profit and loss account; and micro-entities will be required to file just the profit and loss account (a directors' report will still not be required in a micro-entity's annual accounts).

At the time of writing these notes, secondary legislation is awaited that will specify the form and content of the profit and loss account that will need to be filed at Companies House.

In addition, we are also waiting on confirmation as to whether, or not, the profit and loss account will be available for inspection on the public record. There are provisions in the ECCTA that provide the Registrar of Companies with the option of making the profit and loss account unavailable for inspection. Specifically, section 56 of the ECCTA states:

The Secretary of State may by regulations make provision requiring the registrar, on application or otherwise—

(a) not to make available for public inspection profit and loss accounts, or parts of them, delivered to the registrar under—

Section 443A (micro-entities), or

Section 444 (other small companies);

(b) to refrain from disclosing such accounts, or parts of them, except in specified circumstances.

This was a notable change from the original Bill which did not contain this provision. Hence, it would seem strange for the ECCTA to contain this provision and for the Registrar of Companies *not* to take advantage of it. Time will, of course, tell whether the Registrar decides, through secondary legislation, to make profit and loss accounts of micro-entities and small companies unavailable for inspection or not. Opinion on this is divided – some in the profession think they should be available for inspection on the grounds of the limited liability afforded to incorporated entities; whereas others disagree and state that the profit and loss should not be available for public inspection on the grounds that it may contain commercially sensitive information.

Also, at the time of writing these notes, we are still awaiting confirmation from the government as to when these new filing requirements will take effect. In any event, it is expected that an ample amount of time will be given by the government to transition to the new filing requirements because software providers will need time to update their software for the new filing regime and the systems at Companies House will also need to be changed.

7.4 Practical considerations

Many companies will be keen to take advantage of a reduced disclosure regime once they drop into medium-sized, small or micro territory. However, there may also be disadvantages to doing this and companies should consider the bigger picture before jumping ship.

Lenders and financiers may not look favourably on the entity including fewer disclosures in the financial statements just because they can. This may prevent useful information being conveyed to them. In addition, parent entities may find the consolidation process more arduous if certain disclosures are not made in the financial statements.

Companies should therefore consider the practical pros and cons of preparing simpler financial statements to avoid any contentious issues being raised with interested stakeholders.

In most cases, there will be no issue in preparing financial statements under, say, FRS 102, Section 1A *Small Entities*, but in some cases there could be some issues to resolve first.

8 Audit exemption availability set to increase (Lecture A864 – 5.18 minutes)

As noted in section 7 of these notes, the government are consulting on increasing the company size thresholds which will enable more business to fall into the small companies' regime. As the audit exemption thresholds are coupled with the small companies' thresholds, more businesses will be able to claim audit exemption.

For many practising accountants, the audit regime has become costly. In 2023, the number of audit firms recognised with Recognised Supervisory Bodies continued to decline. The total number of registered audit firms was 4,310 as at 31 December 2022, compared with 4,745 in 2021 and 5,007 in 2020.

These figures confirm that audit firms, particularly at the smaller end of the scale, are finding audit unsustainable for their practice or it may be that former audit clients have contracted and become small hence they are able to claim audit exemption. In addition, the current recruitment crisis in the auditing profession suggests that many entrants into the profession are choosing to avoid audit. This could be due to many factors; but it goes without saying that today's auditing profession is very demanding (some would say too demanding) and the recent high-profile corporate scandals that have rocked the auditing profession have clearly not helped.

8.1 Benefits of an audit

Setting aside the scandals that have rocked the auditing profession in the last decade, there are clear benefits to having an audit:

An audit identifies weaknesses in controls

Part of the audit process involves assessing the entity's system of internal control to identify weaknesses. For example, if there is a lack of segregation of duties in the payroll department, this creates a fraud risk factor as a 'ghost' employee could be set up to divert funds. Additionally, if bank reconciliations are not reviewed by a senior official, or if reconciling items on the bank reconciliations are not investigated, this could also create a fraud risk factor.

Fraud deterrent

An audit is a rigorous process and much of this process involves carrying out audit procedures on the amounts and disclosures in the financial statements to ensure the accounts give a true and fair view. These procedures are much more in-depth than, say, a compilation engagement.

Having an audit can also be a fraud deterrent as any potential fraudster may be nervous of being caught out by the audit process.

Reduced risk of management bias

An audit may reduce the risk of management bias (e.g. deliberately inflating revenue or decreasing expenditure to improve profitability) as it is likely that an auditor will detect such bias during the course of their audit procedures.

Improved credibility of the financial statements

Audited financial statements enhance the credibility and reliability of the figures because they have been subject to a review by an independent audit firm. Lenders and prospective investors prefer to receive audited financial statements than unaudited ones. In addition, tax authorities (such as HM Revenue and Customs) place more reliance on audited financial statements than unaudited ones. Although, that is not to say that an audited entity stands a lesser chance of being selected for a tax enquiry than an unaudited entity.

A business has many stakeholders who will all require different levels of information from the financial statements. Audited financial statements can provide some level of comfort to these stakeholders, who may be:

- Banks/other lenders
- Employees
- Suppliers
- Customers
- Insurance companies
- Current and potential investors
- Shareholders

It is true that the auditing profession has come under increasing levels of scrutiny over the last few years due to the high-profile corporate collapses such as Carillion and Patisserie Valerie. The Brydon review of auditing also included many recommendations to improve the profession. However, the FRC are aiming to restore trust and confidence in the auditing profession and while this does come at a cost to auditors (in the form of increased requirements through revised and new ISAs (UK)/ISQMs (UK)), the benefits are worthwhile.

9 Assurance work (Lecture A865 – 6.47 minutes)

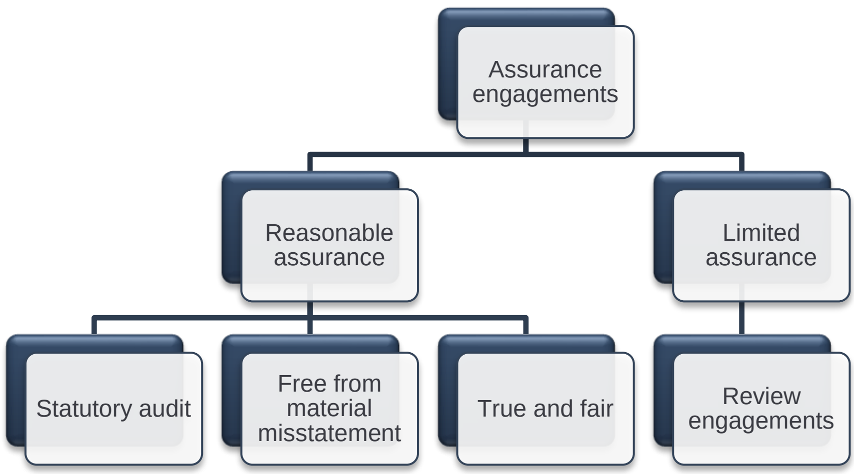
For several years, the Audit and Accounting Quarterly Updates have concentrated on auditing in the latter part of the updates. However, this quarter we have decided to take a look at assurance and the other types of assurance engagements that a practitioner may perform.

The *Handbook of International Quality Management, Auditing, Review, Other Assurance, and Related Services Pronouncements* issued by the IAASB defines an 'assurance engagement' as:

> *An engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria).*

IAASB Handbook – Glossary of Terms – Assurance engagement (extract)

The definition then goes on to clarify that each assurance engagement is classified on two dimensions: a **reasonable assurance** engagement or a **limited assurance** engagement.



Providing assurance means offering an opinion about specific information so the users of that information are able to make confident decisions in the comfort that the risk of the information being wrong is reduced (as it has been subject to some form of assurance work).

9.1 Elements of an assurance engagement

There are five elements of an assurance engagement:

Putting these five elements in the context of an audit engagement:

Three parties involved

1. The preparers (management/directors)
2. The users (shareholders)
3. The practitioner (the audit firm)

An appropriate subject matter

This would be the financial statements that have been prepared by management/directors.

Suitable criteria

The applicable financial reporting framework, such as FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

Sufficient appropriate evidence

This would be the audit evidence obtained throughout the course of the audit fieldwork that is used to formulate the opinion.

A written assurance report

This would be the auditor's report which is presented to the shareholders and confirms whether the financial statements give a true and fair view.

9.2 Reasonable assurance engagements

An audit is the only assurance engagement that provides **reasonable** assurance. Reasonable assurance is a high level of assurance, but it is not maximum or absolute assurance.

There is what is known as the 'expectations gap' that exists where auditing is concerned. The expectations gap is the difference between what the auditor is expected to do to comply with professional standards (ISAs (UK) and other regulatory requirements) and what the general public perceives that the auditor does.

An auditor can never provide 100% assurance on a set of financial statements. This is because of the inherent limitations of an audit which are as follows:

- Financial statements include subjective estimates and other judgemental matters.
- The auditor may place reliance on a client's internal controls which have their own limitations.
- Representations from management may have to be relied upon as the only source of evidence in some areas.
- Audit evidence is often persuasive rather than conclusive.
- The auditor does not test all transactions and balances as this is impractical. Auditors test on a sample basis.

Examples of the expectations gap include:

- A belief that the auditor tests all transactions and balances.
- A belief that auditors are required to detect all fraud. While ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* places a certain level of responsibility on the auditor to obtain reasonable assurance that the financial statements are free from material misstatement whether caused by fraud, they are not responsible for detecting all fraud.
- A belief that auditors prepare the financial statements. This is the responsibility of management.

Illustrative auditor's report extract

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether caused by fraud or error, and to issue a Report of the Auditors that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists.

As you can see from the above extract, the auditor's report is clear that the opinion is only reasonable assurance and is not a guarantee that the financial statements are 100% accurate.

A reasonable assurance **opinion** is also positively worded.

Illustrative positively worded audit opinion

Opinion

We have audited the financial statements of …

In our opinion the financial statements:

- give a true and fair view of the state of the group's and of the parent company affairs as at 31 December 2023 and of the group's profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

9.3 Limited assurance engagement

A limited assurance engagement is increasingly being regarded as an alternative to an audit. Some professional bodies have introduced 'mini audits' for companies that fall into audit exemption although there is no statutory requirement to have this form of 'mini audit' (see also **9.5** below).

A limited assurance engagement cannot give the same level of assurance as an audit. To that end, an 'opinion' (i.e. which provides reasonable assurance) is not provided. Instead, a limited assurance conclusion is expressed and this is known as 'negative assurance' based on the more limited procedures than are required with a statutory audit.

A negative assurance conclusion will typically be worded as follows:

Nothing has come to our attention that causes us to believe that the financial statements of Sunnie Industries Ltd as at 31 December 2023 are not prepared, in all material respects, in accordance with FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland.

In contrast to an audit opinion, no opinion is being expressed in an assurance conclusion. Although some assurance is provided that the information 'appears reasonable'.

Summary

The table below summarises the principal differences between a reasonable assurance engagement (an audit) and a limited assurance engagement:

Reasonable assurance engagement	Limited assurance engagement
Auditors gathers sufficient and appropriate audit evidence to be able to draw a reasonable conclusion. The auditor concludes that the subject matter conforms in all material respects with the identified suitable criteria. The auditor provides a positively worded assurance opinion. This opinion provides a high level of assurance (confidence). An audit involves performing thorough audit procedures to obtain sufficient and appropriate audit evidence which includes tests of controls and substantive procedures.	The practitioner gathers sufficient and appropriate evidence to be able to draw limited conclusions. The practitioner concludes that the subject matter, with respect to identified suitable criteria, is plausible in the circumstances. The practitioner provides a negatively worded assurance conclusion. The conclusion provides a moderate or lower level of assurance than an audit. Significantly fewer procedures are performed and will consist mainly of inquiries and analytical procedures.

9.4 Guidance for assurance engagements other than audits

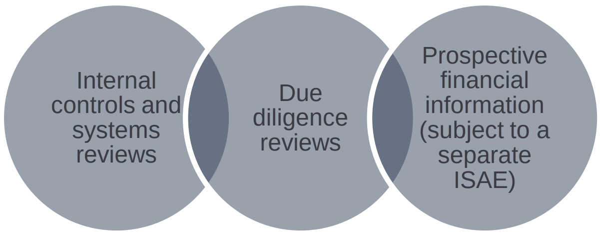
The International Standard on Assurance Engagements (ISAE) 3000 provides guidance to practitioners on carrying out an assurance engagement other than audits or reviews of historical financial information. A summary of the requirements of ISAE 3000 is as follows:

Ethical requirements	Practitioners should comply with ethical requirements such as those issued by the relevant professional body (e.g. ACCA's *Code of Ethics and Conduct*)
Quality control	The practitioner should implement quality control procedures that are applicable to the individual engagement

Engagement	The terms of the engagement should be recorded in an engagement letter, and the practitioner should agree on the terms of the engagement with the engaging party
Planning and obtaining evidence	The practitioner should plan the engagement so that it will be performed effectively, and should consider materiality and assurance engagement risk, and sufficient appropriate evidence should be obtained on which to base the conclusion
Reporting	The assurance report should be in writing and should contain a clear expression of the practitioner's conclusion about the subject matter information

The approach required by ISAE 3000, and the work carried out in an assurance engagement, may be similar in some respects to an audit, although the context is different.

Some of the most common areas where assurance engagements on other information will typically arise include the following:



Internal control and systems reviews

This type of work is similar to when an auditor carries out controls testing to assess the operating effectiveness of a client's internal control system.

Due diligence reviews

There is very sparse guidance on due diligence reviews, although it is a common form of assurance. Ordinarily, the assurance provider is engaged by a potential acquirer of a business who wishes to delve into information concerning the target business. The assurance provider will attempt to verify specific representations made by management of the target company and to offer practical recommendations concerning the acquisition process.

Prospective financial information

It should be noted that there is separate guidance in the form of ISAE 3400 *The Examination of Prospective Financial Information*. Prospective financial information (PFI) is highly subjective in nature because it relates to events and actions that have not yet occurred (and may not occur). Hence its preparation requires the exercise of professional judgement.

To comply with ISAE 3400, the terms of the engagement must be agreed on and sufficient knowledge of the business should be obtained. In addition, the period of time covered by the PFI should be clarified – for example, it could be a forecast covering up to 12 months or it could be a projection covering a five-year period.

Written representations should be requested from management concerning the intended use of the PFI, the completeness of significant management assumptions and also management's acceptance of its responsibility for the PFI. The assurance report provided by the practitioner should make it clear that management is responsible for the PFI and also the assumptions on which it is based.

As PFI is purely subjective and speculative, an opinion cannot be provided on whether the results in the report will be achieved hence only negative assurance can be given in such an engagement.

9.5 Review engagements

The objective of a review engagement is for the practitioner to state whether, on the basis of the procedures carried out, anything has come to the practitioner's attention that causes them to believe that the financial statements are not prepared in accordance with the applicable financial reporting framework.

Hence, a company that claims audit exemption may choose to have a review of their financial statements instead. This review will still provide some assurance but will cost less and be less disruptive than an audit.

In a review engagement, the procedures carried out will focus mainly on analytical procedures and enquiries of management. Tests of control will not be carried out and because only limited assurance is being expressed, substantive procedures will be minimal. In other words, there is no requirement to comply with the ISAs (UK) in a review engagement.

10 Grant claim reports

Many businesses apply for grants and are successful in receiving these grants. However, the grant provider needs some assurance on how the recipient is using the grant funding.

To that end, the grant provider will need an independent accountant to review the costs incurred and confirm that those costs meet the terms and conditions of the grant. An accountant's report is then produced, stating whether expenditure meets the conditions imposed.

The grant offer letter will often be the starting point in deciphering whether, or not, a client requires an accountant's report to be prepared. However, grant-paying bodies will need to be clear about:

- The purpose for which the practitioner's report is needed
- The type of the engagement
- The type and format of the report
- The criteria against which the practitioner's report is to be issued
- What they intend to do with the report once they receive it
- The timeliness and frequency of the report

10.1 Practitioner's responsibilities

The practitioner will be engaged to provide an independent report that the monies paid out by the grant have been spent in accordance with the returns submitted by the recipient. While the engagement will be between the practitioner and the recipient, the report will be provided to the grant-paying body and it is acknowledged that they may rely on that report.

Before taking on such an engagement, the practitioner must clarify:

- The purpose of the request for the report
- The scope of work
- To whom they will be reporting
- To whom they will owe a duty of care
- What the report will be used for

The practitioner must also clarify that the grant recipient understands their responsibilities and the need to maintain effective systems and documentation to record the transactions relative to the grant.

The practitioner will consider the information provided in the context of ISAE (UK) 3000 or ISRS 4400. ISA (UK) 805 *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement* may also apply in the circumstances.

It is important to emphasise that practitioners have a duty to take reasonable care in preparing and providing the report on a timely basis. Equally, though, the practitioner should not be pressured in meeting deadlines if claims are only provided at short notice.

10.2 Duty of care

If a grant-paying body has decided that it does need a practitioner's report, it must then need to consider if it requires a formal duty of care from the practitioner. This will then lead into determining the best type of engagement that would provide the grant-paying body with the assurance it requires. The options available are as follows:

Tripartite or multipartite engagement

The grant recipient and the practitioner enter into dialogue concerning the purpose of the report, the type of engagement, the scope of work and the sort of report required. In such an engagement, the practitioner's report is addressed to both the grant-paying body and the grant recipient.

However, for large grant-paying bodies where there are several grant schemes and a large number of grants being awarded, it may be impractical to have an engagement letter with each individual practitioner.

Standardised engagement terms

Standardised terms will include the terms under which the grant-paying body is willing to contract with the practitioner at the outset. Where the terms are standardised, the grant-paying body is not required to sign individual engagement letters with practitioners. Practitioners would take the work on if they accepted the standard terms set by the grant-paying body and this then implies a duty of care to the grant-paying body. In such a case, the report is addressed to both the grant-paying body and the grant recipient.

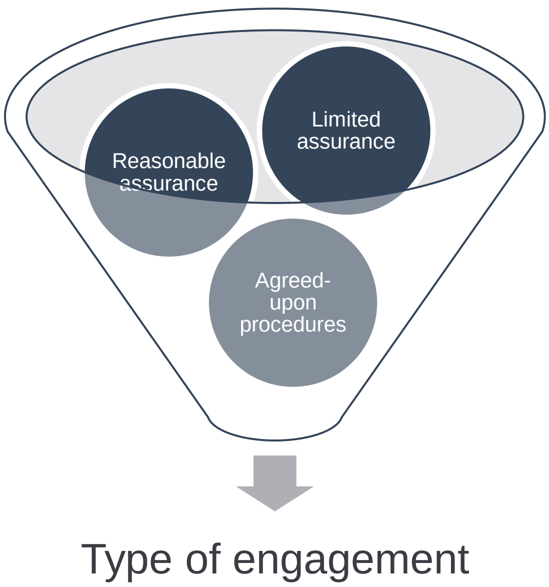
In some cases, the grant-paying body is clear that they do not expect a duty of care from practitioners. In this instance, this must be stated in the terms and conditions to the grant recipient so that it is explicit from the outset to all parties involved. The engagement will be between the grant recipient and the practitioner, so the report is addressed solely to the grant recipient. It is a risk-based decision if the grant-paying body refuses to accept any duplication and rejects reports which disclaim liability.

If the practitioner is not the grant recipient's statutory auditor, they may wish to include terminology within their engagement letter which clarifies their responsibilities and liability to the statutory auditor of the financial statements. The two engagements will be separate, with the statutory auditor being responsible for their own auditor's report. The statutory auditor must determine what reliance, if any, to place on the practitioner's work as part of the evidence for their audit. Similarly, the practitioner should include similar clarifying wording in their letter of engagement to the auditors of the grant-paying body.

Where the practitioner is the statutory auditor of the grant recipient, the relationship will need to be carefully managed. Both the grant recipient and the grant-paying body will need clarification that these engagements are separate from the statutory audit engagement. To that end, the practitioner may, within the engagement terms, confirm that their responsibilities in relation to the statutory audit engagement are separate and carried out for a different purpose from the engagement to provide a report on the grant funding.

10.3 Type of engagement

There are three main options available for a practitioner's report:



We examined the engagements that result in reasonable and limited assurance previously.

However, in an agreed-upon procedures engagement, no assurance is given and hence no assurance conclusion is expressed. Instead, an agreed-upon procedures engagement sets out the agreed scope of work and procedures to be undertaken and the findings from the procedures along with details of any exceptions that practitioners have identified from their work.

It is not possible to combine the three options. For example, carrying out an agreed-upon procedures engagement and expecting a reasonable assurance conclusion.

Where the form and content of the practitioner's report is deemed to be paramount, or is prescribed by legislation, this is likely to determine the type of engagement that is to be provided.

Inherently, a reasonable assurance engagement (an audit) will cost more than a limited assurance engagement because far more procedures and planning are involved in a reasonable assurance engagement than there is in a limited assurance one. If cost is a concern of the grant-paying body, then it should be borne in mind that an agreed-upon procedures engagement will be the cheapest; a limited assurance engagement will be more expensive; but an audit will be much more expensive.

10.4 Scope of work

The practitioner must be clear at the outset about what the grant-paying body requires a report on (i.e. the grant-paying body may want a specific outcome and may also want the work to be carried out in a specific way). The practitioner will also need to be certain whether the grant-paying body wants them to carry out a reasonable assurance engagement, a limited assurance engagement or agreed-upon procedures.

The procedures carried out will depend on the type of engagement the grant-paying body wishes the practitioner to carry out.

10.5 Format of the report

The terms and conditions of the grant scheme and offer letter should make it clear the type of report that is required. Agreeing the wording and format of the report at the outset will help to avoid disagreements further down the line. The report should make clear:

- for whom the report is prepared, who is entitled to rely on it and for what purpose;
- that the engagement has been undertaken in accordance with agreed engagement terms;
- the work performed and the findings; and
- a conclusion or report that can be supported by the work done.

10.6 Confidentiality

There may be statutory rights of access for parties, such as government departments or audit agencies, to see reports and possibly working papers. This could be to clarify or confirm the processes that have been put in place by the grant-paying body to allocate and verify the use of grant monies, or because they have a statutory duty to report to Parliament matters of significance that arise out of their reviews.

The practitioner's working papers are their legal property, and they have the right to restrict or decline access to them (except where there is a statutory right of access). The working papers may contain confidential information concerning the grant recipient and by permitting access to them, practitioners could be acquiring a significant legal risk.

If a grant-paying body (or other relevant body) makes a request for access to the working papers, the practitioner must determine whether, or not, there is a statutory right to access. If there is no statutory right of access, the practitioner must establish the reasons for access and agree a protocol with the body that is requesting access on how access may be obtained to ensure that the interests of all parties are protected.

Access to working papers may be permitted by using client authorisation and release letters (although liability risks must be managed properly).

10.7 Data protection

Certain information held by the practitioner will contain personal data relating to individuals and the practitioner may be obliged to provide access to relevant information through legislative requirements. Where personal data is disclosed, provided the information being provided is necessary to discharge the practitioner's legal obligation, there will be no data protection risks for practitioners.

10.8 Fraud and illegal acts

While carrying out their work, the practitioner may come across uncorrected errors, fraud or illegal activity relating to the grant recipient's system, management or employees that may affect the grant claimed.

Where the practitioner discovers such acts, they must consider their reporting obligations carefully (i.e. under the Anti-Money Laundering Regulations (AMLR)) and the need to make a Suspicious Activity Report (SAR) to their Money Laundering Reporting Officer (MLRO). This may, in turn, result in the MLRO filing a SAR with the National Crime Agency, although that decision is theirs.

Where a SAR has been made, the practitioner must carefully consider the risk of 'tipping off' before communicating their suspicions or findings to the directors and/or the audit committee. It is advisable to seek advice in this respect to ensure no AMLR are breached.

11 Audit implications of the periodic review (Lecture A866 – 16.22 minutes)

11.1 Background

FRS 102 periodic review

After considering the feedback from FRED 82 *Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs – Periodic Review*, the final amendments were published by the FRC on 27 March 2024.

Effective date

Application is for periods commencing 1 January 2026. Early adoption is permissible provided all the amendments are adopted at the same time.

Changes

The amendments include:

- a new model for revenue recognition in FRS 102 and FRS 105;
- a new model for lease accounting in FRS 102; and
- numerous other incremental improvements and clarifications.

Why is this an audit issue?

Complexity – the revised FRS 102 takes a more sophisticated approach to leasing and revenue. This will result in there being more areas where audit evidence needs to be obtained, particularity on transition to the revised standard.

Independence – transition to the revised FRS 102 approach in respect of leasing and particularly revenue will not be easy. Management in SME audited entities will often not have the necessary knowledge and skills to do this unassisted. To what extent could the auditor help in providing a non-audit service?

11.2 Leasing

Changes to the standard

The aim of these amendments is for FRS 102 to be aligned more closely to IFRS® 16 *Leases*, with most leases (except leases of low-value assets and short-term leases) coming on-balance sheet. There were several simplifications when compared with the international standard, including (but not limited to):

- The ability to use the interest rate implicit in the lease or, if not readily determinable, the lessee's incremental borrowing rate or the lessee's obtainable borrowing rate.

- A few simplifications to lease modifications which mean fewer modifications will require a revised discount rate to be used.

- Simplifications to variable lease payment recognition (the impact of which is taken to profit and loss rather than adjusting the right-of-use asset and lease liability).

There are transitional exemptions available with the use of the modified retrospective approach, which applies the impact cumulatively at the start of the first period of adopting the amendments. There is no option available to restate comparatives. There are also a number of practical expedients available (such as using a single discount rate for a whole portfolio of leases with reasonably similar characteristics).

Where the low-value asset and short-term lease exemptions are taken, disclosure will be required similar to what we currently see for operating leases.

Key audit issues?

Management will be required to make judgments concerning:

- low values assets and short-term leases;
- lease terms; and
- discount rates.

Auditors will need to evaluate these judgments and obtain audit evidence to support management's assertions.

Independence issues

The biggest issue arises from determining discount rates to calculate the net present value of lease liabilities. Where management does not have the ability to do this themselves, the consequential management and self-review threats could be very significant.

Could management simply ask the auditor to determine this figure for them (as a non-audit service)? Assuming that the issue is material, the answer is almost certainly, 'no'. The issue requires judgement and the threats to independence could not be appropriately addressed with safeguards.

The auditor, however, might be able to assist to some lesser extent, by providing guidance. Safeguards would be needed in this respect, which should also be documented on the audit file, together with the reason *why* those safeguards reduce threats to independence and objectivity to an acceptably low level.

11.3 Revenue

Changes to the standard

The revisions to UK and Ireland GAAP (in this case both FRS 102 and FRS 105) see an aligning of the revenue recognition principles to IFRS 15 *Revenue from Contracts with Customers*. These five steps (as discussed earlier in the course) are:

Step 1: Identify the contract(s) with a customer.

Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract.

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation.

There are a few simplifications compared to the international standard, such as not having to consider the time value of money if payment is within six months of transferring the goods/services (although this is unlikely to be a significant issue when applying the concept of materiality in any case).

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

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

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

- There is a requirement for refund liabilities to be measured at the amount of consideration received (or receivable) to which the entity does not expect to be entitled (i.e., amounts not included in the transaction price).

Key audit issues?

The key issues to carefully consider are as follows:

- Does management do the work to establish the appropriate accounting policy to comply with the five-step approach?
- Do they do it properly?
- Do they document their work?
- If necessary, is there corroborating audit evidence to support any relevant management assertions?

Independence issues

Carrying out the above to ensure the entity's revenue recognition practices comply with the five-step model may be completely beyond the management of many audited entities.

Establishing accounting policies is the role of management and the auditor is very limited in terms of how much assistance they can provide.

11.4 Other issues

Transition

There are many requirements relating to transition for lease accounting and revenue. Auditors will need to watch for compliance with these and appropriate presentation and disclosure.

Small company disclosures

Whilst most small companies are not subject to audit, some are. There are extensive additions to the disclosure requirements for small entities in the UK, some of which management might be reluctant to make (e.g. dividends paid or payable).

Auditors will need to be aware of these changes.

Documentation

As always, auditors will need to document their work to include:

- An evaluation of management's approach.
- Sufficient appropriate audit evidence.
- Basis for the auditor's conclusions.
- Consideration of independence issues.