TABLE OF CONTENTS

AMENDMENTS PROPOSED TO FRS 102 (LECTURE A586 – 24.08 MINUTES)

On 23 March 2017, the Financial Reporting Council (FRC) issued FRED 67 *Draft Amendments to FRS 102 – Triennial Review 2017*. This FRED proposes several amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* as part of the FRC's triennial review of the suite of 'new' UK GAAP. In addition, there are also some amendments being proposed to FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*.

When FRS 102 was first issued in March 2013, the FRC confirmed that it would review the standard at least every three years. The purpose of this review process is to ensure that the standard does not depart significantly from developments in IFRS, on which FRS 102 is principally based. The first tranche of proposals were originally planned to have an effective date of accounting periods starting on or after 1 January 2018; however, in order to give small companies the same length of time that companies outside of the small companies' regime have had (i.e. three years) to implement the standard, the effective date has been deferred by one year and hence the changes proposed in FRED 67 are scheduled to have an effective date of accounting periods starting on or after 1 January 2019.

The proposals contained in FRED 67 have been developed based on feedback received by the FRC and hence address many of the implementation issues that preparers of financial statements under the new reporting regime have faced. Many of the changes proposed are designed to either clarify the requirements within the standard or are improvements and hence should not be viewed as being arduous to implement. The FRC have listened to feedback and have taken on board criticisms of the standard and have sought to improve it in FRED 67.

The comment period on FRED 67 is open until 30 June 2017 and constructive comments on implementation issues as well as the contents of FRED 67 are welcomed by the FRC, preferably by email, to ukfrs@frc.org.uk.

The majority of the changes proposed in FRED 67 are editorial and/or intend to clarify certain accounting treatments rather than make changes to those treatments. However, some of the changes proposed will have an impact on financial statements as follows:

Undue cost or effort exemptions

There are a number of undue cost or effort exemptions contained within FRS 102, some of which the FRC propose to remove. While the International Accounting Standards Board (IASB) included a number of additional undue cost or effort exemptions within *IFRS for SMEs*, the FRC have decided not to follow the IASB's stance on the grounds that some of the undue cost or effort exemptions already contained in FRS 102 are not being applied with sufficient rigour. In some cases, it is apparent that the undue cost or effort exemptions are being viewed as accounting policy choices, which they are not.

An example of where the FRC are going to remove a 'popular' undue cost or effort exemption is within the investment properties section of FRS 102 (Section 16 *Investment Property*). In the September 2015 edition of FRS 102, paragraph 16.7 says that where the fair value of an investment property can be reliably measured without undue cost or effort, then it should be measured at fair value with changes in fair value being recognised in profit or loss.

Some entities have interpreted the undue cost or effort exemption in Section 16 as being an accounting policy choice; whereby they can either choose to measure investment property at fair value or measure such properties under the historic cost model. This was never the intention by the FRC and therefore FRED 67 proposes to remove the undue cost or effort exemption in Section 16. The consequence of this will be that all investment properties will be measured at fair value at each reporting date.

While to some extent the proposals appear to be going back to a similar treatment that applied under old UK GAAP, it is not a complete reversal as the accounting treatment for investment property under Section 16 will continue to be at fair value through profit or loss rather than via a revaluation reserve, although the FRC are proposing an additional accounting policy choice in respect of investment property in a group situation which would allow an investment property to be measured under the historic cost method (see next section). Deferred tax should also continue to be brought into account as well to comply with the requirements in paragraph 29.16 of FRS 102.

Other areas where undue cost or effort exemptions are planned for removal are as follows:

Section	**Paragraphs**
Section 14 *Investments in Associates*	14.10
Section 15 *Investments in Joint Ventures*	15.15
Section 16 *Investment Property*	16.3, 16.4 and 16.10(e)(iii)
Section 17 *Property, Plant and Equipment*	17.1(a)

Investment properties within a group

Under old UK GAAP at SSAP 19 *Accounting for investment properties*, paragraph 8(b) contained a scope exemption for groups which meant that property let to, and occupied by, another group member is not an investment property for the purposes of either the separate financial statements or the consolidated financial statements.

This scope exemption was not carried over into FRS 102 and has proved to be quite problematic for group companies. As the scope exemption relating to groups was not carried over, it meant that where, say, a parent company rented out a property to a subsidiary, the property would be classified as an investment property in the parent's own individual financial statements and hence should have been measured at fair value through profit or loss. In the consolidated financial statements, a consolidation adjustment would have to be done to reclassify the property from investment property to property, plant and equipment. This is because consolidated financial statements must show the results of the group in line with its economic substance, which is that of a single reporting entity and hence any intra-group issues are eliminated.

The FRC have taken on board feedback from some groups that have criticised this requirement and are proposing to insert new paragraphs 16.4A and 16.4B which will deal specifically with investment property that is rented to another group entity. Paragraph 16.4A provides an accounting policy choice for group members to either account for such properties at fair value through profit or loss OR transfer them to property, plant and equipment (Section 17) and apply the cost model contained in that section in the individual financial statements of the group member. It is likely that the latter option will prove to be the most popular as effectively this will restore the position in FRS 102 to what it was in SSAP 19 for properties let to group members.

Financial instruments and loans from director-shareholders

The treatments under FRS 102 where financial instruments are concerned has certainly not been without controversy and are proving somewhat challenging to many companies, particularly where there are loan transactions entered into at below market rates.

Financial instruments are dealt with in FRS 102 in Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*. In order to treat a financial instrument as basic, and hence be able to account for it under Section 11, the instrument has to meet the detailed conditions outlined in paragraph 11.9. The wording in Section 11 can be quite difficult to interpret in many situations and to aid clarity, FRED 67 proposes to introduce a description of a basic financial instrument whose objective is to support the detailed conditions in paragraph 11.9.

The intention of including a description of a basic financial instrument is that a relatively small number of financial instruments that would have otherwise been accounted for under Section 12 (as they breached the conditions in paragraph 11.9) would be able to qualify for treatment as basic, and hence be accounted for under Section 11 and be measured at amortised cost rather than at fair value through profit or loss.

Loans from director-shareholders

It is not uncommon for a company to receive or make a loan to a director who is also a shareholder – and this is particularly common among the SME sector. Invariably, such loans are often entered into at below market rates, or at 0% rates of interest.

Under FRS 102, where there are formal loan terms in place and the loan is repayable after more than 12 months from the balance sheet date, the loan has to be discounted to present value using a rate of interest which is market rate and the difference between the loan amount and the present value (the measurement difference) is brought into the financial statements. The accounting treatment for the measurement difference will depend on the substance of the arrangement (in the case of a loan from a director-shareholder, the measurement difference will usually be treated as a capital contribution).

The requirement to obtain market rates of interest and the discounting of these types of loans from director-shareholders have proved to be particularly challenging for companies and the FRC have taken on board feedback received where this is concerned.

In order to provide relief **for a small company only** from the requirement to account for loans from a director to the small company at present value, FRED 67 proposes to introduce paragraph 11.13A which will mean that a loan from a director or a **close member of the family of that person** (as defined in the Glossary to FRS 102) can be accounted for at transaction price rather than at present value.

Care must be taken with this exemption because it is restrictive and only applies to loans **FROM** a director who is also a **shareholder** in the small entity, or a close member of the family of that person. Companies outside of the small companies' regime will not be able to apply the exemption and the exemption does not apply to loans **TO** a director-shareholder.

Intangible assets

FRS 102 brought in a new definition of an intangible asset which meant that it required the recognition of more intangible assets on the balance sheet rather than them being subsumed within goodwill.

FRED 67 proposes to amend paragraph 18.8 in respect of intangible assets that have been acquired in a business combination (i.e. where a parent acquires a subsidiary). The effect of this proposal would mean that an entity has to recognise fewer intangible assets acquired by way of a business combination separately from goodwill.

FRED 67 does propose to allow an entity the option, on an asset-by-asset basis, to separately recognise additional intangible assets acquired through a business combination where doing this will provide useful information to the entity. Where a reporting entity chooses to apply this option, then it must apply it consistently to the relevant class of intangible assets.

Financial institutions

The definition of a financial institution in FRS 102 has been causing a few problems for certain types of entity. FRED 67 proposes to amend the definition of what constitutes a financial institution by removing references to '… generate wealth' and '… manage risk'. The effect of this change will mean that fewer entities will meet the definition of a financial institution and should also allow for fewer interpretational difficulties.

Cash flow statement

FRED 67 proposes to reinstate the net debt reconciliation as part of the changes to Section 7 *Statement of Cash Flows* by introducing paragraph 17.22. The FRC want to introduce this change into FRS 102 on the grounds that it gives users better information as it takes into account both cash balances of the entity and borrowings.

This is a departure from the requirements in IFRS, but the FRC believe that a net debt reconciliation meets the overriding objective of financial statements and as practitioners are already familiar with the net debt reconciliation, it should be cost-effective to apply in practice.

Revenue

FRED 67 proposes to introduce a new paragraph 23.3A into Section 23 *Revenue* which provides additional clarification relating to recognising revenue arising from each and every separately identifiable good or service within a single transaction. To a certain extent, this aligns Section 23 more to the new revenue recognition standard, IFRS 15 *Revenue from Contracts with Customers* although an exception to this requirement would be where another basis better reflects the substance of the transaction.

Key management personnel compensation

Paragraph 33.7 of FRS 102 require an entity to disclose key management personnel compensation in total. FRED 67 proposes a new paragraph 33.7A which says that when there is a legal or regulatory requirement to disclose directors' remuneration (or equivalent), an entity will be exempt from the requirements of paragraph 33.7 if the key management personnel and the directors are the same.

Section 1A Small Entities

FRED 67 proposes some incremental changes to Section 1A *Small Entities* within FRS 102 as follows:

- A new paragraph 1A.4A which requires the financial statements of a small entity applying Section 1A to include a statement in a prominent position on the balance sheet confirming that the financial statements have been prepared in accordance with the provisions applicable to the small companies' regime.

- Paragraph 1AC.33, which requires information concerning employee numbers, is now moved within its own section.

FRS 105 amendments

There are some changes proposed in FRED 67 to FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* as follows:

- The requirement for a micro-entity's financial statements to state:
    - the part of the UK in which the micro-entity is registered;
    - the micro-entity's registered number;
    - whether the micro-entity is a public or private company, and whether it is limited by shares or guarantee (this requirement does not apply to micro-entities which are LLPs);
    - the address of the micro-entity's registered office; and
    - where applicable, the fact that the LLP is being wound up.

As expected, there are two additional disclosure requirements proposed in FRED 67 relating to:

- off-balance sheet arrangements (as required by Section 410A of the Companies Act 2006); and
- information about employee numbers (as required by Section 411 of the Companies Act 2006).

ACCOUNTING FOR FINANCE AND OPERATING LEASES (LECTURE A587 – 14. 55 MINUTES)

Leasing transactions are dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 20 *Leases*. To a certain extent, much of the content of Section 20 is similar to that of previous UK GAAP in SSAP 21 *Accounting for leases and hire purchase contracts* and the FRSSE, although there are some notable differences as follows:

- the 90% 'bright-line' test contained in paragraph 15 of SSAP 21 is not carried over into Section 20. Instead FRS 102 substitutes this test at paragraph 20.5(d) which says that a lease is treated as a finance lease if, at the start of the lease, the present value of the minimum lease payments equates to at least 'substantially all' of the fair value of the leased asset. In practice it is not expected to have a material difference on transition where the fair value of a leased asset was considered to be a sufficiently close approximation to the present value of the minimum lease payments;[1]
- the minimum lease payments in a finance lease are split between the capital element and the interest element. Paragraph 20.11 of FRS 102 requires the use of the effective interest method to apportion those payments and this can be done quite easily using an Excel spreadsheet;
- the disclosure requirements in respect of operating leases are somewhat different under FRS 102 than under previous SSAP 21 and the FRSSE; and
- lease incentives are treated differently under FRS 102.

Many practitioners have been used to calculating interest in a finance lease (on the part of the lessee) using either the level-spread method of interest allocation or another established method, such as the sum-of-the-digits method. These methods are not referred to in FRS 102 and hence only the effective interest method can be used.

Initial recognition of a finance lease for a lessee

Paragraph 20.9 says that at the start of the lease, the lessee recognises a finance lease in the balance sheet at an amount equivalent to the fair value of the leased asset, or, if lower, the present value of the minimum lease payments determined at the start of the lease. Any directly attributable costs (such as legal fees) associated with arranging the lease are also included in the cost of the capitalised asset.

Effective interest method

The effective interest method uses an effective interest rate. The effective interest rate exactly discounts the estimated future cash payments for a lessee, or future cash receipts for a lessor, over the life of the lease. It is advisable to calculate this using the 'Goal Seek' function within Microsoft Excel.

Example – Dealing with a finance lease for a lessee

[1] SSAP 21 did not rely exclusively on the 90% test and paragraph 16 of SSAP 21 said that the presumption that a lease which fails to meet the conditions in paragraph 15 (which refers to the 90% test) may, in exceptional circumstances, be rebutted.

A company enters into a finance lease for an item of machinery that has a fair value of £35,000 and this is also equivalent to the present value of the minimum lease payments. The term of the lease is for five years, which is also considered to be the major part of the economic life of the machine and therefore the lease qualifies for treatment as a finance lease per paragraph 20.5(c). The machine is not expected to have any residual value at the end of the five-year lease. The monthly payments, comprising capital and interest, are £685 per month and there is an option to purchase fee payable at the end of the lease term of £150 which is included in the final payment. The company has not incurred any arrangement fees in connection with this lease.

In years one to four, the company will pay £8,220 (£685 x 12) and in year five it will pay £8,370 (£685 x 12 + £150). The lease provisions are profiled in an Excel spreadsheet as follows:

	A	B	C	D	E
1	Effective interest rate				
2					
3		Opening		Interest at	Closing
4	Year	liability	Cash flow	EIR	liability
5		£	£	£	£
6	1	35,000	(8,220)	0	26,780
7	2	26,780	(8,220)	0	18,560
8	3	18,560	(8,220)	0	10,340
9	4	10,340	(8,220)	0	2,120
10	5	2,120	(8,370)	0	(6,250)

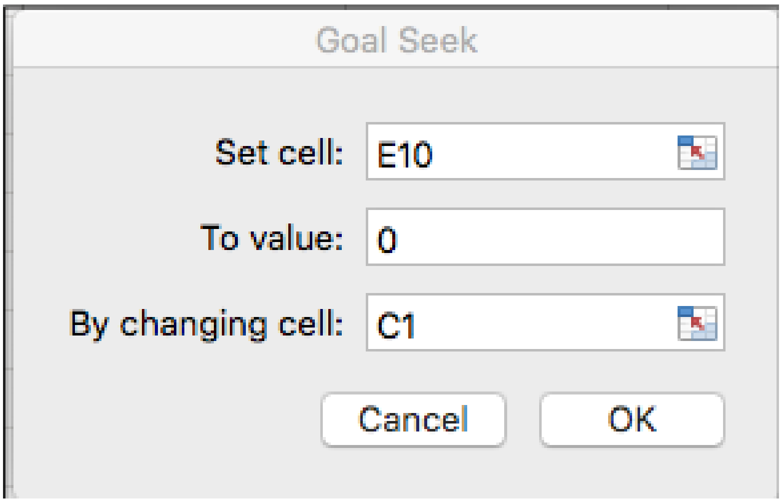
The formulas used in the above spreadsheet are as follows:

	A	B	C	D	E
1	Effective interest rate				
2					
3		Opening		Interest at	Closing
4	Year	liability	Cash flow	EIR	liability
5		£	£	£	£
6	1	35000	-8220	=C1*B6	=B6+C6+D6
7	2	=E6	-8220	=C1*B7	=B7+C7+D7
8	3	=E7	-8220	=C1*B8	=B8+C8+D8
9	4	=E8	-8220	=C1*B9	=B9+C9+D9
10	5	=E9	-8370	=C1*B10	=B10+C10+D10

The Goal Seek function in Excel can be used to work out the effective interest rate in cell C1 that can then be applied to cells D6 to D10 resulting in cell E10 becoming £nil.

To use the Goal Seek function go to the Data tab at the top of the Excel workbook and then into 'What-if Analysis'.

The objective is to get cell E10 to show a value of £nil by changing cell C1 so as to work out the interest over the life of the lease that will be recognised in profit or loss. Once we select the Goal Seek function, we enter the following information:



Once we click 'OK', Excel will calculate the effective interest rate in cell C1 and the interest expense in cells D6 to D10 automatically as follows:

	A	B	C	D	E
1	Effective interest rate		5.72%		
2					
3		**Opening**		**Interest at**	**Closing**
4	**Year**	**liability**	**Cash flow**	**EIR**	**liability**
5		£	£	£	£
6	1	35,000	(8,220)	2,004	28,784
7	2	28,784	(8,220)	1,648	22,211
8	3	22,211	(8,220)	1,272	15,263
9	4	15,263	(8,220)	874	7,917
10	5	7,917	(8,370)	453	(0)

The effective interest rate has been calculated at 5.72% and is allocated to each period during the term of the lease in order to produce a constant periodic rate of interest on the remaining liability. It is to be noted that interest charges are higher in the earlier years of the lease and lower in the later years. In contrast, the level spread method would have charged an amount of £1,250 per annum over the life of the lease (£41,250 less £35,000 ÷ 5 years).

While the effective interest rate method is inherently more complex than, say, the level-spread method, it does produce a more realistic interest expense in the profit and loss account as it is based on the remaining balance of the liability.

The depreciation charges on this machine are charged over the life of the lease at an amount of £7,000 as there is no residual value expected at the end of the useful economic life of five years.

The journal entries in respect of this machine in year one are as follows:

	£
Dr Plant and machinery additions	35,000
Cr Finance lease obligation	35,000
Being introduction of new machine on a finance lease	
Dr Depreciation expense	7,000
Cr Accumulated depreciation	7,000
Being depreciation charge in year 1	

Dr Finance lease obligation	8,220
Cr Cash at bank	8,220
Being payment to lessor in year 1	
Dr Interest expense	2,004
Cr Finance lease obligation	2,004
Being interest on finance lease under EIR	

Operating lease disclosures

Under SSAP 21, a lessee that had entered into an operating lease would disclose the payments that the entity is committed to make in the relevant time bands according to when the lease commitment expires.

Example – Disclosure under previous UK GAAP

A company enters into a five-year operating lease for some computer equipment on 1 January 2014 and is preparing its financial statements to 31 December 2015. Annual payments in respect of this operating lease are £10,000 and hence this is the amount that will be paid to the lessor in the 12-months ended 31 December 2016.

SSAP 21 required disclosure of the annual commitment analysed between those which expire:

- within one year;
- within two to five years; and
- over five years from the balance sheet date.

Therefore, the company would show £10,000 in the two to five years' time band.

Under FRS 102, the lessee discloses the total future minimum lease payments due within each of the required periods rather than the annual amount due to expire in the relevant year.

Example

Using the example above, the total of future minimum lease payments under non-cancellable operating leases as at 31 December 2015 would be disclosed as follows:

Not later than one year:	£10,000
Later than one year and not later than five years:	£20,000

(Note: the lease started on 1 January 2014 so at the end of December 2015 the company has made two payments totalling £20,000 (one to December 2014 and the other to December 2015) so there is £30,000 outstanding in the operating lease at 31 December 2015).

Lease incentives

It is not uncommon for a lessee entering into an operating lease to receive an incentive. Typically lease incentives are granted for commercial property whereby the lessee may receive a reduced rent for a specified period of time, or a rent-free period for, say, one year.

Lease incentives were dealt with in previous UK GAAP under UITF Abstract 28 *Operating lease incentives*. This UITF said that operating lease incentives for lessors (hence a reduction against rental income) and lessees (a reduction against rental expense) are allocated over the term of the lease, or a shorter period ending on the date from which it is expected that rentals will revert to market rate. In many cases, this would normally be after the first rent review and the allocation of the lease incentive would normally be on a straight-line basis unless another systematic basis was more representative of the time pattern of the benefit receivable/received from the asset's use.

Under FRS 102, paragraph 20.15A says that a lessee (paragraph 20.25A for lessors) recognises the aggregate benefit arising from a lease incentive over the term of the lease on a straight-line basis unless another systematic basis is more representative of the time pattern of the asset's use.

In both cases, lease incentives are usually recognised on a straight-line basis. However, the difference in FRS 102 is the period over which the incentive is recognised because this will be longer (the standard does not refer to rentals reverting to market rate; merely they are recognised over the term of the lease). The *lease term* is the non-cancellable period for which the lessee has entered into a contract with the lessor to lease the asset (i.e. the most likely period for the lease).

Example – Lease incentive UITF 28 versus FRS 102

A lessee enters into an operating lease agreement to rent a commercial building. The term of the lease is for ten years and the landlord has agreed to a reduced rent for five years totalling £30,000. At the end of year five rentals will revert to market rate.

Under UITF 28, the £30,000 incentive would be recognised in the profit and loss account at £6,000 per annum (i.e. over a five-year period). This is because the incentive is allocated over the lease term of a shorter period ending on the date from which it is expected that prevailing market rentals will become payable.

Under FRS 102, the £30,000 is recognised at an amount of £3,000 per annum (i.e. over a ten-year period). This is because paragraph 20.15A requires the aggregate benefit of the lease incentive to be recognised as a reduction to the expense over the term of the lease; not when lease rentals revert to market rate.

On transition to FRS 102, paragraph 35.10(p) allows a choice. If the lease commenced before the date of transition to FRS 102 and there is still some lease incentive yet to amortise, the first-time adopter can either:

- restate the lease incentive to the amount it would be carried at in the financial statements as if FRS 102 had always applied; or
- continue to recognise the residual benefit (or cost) on the same basis as under previous UK GAAP.

Preparers should note that paragraph 35.10(p) only applies if the term of the lease commenced PRIOR to the date of transition to FRS 102.

DEFERRED TAX AND REVALUED ASSETS (LECTURE A588 – 11.25 MINUTES)

Section 29 *Income Tax* in FRS 102 deals with the accounting requirements where deferred tax is concerned. One of the additional situations which will now give rise to deferred tax under FRS 102 is in respect of non-monetary assets that are subject to revaluation.

Under previous UK GAAP, FRS 19 *Deferred tax* at paragraph 14 said that deferred tax is not recognised on timing differences in respect of non-monetary assets subject to the revaluation model unless, by the balance sheet date, the entity has:

- entered into a binding agreement to sell the revalued asset; and
- recognised the gains and losses that are expected to arise on the sale.

The treatment for non-monetary assets subject to revaluation is different under FRS 102. Revaluations of assets creates timing differences because the gain or loss will be recognised in total comprehensive income in the current period, but will be recognised in taxable profit in a later period, either when the asset is sold and a gain is realised, or as the asset is used, generating taxable income. This means that a deferred tax asset or liability is recognised under FRS 102 due to the standard's use of the timing difference plus approach which removes some of the exemptions from deferred tax in previous UK GAAP.

Investment property

Investment property is dealt with in Section 16 *Investment Property* in FRS 102 and the accounting treatment for gains and losses are markedly different under FRS 102 than was the case under previous UK GAAP.

Fair value gains and losses arising on investment property are taken to the profit and loss account under FRS 102 and **not** to a revaluation reserve as was the case under old UK GAAP. In addition, an entity with an investment property on the balance sheet measured at fair value is also required to bring deferred tax into account.

Deferred tax in respect of investment property is covered in paragraph 29.16 of FRS 102. This paragraph requires an entity to measure deferred tax using the tax rates and allowances which will apply to the sale of the asset. The exception to this rule would be where the investment property has a limited useful life and the entity will consume substantially all of the economic benefits embodied in the property over time.

Of course, in reality many entities that have investment property on the balance sheet will hold the property for a considerable period of time. Therefore, where a reporting entity plans to hold an investment property for a long period of time, it should use the tax rates that have been enacted or substantively enacted by the balance sheet date. At the time of writing these notes, the rate of tax would therefore be 17% which is scheduled to take effect from 2020.

Example – Accounting treatment for a fair value gain on an investment property

A company reporting under FRS 102 has an investment property on its balance sheet as at 31 March 2016 with a carrying value of £235,000. On 31 March 2017 a fair value exercise carried out by a firm of Chartered Surveyors confirmed that the value of this investment property had increased to £263,000. The company is not planning to sell this investment property in the foreseeable future.

Under FRS 102 the accounting treatment in respect of this gain is:

Dr Investment property	£28,000
Cr Profit and loss account	£28,000

In addition, the entity would also bring a deferred tax liability into account using the 17% tax rate as follows:

Dr Tax expense (P&L)	£4,760
Cr Deferred tax provision	£4,760

In the example above, the deferred tax treatment follows its underlying transaction into the profit and loss account.

Revalued property, plant and equipment

Property, plant and equipment is dealt with in Section 17 *Property, Plant and Equipment* of FRS 102. As with previous UK GAAP, Section 17 requires property, plant and equipment that qualifies for recognition on the balance sheet to be included at cost. After initial recognition, an entity can continue measuring the asset(s) under the historical cost model or it can apply the revaluation model.

Paragraph 17.15B of FRS 102 says that under the revaluation model, where an item of property, plant and equipment can be fair valued reliably, then it shall be carried at a revaluation amount (which is its fair value at the date of revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses). This is no different than the revaluation model contained in FRS 15 *Tangible fixed assets* and the FRSSE. What is different, however, is the frequency of the revaluation exercise. Under FRS 15, the standard required an asset subjected to the revaluation model to be revalued at least every five years, with valuations in the intervening years where there had been a material change in value. Under FRS 102, revaluations have to be undertaken with **sufficient regularity** to ensure that the carrying amount of the revalued asset does not differ materially from that which would be determined using fair value at the balance sheet date.

When an asset is measured under the revaluation model, a timing difference will be created for which deferred tax has to be brought into account under FRS 102 due to the timing difference plus approach.

Assets carried under the revaluation model are accounted for under the Alternative Accounting Rules which require gains and losses to be taken to a revaluation reserve within other comprehensive income. This is notably different than the accounting treatment for a fair value gain or loss arising on an investment property where such gains and losses are taken to the profit and loss account.

It follows, therefore, that when an asset is revalued under Section 17 of FRS 102, a revaluation gain is taken to the revaluation reserve (in the same way as it was under previous UK GAAP) and the associated deferred tax is also taken to the revaluation reserve. Losses on revaluation are taken to the revaluation reserve to the extent of a surplus on the reserve; any losses in excess of the surplus are taken to the profit and loss account.

Ordinarily gains on revaluation will be taken to the revaluation reserve, but a gain can be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

Example – Deferred tax on a revalued Section 17 asset

A company has an asset that has increased in value by £25,000 and the company uses the revaluation model to measure this asset. The company is not planning on disposing of the asset for several years.

Under FRS 102, the accounting entries in respect of this revaluation are as follows:

Dr Property, plant and equipment	£25,000
Cr Revaluation reserve	£25,000

Deferred tax is calculated using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date and in this example the tax rate will be 17% and the revaluation gain will give rise to a deferred tax liability accounted for as follows:

Dr Revaluation reserve	£4,250 (£25,000 x 17%)
Cr Deferred tax provision	£4,250

The key point to remember where deferred tax is concerned is that its scope is wider under FRS 102, even for small companies (although irrelevant for micro-entities under FRS 105), because of the standard's use of the timing difference **plus** approach. Practitioners need to understand where the corresponding entry for deferred tax goes to as this will be different depending on whether the asset is an investment property measured at fair value under Section 16 or whether it is an item of property, plant and equipment measured under the revaluation model in Section 17. The phrase '*tax treatment follows accounting treatment*' is appropriate where this issue is concerned.

GROUP ACCOUNTS UNDER FRS 102 (LECTURE A489 – 12.10 MINUTES)

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

Groups which are medium-sized and large will invariably be required to prepare consolidated financial statements unless the provisions in paragraph 9.3 (exemption from preparing consolidated financial statements) or paragraph 9.9 (exclusions from consolidation) apply.

Small groups are not mandated to prepare consolidated financial statements; although that is not to say that all small groups choose to take up this exemption. Indeed, some small groups do voluntarily prepare group accounts and where this is the case, Section 1A *Small Entities* provides guidance for small groups in paragraphs 1A.21 and 1A.22.

This section of the course will not look in detail at the preparation of group accounts, but will look at some of the changes to the preparation of such accounts under FRS 102 and will recap on some of the key concepts involved when preparing consolidated financial statements.

The concept of control

The term 'business combination' applies when a parent company acquires a subsidiary. In this situation, the parent company obtains **control** over the subsidiary. Control is usually evidenced by way of an ownership interest of more than 50%, but this is not absolute and other characteristics of the relationship can indicate that a parent has obtained control over a subsidiary even with an ownership interest of less than 51%, such as:

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

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

The purchase method

The purchase method of accounting is used when a parent acquires a subsidiary. The September 2015 edition of FRS 102 includes three steps in applying the purchase method at paragraph 19.7 as follows:

1. Identify the acquirer
2. Measure the cost of the business combination
3. Allocate the cost of the business combination to the identifiable assets acquired, liabilities and contingent liabilities (see later) assumed.

FRED 67 proposes to change the purchase method described above so that it is more aligned to IFRS by inserting three additional requirements (shown in <u>underlined</u> text) as follows (the underlined text is not verbatim from the exposure draft):

1. Identify the acquirer
2. <u>Determine the acquisition date</u>
3. Measure the cost of the business combination
4. Allocate the cost of the business combination to the identifiable assets acquired, liabilities and contingent liabilities assumed <u>and recognise and measure any non-controlling interest (i.e. minority interest) in the acquiree</u>
5. <u>Recognise and measure goodwill</u>

The above changes required by FRED 67 are not expected to have any significant impact on the way that groups will deal with the acquisition of subsidiaries.

Is it an acquisition or is it a group reconstruction?

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

When a group reconstruction takes place, the use of the merger method of accounting is used and not the purchase method. The two concepts are fundamentally different. Merger accounting uses book values of assets and liabilities to combine the merging entities (fair values are not used, but some adjustments may be necessary to achieve uniformity of accounting policies). Under the purchase method of account, fair values are used to consolidate the subsidiary at the date of acquisition.

In addition, to qualify for the use of the merger method of accounting, no one party can be in control and no non-controlling interest in the net assets of the group are altered by the transfer. This is because if there is a controlling party, it is not a group reconstruction, it will be a business combination and hence the purchase method of accounting will be used.

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

Overview of the principles of consolidation

As noted above, the course will not be going into the detailed mechanics of consolidation as it is expected that practitioners will already have a sound grasp of the basics and to a large extent, the mechanics are no different under FRS 102 than they were under previous UK GAAP.

Accounting policies

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

Accounting period-end dates

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

Consolidated profit and loss account

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

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

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

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

Consolidated balance sheet

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

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

	the balance sheet date

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

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

Contingent liabilities in a business combination

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

Under paragraph 19.15 of FRS 102, contingent liabilities whose fair value can be measured reliably are recognised. This is because the transfer of economic benefit is reflected in the contingent liability's fair value rather than it being a criterion for recognition. The fair value of a contingent liability is the amount which a third party would charge to assume the contingent liability.

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

Example – Contingent liability not recognised at the date of acquisition

On 1 March 2017, Topco Ltd acquired 100% of the net assets of Subco Ltd that is in the building industry. On the date of acquisition, Subco was actively defending a lawsuit brought against the company by one of its contractors who is alleging a breach of contract. The fair value of the possible payment if breach of contract is proven is £100,000 but the lawyers have only said that there is a 10% chance that the courts would uphold the claim.

The contingent liability should be recognised by Topco on acquisition at its fair value of 10% of the potential payment (£10,000) that may arise if breach of contract is proven.

Measurement after initial recognition

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

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

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

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

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

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

Step acquisitions

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

Quite often a parent company, owning more than 50% of the net assets, will obtain further ownership interest in the subsidiary. It is this scenario that has been subjected to significant amounts of change in FRS 102 when compared to previous FRS 2 *Accounting for subsidiary undertakings*.

Under the previous FRS 2, if a parent that already has control over a subsidiary, acquired more of the subsidiary's net assets, resulting in a diluted minority interest, the net assets of the subsidiary would be revalued to fair value at the date control is increased and additional goodwill would also have been recognised. Under FRS 102 the net assets of the subsidiary are not revalued and no additional goodwill is recognised because paragraph 9.19D of FRS 102 would regard this transaction as one among equity holders in their capacity as equity holders.

Example – Further investment in a subsidiary

On 1 June 2016, Topco Ltd acquired 70% of the net assets in Subco Ltd for a purchase price of £500,000. On the date of acquisition, the fair value exercise revealed the net assets of Subco to be £380,000, which was also equivalent to book values. On 1 June 2017, Topco agreed to invest an additional £75,000 in Subco in exchange for a further 10% of the net assets and on this date Subco's net assets had a book value of £435,000 and a fair value of £485,000. The group's accounting reference date is 31 May.

<u>Accounting for the subsidiary at the date of acquisition (1 June 2016)</u>
At the date of acquisition, Topco has acquired control of Subco because it is has acquired an ownership interest of 70% of the net assets. As a result, the identifiable assets and liabilities of Subco are consolidated at their fair value of £380,000. Positive goodwill is recognised in the consolidated financial statements of £234,000, calculated as follows:

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

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

<u>Year-end 31 May 2017</u>
The increase in Subco's net assets amounts to £55,000 (£435,000 less £380,000) which has arisen due to the profit yielded by Subco during the year to 31 May 2017. This profit is split

£38,500 to Topco (being 70% x £55,000) and £16,500 to the NCI. The NCI share is now £130,500 (£114,000 plus £16,500).

Further acquisition on 1 June 2017
On 1 June 2017, Topco acquired a further 10% of Subco which means that the NCI share of Subco's net assets drops from 30% to 20%.

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

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

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

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

Disposals

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

If control is lost, there are no differences in accounting treatment under FRS 102 when compared to previous FRS 2. In such cases, therefore, the results of the subsidiary are included in the consolidated financial statements up to the date at which control is lost and a gain or loss (calculated as the difference between the fair value of the consideration received and the identifiable net assets (including goodwill) of the subsidiary disposed of) recognised.

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

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

This treatment is notably different under FRS 102 as opposed to previous FRS 2. Under the previous FRS 2, a gain or loss would be recognised on the disposal and a proportion of the associated goodwill would also be written off.

Example – Disposal where parent retains control

On 31 March 2017, Topco Ltd disposes of a 20% ownership interest in Subco Ltd for £300,000 which reduced Topco's holding from 80% to 60%. On 31 March 2017, the carrying amount of the identifiable net assets in Subco was £500,000 and the carrying amount of goodwill on acquisition at the date of the disposal was £30,000.

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

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

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

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

Illustrative statement of changes in equity showing change in ownership interest

Group	Called up share capital £'000	Retained earnings £'000	Total Shareholders equity £'000	Non controlling interest £'000	Total equity £'000
At 01.04.2015	10	240	250	60	310
Profit for the year		120	120	30	150
Equity dividend		(50)	(50)		(50)
At 31.03.2016	10	310	320	90	410
Profit for the year		40	40	10	50
Equity dividend		(10)	(10)		(10)
Change in ownership		200	200	100	300
At 31.03.2017	10	540	550	200	750

COMPONENT ACCOUNTING (LECTURE A590 – 10.23 MINUTES)

Component accounting features quite prominently in FRS 102, particularly in Section 17 *Property, Plant and Equipment* and in many cases, the art of component accounting will not be an unfamiliar concept.

When an item of property, plant and equipment meets the recognition criteria and hence is capitalised in the balance sheet, the asset in question may have components that have significantly different useful economic lives than the main asset itself. Paragraph 17.6 of FRS 102 cites an example of the roof of a building that may require replacement at regular intervals. Where an asset is comprised of components that have significantly different useful economic lives, the entity should allocate the initial cost of the asset to its major components and depreciate each such component separately over its useful life. The most common type of asset frequently cited where this accounting treatment would be appropriate is the lining of a blast furnace, where the lining has to be replaced periodically and hence has a different useful life from the rest of the furnace.

Allocating components

The problem arises when it comes to allocating the cost of the asset among its major components. This is because FRS 102 does not provide any such guidance. Ordinarily when a business acquires a fixed asset, the invoice from the supplier will often just be for the asset as a whole, rather than split into its individual component parts. To overcome this issue, the cost of the identifiable components should be estimated having regard to their current market prices, or by contacting the supplier concerned. This information can then be used to allocate the asset among its major components.

Example – Component accounting for a new machine

A company manufactures disposable clothing and during the year to 31 March 2017 has invested in a new computerised cutting unit that is a crucial machine in the manufacturing process. The machine cost £16,200 and has been assessed as having a useful economic life of ten years. The computer equipment which controls the machine will need replacing after three years to keep up to date with changes in technology and the supplier of the machine has confirmed that the computer equipment, when bought separately, would be worth £4,500.

In this example, the cost of the machine of £16,200 would be separated into the cutting machine itself and the computer equipment which controls the machine. This is because the computer equipment has a significantly shorter useful economic life than the main asset to which it relates. Assuming nil residual value, the cutting machine would be depreciated over ten years and the computer equipment would be depreciated over three years.

In the example above, it was fairly straightforward to apply component accounting because the supplier was able to provide a price for the computer equipment which had been identified as having a significantly shorter useful economic life than the main asset to which it relates. There are, however, many situations where the cost of a component is not available on acquisition of a new asset even though the component may be subsequently replaced, or the components are not physically identifiable. If an appropriate discount rate can be arrived at by the entity, it may be possible to estimate the cost as shown in the following example.

Example – Estimating the cost of a component

Shutters R Us Ltd manufactures industrial window and door shutters that are fitted to the exterior of commercial buildings. The company purchased a machine to manufacture the shutter curtains for £60,000 and this machine was deemed to have a useful economic life of ten years.

At the end of year 4, the machine breaks down completely and a major component, costing £9,500 has to be replaced. Once this component is replaced, the machine will be back to good working order and the entity expects to continue to use the machine over the next six years. The directors decide to go ahead and replace the component because it is concluded that it is more economically viable to do this than to replace the machine at the current time due to cash flow constraints.

The replacement component will meet the recognition criteria for an asset because the cost of the component can be reliably measured and the business will receive economic benefit. The cost of the replacement component can be used as a basis for the likely cost of the component at the date the company acquired the machine and the finance director has suggested that an appropriate discount rate would be 5%.

Using the 5% discount rate, the discounted value of the cost of the new component amounts to £7,816 (£9,500 / $(1.05)^4$). After four years' worth of depreciation, the current carrying amount of the new component would be in the books at £4,690 (£7,816 x 6/10). The amount of £4,690 is derecognised from the remaining carrying value of the asset of £36,000 (£60,000 cost less four years' depreciation at £6,000 per year) and the cost of the new component of £9,500 would be added to the asset. The new carrying value of the asset is £40,810 (£36,000 + £9,500 - £4,690) and this is the amount that is depreciated over the remaining useful life of six years.

Component depreciation

The sections above provided guidance on how to allocate the initial cost of an asset to its major components, even if the initial cost of a component is unknown at the time the asset is acquired. Any other assets should be depreciated over their useful lives as a single asset according to paragraph 17.16.

Where component accounting has been applied to an asset, that component is then depreciated on a systematic basis over its useful economic life; in other words, they are treated separately from the main asset itself. Where it is concluded that the significant components have the same useful life as the main asset itself, they can be grouped together and depreciated over their useful lives.

Example – Component depreciation

A company manufactures chemicals for use in domestic cleaning products. It purchases a new machine on 1 January 2017 for £60,000 that is expected to have a useful economic life of ten years with a nil residual value at the end of this useful economic life. The company identifies the following major components:

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

Component C: Cost £6,500 with a useful life of five years

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

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

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

Component accounting for an investment property under FRS 105

FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* can be used for entities that qualify as micro-entities. One of the notable features of FRS 105 is the fact that the standard does not use any of the fair value or alternative accounting rules in the Companies Act 2006. This was not something which the Financial Reporting Council decided upon, it was reflected in FRS 105 because the micro-entities' legislation, as issued by the EU, prohibits the use of fair value or revaluation accounting.

In a situation where a micro-entity has, say, an investment property on its balance sheet which was previously carried at open market value under the FRSSE, then it is required to restate the value of that investment property on transition and in the prior year as if the property had been carried under the historic cost model. Of course, in these situations, it is often advisable to try and persuade the client to use FRS 102 to account for the investment property because restating assets from revaluation to historic cost is likely to have a detrimental impact on the balance sheet. However, in situations where FRS 105 is going to apply and the client has an investment property, then it can follow the optional exemption in paragraph 28.10(c) to restate the investment property.

In restating the investment property to historic cost principles, the micro-entity would be required to apply a depreciation policy to the property (which it would not have under the FRSSE as the property would have been carried at open market value at each balance sheet date). Once this depreciation policy has been applied to the total cost of the investment property, excluding land, from the date of acquisition (not the date of transition), then paragraph 28.10(c) would require component accounting to be applied.

Paragraph 28.10(c)(iv) says that a portion of the estimated total depreciated cost, i.e. cost (net of the revaluation reserve on transition), less land, less accumulated depreciation since initial acquisition, should be allocated to each of the other major components of the investment property. This would involve the directors assessing which other major components of the main structural element of the building have a significantly shorter useful economic life than the main asset itself, for example a central heating system or the roof. Paragraph 28.10(c)(iv) requires this allocation to be made on a reasonable and consistent basis. Any remaining total depreciated cost which is not allocated to the other major components is allocated to the most significant component of the investment property (i.e. the main structural element).

AUDITING THE TRANSITION TO FRS 102 (LECTURE A591 – 14.19 MINUTES)

The transition to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* becomes mandatory for small companies for accounting periods starting on or after 1 January 2016; i.e. December 2016 year-ends are the first ones to start coming through in 2017 under FRS 102, unless the company has early-adopted FRS 102. In a lot cases, however, small companies will not early-adopt FRS 102 and hence this will be the first year many small companies will prepare financial statements under the new regime.

While many small companies take up audit exemption, it is not the case that every small company is not audited. Indeed, some companies voluntarily choose to have an audit and some small companies are mandated by, say, their bank to have to an audit in order to preserve borrowing facilities. In addition, SI 2015/980 contains an early-adoption clause meaning that, for example, a business which would have been classed as medium-sized under the old size thresholds may now qualify as small under the new thresholds and hence such an entity can early-adopt SI 2015/980 and prepare their financial statements under the small companies' regime (although early-adoption of the revised audit exemption limits is not available to such companies).

Where small companies are concerned, it is not uncommon for the audit firm to have input into the transition process and, in some cases, even undertake the transition process for the small company client. Care must be taken in these respects because where the auditor becomes involved in a transition to FRS 102, ethical threats will arise that have to be carefully managed so that independence and objectivity is maintained. To that end, the auditor must bear in mind that they are bound by FRC's *Ethical Standard*.

It is understandable that for many small companies, the prospect of moving from old UK GAAP onto FRS 102 is going to be daunting and invariably many will seek advice from their auditors. In these instances, adequate safeguards can be applied to minimise the threat to independence and objectivity, such as having a separate team, with no involvement in the audit, dealing with the transition or with aspects relating to the transition.

Threats to independence directly linked to the transition

The FRC's *Ethical Standard* outlines the threats to independence that need to be considered for all audit engagements, namely:

- self-review threats;
- self-interest threats;
- advocacy threats;
- management threats;
- familiarity threats; and
- intimidation threats.

The *Ethical Standard* requires any threats to independence and objectivity to be evaluated and safeguards put in place to minimise the identified threats to an acceptably low level. Where adequate safeguards cannot be put in place, the auditor cannot carry out the work.

As mentioned above, it is likely that a small company will seek the advice of their auditors to assist with the transition to FRS 102. This gives rise to two specific threats:

- a self-review threat; and
- a management threat.

Self-review threat

Where the transition to FRS 102 for a small company is concerned, a self-review threat will arise because if the auditor is involved in aspects of the transition, or undertakes the transition on behalf of the client and subsequently audits that transition, they will be effectively be auditing their own work. Clearly, independence will be impaired in these situations and an effective way of managing this threat is to have an experienced member of staff who is not involved in the audit carrying out the non-audit service.

The FRC's *Ethical Standard* acknowledges that for small entities, certain dispensations are needed so as to facilitate a cost-effective audit for a small entity that is not a 'public interest entity' (the majority of small companies are not public interest entities). These provisions are outlined in Section 6 *Provisions Available for Audits of Small Entities* which are also covered later in these notes (see page 50).

Accounting-related services, particularly where the transition to FRS 102 is concerned, would ordinarily give rise to a self-review threat, although the *Ethical Standard* does provide some relaxations to the rules in Section 6. Paragraph 6.7 of the *Ethical Standard* says that if an audit firm undertakes non-audit services for a small audited entity, the audit firm need not apply safeguards to address a self-review threat, provided that:

(a) the audited entity has informed management; and

(b) the audit firms extends the cyclical inspection of completed audit engagements that it performs for quality control purposes.

In (a), 'informed management' exists when:

- a member of the management team, or senior employee, is to receive the results of the non-audit service and is delegated the responsibility of making judgements and decisions of the types set out in paragraphs 1.24 and 1.25 of the *Ethical Standard*;
- that member of the management team is capable of making independent management judgements and decisions on the basis of the information provided to them; and
- the results of the non-audit service are communicated to the entity. If judgements or decisions are to be made by management, they must be supported by an objective analysis of the issues to consider and the entity is also provided the opportunity of deciding between reasonable alternatives.

In (b), the audit firm must extend the number of audit assignments inspected under the requirements of ISQC (UK) 1. This means that the audit firm must include a random selection of audit assignments where non-audit services have been provided. In selecting these files, the firm must pay particular attention in ensuring there is adequate documentation on those files which provides evidence that informed management have made such judgements and decisions deemed necessary in relation to the presentation and disclosure of information in the financial statements, especially in relation to the transition. Usually, those inspecting the files are external parties, such as SWAT, who are able to provide independent and objective feedback on the quality of the work performed.

Management threat

One of the first things a small company would be required to do in a transition to FRS 102 is to consider their accounting policies and whether those policies are compliant with FRS 102.

In addition, there are 21 optional exemptions contained in Section 35 *Transition to this FRS* that apply to small companies (three, in particular, are specific to small entities only).

A management threat arises when the audit firm makes judgements and decisions that are the responsibility of management. For example, if the audit firm decides that it is appropriate to use a previous GAAP revaluation as deemed cost for a tangible fixed asset on transition, this is a decision which should be made by management of the entity and hence will give rise to a management threat. Therefore, where the auditor takes decisions such as the application of any of the optional exemptions from retrospective transition in paragraph 35.10 of FRS 102, it will impede on the auditor's independence and objectivity when it comes to auditing that area of the transition because auditors should be concerned with whether, or not, it is appropriate in the small company's individual circumstances to apply certain optional exemptions and where it is appropriate, to then determine whether they have been applied correctly.

Paragraph 6.11 of the *Ethical Standard* says that if the audit firm undertakes non-audit work for a small entity (such as considering an audit client's accounting policies), the auditor need not comply with the prohibitions in respect of management decisions, provided that:

(a) the auditor discusses objectivity and independence issues relating to the non-audit service with those charged with governance and also confirms that management accept responsibility for any decisions taken; and

(b) the firm discloses the fact that it has applied the FRC's *Ethical Standard – Provisions Available for Audits of Small Entities*.

Disclosure requirements

When undertaking a transition for an audit client and the auditor uses any of the provisions in Section 6 of the *Ethical Standard*, the audit engagement partner must ensure that:

(a) the auditor's report discloses this fact; and

(b) either the financial statements or the auditor's report discloses the type of non-audit services the firm has provided to the audited entity.

Small company transitional considerations prior to the audit

For many small companies, the transition process is likely to be relatively straightforward and it is not uncommon for some small companies to experience no transitional or prior year adjustments on first-time adoption of FRS 102. However, companies and their auditors need to start thinking about the transition as early on in the process as possible because if there are difficulties or contentious issues expected, then these need to be managed effectively to ensure that the transition is as smooth as possible.

Factors which the directors of a small company may need to consider are:

- Does the entity have adequate resources to deal with the transition?
- Are there any loan covenants in place which may be breached if additional assets or liabilities are brought onto the balance sheet as a result of the transition? Will such covenants need to be renegotiated?
- Does the entity have any complex financial instruments that may need to be considered, such as interest rate swaps?
- Is the accounting system capable of handling the transition and can the chart of accounts be easily changed to cope with any different accounting treatments under FRS 102?

- Have issues such as dividend planning and any profit-related remuneration schemes been considered in light of the retrospective nature of FRS 102?
- Do the directors understand the entity's accounting policies and are these compliant with the requirements of FRS 102?
- Has a realistic timetable been set for the transition process?
- To what extent will the auditors need to be consulted on aspects related to the transition?
- Have the tax implications of the transition been taken into account and understood?

While the above factors are certainly not exhaustive, they do flag up some important points which a small entity (particularly one which may have a relatively high level of turnover in the context of the new small company size thresholds) needs to consider.

Auditors' considerations prior to the transition

For many auditors with only one or two small company audits, this may be the first time that the auditor has audited a transition to a new financial reporting framework and thus there will be an element of unfamiliarity with the process.

The responsibility for the transition to FRS 102 lies with management. That is not to say, however, that the auditor can ignore the transition; indeed, the risk of material misstatement due to the transition is inherently higher due to the infrequent nature that entities' move onto a new financial reporting process. In addition, nowadays companies are keen to reduce audit fees as much as possible and certainly some entities will want to do as much of the process as possible in an attempt to keep audit fees to a minimum. For these types of entities, the risk of material misstatement is inherently higher and therefore audit procedures should be tailored accordingly to reflect this increased risk.

Issues which the auditor should consider prior to the transition are:

- Do audit programmes adequately cater for first-time adoption of FRS 102?
- Will we need any additional resources deployed on this year's audit bearing in mind the additional work needed on the transition?
- How much time will be needed to complete the audit in accordance with the ISAs (UK and Ireland)/ISAs (UK)?
- Is the client aware of the changes and the retrospective nature of FRS 102 on first-time adoption?
- Have we considered the potential impact of first-time adoption of FRS 102 on distributable reserves (keeping in mind any audit clients which may have limited distributable profits under previous UK GAAP and the impact that any additional liabilities brought onto the balance sheet on transition or in the prior year may have on these distributable profits)?
- Are staff that are to be deployed on the audit familiar with the requirements of FRS 102 or are there any additional training needs that need to be addressed?
- Will we need to use any experts, such as fair value experts?
- To what extent are we going to be involved in the accounting aspects of the transition and are there any threats to independence or can we use PAASE (Section 6) of the *Ethical Standard*? (See page 50 of this course material)
- Is an engagement quality control review needed this year?

- Have previous audits been problematic or is the internal control environment weak which may result in higher risks of material misstatement where the transition is concerned?
- Are the client's accounting policies compliant with FRS 102?
- Is the client planning on using any of the optional exemptions outlined in Section 35 and, if so, are these appropriate?
- Have we considered the most common transitional adjustments, such as:
  - additional deferred taxes due to the timing difference plus approach;
  - calculation of holiday pay accruals;
  - accounting differences, such as investment property fair value gains and losses;
  - revenue recognition issues (bearing in mind that fraud risk is usually high where revenue recognition, particularly on transition to a new financial reporting framework, is concerned);
  - prohibition of contracted rates for foreign currency, hence creating derivatives; and
  - financing transactions and the effective interest method.

In addition to the above, the auditor must consider whether the small entity should be reminded of the terms of their engagement in accordance with ISA (UK) 210 *Agreeing the Terms of Audit Engagements*. It may be that those terms and conditions need to be refreshed, particularly as FRS 102 is a brand new financial reporting regime and hence it is likely that previous engagement letters could be out-of-date.

Planning the engagement when FRS 102 is used for the first time

The planning side of the audit will need extra work due to the transition process and this, of course, will increase the amount of time spent on the audit so it should be explained to management how transitioning to FRS 102 will affect the audit because the final audited draft financial statements may be available later than in previous audits.

Even if there are no transitional or prior year adjustments in the draft financial statements, the auditor should not simply take this at face value and go on to ignore doing any audit work on the transition. It is likely that the client may have missed some technical aspects of FRS 102 (such as the calculation of holiday pay accruals or reallocation of investment property fair value gains/losses on transition and in the comparative period). Therefore, even if the client confirms there are no transitional adjustments, procedures should still be planned to obtain sufficient and appropriate evidence to corroborate this assertion.

Auditors will obviously take into account their knowledge of the client and how efficiently the transition process has been. If the transition to FRS 102 has been troublesome, this will increase the risk of material misstatement and therefore this should be reflected in the auditor's risk assessment. In these instances, the auditor should consider increasing sample sizes and lowering materiality levels in this area to reduce audit risk.

Materiality

Materiality should be carefully thought about prior to the audit where a transition is concerned, particularly performance materiality. This is because a transition exercise is likely to give rise to a higher risk of material misstatement than in previous audits (especially if the transition was problematic).

In addition, the auditor must also consider the extent to which unadjusted misstatements at the transition date balance sheet and comparative year, identified in previous audits, which do not cancel out on transition, impact on the opinion of the auditor in the first FRS 102 financial statements.

Due to the retrospective nature of FRS 102, the auditor may also need to reconsider previous materiality levels because the benchmarks (turnover, profit before tax and gross assets) may have changed due to the transition.

Management bias and fraud

As noted above, a transition to FRS 102 inherently brings with it a higher risk of material misstatement. This is because FRS 102 requires a greater level of subjectivity and judgement on the part of management. Management bias where accounting policies are concerned is wider in scope on transition to a new financial reporting framework because management may simply opt for an accounting policy choice that may give rise to a higher reported profit, thus having a direct impact on profit-based management bonuses, rather than considering the appropriateness of accounting policies in the context of the company's individual facts and circumstances. To that end, the auditor should consider whether such motives are apparent in their initial risk assessment and tailor their audit procedures accordingly.

Conversely, management may just simply continue with their existing accounting policies and have no regard to any additional policies that may be appropriate under FRS 102. The auditor should use this opportunity to challenge any long-standing accounting policies to establish whether they continue to be appropriate.

Fair value accounting

FRS 102 places more emphasis on fair value accounting than previous UK GAAP and therefore the requirements of ISA (UK) 540 (Revised June 2016) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* may become more relevant than it did in previous audits. Determining fair values will often involve a large amount of subjectivity and estimation uncertainty. For the small entity, whilst judgements and key sources of estimation uncertainty are not legally required to be disclosed, the auditor should consider whether disclosure of key sources of estimation uncertainty would be required in order to give a true and fair view.

If an accounting estimate gives rise to a significant risk, the auditor must evaluate how management has considered alternative assumptions or outcomes and why it has rejected them; or how management has otherwise addressed measurement uncertainty in arriving at the accounting estimate. Such procedures should be considered at the planning stage and devised in such a way that the audit evidence obtained is sufficient and appropriate.

IT systems

A new financial reporting framework brings with it changes in the way that certain items are accounted for in the financial statements. The retrospective nature of FRS 102 means that these new treatments must be reflected at the date of transition and in the prior year (subject to any mandatory exceptions and optional exemptions from retrospective application per Section 35). The most common example relative to a small entity would be investment properties where fair value gains and losses are reported via profit and loss rather than a revaluation reserve.

The auditor should consider how the IT system has been able to cope with such accounting treatment changes and how management have controlled any such changes.

Internal control environment

For many small companies, the transition may have little impact on the business. However, in some it may have a more significant impact and therefore management may deem it necessary to establish new systems or controls that relate to the financial reporting process. Where a new system or new controls have been established due to the transition, the auditor will have to consider:

- updating existing narrative notes outlining the systems in place;
- undertaking tests of controls on the new controls in place to assess operating effectiveness;
- assessing the design and implementation of any controls that relate to significant risks;
- determining whether audit evidence can be obtained from testing those new systems or controls as a means of reducing substantive procedures; and
- reporting any deficiencies noted by the auditor to management.

Specific risks relevant to the transition

As noted above, the transition to FRS 102 inherently brings with it certain risks that the auditor should consider at the outset of the audit assignment, including:

Requirements of Section 35

Where the small entity has undertaken the transition to FRS 102 themselves, the auditor must consider whether the requirements of Section 35 of FRS 102 have been applied correctly – particularly whether the requirements have been applied to the entity's *date of transition* and not simply applied to the end of the comparative period.

In addition, where the small entity has not restated any items on transition or in the prior period, the auditor must ensure that the exception or exemption from retrospective application is appropriate.

Unadjusted misstatements in prior years

Opening balances on transition and in the comparative year may contain errors that have not been previously reported. Those errors which relate to the comparative year should be treated as such and not treated as transitional adjustments.

Undue cost or effort exemptions

Extreme care should be taken on the part of both the small entity and the auditor where undue cost or effort exemptions in FRS 102 are concerned. Indeed, it is apparent that some entities have viewed undue cost or effort exemptions as accounting policy choices (especially in relation to obtaining fair values for assets such as investment properties).

Where undue cost or effort exemptions have been applied by management, the auditor must consider the rationale for using them and be prepared to challenge management's explanations where appropriate because the auditor may consider that the use of undue cost or effort gives rise to management bias.

Restated comparative information

The auditor should plan additional procedures to ensure that comparative information has been correctly restated for the effects of FRS 102 and that prior period adjustments have been appropriately presented in the financial statements.

Disclosure of transitional information

For small entities, this may prove to be a challenge because they are not legally obliged to provide the transitional disclosures; they are, instead, an encouraged disclosure per Appendix D of Section 1A *Small Entities*. Notwithstanding the fact that the transitional information is only encouraged as opposed to mandated, disclosure of transitional information may be needed in order to give a true and fair view.

Auditors need to carefully consider any reluctance by management to provide the transitional disclosure information as this may give rise to a fraud risk factor (management may be concealing a fraud) or a material misstatement (management may have corrected a material prior period error as a transitional adjustment rather than treating it as a prior period adjustment).

Residual values of fixed assets

Depreciable amounts of fixed assets are calculated as cost less residual value and the balance is then depreciated over the assets' useful economic lives. Under previous UK GAAP, residual values were based on historic prices, whereas under FRS 102 they are based on current price. For some assets that are being depreciated over a relatively lengthy period of time, residual values may have fluctuated to such an extent that depreciation may be materially misstated due to current prices being significantly different than historic prices. The auditor should also consider how best to obtain evidence as to what constitutes a current price.

Intangible assets and goodwill

These are probably one of the main areas that have caused a certain element of confusion among practitioners.

Some small entities have previously not amortised intangible assets (more commonly goodwill) because management deem goodwill to have an indefinite useful life. Under FRS 102, indefinite useful lives for all intangible assets are prohibited and hence the small entity will have to develop an amortisation policy that is appropriate in the entity's circumstances. If management are unable to reliably estimate a useful economic life for an intangible asset, it must choose an amortisation period that does not exceed ten years.

Auditors must consider the amortisation policies in terms of whether they are appropriate. In addition, they will need to plan audit procedures to obtain sufficient appropriate audit evidence that any amortisation periods beyond ten years are appropriate. In addition, auditors will need to ensure that they understand the rationale for management's decision to either continue with existing amortisation policies, carried over from old UK GAAP, or whether they have decided to reconsider the useful life of an intangible asset on transition to FRS 102 as this may give rise to the previously assessed useful life as being inappropriate.

Going concern

The inclusion of additional items in the financial statements on transition to FRS 102 may give rise to any loan covenants being breached. It is important that this issue is considered as early as possible to give the small entity enough time to renegotiate any loan covenants.

However, the recognition of additional assets and liabilities on transition and in the prior period may breach existing loan covenants and auditors need to consider the impact that such breaches may have on the entity's going concern status. In addition, the recognition of additional liabilities on transition and in the prior year may result in net assets turning into net liabilities.

Where there are material uncertainties in respect of going concern, a small entity is encouraged to make disclosure of these uncertainties in accordance with paragraph 3.9 of FRS 102. Invariably any going concern uncertainties will be deemed material by the auditor and hence if management do not make, or refuse to make, any disclosures in respect of material uncertainties relating to going concern, there will be an impact on the auditor's report.

Communication with those charged with governance

At the outset, the auditor must consider whether those charged with governance understand their responsibilities. Often, in a small company, those charged with governance are the same body of individuals as management, but the auditor still need to consider whether they understand their responsibilities in respect of:

- preparation of the financial statements;
- forming judgements, estimates and fair values;
- implementing an adequate system of internal control;
- determining the accounting policies to be applied; and
- any undue cost or effort exemptions that have been applied in the preparation of the financial statements.

In respect of the above, the auditor may wish to obtain written representations from management/those charged with governance, particularly in respect of accounting policy choices that have been adopted and the formation of judgements, estimates and fair values.

Tests of control should be applied by the auditor, particularly in respect of new controls or systems that have been implemented following the transition to FRS 102 as these are more likely to be deficient as they are not established and have not previously been tested. Where the auditor identifies deficiencies in the internal control environment, those charged with governance should be notified of the deficiencies. If the auditor judges the deficiencies to be significant deficiencies, the auditor must communicate them in writing as soon as possible.

Misstatements

Most audits identify misstatements within the financial statements which are documented on an audit error schedule (also referred to as a 'schedule of unadjusted misstatements'). Where the auditor identifies misstatements arising as a result of the transition which are not clearly trivial, they should be notified to those charged with governance with a request that they be corrected.

If misstatements are not corrected, the auditor considers the impact on the auditor's report. Misstatements in respect of the comparative information should also be taken into consideration as well by the auditor together with the consequences the comparative misstatements have on the current year's financial information.

Documenting the work on the transition

It is vital that the auditor prepares adequate documentation in respect of the transitional exercise in accordance with ISA (UK) 230 *Audit Documentation*. Work programmes must also be reviewed to ensure that the procedures documented on the work programmes will enable the auditor to obtain sufficient appropriate audit evidence. Auditors must not be reluctant to tailor off-the-shelf audit work programmes to be client-specific.

In all cases, audit documentation must be able to 'tell a story' in respect of the judgements and conclusions that have been reached in respect of the transition to FRS 102. If the auditor has challenged management and/or those charged with governance in respect of judgements and estimates, the auditor must ensure that they document those challenges adequately.

Reporting on the transition

In forming their conclusion on the financial statements, the auditor must take into consideration:

- any non-compliance with, or inappropriate application of, FRS 102;
- inappropriate application of transitional exceptions or exemptions;
- inadequate transitional processes or a lack of knowledge by the person(s) executing the transition; and
- the misstatements identified in respect of the transition during the audit.

If misstatements have been identified in respect of the transition that are either material in isolation, or become material when combined with other uncorrected misstatements identified during the audit, the auditor must then modify their opinion accordingly. The wording of the basis of the modification must be carefully considered and the auditor should also have regard to the requirements of the new financial reporting framework.

LONG ASSOCIATION WITH AN AUDIT CLIENT (LECTURE A592 – 4.40 MINUTES)

The Financial Reporting Council's *Ethical Standard* (ES) requires that an audit firm establishes policies and procedures that monitor the length of time that partners and staff in senior positions are involved on the audit engagement team. In addition, the ES requires that the audit firm monitors the extent of the involvement of the partners and senior members of staff in the audit assignment.

Long association with an audit client can give rise to a familiarity threat which, if not reduced to an acceptable level, can impede upon independence and objectivity. To that end, the ES requires that where there is long association with an audit client, the firm and covered persons must:

- apply safeguards that reduce the threats to independence and objectivity to a level where independence is not compromised; and
- disclose the engagements the firm has previously undertaken for an entity relevant to the engagement to those charged with governance and, where applicable, any other persons or entities which the firm is instructed to advise.

In situations where the audit firm is unable to apply appropriate safeguards, the firm cannot accept the engagement and must resign or not stand for reappointment, whichever is appropriate. Where legislation or regulation assigns responsibility for the audit and the firm cannot resign, it must consider alternative safeguards that can be put in place.

Investment circular reporting engagements

In respect of investment circular reporting engagements, the audit firm must carefully consider which individual is to be appointed as the engagement partner. Factors which must be considered include:

- the nature of the investment circular reporting engagement;
- whether the nature of the investment circular reporting engagement will involve the reappraisal of previously audited financial information;
- the length of time that the audit engagement partner has been associated with the audit engagement;
- the length of time that other partners have acted for the entity on corporate finance and other transaction-related engagements;
- whether the objectivity of the engagement partner on a subsequent engagement could be adversely affected by an opinion on a profit forecast that is included in the investment circular; and
- the scope of the engagement quality control review.

Appropriate safeguards

To manage the threat to independence and objectivity where long association is concerned, the audit firm can apply appropriate safeguards, such as:

- appointing an engagement partner that has had no previous involvement with the entity in the capacity of engagement partner;

- rotating partners and senior members of the audit engagement team after a specified number of years;
- having another partner that has not recently been a member of the audit engagement review the work done by the partners and engagement team; and
- arranging an engagement quality control review to be undertaken.

Where an audit engagement partner has held this position for a period of ten years on a continuous basis, the audit firm must give careful consideration as to whether it is probable (i.e. more likely than not) that an objective, reasonable and informed third party would conclude that the integrity, objectivity or independence of the firm or covered persons are compromised. If the conclusion is that integrity, objectivity or independence are not compromised, then it is important that:

- safeguards, other than rotation, are applied (see above);
- the reasons why the individual continues to be involved in the audit are documented; and
- the facts are communicated to those charged with governance.

Public interest entities

Legislation dictates the relevant period that key audit partners can act for an audit client. Where a public interest entity is concerned, key audit partners who are responsible for carrying out the statutory audit must not act for more than five years. Following the partner's removal from the audit, they are not permitted to participate in the statutory audit of the public interest entity until a period of five years has elapsed from their cessation.

When an audit client becomes a public interest or other listed entity, the length of time that the audit engagement partner has served the entity in the capacity as engagement partner is taken into account when calculating the period before the engagement partner is rotated off the audit. When the engagement partner has already served for four or more years, that partner can continue to serve as the engagement partner for not more than two years after the entity becomes a public interest or other listed entity. Where this is the case, and the audit engagement partner continues to act for no more than two years, this fact and the reasons for it, are to be disclosed to the entity's shareholders as soon as possible and in each of the additional years the engagement partner continues to be involved in the audit. In the rare situation that the audit firm is not prepared to make this disclosure, the engagement partner is not permitted to be involved in the audit of the public interest or other listed entity.

Engagement quality control reviewers

In respect of public interest and listed entities, no one is permitted to act in the capacity of engagement quality control reviewer for a period longer than seven years. Where the engagement quality control reviewer has acted for a period of seven years, whether continuously or in totality, they are not permitted to participate in the engagement until a further five years have elapsed.

If a key partner has been involved in an audit of a public interest or listed entity for a period of seven years, whether continuously or in totality, they are not permitted to participate in the engagement until a further period of two years have elapsed.

Where roles have been combined, anyone who has acted in the capacity of engagement quality control reviewer, key partner or the engagement partner for a public interest or listed entity for a period of seven years, whether continuously or in totality, they are not permitted to be involved in the audit until a period of five years have elapsed.

Other partners and staff involved in the audit in senior positions

Where public interest and listed entities are concerned, it is the responsibility of the engagement partner to review the safeguards the audit firm has put in place to address threats to independence and objectivity where partners and audit staff have been involved in the audit in a senior capacity for a continuous period longer than seven years and must discuss those situations with the engagement quality control reviewer. Where any problems or issues remain unresolved, they must be referred to the ethics function or partner.

FEES, REMUNERATION AND EVALUATION POLICIES, GIFTS AND HOSPITALITY, LITIGATION (LECTURE A593 – 9.31 MINUTES)

Fees

Regardless of the levels of fees to be charged, the audit engagement partner is responsible in ensuring that the staff deployed on an audit assignment have the appropriate levels of skill and expertise to carry out the engagement in accordance with all Engagement and Ethical Standards.

For audits where the firm also carries out non-audit work, the non-audit services provided must not influence or determine the fee to be charged for the audit. For example, if the audit firm is providing lucrative tax advisory services, this cannot influence the levels of fee charged for the audit which must be based on the time and levels of skills and expertise of the engagement team required to carry out the audit in accordance with the ISAs (UK)/(UK and Ireland) and Ethical Standards.

The prohibition of non-audit work influencing audit fees is not intended to prevent cost-savings that can be achieved by providing non-audit services. Indeed, it is not uncommon to rely on various information prepared during the course of, say, management accounts, when auditors are carrying out the statutory audit.

Under no circumstances can audit fees be contingent. For example, if the audit client suggests an audit fee which is directly related to the entity's pre-tax profit or net assets. However, in situations where a court, competent authority or other public authority has established the levels of fees, these will not be contingent.

Non-audit services also must not be carried out on a contingent fee basis when:

- the contingent fee is material to the audit firm, or the part of the firm which the engagement partner's profit share is derived; or
- the amount of the fee depends on the outcome or result of the non-audit services which is relevant to a future or contemporary judgement relating to a material matter in the financial statements, or other subject matter information or subject matter pertinent to the engagement.

In cases where the audit firm proposes to adopt contingent fee arrangements in respect of non-audit services to the audit client, or its affiliates, the audit firm must put in place policies and procedures designed to ensure that the engagement partner and ethics partner/function are notified accordingly. Where public interest or listed entities are concerned, the engagement partner must disclose to the audit committee, in writing, any contingent fee arrangements for non-audit work provided by the firm or its network firms.

Overdue fees

The audit fee in respect of the prior period/year's audit should be paid before the firm carries out any new audit engagement work. If the fees in respect of the prior period/year's audit are still outstanding, it is important that the engagement partner understands the nature of any disagreement or issue relating to the overdue fee.

Where fees are outstanding and they are not trivial, the engagement partner, in consultation with the ethics function/partner, must consider whether the firm can accept, or continue, an engagement or whether it is necessary to resign.

A self-interest threat is created when fees remain unpaid. This is because the audit engagement partner may be under pressure not to express a qualified audit opinion as this may further delay payment of the audit fee, whereas an unqualified audit opinion may enhance the firm's prospects of securing payment of the overdue fees.

It may be the case that the reason for the overdue fees is because the client is in financial distress. Where this is the case, the audit engagement partner must consider whether the entity will be able to resolve the financial difficulties and must also consider the threats to independence, integrity and objectivity if the firm were to remain appointed as auditors. This must then be judged against if the firm were to resign as auditors in terms of how likely it would be that the audit client would find another firm to carry out the audit.

In any case, the *Ethical Standard* requires that where the audit firm does not resign, appropriate safeguards must be put in place by the audit engagement partner, for example, a review by a partner with relevant expertise that is not involved in the audit. The ethics partner must also be notified of the facts concerning the fees that are overdue.

Fee restrictions

If the audit firm, or a member of its network, provides a public interest entity that it audits, its parent or controlled undertakings with non-audit services (excluding those referred to in Article 5(1)[43] of the EU Audit Regulation):

(a) the total fees for such services to the audited entity and its controlled undertakings must not exceed more than 70% of the average of the fees paid in the last three consecutive financial years for the audit(s) of the audited entity and its controlled undertakings and of the consolidated accounts; and

(b) the total fees for such services provided by the audit firm must not exceed more than 70% of the average of the fees paid to the audit firm in the last three consecutive financial years for the audit(s) of the audited entity and, where applicable, of the parent undertaking, controlled undertakings and the consolidated accounts.

Public interest or listed entities

When it is expected that the total fees for services rendered to a public interest or listed entity and its subsidiaries will regularly exceed 10% of the annual fee income of the practice or, where profits are not shared on a firm-wide basis, of the part of the firm which the engagement partner's profit share is calculated, the firm must not act as the provider of the engagement for that entity and must either resign or not stand for reappointment.

When it is expected that the total fees for services rendered to a public interest or listed entity and its subsidiaries will regularly exceed 5% of the annual fee income of the practice, or part of the practice where the engagement partner's profit share is calculated, but will not regularly exceed 10%, the engagement partner must disclose that expectation to the ethics partner/function and to those charged with governance (including the audit committee where there is one). The engagement partner must also discuss with both parties the threat to integrity, objectivity and independence and whether safeguards need to be applied to either eliminate the threat completely or reduce it to a level where independence is not compromised.

Unlisted entities

When it is expected that the total fees for services rendered to a non-listed entity which is not a public interest entity and its subsidiaries will regularly exceed 15% of the annual fee income of the practice or, where profits are not shared on a firm-wide basis, of the part of the firm which the engagement partner's profit share is calculated, the firm must not act as the provider of the engagement and must either resign or not stand for reappointment.

Where the entity is not a public interest entity and it is expected that total fees for services to the entity and its subsidiaries will regularly exceed 10% of the annual fee income of the practice, or part of the practice where the engagement partner's profit share is calculated, but will not regularly exceed 15%, the engagement partner must disclose that expectation to the ethics partner/function and to those charged with governance. The firm must also arrange to have an external independent quality control review of the engagement BEFORE the audit report is finalised (i.e. a 'hot' review).

Remuneration and evaluation policies

The FRC's *Ethical Standard* requires an audit firm to have in place adequate remuneration policies, including profit-sharing policies, which provide sufficient performance incentives to secure audit quality. Any non-audit or additional services provided by the audit firm must not form part of the performance evaluation and remuneration of any covered person that is involved in, or able to, influence the carrying out of an audit.

The audit firm must have policies and procedures in place to ensure that each of the following is **true** regarding each audited entity:

(a) a primary criterion for evaluation of team performance and how they have contributed to audit quality for each audit undertaken;

(b) the objectives of team members do not include selling non-audit or additional services to the entity;

(c) the criteria for evaluating team members or promoting them do not include success in selling non-audit or additional services to the audit client; and

(d) no specific element of remuneration of a member of the audit team is based on his or her success in selling non-audit or additional services to the audit client.

The above do not apply to members of an engagement team from specialist practice areas where the nature and extent of their involvement is clearly insignificant.

Gifts and hospitality

An audit firm, including partners, covered persons and any persons closely associated with them, must not solicit or accept pecuniary and non-pecuniary gifts or favours (including hospitality) from an audit client or entities related to the audit client, unless an objective, reasonable and informed third party would construe the value to be trivial or inconsequential.

Acceptance of gifts or hospitality would give rise to self-interest and familiarity threats and the ES requires a firm to establish policies and procedures on the nature and value of gifts, favours and hospitality that may be accepted from an audit client, or offered to an audit client.

Where team members are in any doubt as to whether, or not, to accept gifts or hospitality, the team should discuss the situation with the audit engagement partner. If further doubt still exists, the engagement partner reports the facts to the ethics partner/function for further consideration regarding any action that is to be taken.

If gifts or hospitality are accepted more than once, the cumulative effect must be considered in terms of its value.

Litigation

When actual litigation takes place between the audit firm, its partners or any covered person and the audit client or its affiliates (or litigation is considered probable), a self-interest, advocacy and intimidation threat is created on the grounds that the firm's interest will be the achievement of an outcome to the dispute or litigation which is favourable to itself. In situations when the firm can foresee that such a threat may arise and thus independence is compromised, the firm must inform the audit committee of its intention to resign or, in the absence of an audit committee, the board of directors. The firm must also inform any other persons or entities that it is instructed to advise of its intention to resign.

Immediate resignation is not necessary in circumstances where an objective, reasonable and informed third party would not regard it as being in the interests of shareholders (or equivalent) or otherwise contrary to the public interest.

NON-AUDIT SERVICES (LECTURE A594 – 11.27 MINUTES)

For the purposes of these notes the term 'non-audit services' refers to non-audit and additional services provided to the audit client by the audit firm.

Many firms provide non-audit services to an audit client, such as payroll, tax compliance/advisory and accounts preparation services. In these respects, the audit firm is required to establish policies and procedures that require others within the firm, when considering whether to provide non-audit services to an audit client or any of its affiliates, to communicate details of the proposed non-audit services to the engagement partner. The engagement partner must then:

(a) identify and assess the significance of any related threats to the integrity and objectivity of the audit firm and consider whether independence would be compromised by providing the non-audit services;

(b) identify and assess the effectiveness of available safeguards which are designed to either eliminate the threat or reduce it to a level whereby independence is not compromised; and

(c) consider whether it is likely that an objective, reasonable and informed third party would conclude that the proposed non-audit services would not impair integrity or objectivity and compromise the independence of the firm or covered persons.

If (c) would result in a conclusion that integrity and objectivity would be impaired and hence independence compromised, then the two options available are:

- not to carry out the non-audit services; or
- resign from the audit as appropriate.

Safeguards

Safeguards which could be applied to reduce threats to integrity and objectivity and hence reduce the threats to a level whereby independence is not compromised could include:

- the use of 'Chinese walls' i.e. separate teams with one team providing the audit services and the other team providing the non-audit services; and
- ensuring that the engagement quality control reviewer is able to challenge both the audit engagement partner and the partner leading the non-audit work and undertakes a comprehensive review of the work and conclusions of the engagement team.

If the engagement partner concludes that there are no appropriate safeguards that are available to eliminate the threat in totality or reduce the threats to a level whereby independence is not compromised, the partner is required to inform the others concerned within the firm of that conclusion and either not undertake the non-audit work or not accept, or resign, from the engagement as appropriate.

Where there is any doubt as to the action that should be taken, the engagement partner must resolve the matter by way of consultation with the ethics partner/function.

Documentation

The audit engagement partner must ensure that they adequately document any decision to provide non-audit services to an audit client. The documentation prepared by the engagement partner must also include any safeguards that have been adopted and the reasons why they are considered to be effective.

Internal audit services

It is never a good idea for an audit firm providing external audit work to also provide the same audit client with internal audit services. The ES is specific where internal audit services are concerned. The audit firm must not provide internal audit services when it is reasonably foreseeable that:

(a) the firm would place significant reliance on the internal audit work provided;

(b) the firm would undertake part of the role of management; or

(c) where the firm is undertaking an investment circular reporting engagement, for the purposes of internal audit services, the firm would undertake part of the role of management in respect of the transaction or the financial information that is the subject of the investment circular reporting engagement.

Public interest entities

The levels of non-audit services provided to listed entities are very restricted. Where a public interest entity is concerned, the audit firm, nor its network members, can provide (directly or indirectly) *prohibited non-audit services* to the entity, its parent or controlled undertakings in:

(a) the period between the beginning of the period audited and the issuing of the auditor's report; and

(b) the financial year immediately preceding the period referred to above.

The term 'prohibited non-audit services' includes:

- tax services
- services involving performing management roles or decision-making functions;
- bookkeeping and accounts preparation;
- payroll services;
- designing and implementing internal controls/risk management processes related to the preparation and/or control of financial information or designing and implementing financial IT systems;
- valuation services;
- legal services;
- services related to the entity's internal audit function;
- services linked to the financing, capital structure and allocation and investment strategy of the entity (except providing assurance services in relation to the financial statements, such as the issuing of 'comfort letters' in connection with prospectuses issued by the entity);
- promoting or dealing with the underwriting of the client's shares;
- HR services;
- structuring the organisation or design; and cost control.

IT systems

The ES places a prohibition on audit firms from designing, providing or implementing IT systems for an audit client where:

(a) the systems would play a significant part in the accounting function and production of the financial statements and the audit firm would place significant reliance on such systems;

(b) where the firm would undertake part of the role of management; or

(c) in respect of an investment circular reporting engagement, the firm would take on part of a management role in respect of the transaction or the financial information which is the subject of the investment circular reporting engagement.

Valuation services

Audit firms must not provide valuation services to an audit client where that valuation would involve a significant degree of subjective judgement and also have a material effect on the financial statements, either in isolation or when combined with other valuations provided. This is particularly important on transition to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* where audit clients may seek the advice of their auditors in respect of valuations of things like derivative financial instruments.

Where valuation services are concerned, the following would not constitute valuation services:

- comments on valuation assumptions and their appropriateness;
- errors identified in a valuation calculation and suggestions for their correction; and
- the provision of advice on accounting policies and any valuation methodologies used in their application.

Actuarial valuation services

Where the entity is listed, the audit firm must not provide any actuarial valuation services. For other types of entity, the ES is restrictive on the actuarial valuation services that an audit firm can provide. Where actuarial valuation services for an unlisted entity are concerned, the ES does not allow such services unless the firm is satisfied that either all significant judgements, including the assumptions, are made by **informed management** or the valuation is immaterial to the financial statements (or other subject matter information or subject matter) either separately or in aggregation with other valuations provided.

Tax services

The term 'tax services' is very wide in scope and as a consequence audit firms must identify and assess, on a case-by-case basis, the potential threats to integrity, objectivity and independence of the firm and covered persons before deciding whether to provide the tax services.

Where tax services are concerned, safeguards can include:

- provision of the tax service(s) by partners and staff that are not connected with the audit;
- a review of the tax service(s) by an independent tax partner or other senior tax employee;
- external independent advice is sought with regard to the tax service(s);

- tax computations prepared by the engagement team are reviewed by a partner or senior staff with relevant expertise who are not connected to the audit team; or
- a partner with relevant expertise that is not involved in the audit reviews whether the tax work has been properly and effectively address in the context of the engagement.

Audit firms are strictly prohibited from promoting tax structures or products or providing tax advice to an audit client where there is reasonable doubt as to whether the related accounting treatment involved is based on well-established interpretations or is appropriate, having regard to the relevant financial reporting framework and the requirement for the financial statements to give a true and fair view.

Audit firms are also not allowed to provide tax services, wholly or partly, on a contingent fee basis to:

(a) a listed entity that is not an SME listed entity or a significant affiliate of such an entity; or

(b) any other audit client for which the tax outcome in respect of the services (and hence the amount of the fee) is uncertain, dependent on the proposed application of tax legislation and may be material to present or future financial statements or other subject matter information or subject matter of the engagement.

Audit firms are also prohibited from providing tax services to an audit client where the firm would have to assume a management role.

If the audit client is a listed entity that is not an SME listed entity, or a significant affiliate of such an entity, the audit firm is not allowed to prepare current or deferred tax calculations where such calculations are material.

Acting as advocate in respect of tax issues

The audit firm is not permitted to provide tax services to an audit client which would involve the firm acting as advocate in respect of an issue which is material to the entity's present or future financial statements or the subject matter information or subject matter of the audit engagement or where the outcome of the tax issue is dependent on a future or contemporary judgement by the firm in relation to the financial statements.

Litigation support services and legal services

Audit firms must not provide litigation support services to audit clients (both listed and unlisted clients) where this support would involve the estimation by the firm of the likely outcome of a pending legal matter which could be material to the amounts included, or the disclosures to be made, in the financial statements, or in the subject matter information or subject matter of the engagement.

Audit firms are also unable to provide legal services to an entity where this would involve acting as the solicitor formally nominated to represent the entity in the resolution of a dispute or litigation that is material to the financial statements.

Recruitment and remuneration services

An audit firm is not permitted to provide recruitment services to an audit client which would involve the firm taking responsibility for the appointment of any director. This prohibition also extends to recruitment of employees for an audit client and, in the case of investment circular reporting engagements, the recruiting of an employee who will be involved in an area that is directly concerned with the transaction which is the subject of the investment circular.

Where the entity is a listed entity, which is not an SME listed entity, the audit firm is not allowed to provide recruitment services in respect of a key management position of the entity, or a significant affiliate of the entity.

Audit firms are also prohibited in providing advice on remuneration packages, or the measurement criteria on which remuneration is calculated, for directors or other key management personnel of an audit client.

Corporate finance services

Audit firms are prohibited from providing corporate finance services where:

(a) the service would involve the firm taking responsibility for dealing in, underwriting, or promoting the entity's shares; or

(b) the engagement partner has, or ought to have, reasonable doubt concerning an accounting treatment which is subject to a contemporary or future judgement by the audit firm relating to a material matter in the financial statements or in other subject matter information or subject matter of the engagement, and upon which the success of the transaction depends:

  (i) is based on well-established interpretations; or

  (ii) is appropriate;

  having regard to the financial reporting framework in place, including the requirement for the financial statements to give a true and fair view;

(c) the firm is undertaking an engagement, other than an investment circular reporting engagement, and the service would result in the audit firm assuming a management role; or

(d) the firm is undertaking an investment circular reporting engagement and the service would involve the firm assuming a management role in the entity in respect of the transaction or subject matter information or subject matter of the investment circular reporting engagement.

Transaction related services

Transaction related services cannot be provided to an audit client where:

(a) the engagement partner has, or ought to have, reasonable doubt concerning the accounting treatment which is subject to a contemporary or future judgement by the audit firm and is material to the financial statements or other subject matter information or subject matter, and upon which the success of the related transaction depends;

  (i) is based on well-established interpretations; or

  (ii) is appropriate;

  having regard to the financial reporting framework applied including the requirement for the financial statements to give a true and fair view; or

(b) the firm is undertaking an engagement, other than an investment circular reporting engagement, and the service would involve the firm assuming a management role; or

(c) the firm is undertaking an investment circular reporting engagement and the service would involve the firm assuming a management role in the entity in respect of the transaction or the subject matter information or subject matter of the investment circular reporting engagement.

Restructuring services

An audit firm is prohibited from providing restructuring services where:

(a) the service would involve the audit firm assuming a management role within the entity; or

(b) the service would require the firm to act in the capacity of advocate in respect of matters which are material to the financial statements or other subject matter information or subject matter of the engagement.

The provision of restructuring services is also prohibited where the service would result in a self-review threat in a contemporary or future engagement. The exception would be where the threat can be reduced by applying appropriate safeguards to an extent that independence is not compromised.

If an client is in distress and it is a listed entity that is not an SME (or an affiliate of such), the restructuring services provided by the audit firm must be limited to providing:

(a) preliminary general advice to the distressed entity;

(b) assistance with the implementations of elements of an overall restructuring provided those elements are not material to the overall restructuring plan;

(c) challenging (but in no circumstances developing) the projections and assumptions within a financial model produced by the distressed entity;

(d) reporting on a restructuring plan, or aspects of the plan, concerning the proposed issue of an investment circular; and

(e) where specifically permitted by a regulatory body with oversight of the distressed entity.

Accounting services

Understandably the range of accounting services which an audit firm could provide is wide. An audit firm is not permitted to provide accounting services when:

(a) the entity is a listed entity that is not an SME listed entity; or

(b) for any other entity:

  (i) the accounting services would give rise to the audit firm assuming a management role; or

  (ii) the financial information is the subject of an investment circular reporting engagement.

Audit firms are not able to provide accounting services in respect of financial information which is the subject of an investment circular reporting engagement.

The following would not be examples of the provision of non-audit services, rather they would arise as a result of a by-product of the audit engagement and hence would not give rise to any threat to the integrity, objectivity and independence of the firm or covered persons:

- comments on weaknesses in the accounting records and suggestions for addressing them;
- errors identified in the accounting records and financial statements and suggestions for their correction; and
- advice on the entity's accounting policies currently in use and on the application of current and proposed accounting standards.

PROVISIONS AVAILABLE FOR AUDITS OF SMALL ENTITIES
(LECTURE A595 – 8.15 MINUTES)

Section 6 of the FRC's *Ethical Standard* outlines the provisions that are available for small entities and do not apply for audits of public interest entities.

Economic dependence

When a small entity is being audited, the audit firm does not have to comply with paragraph 4.51 of Section 4 (which relates to the 10% and 15% restrictions on fee income for unlisted entities) or Part B of the FRC's *Ethical Standard* and an external independent quality control review is not required. Notwithstanding the fact that an external quality control review is not required, the Provisions Available for Audits of Small Entities (PAASE) requires that the engagement partner discloses that fees will amount to between 10% and 15% of the firm's annual fee income to the ethics partner and to those charged with governance.

Self-review threat in respect of non-audit services

The provisions in PAASE do not require safeguards to be in place in respect of a self-review threat, provided:

(a) the audit client has **informed management** (see below); and

(b) the audit firm extends the cyclical inspection of completed audits performed for quality control purposes.

In (a), 'informed management' exists when:

- a member of the management team, or senior employee, is to receive the results of the non-audit service and is delegated the responsibility of making judgements and decisions of the types set out in paragraphs 1.24 and 1.25 of the *Ethical Standard*;
- that member of the management team is capable of making independent management judgements and decisions on the basis of the information provided to them; and
- the results of the non-audit service are communicated to the entity. If judgements or decisions are to be made by management, they must be supported by an objective analysis of the issues to consider and the entity is also provided the opportunity of deciding between reasonable alternatives.

Management threat – non-audit services

Provisions in PAASE do not require the audit firm to comply with the requirements in Section 5 of Part B of the ES which prohibits the audit firm assuming the role of management, provided that:

(a) the firm discusses objectivity and independence issues related to the non-audit services provided with those charged with governance and also confirms that management accept responsibility for any decisions that may be taken; and

(b) it discloses the fact that it has applied PAASE in the auditor's report and, either in the auditor's report or in the financial statements, discloses the type of non-audit service provided to the client.

Advocacy threat – non-audit services

The audit firm need not comply with paragraphs 5.97 (tax services that involve the firm acting as advocate) and 5.140(b) (restructuring services that involve the firm acting as advocate) of Section 5 of Part B of the FRC's ES provided that the audit firm discloses the fact that it has applied PAASE and discloses the types of non-audit services provided in either the auditor's report or in the financial statements.

Partners and other persons approved as statutory auditor joining the audit client

Where the audit firm applies PAASE it must:

(a) take appropriate steps to determine that there is no significant threat to the audit team's integrity, objectivity and independence; and

(b) discloses the fact that it has applied PAASE and the fact that a former engagement partner, or other person personally approved as a statutory auditor, has joined the audit client.

ISA (UK) 580 *WRITTEN REPRESENTATIONS* *(LECTURE A596 – 11.27 MINUTES)*

A written representation is a written statement by management which is provided by the auditor to confirm certain matters or to support other audit evidence and are dealt with in ISA (UK) 580 *Written Representations*. Written representations are often scrutinised as part of file reviews and, quite often, there are deficiencies noted in the content of the representation itself. For the purposes of ISA (UK) 580, written representations do not include the financial statements or the assertions therein and also do not include the books and records supporting the amounts and disclosures in the financial statements.

Where ISA (UK) 580 is concerned the term 'management' should be read as 'management and, where appropriate, those charged with governance'.

Objectives of the auditor

The objectives of the auditor where written representations are concerned are outlined in paragraphs 6(a) to (c) which state that the auditor's objectives are:

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

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

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

An important point to emphasise where written representations are concerned is that they **are not** sufficient appropriate audit evidence on their own. This is because they are internally generated and hence written representations serve to **complement other audit evidence**.

Management's responsibilities

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

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

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

Other representations

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

Relevant ISA (UK)	**Paragraph**
ISA (UK) 240 (Revised June 2016) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	39
ISA (UK) 250 (Revised June 2016) *Consideration of Laws and Regulations in an Audit of Financial Statements*	16
ISA (UK) 450 (Revised June 2016) *Evaluation of Misstatements Identified during the Audit*	14
ISA (UK) 501 (Revised June 2016) *Audit Evidence – Specific Considerations for Selected Items*	12
ISA (UK) 540 (Revised June 2016) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*	22
ISA (UK) 550 *Related Parties*	26
ISA (UK) 560 *Subsequent Events*	9
ISA (UK) 570 (Revised June 2016) *Going Concern*	16(e)
ISA (UK) 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements*	9
ISA (UK) 720 (Revised June 2016) *The Auditor's Responsibilities Relating to Other Information*	13(c)

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

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

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

Doubts concerning the reliability of written representations

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

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

The auditor may conclude that the written representations are not reliable. In such instances, ISA (UK) 580 requires the auditor to take appropriate actions, including determining the potential effect on the auditor's opinion.

Management fails to provide written representations

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

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

Key points to note where written representations are concerned

Key points to note where written representations are concerned are as follows:

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

SRA ACCOUNTS RULES 2011 UPDATE

Many practitioners have solicitor clients that are required to submit annual Accountant's Reports to the Solicitors Regulation Authority (SRA). The SRA Accounts Rules 2011 replaced the Solicitors Accounts Rules 1998, which were extremely prescriptive. Changes have been made to the SRA Accounts Rules 2011 to reflect the outcomes-focussed regulation which was introduced by the SRA in October 2011.

The SRA Accounts Rules 2011 are contained in the SRA Handbook (the Handbook), the current version of which is Version 18 and was published on 1 November 2016.

The Handbook sets out the principles which apply to all aspects of practice, including the handling of client money and law firms must:

- protect client money and assets;
- act with integrity;
- behave in a way that maintains the trust the public places in the firm and in the provision of legal services;
- comply with their legal and regulatory obligations and deal with regulators and ombudsmen in an open, timely and co-operative manner; and
- run the firm or carry out a role in the business effectively and in accordance with proper governance and sound financial and risk management principles.

Effective financial management

It goes without saying that a law firm must ensure that they have effective financial management processes in place which protect client money. To that end, Rule 1.2 spells out certain requirements which, if adhered to, will ensure that client money is safe. The rules refer to 'you' which is intended to be a 'catch all' to include partners, solicitors and other staff members of the law firm (see the Glossary to the SRA Handbook for the complete definition). Rule 1.2 says that *you* must:

(a) keep other people's money separate from money belonging to *you* or *your firm*;

(b) keep other people's money safely in a *bank* or *building society* account identifiable as a *client account* (except when the rules specifically provide otherwise);

(c) use each *client's* money for that *client's* matters only;

(d) use money held as *trustee* of a *trust* for the purposes of that *trust* only;

(e) establish and maintain proper accounting systems, and proper internal controls over those systems, to ensure compliance with the rules;

(f) keep proper accounting records to show accurately the position with regard to the money held for each *client* and *trust*;

(g) account for *interest* on other people's money in accordance with the rules;

(h) co-operate with the *SRA* in checking compliance with the rules; and

(i) deliver annual accountants' reports as required by the rules.

Scope of the reporting accountant's work

Professional bodies tend to view the work required in compiling a reporting accountant's report as high risk. This is because of the duty of care that is owed by the reporting accountant. Reporting accountants are under a duty, pursuant to Section 34(9) of the Solicitors Act 1974, and the terms of their engagement with the law firm, to report any instances of theft or fraud, or significant concerns about the fitness and propriety of the firm to hold client money.

The duty of care owed by a reporting accountant was tested in the case of *The Law Society v KPMG Peat Marwick and others*. In this case, the judge ruled that there was a duty of care owed by KPMG Peat Marwick (KPMG) to The Law Society. KPMG had prepared accountant's report for a firm of solicitors where fraud was being committed. Following discovery of the fraud, the firm's senior partner was handed a custodial sentence and the losses were paid to the clients from The Law Society Compensation Fund. The judge ruled that a duty of care was owed to The Law Society by KPMG because the loss was reasonably foreseeable as well as the fact that there was reasonable proximity between The Law Society and KPMG.

The SRA do not expect reporting accountants to check a firm's compliance with every rule, indeed reporting accountants need only assess compliance with:

- Rule 1 *The overarching objective and underlying principles*
- Rule 7 *Duty to remedy breaches*
- Rule 13 *Client accounts*
- Rule 14 *Use of a client account*
- Rule 17 *Receipt and transfer of costs*
- Rule 18 *Receipt of mixed payments*
- Rule 20 *Withdrawals from a client account*
- Rule 21 *Method of and authority for withdrawal from a client account*
- Rule 27 *Restrictions on transfers between clients*
- Rule 29 *Accounting records for client accounts*

Where the circumstances outlined in the following rules apply, the reporting accountant must also check for compliance:

- Rule 8 *Liquidators, trustees in bankruptcy, Court of Protection deputies and trustees of occupational pension schemes*
- Rule 9 *Joint accounts*
- Rule 10 *Operation of a client's own account*
- Rule 15 *Client money withheld from client account on client's instructions*
- Rule 16 *Other client money withheld from a client account*
- Rule 19 *Treatment of payments to legal aid practitioners*

Outcomes-focussed nature of the rules

The outcomes-focussed nature of the rules inherently means that, to a certain extent, they are less prescriptive than the previous Solicitors Accounts Rules 1998. Therefore, reporting accountants have to exercise more professional judgement than would have otherwise applied. To that end, the SRA have confirmed that they do not consider it appropriate to define the circumstances in which a reporting accountant should qualify the accountant's report.

Reporting accountants will now have to consider whether certain breaches of the rules give rise to a risk to client money. Previously, reporting accountants would have simply qualified the accountant's report where any breaches were noted. However, under the outcomes-focussed regulation, the SRA would expect the reporting accountant to consider qualifying the accountant's report where there is a risk to client money.

Furthermore, where the reporting accountant identifies a matter that he/she considers should be drawn to the SRA's attention, the report should also be qualified.

When to qualify the SRA Accountant's Report

The outcomes-focussed regulation now means reporting accountants will have to consider whether, or not, certain breaches give rise to the need to qualify the accountant's report. In areas where there is subjectivity or ambiguity, it is always advisable for the reporting accountant to document any decisions or conclusions they have reached.

The SRA no longer require unqualified reports to be submitted to them. Instead, the reporting accountant and the law firm are required to retain the completed accountant's report for a period of six years (this was increased from three years' previously). The SRA take the view that if they do not receive a report within six months from the law firm's reporting date, the report is unqualified. This does not, however, mean that a law firm does not have to get a report prepared (unless they are an exempt firm) and for those law firms who are duty-bound to obtain a reporting accountant's report, they must do so within six months of their reporting date. Sight of an accountant's report will be requested by the SRA during any routine monitoring visit unless the firm is exempt from the requirement to obtain a report.

Reports which are qualified must be submitted to the SRA within six months of the year-end. The SRA have issued guidance to reporting accountants on issues which may give rise to a qualified reports and these have been split into two distinctions: 'serious factors' and 'moderate factors'.

Serious factors

Serious factors are those whereby the presence of one, or more, is likely to be material and/or represent a significant weakness in the firm's systems and controls. This is likely to lead to a definite qualified report.

Examples of serious factors include:

- a significant and/or unreplaced shortfall on a client account, including client monies held elsewhere unless caused by bank error and rectified in a timely manner – this also includes client debit balances and office credit balances;
- evidence of wilful disregard for the safety of client money, for example deliberate overriding of the SRA Accounts Rules 2011 and/or Accounting Guidelines;
- actual or suspected fraud/dishonesty by managers or employees of the law firm;
- material breaches that have not been reported to the SRA in accordance with the Authorisation Rules or the separate duty to report serious failure to comply with the rules in the SRA's Handbook or serious misconduct by any person in accordance with Outcome 10.3 and 10.4 of the *Code of Conduct*;
- wholly inadequate, or no, accounting records maintained;
- significant failure to provide the reporting accountant with documentation requested;
- three-way client account reconciliations not being carried out; and
- the client account being used as a banking facility.

It is likely that the reporting accountant will qualify the report where any of the above serious factors are noted during the detailed fieldwork.

Moderate factors

Moderate factors are those factors which may be material and/or represent a significant weakness in the firm's systems and controls and lead towards a *potential* (not actual) qualification. Where the moderate factors are concerned the reporting accountant will have to exercise professional judgement and it is always advisable to document any conclusions or decisions made. Moderate factors include:

- a significant, fully replaced shortfall on a client account, including client monies held elsewhere, unless this has been caused by bank error and rectified in a timely manner (this also applies to client debit balances and office credit balances);
- actual or suspected fraud or dishonesty of third parties that may impact on the safe custody of client funds;
- material breaches that have not been reported to SRA within one month of identification in accordance with the Authorisation Rules;
- insufficient accounting records are maintained that are unreliable or not retained for six years;
- three-way client account reconciliations not regularly carried out at least every five weeks;
- a poor internal control environment;
- performance or review of the three-way client account reconciliations being rendered inadequate;
- longstanding residual balances owed to clients; and
- improper use of suspense accounts.

Changes to the SRA Accounts Rules 2011

Changes to the SRA Accounts Rules 2011 were introduced by the SRA in a three-tranche phase. Phase one made some minor changes to the format of the reporting accountant's report and also introduced some exemptions for certain firms from the requirement to obtain a reporting accountant's report. Phase one also removed the requirement for a law firm to submit an unqualified report to the SRA.

The second phase, which was implemented in November 2015, encouraged reporting accountants to apply an outcomes-based approach to the rules. This meant that reporting accountants are required to apply professional judgement with a greater focus on risks to client money. Phase two also introduced an exemption from the requirement to obtain an annual accountant's report for firms which have an average client balance of no more than £10,000 and a maximum balance of no more than £250,000 over the accounting period.

The third phase, announced on 1 June 2016, proposes some significant changes. By far the most notable proposed change relates to the handling of monies received to pay disbursements and monies received form clients for costs (especially on-account payments).

Treatment of disbursements

Under the current version of the SRA Accounts Rules 2011, monies which the firm receives in respect of unpaid professional disbursements are caught by the definition of client money and hence must be paid into a client account, unless covered by the limited exemption provided under Rule 17.1(b). The money must be held in client account until the disbursement is discharged.

The SRA are proposing that where the firm is responsible for discharging the disbursement (for example in respect of counsels' fees or medical report fees), the monies received from the client or third party would not be considered client money and hence should be paid into the 'business account' (the new name for the office account). Monies received in respect of disbursement where the client is responsible for discharging, such as Stamp Duty Land Tax and Estate Agent's fees in a conveyancing transaction will continue to be treated as client money and hence be placed in the client account until discharged.

This proposal is likely to be welcomed by many law firms, especially those which are involved in litigation work, because the receipt of such monies will boost the firm's cash flow. This is not without risk to the firm's clients and experts used by the firm, particularly where the law firm is in financial difficulty.

Treatment of costs

Under the current version of the rules, if a client makes a payment to the law firm on account of services yet to be rendered, that payment on account would be caught by the definition of client money and hence must be placed in the client account. If the client makes a payment to the law firm in respect of **agreed fees**, Rule 17.5 says that a payment in respect of an agreed fee (which is a fee that is fixed and cannot be varied upwards, nor a fee which is dependent on completion of the transaction) is office money and is paid into the office account.

The SRA propose to change the definition of client money so that on account payments are no longer caught. Therefore, when a client makes a payment on account of services yet to be rendered, it will be treated in the same as an agreed fee and should be placed in the office account.

While this is a proposal that most firms will welcome, as it will improve the firm's cash flow, it is not without risk. The consultation document issued by the SRA takes the view that those risks would be mitigated by encouraging a client to make an on account payment using a credit card so that they can take advantage of the protection offered under Section 75 of the *Consumer Credit Act 1974* for purchases between £100 and £30,000. The emphasis is, of course, on the use of a credit (not a debit) card as a debit card does not afford the same protection to the consumer.

Restrictions on the use of a client account

The SRA have raised the question of allowing non-client money to be paid into a firm's client account although they do conclude that they would prefer to keep things as they current are meaning that only client money can be placed into a client account. Clearly, from a 'housekeeping' perspective, maintaining the status quo would be beneficial.

This proposal is likely to create a problem for clients if the proposed new treatment of monies received for professional disbursements goes ahead. In the current version of the SRA Accounts Rules 2011, qualifying disbursements for VAT purposes can be paid from the client account and the cost is then passed onto the client without having to charge VAT. If the proposed change goes ahead and firms are to account for unpaid professional disbursements through the office account as an office liability, they will have no choice but to recover the input VAT on the disbursement and then add output VAT when invoicing clients. Essentially, this will mean that the cost to the client will increase by 20% where the supplier in question is not VAT registered (for example when the firm instructs junior counsel or medical experts).

Legal Aid Agency payments

The SRA are proposing to remove the provisions in the SRA Accounts Rules 2011 which are currently in place to deal with payments that a law firm receives from the Legal Aid Agency.

Concerns raised about the rules and expected implementation date

In October 2016, the SRA held their COLP and COFA conference in Birmingham. During that conference, the SRA announced that there would be no changes to the SRA Accounts Rules 2011 in respect of the phase three changes until 2018 at the earliest.

There have been a number of concerns raised, in particular by The Law Society, who are uncomfortable with the proposed treatment of on account costs and certain disbursements being treated as office money rather than client money.

Practitioners who are involved in the preparation of reporting accountant's reports are advised to keep abreast of developments in this area by regularly reviewing the SRA's website at www.sra.org.uk as any further changes to the rules will more than likely impact the way in which reporting accountants carry out their work.