AUDIT AND ACCOUNTING QUARTERLY UPDATE: QUARTER 2, 2020

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1 The impact of Covid-19 on financial reporting (Lecture A705 – 18.18 minutes)

Unsurprisingly, this quarter's course is predominantly about Coronavirus (Covid-19) and the impact that the pandemic will have on financial reporting. Businesses up and down the country have been hit hard by the virus and preparers will need to carefully assess how the effects of the pandemic affect the entity's financial statements.

1.1 Companies House filing deadlines

On 11 March 2020, Companies House issued guidance on what to do if a company is unable to file their accounts on time. This guidance can be found at: https://tinyurl.com/v68pmke. It is emphasised that the entity must act **before** the deadline date in order to be successful in applying for an extension.

Companies House have said that if a company is unable to file on time because it has been affected by Covid-19, it may make an application to extend the period allowed for filing. If an application for an extension has not been made and the company's accounts are filed late, an automatic penalty will be applied.

To apply for an extension you will need:

- The company number;
- Information as to why you need more time; and
- Any documents that support the application.

On receipt of the application, Companies House will make a decision and where they accept the application, they have said they will grant a three-month extension automatically (this was increased from two months on 25 March 2020). A further month delay is the maximum allowed under current rules. Companies House have confirmed that any information they receive will remain confidential. Decisions will be emailed to the applicant as to whether the application has been successful or not.

Where an application is successful, the entity must file their accounts before the new due date or a late filing penalty will be imposed. It is also worth noting that an accepted

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application does not change the due dates for future accounts to be sent to Companies House.

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1.2 Disclosing the effects of Covid-19 in the financial statements

Companies that have 2019 and 2020 reporting dates will need to carefully consider how the pandemic impacts their business and consider making disclosure of the impact in the annual report. FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Section 32 *Events after the End of the Reporting Period* will be relevant in these situations. FRS 102, Section 32 deals with 'adjusting' and 'non-adjusting' events and a company will need to consider whether Covid-19 gives rise to either event.

Where a company has, for example, a 31 December 2019 year end, the effects of Covid-19 would generally not be considered as a condition that existed at the balance sheet date because the virus itself was only discovered in January 2020. Where a company has a 31 January 2020 reporting date or subsequent, the effects of the virus could either be an adjusting or a non-adjusting event.

FRS 102, paragraph 32.2 says that:

FRS 102, para 32.2

'Events after the end of the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the ***financial statements*** *are authorised for issue. There are two types of events:*

(a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the end of the reporting period); and

(b) those that are indicative of conditions that arose after the end of the reporting period (non-adjusting events after the end of the reporting period).'

Non-adjusting event

As noted above, a non-adjusting event is an event that occurs between the balance sheet date and the date on which the financial statements are authorised for issue. Therefore, the conditions giving rise to the event did not exist at the balance sheet date

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and so are not recognised in the financial statements themselves. Non-adjusting events are disclosed in the financial statements where they are material.

Where management conclude that the effect of the virus is a non-adjusting event, no adjustments are made to the entity's assets or liabilities. Instead, the effect of Covid-19 is disclosed as a non-adjusting event if the entity considers it to be material (i.e. if non-disclosure would affect the ability of the user to make proper evaluations and/or decisions). Professional judgement will be needed in this area and where the entity is audited, the auditor must carefully consider whether any disclosures made in the financial statements are adequate. Inadequate disclosures give rise to a potential modification to the audit opinion.

In respect of non-adjusting events, FRS 102, para 32.10 requires an entity to disclose (for each category of non-adjusting event):

FRS 102, para 32.10 (a) and (b)

'(a) the nature of the event; and

(b) an estimate of its financial effect or a statement that such an estimate cannot be made.'

Adjusting event

Adjusting events are those which provide evidence of conditions which existed at the balance sheet date and are more likely to affect companies with 31 January 2020 year ends onwards. FRS 102, para 32.4 says:

FRS 102, para 32.4

'An entity shall adjust the amounts recognised in its financial statements, including related disclosures, to reflect adjusting events after the end of the reporting period.'

Hence, the financial statements are adjusted to reflect adjusting events because their conditions were in existence at the balance sheet date.

The pandemic will give rise to the need to consider a number of factors, including:

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- Which assets are likely to be impaired as a consequence of the virus? It may be the case that additional assets will need to be tested for impairment (see section 2 of these notes) as a result of the virus because they are showing indicators of impairment. Management should consider whether non-financial assets such as property, plant and equipment, intangible assets and goodwill are showing indicators of impairment.

- Does the entity need to make additional provisions? For example, have contracts become onerous as a result of the virus?

- Does the entity need to consider writing down financial assets (e.g. recognising specific bad debts). Please note that **general** bad debt provisions are not allowed under FRS 102.

- Have any fair values that are recognised in the financial statements been appropriately determined?

- Are employee benefits affected, such as defined benefit pension schemes and remuneration packages?

- Is the entity a going concern? The pandemic may give rise to the going concern basis of accounting no longer being appropriate. Under FRS 102, a basis other than the going concern basis needs to be applied when use of the going concern basis of accounting is not appropriate. Section 3 of these notes examine Covid-19 and going concern implications.

- If the entity has received government assistance, how is this to be accounted for in the financial statements? If government assistance meets the definition of a 'government grant', then it will need to be accounted for under the provisions of FRS 102, Section 24 *Government Grants*. For clarity, the definition of 'government grant is:

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

FRS 102 Glossary ***government grant***

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

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2 Impairment of assets (Lecture A706 – 12.13 minutes)

During the pandemic business interruption is at an all-time high. Because of the challenging times we are in, there will invariably be some assets which are showing indicators of impairment, hence may need to be written down to recoverable amount by way of an impairment loss. This is likely to be the case with an asset such as goodwill in the group accounts where a subsidiary has been significantly affected by the effects of Covid-19.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with impairment of assets in Section 27 *Impairment of Assets*. FRS 102, Section 27 also includes requirements for inventory and goodwill impairment.

It is important to understand the order of events where impairments are concerned. **First**, the entity needs to assess whether an asset is showing indicators of impairment. **Second**, if the asset is showing indicators of impairment, recoverable amount will need to be calculated. If the asset is not showing indicators of impairment then recoverable amount does not need to be established (FRS 102, para 27.7). The key issue to emphasise is that a review for impairment has to be carried out at each balance sheet date but that does not mean an impairment test has to be carried out. An impairment test involves comparing recoverable amount to the asset's carrying amount to see if recoverable amount is lower than carrying amount. If recoverable amount is lower than carrying amount, the asset is impaired and is written down to recoverable amount.

FRS 102 defines 'recoverable amount' as:

FRS 102 Glossary ***recoverable amount***

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

Where an impairment loss is required, it is recognised in profit or loss.

2.1 Goodwill

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

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

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

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

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

Examples of CGUs include:

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

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

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

FRS 102, para 27.26 says:

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

FRS 102, para 27.26

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

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

Example – Notionally adjusted goodwill

Topco Ltd owns 80% of Subco Ltd and the group has an accounting reference date of 31 March each year. On 31 March 2020, the carrying amount of Subco's net assets were £880,000, excluding goodwill of £120,000 (net of amortisation). Due to the coronavirus, management have decided that they will have to restructure the group and announced this restructuring exercise immediately prior to the reporting date. The finance director has calculated recoverable amount of Subco's net assets to be £950,000.

FRS 102, paragraph 27.26 requires Topco to notionally adjust the goodwill to take into account the NCI. The impairment loss is calculated as follows:

	£'000	£'000
Goodwill	120	
Unrecognised NCI (£120 x 20/80)	30	
Notionally adjusted goodwill		150
Net assets		880
Carrying amount		1,030
Recoverable amount		(950)
Impairment loss		80

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

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

2.2 Other considerations for CGUs

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

FRS 102, para 27.21

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

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

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

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

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

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

(c) zero.

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

Example – Allocating an impairment loss

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

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

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

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

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

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

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

The impairment is allocated as follows:

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

2.3 Reversing an impairment loss

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

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

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

Example – Prior period impairment loss based on an individual asset

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

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

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

The finance director should record the impairment loss as follows:

Dr Property, plant and equipment	£45,000
Cr Profit and loss	£45,000

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

In the example above, the reversal had been recognised immediately in profit and loss. The exception to this rule would be where the asset had been subject to the revaluation

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

Recoverable amount estimated for a cash-generating unit

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

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

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

(b) If the estimated recoverable amount of the cash-generating unit exceeds it carrying amount, that excess is a reversal of an impairment loss.

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

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

(i) its recoverable amount; and

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

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

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

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

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

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

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

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

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3 Covid-19 and going concern (Lecture A707 – 24.14 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* requires management to prepare an entity's financial statements on a going concern basis unless management intends to liquidate the entity, cease trading or has no realistic alternative but to do so (FRS 102, para 3.8).

The impact of Covid-19 is likely to impact many entities and also may call into question whether an entity can continue as a going concern for the foreseeable future. FRS 102 requires management to carry out an assessment of an entity's ability to continue as a going concern and where there are material uncertainties related to going concern, FRS 102, para 3.9 requires disclosure of those material uncertainties.

The approach taken by FRS 102 is to use the going concern basis of accounting as a 'default' – in other words, even if the company is experiencing significant cash flow difficulties and has sustained a loss, the going concern basis of accounting is still used unless management either intends to liquidate the entity, cease trading or has no realistic alternative but to do so.

Note – the standard only refers to circumstances of liquidation or cessation of trade as a reason to **not** use the going concern basis of accounting. In the absence of such intentions, management will continue to prepare the accounts on a going concern basis but will then disclose any material uncertainties.

Given the unpredictability of the Covid-19 outbreak, there may be material uncertainties that cast significant doubt on the entity's ability to continue as a going concern. Disclosure of such material uncertainties will be required in order to make it clear to the users that the going concern basis is subject to such material uncertainties.

3.1 Small companies

Small companies choosing to report under FRS 102, Section 1A *Small Entities* are encouraged to disclose material uncertainties related to going concern (FRS 102, para 1AE.1(c)). This does not relieve the directors from their duties to carry out an assessment of whether the entity can adopt the going concern basis of accounting in preparing its financial statements – this must still be done.

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Where a small company has identified material uncertainties related to going concern, it would be encouraged to disclose these uncertainties in order that the financial statements give a true and fair view. As going concern has such a material and pervasive impact on the financial statements, it would be difficult to justify a true and fair view is presented where any material uncertainties related to going concern are not disclosed. Where the small entity has an audit (e.g. a voluntary audit or because one is mandated by a shareholder or financier), any non-disclosure of material uncertainties related to going concern could (and is likely to) impact the auditor's opinion, which may be modified accordingly.

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3.2 Measurement

When management are making their assessment of the entity's ability to continue as a going concern, it must take into consideration the effect (and potential effect) of Covid-19 in determining the appropriateness of the going concern basis of accounting.

The disruption caused by Covid-19 has meant that many businesses have had to close until such time as the UK government announces a lifting of restrictions for certain workplaces (e.g. hospitality businesses that are not due to open until Stage 3 of the government's current plan which is scheduled to happen no earlier than 4 July 2020). This means that operations will have had to cease which, in turn, has a detrimental impact on profitability and liquidity. Management will have to carefully consider how the pandemic has impacted on profitability and liquidity and hence whether the going concern basis of accounting is appropriate. In more serious cases, the going concern basis of accounting will not be appropriate even despite the support provided by government during the pandemic (e.g. the Coronavirus Job Retention Scheme, Bounce Back Loans or the Coronavirus Business Interruption Loan Scheme).

3.3 Period of assessment

FRS 102, para 3.8 says:

'In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue.'

FRS 102, para 3.8

The requirements of FRS 102 are more onerous than their international equivalents which some accountants may be familiar with. IAS 1 *Presentation of Financial Statements* requires management to conduct a going concern assessment for a period of at least 12 months from the balance sheet date.

There is, therefore, a notable difference between UK GAAP and IFRS in that UK GAAP requires the going concern assessment to be **at least, but not limited to, 12 months from the date the financial statements are authorised for issue**.

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The wording '… not limited to' means that even if the directors do not intend to cease trading for, say, 18 months after the date the financial statements are authorised for issue, the financial statements should still not be prepared on a going concern basis. This is because going concern is a forward-looking concept and there is no limit as to how long management look forward in assessing going concern.

Management often use budgets and forecasts prepared for some time after the reporting date. Given the impact of the pandemic, it is likely that these budgets and forecasts may well be irrelevant or need to be significantly changed.

3.4 Indicators of material uncertainties related to going concern

In today's climate, even previously profitable companies can find that they now have material uncertainties related to going concern. Keep in mind that uncertainties are considered to be material if their disclosure could reasonably be expected to affect the decision-making process of the users (including the shareholders) of the financial statements. This is, of course, a wholly judgemental issue.

The following is a non-comprehensive list of examples of indicators that an entity has material uncertainties related to going concern:

Indicator	Why it is an issue
The balance sheet shows a net current liabilities or net liabilities position	This indicates the entity may be unable to meet debts as they fall due
The bank does not renew borrowing facilities or does not approve a Bounce Back Loan or Coronavirus Business Interruption Loan	A lack of cash makes it difficult for a company to pay suppliers, employees and other liabilities
Loan agreements have been breached	Breaches of a loan agreement may trigger immediate repayment of the loan hence placing additional pressure on cash flow
Staff are not paid on time	This indicates a lack of working capital and potential loss of employee goodwill
Legal claims have been brought against the entity	If successful, these claims may result in significant cash outflows thus placing additional pressure on working capital
Loss of key staff	This may make it difficult for the entity to trade
Changes in law and regulation	Such changes may make it costlier for the business to comply and the costs of compliance may be more than the company can realistically afford
Withdrawal of credit facilities by suppliers or a failure to obtain credit	This indicates a bad credit-rating which usually arises from a failure to pay

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	liabilities
Missing payments to HMRC	Payments to HMRC should be prioritised and any missed payments may indicate the company has a lack of working capital
Negative cash flows	This indicates overtrading
Significant bad debts	Significant bad debts will place pressure on cash flow resulting in an inability to meet its liabilities
Successful competitors	These will have a detrimental impact on revenue if customers decide to buy from the competitor
Uninsured catastrophes	A fire or a flood or other disaster which is uninsured may mean the company cannot survive
Major technological change	An inability to keep up with major technological changes or an inability to afford to keep up with such changes may result in a loss of customers and inventory obsolescence

3.5 Going concern basis is appropriate but a material uncertainty exists

The vast majority of businesses will be affected by the impact of Covid-19 to some extent. Where management have concluded that the going concern basis of accounting is appropriate but a material uncertainty related to going concern exists, they are required to disclose the material uncertainty.

Example – Going concern uncertainty
The financial statements of Currie Ltd for the year ended 31 March 2020 are going to be authorised for issue on 25 June 2020. During the lockdown the company lost a number of contracts that are unlikely to return. The company has so far been unsuccessful in applying to lenders for the loan schemes put in place by the government due to a poor credit-rating. The company's overdraft facility (on which the company is currently reliant) is due for renewal on 31 July 2020 and the bank has not yet given any indication as to whether, or not, the overdraft facility will be

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renewed.

If the company had received indications that the overdraft facility was going to be renewed, the directors may conclude that there is no material uncertainty related to going concern. However, the fact that the bank has not given any indications of continued support (which the company is currently reliant on), disclosure of a material uncertainty related to going concern will be needed.

If Currie Ltd is a small company reporting under FRS 102, Section 1A, then it would be encouraged to make such disclosures (FRS 102, para 1AE.1(c)).

3.6 Going concern basis is not appropriate

Unfortunately in today's climate, business casualties are expected. Many are expecting this to be the case even after the Covid-19 outbreak has settled with some economists forecasting a deep recession. Therefore it is expected that many entities will consider the going concern basis of accounting to be inappropriate in their circumstances.

FRS 102, para 3.8 states that an entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

When the going concern basis of accounting is inappropriate, UK GAAP does not specify on which basis the financial statements should be prepared. The standards do require a basis other than the going concern basis of accounting to be applied when management intend to liquidate, cease trading or have no realistic alternative but to do so.

Many accountants are nonetheless familiar with the concept of the 'break-up basis'. Under this basis, assets are restated to recoverable amount and long-term liabilities are restated as current, with provisions being made for unavoidable costs under onerous contracts and the costs of winding the business up. Hence, the accruals concept becomes secondary because under the break-up basis, the financial statements reflect a forecast of future realisation rather than how the business has performed up to, and its financial position as at, the balance sheet date.

The break-up basis will only be used in very rare situations as it is not compliant with the normal recognition and measurement principles of FRS 102. However, FRS 102 states

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that the entity must not prepare its financial statements on a going concern basis if management intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

FRS 102 and FRS 105 normally require the financial statements to reflect the transactions, events and conditions which have arisen up to, and exist as at, the reporting date. However, if an entity determines **after** the year end that it intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so, it shall not prepare its accounts on a going concern basis (FRS 102, para 32.7). In this way, what would normally be a non-adjusting event because it occurs after the balance sheet date, becomes an adjusting event if it means the entity is no longer a going concern. This is a necessary exception because, as explained earlier, going concern is a forward-looking concept.

Example – Going concern basis is inappropriate

A company is preparing its financial statements for the year ended 31 March 2020. Due to the impact of Covid-19, the loss of a number of significant contracts and an inability to secure additional financing, the directors have decided to cease trading on 31 August 2020. The following note illustrates the wording that may be used in the Basis of Preparation of the Financial Statements paragraph included within the accounting policies note:

As explained in note X to the financial statements, the company will cease trading on 31 August 2020 and the financial statements have been prepared on a basis other than that of the going concern basis. This basis includes, where applicable, writing the company's assets down to net realisable value. Provisions have also been made in respect of contracts which have become onerous at the reporting date. No provision has been made for the future costs of terminating the business unless such costs were committed at the reporting date.

3.7 Summary of reporting requirements

In 2016, the FRC published *Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks*. This guidance is non-mandatory but is intended to serve as best practice for directors in assessing the going concern ability of an entity. Companies which are required, or choose to voluntarily apply, *The UK Corporate Governance Code* are excluded from the scope of this guidance.

The guidance states that there are three scenarios which can be identified when concluding on the entity's ability to continue as a going concern for the foreseeable future as follows:

Situation	Basis of accounting	Disclosure requirements
The going concern basis of accounting is appropriate and there are no material uncertainties	The directors should use the going concern basis of accounting when preparing the financial statements	No specific disclosure requirements for the financial statements
The going concern basis of accounting is appropriate but there are material uncertainties related to events or conditions that may cast significant doubt upon the company's ability to adopt the going concern basis of accounting in the future	The directors should use the going concern basis of accounting when preparing the financial statements	When the directors are aware, in making their assessment, of material uncertainties related to events or conditions that cast significant doubt upon the company's ability to continue to adopt the going concern basis of accounting, the entity shall disclose those uncertainties
The going concern basis of accounting is not appropriate	The directors should use a basis other than that of the going concern basis of accounting when preparing the financial statements	When a company does not prepare financial statements on a going concern basis of accounting, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the going concern basis of accounting is inappropriate

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4 Provisions and contingencies (Lecture A708 – 21.50 minutes)

In practice, the issue surrounding provisions for assets and liabilities and contingent assets and liabilities can be a complex one. Care needs to be taken to not only account for provisions and contingencies correctly, but also to recognise any provisions at an appropriate amount; particularly where there may be associated tax implications as HM Revenue and Customs (HMRC) may disallow excessive provisions where tax relief has been obtained on such provisions. With interest and penalties potentially being levied by HMRC, excessive provisions can prove costly.

The impact of Covid-19 is likely to result in additional provisions being recognised in the financial statements (e.g. for onerous contracts) so it is appropriate that we examine the concepts included in UK GAAP where provisions and contingencies are concerned.

The requirements for provisions and contingencies are outlined in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 21 *Provisions and Contingencies*.

4.1 Provisions for liabilities

FRS 102 defines a 'provision' as:

FRS 102 Glossary ***provision***

'A ***liability*** *of uncertain timing or amount.'*

In accounting, the term 'provision' is interchangeable; for example, a 'provision for bad debts' or 'provisions for depreciation'. In these contexts, the term 'provision' is the adjustment to carrying values in the financial statements rather than in the same context as that used in Section 21 as a provision for a liability.

The fact that there is uncertainty in respect of the timing and amount of the liability is why it is important to ensure that any provisions made in the financial statements would be able to stand up to scrutiny in the event, for example, of a HMRC enquiry into the entity's corporation tax return.

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There are three criteria which have to be met before a provision can be recognised in the financial statements:

1. The entity must have a present obligation that has arisen because of something that has occurred in the past.

2. It is more likely than not that the entity will have to transfer some economic benefit (e.g. cash or another form of asset) in order to settle the obligation.

3. The amount of the obligation can be measured with some degree of reliability (i.e. a reliable estimate can be made).

Where any of the above criteria **cannot** be met, a provision is not recognised in the financial statements. Instead, a contingent liability will be disclosed (if material).

All three criteria have to be met (it is not one or two out of the three). This is to stop companies from deliberately recognising provisions that are unlikely to crystallise. Prior to the introduction of accounting standards in this area, it was not uncommon for companies to deliberately manipulate the profit (or loss) of a business by creating or releasing provisions that effectively would not crystallise. This act of manipulation was coined 'big bath accounting' or 'big bath provisioning' and worked by focussing on the profit or loss of the business first and then working upwards through the profit and loss account until a desired profit or loss figure was arrived at. The requirement to meet all three criteria was designed to outlaw the act of big bath provisions.

4.2 Creation of an 'obligation'

Not all obligations will give rise to a provision being recognised in the financial statements. Only those obligations which exist at the balance sheet date that have arisen as a result of a past event will give rise to a provision. This means that the reporting entity has no realistic alternative to settling the obligation which can be created in one of two ways:

- by way of a **legal** obligation; or
- by way of a **constructive** obligation.

Legal obligation

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A legal obligation is one which can be enforced by law. It will usually be obvious when a company has a legal obligation, for example by way of agreement or a court order. Provisions can also be made for normal day-to-day transactions, such as a provision for goods and/or services received by the period-/year-end but not yet invoiced; i.e. an accrual.

In terms of Covid-19, some contracts may now become loss-making meaning that a provision may be required. In addition, some contracts may make provision for compensation to be paid for delays or non-performance (although some entities will be using their own discretion when it comes to levying such penalties in light of the fact that Covid-19 and the effects thereof are unavoidable).

It must be emphasised that a business cannot base a provision on its future actions. FRS 102, para 21.6 is strict on its approach to an entity's future actions because such actions do not meet the definition of a provision and the entity has not got an obligation at the balance sheet date for its future actions, regardless of how likely or unlikely they are to occur. An obligation arises because of an obligating event and hence it follows that the obligating event must have occurred at, or by, the balance sheet date in order to give rise to a provision.

Example – No obligating event

In 2016, legislation was passed which requires an entity operating in the chemical industry to reduce its effluent levels by 40% by 31 October 2018 which means investing in additional denitrification processes (the process by which nitrogen is removed from water).

At 31 December 2018, which is the company's year end, the entity had not done anything to reduce its effluent levels. The financial controller has included a provision for the costs that she estimates will be needed to complete the work.

The provision should not be included in the accounts to 31 December 2018. This is because there is no obligating event (the investment in the additional denitrification processes).

At 31 December 2019 the company had still not made any attempts to reduce its effluent levels. The financial controller has made a provision again on the grounds that the date has now passed for the company to have completed this work.

There is still no obligating event at the year end 31 December 2019 because the company has still not done anything to invest in additional denitrification costs. The company may need to make a provision for fines and penalties for non-compliance with the legislation but this would only be the case if it were to be probable that such fines and penalties will be imposed and a reliable estimate could be made of the

penalties. There is an obligating event in respect of the fines and penalties which is the non-compliance with the legislation.

Constructive obligation

A constructive obligation arises when an entity creates an expectation in the mind-sets of others that it will discharge its obligations. This usually arises because of the entity's past practice, published policies or by way of a specific statement.

Example – Constructive obligation

A retailer of office equipment has a sign above its cash desk informing customers that it will give refunds on goods purchased provided the item is returned within 14 days from the date of purchase. This applies regardless of whether the goods are faulty or not.

In this example, the published policy of the retailer goes over and above any legal obligation but a constructive obligation arises from the retailer's established published practice. Conversely, any ad-hoc refunds would be less clear in establishing any obligation.

Extra care should be taken where constructive obligations are concerned because these are less clear-cut than legal obligations and in order for a constructive obligation to be recognised as a provision in the financial statements, an expectation must be created in the mind-sets of those affected that the entity will discharge its obligations.

4.3 Onerous contracts

An 'onerous contract' is defined in the Glossary to FRS 102 as:

FRS 102 Glossary ***onerous contract***

'A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.'

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The unavoidable costs under a contract reflect the least net cost of exiting from the contract. This is the lower of fulfilling the contract and any compensation or penalties arising from a failure to fulfil it.

In a Covid-19 climate, there are many contracts which could (or will) become onerous so such transactions are likely to be more common in financial statements for 2020 year ends.

When an entity has a contract that is onerous, FRS 102, Section 21 requires the entity to recognise and measure the present obligation under the contract as a provision. FRS 102, para 21A.2 cites an example of an entity that may be contractually required under an operating lease to make payment to lease an asset for which it no longer has any use.

A significant impact of Covid-19 is the impact it has had on the global supply chain.

Example – Onerous contract in the Covid-19 pandemic
Tasi Ltd is in the manufacturing industry. It has a contract with a major customer to sell certain products at a fixed price. Due to the government's lockdown, it has had to close its manufacturing division and therefore cannot deliver the goods itself without purchasing them from another supplier at a significantly higher cost. In this example, the provision for the onerous contract will reflect the lower of the penalty for terminating the contract or the present value of the cost of fulfilling the contract. This is the excess of the cost to purchase the goods over the consideration to be received. If, on the other hand, the contract could be cancelled whilst the lockdown is in place without paying any compensation to the other party, the contract does not become onerous and there is no obligation.

During the pandemic, entities will need to carefully review their contracts to establish if there are any special terms that may relieve the entity of its obligations (such as *force majeure* clauses).

4.4 Restructuring provisions

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Some businesses may find themselves having to restructure due to the pandemic – particularly where the virus has had a serious impact on business operations. A 'restructuring' is defined in FRS 102 as follows:

FRS 102 Glossary ***restructuring***

'A restructuring is a programme that is planned and controlled by management and materially changes either:

(a) the scope of a ***business*** *undertaken by an entity; or*

(b) the manner in which that business is conducted.'

A restructuring gives rise to a constructive obligation (see 4.2 above), hence the need to recognise a provision, only when the entity:

FRS 102, para 21.11C (a) and (b)

'(a) has a detailed formal plan for the restructuring identifying at least:

(i) the business or part of a business concerned;

(ii) the principal locations affected;

(iii) the location, function, and approximate number of employees who will be compensated for terminating their services;

(iv) the expenditures that will be implemented; and

(v) when the plan will be implemented; and

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.'

FRS 102, paragraph 21.11D then clarifies that an entity recognises a provision for restructuring costs only when it has a legal or constructive obligation at the balance sheet date to carry out the restructuring.

In practice, the plan itself does not have to be in so much detail that it identifies each employee whose services will be terminated. The plan should be detailed enough that it at least identifies a group of employees who will be directly affected by the restructuring plan. Generally, the entity would have to at least have set out the main features of the plan to those affected in order to create a constructive obligation.

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Example – Sale of an operation

Lineham Ltd manufactures four products in different divisions of its manufacturing premises. Each division is a cash-generating unit in its own right. One of the divisions has been loss-making for a couple of years and now due to the pandemic, the directors have decided to sell that division as it is unlikely that demand for its products will be high once lockdown restrictions have been lifted.

The question arises as to whether the sale of this division creates an obligation.

FRS 102 does not go into specific detail relating to the sale of an operation as part of a restructuring plan. Management does not have to default to IFRS if it does not wish to, but IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* confirms that no obligation would arise for Lineham Ltd until the entity is committed to the sale; in other words, there is a binding sales agreement. Until such an agreement is entered into, Lineham could change its mind or choose another course of action if a willing buyer cannot be found.

Where the sale of an operation or a division is only one aspect of a restructuring plan, a constructive obligation may arise for the other aspects of the plan before a binding sale agreement is entered into. This would trigger an impairment test of the assets relating to the operation to be disposed of.

Example – Creation of a constructive obligation in a restructuring plan

Austin Ltd has five branches spread across the UK and the company has an accounting reference date of 31 March. Over the last two years the depots in Tyneside and Hull have been sustaining heavy losses and have now closed due to the pandemic. The directors have taken the decision not to reopen these depots once lockdown restrictions are lifted and have taken the decision to transfer operations to its head office located in Glasgow. This decision was taken by the board on 26 March 2020.

The restructuring plan was communicated to all staff in the Tyneside and Hull depots on 26 March 2020 and staff were given redundancy notices. Both depots will close officially on 1 June 2020 and the payroll department has been able to calculate the value of the termination payments that will be paid to those staff who will be made redundant.

In addition, the depot in Hull is rented via an operating lease and the agreement is due to end on 31 January 2023. The landlord of the premises has agreed that Austin can come out of the lease on 1 June 2020 provided they pay an early termination fee of £35,000 to which the directors have agreed.

A provision for restructuring should be made in the 31 March 2020 financial statements for the total amount of the termination costs which the company will incur in closing both depots. In addition, the company should also make a provision for the £35,000 early termination fee which is to be paid to the landlord of the Hull branch as this represents the minimum expected obligation and arises as a direct result of the restructuring. This is because a valid expectation has been created in the mind-sets of those affected (the employees and the landlord) that the company will discharge its

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obligations.

4.5 Recognition of a provision in the financial statements

As noted earlier, the impact of Covid-19 is likely to result in more provisions for liabilities being recognised in the financial statements, so it is worthwhile revisiting the accounting requirements for them.

FRS 102 says that where a provision meets the recognition criteria, it must be recognised at the best estimate of the amount that will be required to settle the obligation. FRS 102, para 21.7 clarifies that the 'best estimate' is the amount an entity would rationally pay to settle the obligation at the balance sheet date, or to transfer it to a third party at that time.

As a provision is an estimate of the amount that an entity would rationally pay to settle or transfer the obligation, it does not have to be recognised in respect of actual cash outflows. Instead, the provision is recognised at the amount that *could* be settled in respect of liabilities arising at the balance sheet date.

When a provision involves a large population of items, the estimate must reflect the weighting of all possible outcomes by their associated probabilities.

Example – Provision for defective goods

Mamo Ltd is a well-established company sells electrical products such as dishwashers, washing machines, TV and audio equipment. It sells goods to the general public with a warranty which covers customers for the costs of repair that occur during the first six months from the date of purchase. The company is preparing its financial statements for the year ended 31 December 2019 and calculations carried out by the financial controller suggest that if all the products sold contained minor defects, the costs of repair would be £1 million. If major defects occurred in all the products, the costs of repair would be £4 million.

Management have concluded that past experience, and future expectations, suggest that for the coming year 75% of the goods sold will contain no defects; 20% will contain minor defects and 5% will have major defects.

The provision for the year is calculated as follows:

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	£
75% x nil	nil
20% x £1 million	200,000
5% x £4 million	200,000
Total provision	400,000

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Example – Single obligation

Roby Ltd is preparing its financial statements for the year ended 31 March 2020. Due to the Covid-19 pandemic, it has been unable to fulfil a large contract for one of its major customers. The customer has also suffered a loss and has made a claim for losses against Roby Ltd. The legal advisers acting for Roby have said there is 40% chance of successfully defending the claim with no costs or damages to pay, but there is a 60% chance that Roby will have to pay costs of £500,000 due to the wording of the contract.

Roby would not be able to use an expected value in this example, i.e. £300,000 (£500,000 x 60%) because the legal advisers have stated that they will either successfully defend the claim with no costs to pay, or be found liable and have costs to pay of £500,000. Hence the results are either £nil or £500,000. As it is more likely than not that Roby will have to pay costs of £500,000, this should be the value of the provision in the financial statements as at 31 March 2020.

4.6 Changes to the status of a provision

The definition of a provision is a liability of uncertain timing or amount. The fact that the liability is uncertain in terms of its timing and amount distinguishes it from other liabilities (e.g. trade creditors, sundry creditors and such like). However, over time, facts and circumstances can change and it may be the case that the amount payable under the obligation becomes certain. When this happens, the amount previously recognised as a provision should be reclassified to an appropriate category within liabilities (e.g. trade creditors or sundry creditors). Reclassification is necessary in these circumstances because the liability no longer meets the definition of a provision.

4.7 Contingent liabilities

Contingent liabilities are not recognised in the financial statements because they fail to meet the recognition criteria for a provision. There is, however, one exception to this rule which applies to contingent liabilities which have been assumed by the acquirer of an acquiree in a business combination and for which paragraphs 19.20 and 19.21 of FRS 102 apply (Section 19 deals with business combinations and goodwill).

Contingent liabilities are disclosed in the notes to the financial statements, unless the possibility of an outflow of economic benefit resources is considered to be remote.

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Example – Contingent liability

Taylor Ltd has made a provision for damages amounting to £10,000 in its financial statements for the year ended 31 March 2020 in respect of a legal claim brought against the company by one of its customers for non-compliance with contractual terms of a service contract. The non-compliance was due to government restrictions as a result of the Covid-19 pandemic.

The legal advisers have advised the company that at the reporting date, they are uncertain as to the potential outcome of the case because the wording of the contract has been poorly drafted. The case is considered to be material to the company.

Taylor Ltd should not recognise a provision for damages because it is not 'probable' that an outflow of resources will be required to settle the case. The legal advisers are unsure as to the outcome of the case. In such situations, disclosure of a contingent liability in the notes to the financial statements should be made because the case is considered to be material to the company.

4.8 Contingent assets

A contingent asset is directly the opposite of a contingent liability and, again, is not reflected in the financial statements of the reporting entity. Contingent assets will only be recognised in the financial statements if it is 'virtually certain' that an entity will realise the contingent asset (for example, an insurance company agreeing to pay out a claim to the company). The recognition criterion is stricter because of the underpinning principle in financial reporting that assets cannot be stated in an entity's balance sheet at any more than recoverable amount.

4.9 Offsetting provisions

There may be occasions when a company has to recognise a provision for liabilities in its financial statements as the recognition criteria have been met, but that liability will be reimbursed by a third party (such as an insurance company).

In these cases, it is important that the entity recognises the asset and the liability separately; they must **not** be offset in the balance sheet because this would mean assets and liabilities are both understated; thus presenting a misleading financial position. Section 21 does, however, allow the expense relating to the provision in the profit and loss account to be offset, thus presenting the expense net of the reimbursement in the profit and loss account.

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4.10 Disclosures for provisions

The disclosure requirements in respect of provisions are outlined in paragraph 21.14 of FRS 102.

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For each class of provision, the financial statements should disclose:

(a) a reconciliation showing:

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

(ii) additions to the provision during the period, including any adjustments that have arisen due to changes in measuring the discounted amount;

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

(iv) unused amounts which have been reversed during the period;

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

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

(d) the value of any expected reimbursement – this should also state the amount of any asset that has been recognised for the reimbursement.

Comparative information for previous periods is not required.

Remember that where estimates are involved, unless a small company is applying the presentation and disclosure requirements of FRS 102, Section 1A, it must disclose information about key sources of estimation uncertainty and about significant judgements (FRS 102 8.6 and 8.7). Whether a contingent liability or provision exists, or how much that amount is may well be areas where such disclosures are required.

4.11 Disclosures for contingent liabilities

The disclosure requirements for contingent liabilities are outlined in FRS 102, paragraph 21.15.

FRS 102 requires, for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of the contingent liability's financial effect;

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

(c) the possibility of any reimbursement.

Where a reporting entity is unable to make one, or more, of these disclosures, it must state that fact.

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4.12 Disclosures for contingent assets

FRS 102, paragraph 21.16 requires an entity to disclose a description of the nature of the contingent assets as at the reporting date. In addition, and when practicable, the entity should also provide an estimate of their financial effect. Where it is not practicable to provide an estimate of their financial effect, that fact should be stated.

4.13 Prejudicial disclosures

FRS 102, paragraph 21.17 addresses the issues concerning prejudicial disclosures. These are where any disclosures made to comply with the requirements of the standard could be expected to seriously prejudice the position of the entity involved in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset.

Paragraph 21.17 is heavily restrictive in that it says 'In extremely rare cases …'. The term 'extremely rare cases' is not defined in FRS 102 and in real life, there are a wide range of circumstances where entities may be in negotiation with third parties in respect of a provision, contingent liability or contingent asset. The key point to emphasise is that paragraph 21.17 concerns **disclosure requirements only**. It follows, therefore, that paragraph 21.17 does not exempt a reporting entity from making, say, a provision for a liability. It might also be the case that a provision for liability is reimbursed from a third party (such as an insurance company) and where this is the case and a reimbursement asset has been recognised on the grounds that its receipt is virtually certain, the prejudicial disclosure exemption may extend to the reimbursement asset (although a reporting entity would disclose which asset balance is affected).

The prejudicial disclosure exemption will not be available in respect of the provision, contingent liability or contingent asset once the dispute has been resolved.

Prejudicial disclosures: provisions

FRS 102 requires at least the following where provisions are covered by the prejudicial disclosure exemption:

FRS 102, para 21.17

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

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

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

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Prejudicial disclosures: contingent liabilities

FRS 102 requires at least the following where contingent liabilities are covered by the prejudicial disclosure exemption:

FRS 102, para 21.17

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

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

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

(ii) any subsidiary of the entity; or

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

shall each be stated separately; and

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

Prejudicial disclosures: contingent assets

FRS 102, para 21.17 requires an entity to disclose the general nature of the dispute, together with the fact that, and the reason why, the information required by paragraph 21.16 has not been disclosed.

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5 The impact of Covid-19 on charity reporting (Lecture A709 – 10.25 minutes)

The impact of Covid-19 (Coronavirus) has been significant, placing significant pressure on businesses throughout the country through 'lockdown' restrictions. Despite lockdown restrictions easing, at the time of writing there is still a long way to go and so there is disruption among businesses, including charities

.

5.1 Financial support for charities

Like businesses, charities have been hit hard where the impacts of Covid-19 are concerned and are currently subject to the same restrictions that for-profit entities are subject to. On Wednesday 8 April 2020, the Chancellor announced a £750 million package of support to frontline charities across the UK to ensure that they can continue their work during the pandemic. This includes hospices and those which support domestic abuse victims. In addition, the Chancellor said government would also provide:

- £360 million direct from government departments and £370 million for smaller charities, including through a grant to the National Lottery Community Fund; and
- government matched donations to the National Emergencies Trust as part of the BBC's *Big Night In* fundraiser that took place in April 2020 – pledging a minimum of £20 million.

All charities are advised to see whether they can get access to these measures provided by government to help them through the pandemic.

5.2 Use of unrestricted and restricted funds

Some charities will maintain unrestricted funds which can be spent at the discretion of the trustees provided they are in line with the charity's objects outlined in the governing document. Restricted funds are funds that can only be spent on a specific purpose (usually as defined by the donor).

Of course, the restrictive measures that are currently in place (at the time of writing) will mean that some charities are concerned about their financial position. Trustees must

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consider what their short-, medium- and long-term priorities are and then carry out a review as to whether they need to amend their financial planning in light of their current situation. In doing this, trustees should assess whether certain projects, spending or activities should be stopped or delayed (having regard to the current lockdown measures and social-distancing rules) in order to try to preserve funds.

While many charities have restricted funds, whose use is dictated by the donor, a lot of charities place internal restrictions on certain funds. For example, a charity may have decided, prior to the pandemic, that certain funds will be earmarked for a specific purpose. Charities that have done this may be able to re-prioritise these funds – although this may not be possible with restricted funds that may only be used for a particular and defined purpose.

It can be possible for restricted funds to have the restrictions amended. However, this should only happen when other options, such as reserves, are not possible. Indeed, the Commission encourages trustees to carefully consider the wider and longer term impacts of making such decisions – particularly on financial resilience and donor relationships and the advice is to seek professional advice on this, which is where accountants may find they need to advise their charity client to seek legal advice.

5.3 AGMs and other meetings

In light of the social-distancing and lockdown measures currently in place at the time of writing, it may not be possible for a charity to convene an AGM or other critical meeting. In a lot of cases, a meeting has to be 'quorate' before it can go ahead and if a number of trustees are, for example, self-isolating, suffering from the virus or are 'shielding', it may be the case that a meeting is not quorate, hence cannot go ahead. Given the impact the virus is having, it is expected that many charities will have to cancel AGMs or other critical meetings.

Where a charity decides it cannot convene the AGM or another meeting because of the restrictions, the trustees must record this decision to demonstrate good governance. This is particularly important where the AGM is concerned because it may be the case that the annual report and accounts that would otherwise be presented at the AGM to the trustees cannot be approved and subsequently finalised (see below for filing issues).

Governing documents may allow 'virtual' meetings (e.g. meetings held through Zoom or other 'apps') or by way of telephone. Hence, charities are advised by the Commission to review their governing documents to check whether this method of holding a meeting is

permissible. If not, it may be possible for the trustees to amend the governing document to facilitate changes as to how, or when, meetings are held.

In situations where there is no such clause in governing documents and a charity decides it will hold a meeting over the phone or 'virtually', the Commission will understand. However, the trustees should record this decision so as to demonstrate good governance.

5.4 Filing the accounts

Where possible, the Commission request that charities still file their annual reports and accounts on time. However, where the pandemic impacts on the completion of annual returns and accounts, charities that have an imminent filing date can contact the Commission to ask for an extension.

To do this, include your charity name and charity registration number when you contact the Commission at filingextension@charitycommission.gov.uk.

5.5 Reporting serious incidents

The primary interest of charities is looking after the public and the communities which they serve. The impact of the pandemic will undoubtedly have an impact on this, particularly while the government's lockdown and social-distancing measures are in place.

The pandemic does not relieve the trustees from continuing to report serious incidents to the Commission using their current guidelines. The Commission continues to ask trustees to use their judgement in deciding whether an incident is significant in the context of their charity as to warrant a report.

The Commission will still continue to prioritise incidents which place individuals at risk, or incidents which have had a significant impact on the charity's operations and thus have caused serious harm to the charity's work.

5.6 Impact on financial reporting of charities

The SORP-making body has issued advice on issues concerning Covid-19 and the financial statements of charities. This advice acknowledges that these are unprecedented times and the situation is rapidly changing. The key messages from the advice are:

- the charity trustees must understand the impact of Covid-19 on the delivery of their activity and their governance, including finances (see **5.7** below).
- Where a charity is preparing its financial statements that have not yet been approved, trustees should consider whether information needs to be included to explain the impact of Covid-19 on their charity.
- There could be changes to the financial statements needed due to the pandemic and so it is important that trustees understand and consider these.
- Charities must keep up to date with developing guidance from the relevant charity regulator in their jurisdictions.

5.7 Financial reporting considerations

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On 23 March 2020, the SORP-making body of the various charities' commissions in the UK issued advice in the form of *Implications of COVID-19 control measures and charity financial reporting*. This advice concerns the financial reporting implications of COVID-19 (Coronavirus) that should be considered by trustees when they are preparing the charity's financial statements.

It should be noted that the advice issued by the SORP-making body does not make any amendments to the Charities SORP (FRS 102) nor is the advice mandatory. However, it is recommended that the advice is considered carefully by preparers of a charity's financial statements in light of the significant impact that COVID-19 is having on charities across the country.

The impact of COVID-19 is being felt by all businesses given the significant level of disruption the pandemic has caused. In respect of charities, there could well be implications for the charity's income, expenditure and commitments as well as an impact on the charity's assets and liabilities. In some serious cases, the disruption caused by the pandemic may affect the charity's ability to continue as a going concern.

5.6.1 Trustees' annual report and risk reporting

The advice suggests that the trustees consider the impact on the financial statements as a result of the changing activities of the charity itself. For example, trustees may need to consider the impact on:

- fundraising;
- the changing circumstances of its staff and volunteers; and
- changes beyond the control of the charity – for example, demand for charitable services; effect of failing supply chains; and the values of assets and liabilities due to economic changes.

Trustees should consider the effect of changes in fixed asset values – for example due to impairment. In addition, investments may also have seen a decline in value given the virus's impact on the worldwide economy. Such declines in values may have a detrimental impact on the financial position reported in the balance sheet for which the trustees may wish to include additional narrative in the notes to the financial statements for the purposes of transparency.

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The advice sets out some useful suggestions which charity trustees may wish to consider. The table below outlines these suggestions, together with the relevant paragraphs of the SORP dealing with such issues:

Issue that charity trustees should consider	Relevant paragraph of the Charity's SORP
Where the charity reports main achievements, it may wish to consider how the restrictions put in place by the government have affected the charity's activities	1.20
Any material uncertainties related to going concern and any uncertainties regarding the charity's financial sustainability together with the steps that the trustees are taking to address these uncertainties (see later)	1.23
How the contribution of volunteers have assisted the charity in managing in the changed circumstances	1.39
The impact the pandemic has had on the charity's ability to carry out fundraising activities and how the trustees have managed this situation	1.41
How the outbreak of the virus has affected the charity's staff, volunteers and beneficiaries including the implications for the charity's operations and activities for the coming year	1.45
The financial and operational effects of the virus together with how the restrictions imposed by government have affected the charity's principal risks and uncertainties during the reporting period	1.46
Whether there are any implications on the charity's defined benefit pension plan and/or investments which the charity may hold	1.47
The impact of the pandemic on the charity's reserves policy, level of reserves and any change to designated funds that have been set aside for future commitments	1.48
The likely impact of the government's restrictions (and potential duration of these restrictions) on the future aims and activities of the charity	1.49
The impact of the restrictions on any wider network of which the charity is a part and how this affects the charity's operations	1.51

5.6.2 True and fair view

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The trustees are required to ensure that the financial statements which they prepare for the charity give a true and fair view. The advice acknowledges that this is based on an assessment that the charity's reported income, expenditure, assets, liabilities and funds are fairly described and presented as at the reporting date.

To enable a true and fair view to be presented in the charity's financial statements, the trustees must ensure that they take into consideration all relevant information regarding the conditions that exist as at the reporting date. In some unfortunate cases, this may mean that the charity is considered not to be a going concern and hence the financial statements will not be prepared on a going concern basis. This issue is considered later in the article.

5.6.3 Subsequent events

Subsequent events (often referred to as 'post balance sheet events') give rise to either 'adjusting' or 'non-adjusting' events. **Adjusting events** are those events which occur after the reporting date but whose conditions exist at the reporting date and which affect the items in the balance sheet and statement of financial activities. Module 13 of the SORP deals with such events.

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An example of an adjusting event would be where stock for resale is overstated in the financial statements because it is sold for less than cost after the reporting date, but before the financial statements are approved. Here, the sale post-year end provides evidence that selling price is less than cost so the stock should be written down to its selling price less costs to complete and sell in the financial statements.

Another example would be where a debtor goes bankrupt shortly after the reporting date; this is evidence that the charity had suffered a loss at the reporting date and hence the debtor should be written off in the charity's year end financial statements.

Non-adjusting events are those events which occur *between* the reporting date and the date of approval of the financial statements. The conditions giving rise to non-adjusting events do not exist at the reporting date, but where they are material the nature of them should be disclosed in the financial statements. An estimate of their financial effect or a statement that such an estimate cannot be made reliably should also be disclosed.

The advice provides two examples of non-adjusting events as follows:

- a material loss in value of an asset subsequent to the reporting date; and
- a material loss in the value of investments.

So, where the charity has an investment measured at fair value, it will be recognised in the balance sheet at its fair value at the reporting date. If the fair value of this investment falls significantly after the reporting date, the financial statements do not recognise this fall in value. The charity should disclose a non-adjusting event describing the fall in value of the investment after the reporting date together with the financial effect (i.e. the value of the decline in value).

The impact of COVID-19 may not necessarily have an impact on the amounts recognised in the financial statements depending on the charity's reporting date. This is because the virus was only discovered in February 2020 and hence a charity with a December 2019 reporting date will be less likely to have an adjusting event in respect of the virus. However, for charities with January 2020 year ends onwards, adjusting events in respect of the pandemic are more likely.

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5.6.4 Going concern

The issue of going concern has moved up the ranks of importance more than ever during the pandemic.

The trustees are required to assess the charity's ability to continue as a going concern at each reporting date. This will then lead them into concluding whether the financial statements should be prepared using the going concern basis of accounting or otherwise. In doing this, they must take into account all information about the future at the **date of approval** of the financial statements.

As noted earlier in the notes, the assessment of going concern is a forward-looking exercise and it is to be done for a minimum of period of **at least 12 months from the date of approval of the financial statements**. This is a minimum period and it is not limited to 12 months from the date of approval of the financial statements – it can go further. Trustees must keep in mind that the review period is not just 12 months from the reporting date as this would mean an inadequate assessment of going concern is carried out.

The trustees must focus attention on the charity's available unrestricted funds and reserves, borrowing facilities (including overdrafts) and any other forms of financial assistance that may be available.

5.6.5 Charities which are not a going concern

If the trustees conclude that the charity is not a going concern and hence the going concern basis of accounting is inappropriate for use in the financial statements, the trustees must prepare the financial statements on a basis other than the going concern basis.

The trustees must disclose in the financial statements that the going concern basis of accounting has not been used. The trustees must then consider the impact of this on the charity's accounting policies (especially where judgements and estimates relating to the valuation of assets and liabilities are concerned). The trustees must also consider whether the decision not to prepare the financial statements on a going concern basis

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triggers the need to recognise additional liabilities (such as where contracts may become onerous).

The advice confirms that where the charity's accounts are not prepared on a going concern basis, assets may be valued on the basis of recoverable amounts which may be realised upon disposal. Liabilities may be valued on the likely value that could arise when they are crystallised.

Trustees should disclose any significant assumptions they make as to the nature of disposal and its impact on valuations of assets and the judgements as to the market or disposal values assigned. Consideration should also be given to any impairment in respect of operational and other assets. The SORP at Module 12 provides the requirements for impairment of assets.

5.6.6 Defined benefit pension plans

Unlike defined contribution plans, defined benefit plan liabilities are recognised on the charity's balance sheet (plan surpluses are only recognised if the surplus is recoverable through a cash refund or reduced pension contributions).

The valuation of assets and liabilities for a defined benefit pension plan (also referred to as a 'final salary pension plan') may be affected by changes in financial markets for shares, other securities and government bonds. An adjusting event would not arise where any changes to conditions occur after the reporting date.

5.6.7 Liabilities and provisions

Additional liabilities and provisions may need to be recognised in the charity's financial statements for costs arising from disruption to supply chains, availability of staff and the charity's inability to fulfil any contractual obligations due to current restrictions. Additional costs or penalties may also arise because of a failure by the charity to meet any performance targets meaning that additional liabilities (or provisions for liabilities) may be recognised in the charity's financial statements.

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Unless any change to conditions at the reporting date results from this information, the charity would not class this as an adjusting event thus no additional liability would be recognised (but a non-adjusting event may need to be disclosed). Events after the end of the reporting period are dealt with in the SORP at Module 13.

5.6.8 Audit and external scrutiny

The current government restrictions may impact on the charity's ability to prepare financial statements and the availability of auditors or independent examiner to undertake their review. The trustees will need to carefully consider any alternative means of verification and providing evidence which may involve extra effort or require additional time to complete.

Current restrictions will more than likely affect any previously planned timetables for reporting, including convening of meetings to approve the financial statements, which may need to be rescheduled or held by other means.

5.6.9 Reporting matters to the regulator by trustees

The charity regulators have provided guidance on their respective websites where the trustees consider there is a matter regarding beneficiary welfare or the charity's ability to continue which they may need to notify to the relevant regulator.

5.6.10 Filing issues

The advice confirms that a disagreement relating to the going concern status of a charity between the trustees and the auditor or independent examiner is not a reason for non-submission of the financial statements. Once the auditor or independent examiner has provided their report, the annual report is then filed with the registrar.

If circumstances are such that the trustees' annual report and accounts (or directors' annual report and accounts) are going to be filed late, then the trustees must consider the impact of the late filing by having regard to information published by the relevant charity regulator.

Companies House have issued guidance that confirms they will require trustees and directors to inform them **before** the filing deadline if the accounts will be filed late and have said that they may grant a filing extension of up to three months. Any extension granted by Companies House will be at their discretion and will not affect the filing deadlines for subsequent years accounts. If the accounts are filed late at Companies House and permission for a filing extension has not been obtained before the original filing deadline, a penalty will be levied.

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6 Accounting for Coronavirus government aid Q&A (Lecture A710 – 29.01 minutes)

The following is taken from John Selwood's Q&A written for *Audit & Beyond*.

6.1 Under UK GAAP how should income from government aid be recognised?

Before getting to the specifics, here are the general principles.

There is a choice of accounting policy. The accounting policy selected should reflect the nature of the grant and as auditor you will need to consider whether the appropriate model has been selected.

Accrual model

This model requires the grant to be classified as either a **revenue-based** grant or a **capital-based** grant. Most of the Coronavirus aid packages are revenue-based grants.

FRS 102, paragraph 24.5D states that grants which relate to revenue shall be recognised in income on a systematic basis over the periods in which the entity recognises the related costs for which the grant is intended to compensate.

Where the performance model is applied:

FRS 102, para 24.5B(a)

A grant that does not impose specified future performance-related conditions on the recipient is recognised in income when the grant proceeds are received or receivable.

FRS 102, para 24.5B(b)

A grant that imposes specified future performance-related conditions on the recipient is recognised in income only when the performance-related conditions are met.

FRS 102, para 24.5B(c)

Grants received before the revenue recognition criteria are satisfied are recognised as a liability.

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The accounting treatments for the various government aid packages is an emerging issue and in some areas there is a lack of consensus on the correct accounting treatment. However, here are my views:

Coronavirus Job Retention Scheme (CJRS) – the accruals model appears most appropriate to me. Not that it makes it any difference because the accounting treatment for this grant, in relation to furloughed staff costs, under the performance model would be the same. The income is recognised in the P&L (as other income), to match the related staff costs.

Business rates relief – this is not a government grant and should not be accounted for as such. It is merely the absence of a cost and the P&L charge will be reduced for the period of the relief.

Small Business Grants Fund (SBGF) and Retail, Hospitality and Leisure Grant Fund (RHLGF) - at first glance it is not clear whether these grants should use the accruals or performance method. However, like the CJRS I don't think it makes any difference to the income recognition.

Under the performance model, income would be recognised as soon as the entity's eligibility had been established.

Under the accruals model this element of FRS 102 would apply:

'*A grant that becomes receivable as compensation for **expenses** or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs shall be recognised in income in the period in which it becomes receivable.*'

FRS 102, para 24.5E

Obviously, this gives the same accounting result as the performance model. Although, the wording in this paragraph does suggest that the accruals method was intended for this sort of 'immediate financial support'.

Coronavirus Business Interruption Loan Scheme (CBILS) – at the time of writing there is no clear consensus on a couple of issues.

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Firstly, the government guarantee significantly improves the lending proposition for the bank which reduces the interest rate. Is this a below market rate loan for accounting purposes, requiring appropriate discounting? There seem to be different views on this, but in my opinion there is clearly a competitive market for CBILS and it is in an arm's length transaction. Therefore, the interest rate is a market rate for a CBILS loan and no discounting is required.

The second issue relates to the Business Interruption Payment (BIP) element of the scheme. This is where the government pays the interest and any loan arrangement fee for the first 12 months. Currently, there is a lack of clarity as to how this works. Here are two possibilities:

- If the borrower is legally responsible for the interest liability and the government settle it on behalf of the company then the interest charge and the related government grant should be recognised in the P&L.

- If it is the government who are obliged to settle the interest charge then the interest and grant would not appear in the P&L.

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6.2 What other accounting issue are arising as a result of the COVID-19 lockdown?

There are also many other accounting consequences of the COVID-19 lockdown including going concern, post balance sheet events, impairment reviews, asset valuations, onerous contracts, narrative reporting etc which have been included in these notes. For more on the above take a look at the Financial Reporting resources on the ICAEW Coronavirus Hub[1].

6.3 How should rent holidays be accounted for under FRS 102? Should the benefit be spread as a lease incentive?

It is unlikely that a short rental holiday would actually be a lease incentive unless the lease is new or is being renewed. Indeed the definition of a 'lease incentive' in the Glossary to FRS 102 refers to:

'Incentives provided by the lessor to the lessee to enter into a new or renew an ***operating lease****.'*

The term that is being used to describe these short term rent holidays is a ***lease modification.*** FRS 102 does not use this term but I have seen it used in one of the UK GAAP accounting manuals. The FRC may issue guidance at some stage concerning this given that the IASB have issued clarification on their leasing standard (IFRS 16 *Leases*) for the same issue but in my view the rental holiday should be recognised in the period in which it benefits from the holiday rather than spreading it over the remaining lease term.

6.4 What disclosures are required by FRS 102 in relation to government grants?

The requirement in Section 24 of FRS 102 (applicable to medium-sized and large companies) is to disclose:

- the accounting policy;
- the nature and amounts of grants;
- unfulfilled conditions and other contingencies; and

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[1] ACCA members have access to the equivalent in the ACCA's Coronavirus Hub.

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- an indication of other forms of government assistance received.

I would envisage a note in the financial statements that would include these disclosures on a grant by grant basis.

6.5 What are the disclosure requirements for small companies choosing to report under Section 1A?

FRS 102, Section 1A *Small Entities* does not specifically require disclosure in relation to government grants. However, it does require accounting policies to be disclosed as well as any disclosures necessary to show a true and fair view. Where government aid is material I think that disclosures similar to those required in Section 24 of the FRS will be needed for small companies.

6.6 Does FRS 105 (the micro-entities regime) differ from FRS 102 in relation to accounting for government grants?

Yes, in two significant ways:

Accounting policy - the performance model is not available when accounting for government grants.

Disclosures – there are no disclosure requirements relating to these schemes other than anything that might be caught as ‘off balance sheet events’ or ‘financial commitments, guarantees and contingencies’. Micro company accounts are presumed to show a true and fair view so additional disclosures will not be required, although directors could always choose to add disclosures.

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7 Coronavirus lockdown and audit reports – Q&A (Lecture A711 – 21.45 minutes)

The following is taken from John Selwood's Q&A written for *Audit & Beyond.*

The coronavirus pandemic looms large for all of us professionally and personally. Understandably, this topic also dominates the questions this month, which deal with the financial fallout from the COVID-19 lockdown.

7.1 Almost every company is being affected by the lockdown. How should auditors be addressing the resulting uncertainties?

When you think about it, the extent to which accountants and auditors are required to predict the future is sobering. Particularly in the current climate.

Showing a true and fair view involves properly addressing accounting issues, which involve making judgments about the future on matters such as:

- going concern;
- impairment reviews;
- asset valuations; and
- provisions/contingencies.

It probably goes without saying that the impact of the lockdown will need to be addressed in the auditor's understanding of the entity, risk assessment, design of audit procedures and the evaluation of the audit evidence. Clearly, auditing is currently more difficult, but this crisis will not be an excuse for a drop in audit quality.

Now let me move onto the bit that everyone really wants to talk about: the auditor's report.

First, I am going to begin with my disclaimer. As I write this, it is early days in the crisis and a consensus has not yet started to coalesce. Hopefully, by the time that you read this there will be further ICAEW guidance that directly addresses the issue (and you will

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be able to find it, along with all other audit-related COVID-19 insights on the ICAEW website at https://www.icaew.com/insights/coronavirus).

I am going to ignore ISA 701 auditors' reports (which contain Key Audit Matters), and concentrate on the vast majority of audits. Here are the things to think about:

Qualified audit opinions

There will be instances where auditors disagree with how management address an issue in the financial statements or where audit procedures are limited in scope. Examples of this are where management refuse to make certain disclosures or where the auditor could not attend a stocktake and no alternative audit procedures were possible.

From a purely technical perspective though, this should be 'business as usual' for the auditor, and the auditor's report will be modified in the normal way. There are a number of Faculty Guides (which used to be known as 'helpsheets', available to assist you, if needs be that can be obtained from: https://www.icaew.com/technical/audit-and-assurance/audit-and-assurance-helpsheets).

Material uncertainty relating to going concern

I have heard it suggested that, during this crisis, every audit should have a COVID-19, material uncertainty relating to going concern paragraph.

This does not sound like the right approach to me. The material uncertainty relating to going concern paragraph states that 'a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern'. I agree that this could be true in many instances, at the moment. But I do not accept that this will be the case all of the time, because whilst most entities face material uncertainty, it might not result in significant doubt about going concern.

Therefore, the material uncertainty paragraph might be relevant for many audits but it should not be a boilerplate addition to every auditor's report.

Also, note that a very important element of this situation is the quality of the going concern disclosure that management draft. This is covered more fully elsewhere in these Q&As.

Emphasis of matter

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I think that where COVID-19 is not mentioned in a company's going concern disclosure it is bound to be mentioned elsewhere in the financial statements during this crisis.

Given the global prominence of the coronavirus pandemic, it might be appropriate for the auditor to include an emphasis of matter paragraph directing the users' attention towards these important disclosures. Remember that for this to be included the matter would need to be fundamental to the users understanding of the financial statements.

When drafting the wording of the emphasis of matter paragraph the auditor should remember that the purpose of the emphasis of matter is to draw attention to management's disclosures, and the auditor should be satisfied that those disclosures are properly tailored to the entity's circumstances.

Also, it seems to me, that including an emphasis of matter relating to COVID-19 matters as well as a similar material uncertainty related to going concern paragraph would be excessive and unnecessary.

One last point

The material uncertainty related to going concern paragraph and the emphasis of matter referred to above are all about the auditor (and to a great extent management) addressing uncertainty. It might be possible to delay the finalisation of the financial statements in order to allow the current situation to develop and hopefully reach a time when the future becomes less uncertain.

The Registrar of Companies has stated that directors can apply to Companies House for a filing extension, (before the filing deadline), citing COVID-19 as the reason. Find relevant guidance at https://www.icaew.com/insights/features/2020/mar-2020/coronavirus-going-concern-and-the-auditors-report.

7.2 Lots of companies are in in trouble at the moment. As an auditor how do I need to respond to financial statements being prepared on a break-up basis?

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First thing, I would avoid using the term 'break-up basis'. It is not defined in accounting standards, so is unhelpful. We usually refer to 'a basis other than going concern'.

Remember that financial statements should be prepared using the going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. Events after the balance sheet date are used to assess whether the going concern basis is appropriate at the year end.

In the current crisis, I might expect there to be significantly more uncertainty surround the appropriateness of the going concern basis, but this does not automatically result in the going concern basis not being appropriate. Financial distress in itself does not necessarily lead to the going concern basis being inappropriate. The issue is whether it leads to there being no realistic alternative to liquidation.

Therefore, I think that the going concern basis will still be appropriate most of the time.

Where the going concern basis is not appropriate, and you agree with management on this, there should be good disclosure in the financial statements about the alternative basis used. As auditor you would include an appropriate emphasis of matter paragraph referring to this.

7.3 Currently, I am finding that there are going concern issues that need disclosing on virtually every audit I finalise. I am frequently getting pushback from directors on this along the lines of "*the last thing that the company needs is a going concern disclosure to unsettle the shareholders/lenders/or whatever*". I am dealing with some very stressed directors. What should I do?

These are unprecedented times but the quality of auditing needs to remain high. If management's disclosures do not show a true and fair view then auditors need to strongly encourage management to improve disclosures. Failing this, the resulting disagreement may need to be reflected in a modified audit opinion. It is also worth mentioning that at the current time there is an expectation that there will be more going concern disclosures, and more material uncertainties related to going concern, so it is not perhaps as concerning, to the users of financial statements, as may have been the case in more certain times.

Again, do not forget that it might be best to delay the completion of the financial statements to a time when the extent of the current uncertainty has reduced.

7.4 Due to the lockdown, audit teams can no longer attend stock takes. Indeed, many clients are not performing stock takes. Does this mean that there will be more qualified audit opinions?

Maybe, yes.

However, don't forget that there might be alternative audit procedures that are possible:

- stock takes could be attended, at some future date, after the year end, and there could be a roll-back procedure/test; and
- auditors could use online tools (such as Facetime, WhatsApp, Zoom or an another video conferencing tool) to attend stocktakes remotely. Note, that some auditors are concerned that this sort of procedure might not properly address certain fraud risks that might arise, so views are divided on this effectiveness of this procedure.

Having said this, I understand that auditors are, in fact, issuing auditor's reports with modified opinions, at the moment. For further guidance on COVID-19 related stocktake issues see https://www.icaew.com/technical/audit-and-assurance/audit/quality-control/coronavirus-considerations-for-inventory-audit-testing and https://www.icaew.com/insights/viewpoints-on-the-news/2020/mar-2020/coronavirus-stocktake-attendance-and-the-auditors-report.

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8 Revised Ethical Standard for Auditors (Lecture A712 – 26.57 minutes)

In December 2019, the FRC issued a revised Ethical Standard (ES).

The effective date of the revised ES is for periods beginning 15 March 2020 (except paragraph 5.42 which applies to accounting periods commencing on or after 15 December 2020 and which caps non-audit services to 'other entities of public interest'). The FRC have included transitional provisions in the revised ES and the effective date for changes to ISAs (UK) remains at 15 December 2019.

The changes are more wide-ranging than many auditors think and there are a number of challenging grey areas.

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

Yes. Some auditors seem to have made the mistake of thinking that it is only auditors of Public Interest Entities (PIEs) that have to report.

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

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

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

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

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

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

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

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

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

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

ES 2019, para 4.2

Would an objective, reasonable and informed third party think that not charging a fee could compromise the auditor’s independence? Almost certainly, yes. At the least safeguards will be needed.

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

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

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

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

ES 2019, para 3.6

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

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

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

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Note

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

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

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

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

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

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

8.6 What is an OEPI?

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

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

ES Glossary

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

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

b) Lloyd's syndicates;

c) Private sector pension schemes with more than 10,000 members and more than £1billion of assets, by reference to the most recent set of audited financial statements11;

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

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

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

These thresholds apply to a single company, globally.

Charities are excluded.

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

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

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

ES 2019, para 5.44

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

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

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

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

8.8 What is 'tax advocacy'?

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

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

ES 2016, para B 5.97

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

(a) that is material to the entity's present or future financial statements, or the subject matter information or subject matter of the engagement; or

(b) where the outcome of the tax issue is dependent on a future or contemporary judgment by the firm in relation to the financial statements, or other subject matter information or subject matter of the engagement.'

The updated prohibition in the 2019 Standard simply states:

ES 2019, para 5.75

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

However, auditors might continue to provide non-audit service to their audit client in assisting with tax investigations. With the application of the appropriate safeguards,

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auditors could continue to provide information to the tax authorities and communicate management's arguments. However, auditors must not closely align themselves with management' position. Auditors might also provide a technical resource to management to help management formulate their arguments.

A good example would be where the FD and the auditor were to have a meeting HMRC on a tax dispute, the FD should be doing most of the talking.

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

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

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

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

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

ES 2019, para 5.55

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

8.10 Has anything changed regarding the provision of accounting services?

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

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

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

ES 2019, para 5.120

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

(b) for any other entity:

- *those accounting services would involve the firm undertaking part of the role of management, <u>or initiating transactions</u>; or*
- *<u>the services are anything other than of a routine or mechanical nature, requiring little or no professional judgement</u>.'*

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

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

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

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

8.12 Are there still exemptions for audits of small entities?

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

There is now reference within the 'self-review threat alternative provision - cyclical inspection condition' to inspection cycles 'not being more than three years' (from 'ordinarily not more than three years'). There is also now reference to the documentation requirements in ISA (UK) 220 when those inspecting the engagement

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evaluate whether there is documentary evidence of informed management making judgements and decisions needed.

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