Audit and Accounting notes

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1 FRC calls for feedback on UK GAAP (Lecture A740 – 9.07 minutes)

In March 2021, the Financial Reporting Council (FRC) announced confirmation that they intend to commence the next periodic review of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. The last comprehensive review of UK GAAP was via the triennial review which was completed in December 2017, and the amendments arising from this triennial review became effective for periods commencing on or after 1 January 2019.

The vast majority of the amendments arising from the triennial review were either editorial in nature or merely offered clarifications to existing accounting treatments. In other words, the FRC did not want to 'reinvent the wheel'. Some changes did, however, result in different recognition and measurement principles. For example, including additional accounting policy options (such as for intra-group investment property and permitting off-market rate loans from director-shareholders to small entities to be recognised at transaction price).

In the Basis for Conclusions section of FRS 102, the FRC confirm that they will carry out future periodic reviews every four or five years rather than carry out triennial reviews. The advantage of doing periodic (rather than triennial) reviews is that it allows the most recent edition of the standards to become established. This helps practitioners and entities applying UK GAAP to avoid having to deal with regular changes; it also helps the FRC to receive more constructive feedback on potential changes to accounting standards prior to them carrying out their next review. This is also consistent with one of the FRC's principles of standard-setting which is to '… balance improvement, through reflecting up-to-date thinking and developments in the way businesses operate and the transactions they undertake, **with stability** [emphasis added].'

It should be noted that while the periodic review will clearly focus on FRS 102, it will also involve a review of the other standards comprising UK GAAP (see **1.2** below). The primary purpose of these reviews is to ensure that the standards remain up-to-date and continue to require high-quality and cost-effective financial reporting from entities that fall within their scope.

FRS 101 *Reduced Disclosure Framework* is reviewed by the FRC on an annual basis in any event. This is to ensure that developments in the world of IFRS are tracked to ensure disclosure exemptions remain up-to-date and to respond to stakeholder feedback about improvements.

1.1 Initial process

The initial stage of the FRC's periodic review process is to seek views from stakeholders on areas that may be considered as part of this review.

The FRC would like to hear from preparers as to what could be improved, what could be changed and even what appears to be working well in practice.

Delegates should respond to the call for feedback where they have concerns about a specific issue or several issues. All responses are reviewed by the FRC and may be published on their website. It should be emphasised that **constructive feedback** is required so if you do feel strongly about a particular issue that may be causing difficulties or interpretational issues, then the response should highlight the issue and explain *why* it is causing a problem. Also, don't be reluctant to offer any potential advice in terms of a workable solution. Remember, if the FRC are not made aware of any problems then they will assume that everything is fine.

1.2 Comment period and how to comment

The comment period for this initial call for feedback is quite long and closes on 31 October 2021. Comments can be emailed to the FRC using the email address ukfrsperiodicreview@frc.org.uk. All feedback received will be read by the FRC and feedback can be provided on any FRS in the suite of UK GAAP which comprises:

- FRS 100 *Application of Financial Reporting Requirements*
- FRS 101 *Reduced Disclosure Framework*
- FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*
- FRS 103 *Insurance Contracts*
- FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*

FRS 104 *Interim Financial Reporting* is not an accounting standard (as there is no requirement to prepare interim financial statements for private entities) and hence is not included in the above list.

The FRC have stated that they intend to hold roundtable events for stakeholders to provide their views as well. This will, of course, depend on the current Covid-19 situation and it is expected the FRC will announce further details on this in due course.

1.3 Planned effective date of the amendments

The FRC have clearly stated that any changes to accounting standards which are proposed as a result of this forthcoming periodic review will be subject to a public consultation. This was also the case when the FRC carried out the last triennial review in 2017. This consultation is not expected to take place before 2022.

Any effective date for the amendments is currently expected to be 1 January 2024. This effective date is tentative and could be subject to change.

1.4 Will IFRSs 9, 15 and 16 be included in this review?

There have been some queries about whether the FRC will amend UK GAAP to cater for the effects of the following IFRSs:

- IFRS 9 *Financial Instruments*
- IFRS 15 *Revenue from Contracts with Customers*
- IFRS 16 *Leases*

IFRS 9 applies an *expected credit loss model* in respect of impairment losses on financial instruments. This is more arduous to apply in practice than the current *incurred credit loss model* which is contained in UK GAAP and generally results in higher levels of impairment losses being recognised in the financial statements.

IFRS 15 contains a five-step model approach to recognising revenue and contains significantly more in the way of disclosure and has proved to be tricky for some entities on first-time adoption of the standard.

IFRS 16 is probably the most contentious of all. This standard does not distinguish between a finance lease and an operating lease (as is the case under UK GAAP). Instead it requires the vast majority of leases to be recognised on the balance sheet of lessees. There are a very limited number of exceptions to recognising leases on the balance sheet – notably short-life leases (i.e. those with 12 months or less to run) and low-value assets. IFRS 16 does not actually state what 'low value' actually is, but the Basis for Conclusions in IFRS 16 does indicate that the IASB did have an amount of $5,000 in mind at the time they drafted the standard, so that seems to be the figure most entities applying IFRS 16 are working with.

It should be borne in mind that just because the IASB may do something to introduce, amend or withdraw an accounting standard does not mean the UK standard-setters will automatically follow suit. This is particularly the case since 1 January 2021 as the UK has now completely left the EU and can no longer use EU-adopted IFRS. The UK Endorsement Board are now responsible for endorsing IFRS for use in the UK.

The FRC are currently analysing implementation feedback from IFRS reporters on IFRSs 9, 15 and 16. This analysis is likely to inform the basis on which the FRC proceed.

We currently do not know whether the FRC will propose to change UK GAAP to reflect the provisions of IFRSs 9, 15 and 16 as part of the next periodic review amendments; or whether such proposals will be separate proposals. In any event, given the complexities of these IFRSs, it is likely that any changes to UK GAAP to align the standards more to those IFRSs will be simplified.

The *IFRS for SMEs* is currently going through a comprehensive review by the IASB. Delegates may be aware that FRS 102 has its 'roots' embedded in *IFRS for SMEs,* but it is not identical to that standard. The FRC are likely to track how the IASB incorporate the

principles of IFRSs 9, 15 and 16 into their *IFRS for SMEs* and this could offer a 'starting point' for the FRC.

Given the complexities involved with the expected credit loss model, the revenue recognition model and the treatment of leases under those IFRSs, it is unlikely that any changes to UK GAAP in respect of these standards will happen in the foreseeable future (even if at all). If any changes to UK GAAP are made, it is expected the FRC will give plenty of lead time in the run up to any transition.

While the message here is that it is very much 'business as usual' where financial instruments, revenue recognition and leases are concerned, delegates are still advised to keep abreast of developments in this area and to respond to any proposals for change if they feel the need to do so.

2 FRS 101 update (Lecture A 741 – 2.34 minutes)

The latest amendments to FRS 101 were in respect of Britain's exit from the EU which apply for accounting periods commencing on or after 1 January 2021.

In November 2020, the FRC issued FRED 77 *Draft amendments to FRS 101 Reduced Disclosure Framework 2020/21 cycle.* FRED 77 proposes narrow-scope amendments in respect of:

- IAS 16 *Property, Plant and Equipment*
- IAS 1 *Presentation of Financial Statements*

It is expected that the proposed changes to FRS 101 outlined in FRED 77 will go ahead as documented. The comment period on FRED 77 closed on 28 February 2021.

2.1 IAS 16

FRED 77 proposes a disclosure exemption in relation to IAS 16 – notably IAS 16, para 74A(b). IAS 16 was amended by the IASB in May 2020 to insert paragraph 74A. IAS 16, para 74A(b) introduces a new requirement to disclose information about the sale of items that are not an output of the entity's ordinary activities, which are produced while bringing an item of property, plant and equipment to the location and condition necessary for it to be capable of operating in the manner intended by management. FRED 77 proposes to scope out this disclosure requirement.

2.2 IAS 1

The 2020/21 cycle of amendments also propose to delete references to FRS 101, para 8(g) to certain paragraphs of IAS 1 which apply to accounting periods commencing prior to 1 January 2013. As this date has now passed, these paragraphs are redundant.

At the time of writing these notes, the above amendments had not been finalised but given their narrow scope, it is likely they will be finalised as proposed.

3 FRS 102 and FRS 105 update (Lecture A742 – 8.14 minutes)

As we are all aware, the global pandemic has caused a significant amount of business disruption over the last year or so, and for some businesses the legacy left by the pandemic will last for a long time. In some unfortunate cases, businesses have not survived the impact of Covid-19.

In October 2020, the Financial Reporting Council (FRC) made amendments to UK GAAP in respect of Covid-19-related rent concessions. These amendments set out the accounting treatment and disclosure requirements for lessees which occupy premises through an operating lease and who receive a rent concession from a landlord as a means of assisting them during the turbulent period.

A rent **concession** arises when the landlord forgives part of the rent that would otherwise be received per the lease agreement. In other words, the landlord will receive less money over the remaining life of the lease than they would have done had the Covid-19 pandemic not occurred. A rent **deferral** is not a rent concession as a deferral merely defers a portion of the rent (i.e. it changes the timing of the cash outflow) and hence a liability is likely to be recognised in the lessee's balance sheet at the reporting date for the rent deferred and the profit and loss account charge will be the same as it would normally be.

The FRC made changes to UK GAAP to avoid diversity in practice arising. Prior to the October 2020 amendments, UK GAAP did not deal with the issue of rent concessions and some commentators suggested that the rent concession granted by a landlord should be recognised in the lessee's financial statements over the remaining lease term (in a similar way to how a lease incentive is recognised). Others suggested the concession be recognised in the period the lease incentive is intended to benefit (for lessees) or the period in which the concession is intended to compensate (for lessors).

Such diverse views were considered unhelpful by the FRC as it would result in inconsistent financial reporting hence, they made amendments to both FRS 102 and FRS 105. The amendments to both standards were the same (with the exception of an additional disclosure requirement that was not included in FRS 105).

3.1 Current requirements

FRS 102, para 20.15C clarifies that a lessee recognises a change in lease payments arising because of Covid-19 on a systematic basis over the period that the change in lease payments is intended to compensate. FRS 102, para 20.25B clarifies that a lessor recognises a change in lease income arising from rent concessions due to Covid-19 on a systematic basis over the periods that the change in lease payments is intended to compensate.

FRS 102, para 20.15D only allows this accounting treatment for rent concessions arising as a **direct consequence** of the Covid-19 pandemic. This paragraph then sets out three conditions, all of which must be met, as follows:

FRS 102, para 20.15D (extract)

(a) *the change in lease payments results in revised consideration for the lease that is less than the consideration for the lease immediately preceding the change;*

(b) *any reduction in lease payments affects only payments originally due on or before 30 June 2021; and*

(c) *There is no significant change to other terms and conditions of the lease.*

3.2 Proposed amendment

On 20 April 2021, the FRC issued FRED 78 *Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime – Covid-19-related rent concessions beyond 30 June 2021*.

FRED 78 proposes to make amendments to FRS 102 and FRS 105 by extending the requirements so that they apply to rent concessions for which any reduction in lease payments affects those payments originally due on or before **30 June 2022**, provided the other conditions are met. Hence, FRED 78 is proposing a 12-month extension to the current cut-off date. Should these proposals go ahead as drafted, the FRC is suggesting that they will become effective for accounting periods commencing on or after 1 January 2021, with early adoption permitted.

If an entity chooses to early adopt the amendment, FRS 102 [draft] para 1.33 would require the entity to disclose the fact that it has early adopted the amendment. Small entities would be encouraged to disclose that fact.

The proposed amendment to FRS 105 is consistent with that of FRS 102.

The original time condition of 30 June 2021 was included in FRS 102 and FRS 105 to limit the requirements to those concessions where the treatment reflects the substance of the concession and hence achieve consistency of financial reporting over this period. The 30 June 2021 cut-off date was also included as a means of ensuring that the requirements are not applied to more broader rent concessions when it may be appropriate to apply a different accounting treatment to those changes in lease payments.

The FRC have suggested the change in time condition to 30 June 2022 is necessary because there is a risk that rent concessions which may be granted after 30 June 2021 are similar in substance to those concessions where the requirements currently apply. Again, the rationale of limiting the requirements to a specific timeframe still applies to reduce the risk that the requirements are interpreted and applied inconsistently.

FRED 78 also confirms that the requirements will continue to be reviewed in light of any future changes which the Government may announce in the future.

The FRC expects to finalise these amendments in the first half of this year and an entity will have the option to apply these amendments in financial statements which are not yet authorised for issue at the date the amendments are issued.

The comment period on FRED 78 closed on 11 May 2021.

4 Financial instruments: A recap (Lecture A743 – 16.49)

Financial instruments are one of the most complex areas of financial reporting. There are four areas of UK GAAP that deal with financial instruments as follows:

- FRS 102: Section 11 *Basic Financial Instruments*
- FRS 102: Section 12 *Other Financial Instruments Issues*
- FRS 102: Section 22 *Liabilities and Equity*
- FRS 105: Section 9 *Financial Instruments*

4.1 Accounting policy choice to use IAS 39 or IFRS 9

To further complicate matters, entities which apply FRS 102 can also choose to apply the recognition and measurement requirements of either IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* rather than Section 11 or Section 12. For completeness it is worth noting that IAS 39 has been superseded by IFRS 9.

As part of the triennial review in 2017, the FRC included a footnote to FRS 102, para 11.2(b) as follows:

> *Until IAS 39 is superseded by IFRS 9 Financial Instruments, an entity shall apply the version of IAS 39 that is in effect at the entity's reporting date, by reference to the IFRS publication titled International Financial Reporting Standard IFRS Consolidated without early application. When IAS 39 is superseded by IFRS 9, an entity shall apply the version of IAS 39 that applied immediately prior to IFRS 9 superseding IAS 39. A copy of that version will be retained for reference on the FRC website (www.frc.org.uk). Entities shall apply the so-called "EU carve-out of IAS 39", which amended paragraph 91A and related Application Guidance in IAS 39.'*

FRS 102, para 11.2(b) footnote

The accounting policy choice to use IAS 39 or IFRS 9 assumes that those standards are being applied with other IFRSs. For that reason, the FRC did not provide the amendments necessary to align those standards with other requirements of FRS 102. Therefore, when applying IAS 39 or IFRS 9, it is necessary to consider the interactions with FRS 102 (for example, how to treat references made to other IFRSs). Entities that choose to apply the recognition and measurement requirements of IAS 39 or IFRS 9 must also apply the presentation and disclosure requirements of FRS 102, Sections 11 and 12.

In practice, the choice will be straightforward. It is uncommon to see an entity applying FRS 102 also applying the recognition and measurement requirements of IAS 39 or IFRS 9. However, one advantage of applying IFRS 9 is that it allows more flexibility when applying hedge accounting which may reduce profit or loss volatility from measurement mismatches. Hedge accounting is optional under UK GAAP and, in practice, it is not very common to see hedge accounting being applied due to its inherent complexity.

4.2 IFRS 9

As noted in section 1 of these notes, the provisions of IFRS 9 are not reflected in UK GAAP as the FRC are reviewing implementation feedback from IFRS reporters on their implementation of the standard. There is currently no indication as to whether the FRC will consult on amending UK GAAP to reflect some, or all, of the provisions of IFRS 9 into UK GAAP.

It was not possible to apply IFRS 9 in the UK prior to EU-endorsement because the law which applies to IAS accounts requires IFRSs to be applied which were endorsed in the EU (prior to Britain's exit from the EU). Reporting entities which are applying the provisions in FRS 101 *Reduced Disclosure Framework* are preparing Companies Act accounts and hence were not constrained by this legal requirement, but FRS 101 did require IFRSs to be applied which had been endorsed by the EU.

4.3 Basic financial instruments: Introduction

Before going into the detail of the accounting requirements, it is worth examining some of the defined terms per the Glossary to FRS 102 as follows:

Term	Definition
Derivative	A **financial instrument** or other contract with all three of the following characteristics: (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying'), provided in the case of a non-financial variable that the variable is not specific to a party to the contract; (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (c) it is settled at a future date.
Effective interest method	A method of calculating the **amortised cost** of a **financial asset** or a **financial liability** (or a group of financial assets or liabilities) and of allocating the interest income or interest expense over the relevant period.

Effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the **carrying amount** of the **financial asset** or **financial liability**.
Equity	The residual interest in the **assets** of the entity after deducting all its **liabilities**.
Financial asset	Any **asset** that is: (a) **cash**; (b) an equity interest of another entity; (c) a contractual right: (i) to receive cash or another financial asset from another entity, or (ii) to exchange financial assets or **financial liabilities** with another entity under conditions that are potentially favourable to the entity; or (d) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
Financial instrument	A contract that gives rise to a **financial asset** of one entity and a **financial liability** or equity instrument of another entity.
Financial liability	Any **liability** that is: (a) a contractual obligation: (i) to deliver **cash** or another **financial asset** to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a **derivative** that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

FRS 102, para 11.8 provides a useful list of financial instruments that it considers to be basic, hence accounted for under Section 11 as follows:

FRS 102, para 11.8

(a) cash;

(b) a debt instrument (such as an account, note, or loan receivable or payable) that meets the conditions in paragraph 11.9 and is not a derivative financial instrument;

(bA) a debt instrument that, whilst not meeting the conditions in paragraph 11.9, nevertheless is consistent with the description in paragraph 11.9A and is not a derivative financial instrument;

(c) commitments to receive or make a loan to another entity that:

(i) cannot be settled net in cash; and

(ii) when the commitment is executed, are expected to meet the conditions in paragraph 11.9 or be consistent with the description in paragraph 11.9A; and

(d) an investment in a non-derivative financial instrument that is equity of the issuer (eg most ordinary shares and certain preference shares).

FRS 102, para 11.8 cross-refers to the detailed conditions in paragraph 11.9. This paragraph states that in order to be classed as a basic financial instrument, the instrument must meet the following conditions:

FRS 102, para 11.9

A debt instrument that satisfies the following conditions shall be considered a basic financial instrument:

(a) The contractual return to the holder (the lender), assessed in the currency in which the debt instrument is denominated, is:

(i) a fixed amount;

(ii) a positive fixed rate or a positive variable rate[1]; or

(iii) [deleted]

(iv) a combination of a positive or a negative fixed rate and a positive variable rate (eg LIBOR plus 200 basis points or LIBOR less 50 basis points, but not 500 basis points less LIBOR).

(aA) The contract may provide for repayments of the principal or the return to the holder (but not both) to be linked to a single relevant observable index of general price inflation of the currency in which the debt instrument is denominated, provided such links are not leveraged.

(aB) The contract may provide for a determinable variation of the return to the holder during the life of the instrument, provided that:

(i) the new rate satisfies condition (a) and the variation is not contingent on future events other than:

(1) a change of a contractual variable rate;

(2) to protect the lender against credit deterioration of the issuer; or

(3) changes in levies applied by a central bank or arising from changes in relevant taxation or law; or

(ii) the new rate is a market rate of interest and satisfies condition (a).

Contractual terms that give the lender the unilateral option to change the terms of the contract are not determinable for this purpose.

(b) There is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.

(c) Contractual provisions that permit the issuer (the borrower) to prepay a debt instrument or permit the holder (the lender) to put it back to the issuer before maturity are not contingent on future events other than to protect:

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[1] A variable rate for this purpose is a rate which varies over time and is linked to a single observable interest rate or to a single relevant observable index of general price inflation of the currency in which the instrument is denominated, provided such links are not leveraged.

(i) the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or

(ii) the holder or issuer against changes in levies applied by a central bank or arising from changes in relevant taxation or law.

The inclusion of contractual terms that, as a result of the early termination, require reasonable compensation for the early termination to be paid by either the holder or the issuer does not, in itself, constitute a breach of the conditions in paragraph 11.9.

(d) [Deleted]

(e) Contractual provisions may permit the extension of the term of the debt instrument, provided that the return to the holder and any other contractual provisions applicable during the extended term satisfy the conditions of paragraphs (a) to (c).

As you can see, the detailed conditions above are very complex and a financial instrument will need to meet them all in order to be classed as basic.

However, there is one further paragraph that could act as the entity's 'get out of jail free card' in the event that a financial instrument does not meet all of the conditions above. This is the **description** of a basic financial instrument contained in paragraph 11.9A:

> *A debt instrument not meeting the conditions in paragraph 11.9 shall, nevertheless, be considered a basic financial instrument if it gives rise to cash flows on specified dates that constitute repayment of the principal advanced, together with reasonable compensation for the time value of money, credit risk and other basic lending risks and costs (eg liquidity risk, administrative costs associated with holding the instrument and lender's profit margin). Contractual terms that introduce exposure to unrelated risks or volatility (eg changes in equity prices or commodity prices) are inconsistent with this.*

FRS 102, para 11.9A.

The entity should test the financial instrument against the detailed conditions in paragraph 11.9 first. If the instrument fails the conditions, then test it against the description to see if the instrument meets the description. If the instrument fails on the conditions but meets the description it can be classed as a basic financial instrument and hence be measured at amortised cost. If it fails on both the conditions and the description, the instrument is non-basic and must be accounted for under FRS 102, Section 12 *Other Financial Instruments Issues* (i.e. usually at fair value through profit or loss).

4.4 Initial recognition

Accounting standards require an entity to recognise a financial instrument **only** when the entity becomes a party to the **contractual** provisions of the instrument.

The definition of 'financial asset' and 'financial liability' refer to a 'contractual right … to receive cash or other another financial asset' and a 'contractual obligation … to deliver cash or another financial asset'. A financial instrument therefore arises due to contractual obligations.

Example – VAT owed to HMRC

Sunnie Ltd had a reporting date of 31 July 2020. Due to the Covid-19 pandemic, the company deferred its VAT liability as at 30 April 2020. The financial controller contacted the external accountant asking:

'*As this balance will eventually have to be paid to HMRC, I am unsure whether to treat the balance owing as a financial liability and discount it to present value using a market rate of interest for a similar borrowing. Could you advise me*?'

The amount due to HMRC in respect of the VAT balance arises because of legislative requirements and not because of a contractual obligation. Amounts in respect of taxation do not meet the definition of a financial instrument and hence are not

accounted for such in the financial statements.

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Example – Deferred income
Dexter Ltd sold six items of machinery to be used in one of its customers manufacturing process on 17 March 2021. The customer is based overseas, and Dexter raised an invoice on the same date as the sale. The goods were shipped to the customer on the same day but need to be installed as per the contract. Dexter has a year end of 31 March 2021 and a team of fitters are due to attend the customer's premises on 7 April 2021 to complete the installation. The financial controller has correctly recognised the sale in deferred income rather than revenue as there are still ongoing obligations with the contract at the year end. The financial controller has queried whether this transaction should be accounted for as a financial instrument. Deferred income does not meet the definition of financial instrument (although the related debtor balance would). This is because where deferred income is concerned, the cash has already been exchanged. Deferred income requires a transfer of goods and/or services so would not fall within scope of FRS 102, Section 11 or Section 12.

On initial recognition, a basic financial instrument is measured at transaction price which is adjusted for transaction costs. The term 'transaction costs (financial instruments)' is defined as:

> *Incremental costs that are directly attributable to the acquisition, issue or disposal of a **financial asset** or **financial liability**, or the issue or reacquisition of an entity's **own equity instrument**. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial asset or financial liability, or had not issued or reacquired its own equity instrument.*

FRS 102 Glossary ***transaction costs (financial instruments)***

If the financial instrument is to be measured at fair value through profit or loss, transaction costs must be expensed immediately (i.e. they are not included in the cost of the financial asset or the financial liability). This could apply to investments in ordinary and preference shares which are publicly traded, or which otherwise could have their fair value measured reliably.

The tables below summarise the initial measurement of financial assets and financial liabilities according to FRS 102, para 11.13:

Financial asset	Accounting treatment
Long-term market rate loan made to	A receivable is recognised at the amount

another entity	of the cash advanced plus transaction costs incurred
Goods sold to a customer on short-term credit	A receivable is recognised at the undiscounted amount of cash receivable (normally invoice price)
Goods sold to a customer on two-years interest-free credit	A receivable is recognised at the current cash sale price for that item. If the current cash sale price is unknown, it may be estimated as the present value of the cash receivable, discounted using the prevailing market rate(s) of interest for a similar receivable
Cash purchase of another entity's shares	Recognise the investment at the amount of cash paid to acquire the shares

Financial liability	Accounting treatment
Bank loan received at market rate	Recognise a payable initially at the amount of cash received, less any separately incurred transaction costs
Goods purchased from a supplier on short-term credit	Recognise a payable at the undiscounted amount of the amount owed to the supplier (normally invoice price)

Financing transactions

The term 'financing transaction' is not defined in FRS 102. However, paragraph 11.13 states that:

> *… An arrangement constitutes a financing transaction if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate, for example, providing interest-free credit to a buyer for the sale of goods or an interest-free or below market interest rate loan made to an employee.*

FRS 102, para 11.13 (extract)

When an arrangement constitutes a financing transaction, the entity measures the financial asset or financial liability at the present value of the future payments which are discounted at a market rate of interest for a similar debt instrument (e.g. a similar bank loan) as determined at initial recognition adjusted for transaction costs.

Example – Employee loan

On 1 April 2021, Morley Ltd provides a loan to an employee for £7,000 for the purchase of car. The loan is repayable on 31 March 2023. If the employee had gone to their bank for a loan, the interest payable would be at 6%. The loan is made up as follows:

- £6,229.98 is the present value of the financial asset (£7,000 / 1.06^2).
- £770.02 is employee remuneration accounted for under FRS 102, Section 28 *Employee Benefits* (or FRS 105, Section 23).

4.5 Subsequent measurement

The subsequent measurement requirements are outlined in FRS 102, paras 11.14 to 11.26.

In summary, basic financial instruments are measured either at amortised cost, fair value through profit or loss or at cost less impairment. All financial instruments which are not measured at fair value through profit or loss must be subject to impairment assessments at each reporting date. An actual impairment calculation is not required if there are no indicators that the financial asset is impaired. The requirement is for the entity to at least consider whether the financial asset is showing any indicators of impairment.

Note, where impairment of financial assets is concerned, general bad debt provisions are not allowed under FRS 102 for trade debtors. That is not to say that a group of debtors cannot be provided against where the entity deems the group to be irrecoverable – for example those debtors owing balances that are overdue by 90-120 days. It is the old 'X% of total trade debtors' that is not permitted due to the impairment requirements of FRS 102

Investments in ordinary and preference which are within scope of FRS 102, Section 11 are measured at fair value through profit or loss if they are publicly traded because a reliable measure of fair value will exist for such shares.

Where such shares are not publicly traded, they are still measured at fair value through profit or loss if this can be reliably determined. For example, shares held in a business where there is a recent transaction in those shares may provide sufficient information for a reliable fair value to be determined. If there are no recent transactions, then consideration must be given as to whether the nature of the business in which the shares are held is relatively easy to value. This is more likely to be the case if the business is stable and has been operating for some time and where published price-earnings ratios may allow a valuation. In some instances it will not be possible to arrive

at a reliable fair value and, in such cases, the shares should be measured at cost less impairment.

Keep in mind that shares held in subsidiaries, associates or joint ventures need not be recognised at fair value through profit or loss as they are outside the scope of FRS 102, Section 11 and accounting policy choices are available to recognise at cost less impairment or at fair value through other comprehensive income per FRS 102, paras 9.26, 14.4 and 15.9.

Micro-entities choosing to report under FRS 105

For micro-entities choosing to report under FRS 105, it is to be borne in mind that fair value accounting is not available. In respect of micro-entities, investments in preference or ordinary shares in subsidiaries, associates and jointly controlled entities are measured at cost less impairment. In the situation that a micro-entity has a derivative financial instrument (such as a forward foreign currency contract), they are measured at transaction price plus any transaction costs not immediately recognised in profit or loss. Other financial instruments are measured at:

- transaction price;
- plus, in the case of a financial asset, or minus in the case of a financial liability, transaction costs not yet recognised in profit or loss;
- plus the accumulative interest income or expense recognised in profit or loss to date;
- minus all repayments of capital and interest payments or receipts to date;
- minus, in the case of a financial asset, any reduction for impairment.

4.6 Amortised cost and effective interest method

FRS 102, para 11.15 states that the amortised cost of a financial asset or a financial liability at the balance sheet date is the net of the following amounts:

(a) the amount at which the financial asset or financial liability was initially recognised;

(b) minus any repayments of the principal;

(c) plus, or minus, the cumulative amortisation using the effective interest method of any difference in the amount at initial recognition and the maturity amount; and

(d) minus, in the case of a financial asset, any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

The effective interest method is a means of calculating the amortised cost of a financial asset or financial liability (or groups of financial assets and financial liabilities) and allocating the interest income or expense over the life of the instrument. The 'effective interest rate' is the rate which exactly discounts estimated future cash receipts or payments through the expected life of the instrument or, when appropriate, a shorter period, to the carrying amount of the instrument.

An efficient way of applying the effective interest method is to use the Goal Seek function in Microsoft Excel as this will calculate both the effective interest rate and the value of interest expense or income that is to be recognised over the life of the instrument.

Example – Amortised cost method

Westhead Ltd takes out a loan to purchase an item of machinery with a fair value of £35,000. The term of the loan is for five years. Monthly payments are £685 and there is an administration fee payable at the end of year five amounting to £150 which is included in the final payment. The company has not incurred any arrangement fees in connection with this loan.

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

	Balance b/f	Cash flow	Interest at EIR	Balance c/f
Year	£	£	£	£
1	35,000	(8,220)	0	26,780
2	26,780	(8,220)	0	18,560
3	18,560	(8,220)	0	10,340
4	10,340	(8,220)	0	2,120
5	2,120	(8,370)	0	(6,250)

The Goal Seek function in Microsoft Excel can be used to calculate the effective interest rate. To use the Goal Seek function go into the Data tab at the top of the Excel workbook and then into 'What-if Analysis'.

Using the Goal Seek function, the loan is then profiled as follows:

	Balance b/f	Cash flow	Interest at EIR	Balance c/f
Year	£	£	£	£
1	35,000	(8,220)	2,004	28,784
2	28,784	(8,220)	1,648	22,211
3	22,211	(8,220)	1,272	15,263
4	15,263	(8,220)	874	7,917
5	7,917	(8,370)	453	0

The effective interest rate in the above has been calculated at 5.72% and is allocated to each period during the term of the loan. The interest charges are higher in the earlier years of the loan and lower in the later years. In contrast, the 'level spread' method would have charged an amount of £1,250 per annum over the life of the loan

(£41,250 less £35,000 / 5 years).

In year 1, the journals are as follows:

	£
Dr Bank	35,000
Cr Loan payable	35,000
Receipt of loan	
Dr Loan payable	8,220
Cr Bank	8,220
Repayments of loan in year 1	
Dr Finance costs	2,004
Cr Loan payable	2,004
Interest at EIR	

At the end of year 1, the loan would be presented in the balance sheet as a current liability of £6,573 and a long-term liability of £22,211 to comply with the statutory formats of the balance sheet.

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

There are some important points to note when using the amortised cost and effective interest method:

- When calculating the effective interest rate, the entity must estimate the cash flows having regard to all contractual terms of the financial instrument (such as prepayment, call and similar options) and known credit losses which have been incurred (it does not, however, consider possible future credit losses which have not yet been incurred). In respect of variable rate financial assets and variable rate financial liabilities, the current market of interest or index of general price inflation may be used when estimating contractual cash flows.

- When calculating the effective interest rate, an entity amortises any related fees, finance charges paid or received, transaction costs and other premiums or discounts over the expected life of the instrument. A shorter period is used if that is the period to which the fees, finance charges paid or received, transaction costs, premiums or discounts relate. In such cases, the appropriate amortisation period is the period to the next repricing date.

- In respect of variable rate financial assets and financial liabilities, periodic re-estimations of cash flows to reflect changes in market rates of interest or an index of general price inflation will alter the effective interest rate. If a variable rate financial asset or liability is recognised initially at an amount equal to the principal receivable or payable at maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

- When an entity revises its estimates of payments or receipts, the entity must adjust the carrying amount of the financial asset or liability (or group of instruments) to reflect actual and revised estimated cash flows. It will be necessary to recalculate the carrying amount by calculating the present value of estimated future cash flows at the original effective interest rate and the adjustment is recognised as income or expense in profit or loss at the date the change takes place.

4.7 Directors' loans

When an entity enters into a financing transaction, FRS 102, para 11.13 normally requires the entity to impute a market rate of interest and discount the transaction to present value unless the financing transaction (e.g. a below market-rate loan) is repayable on demand. This will also apply to transactions such as directors' loans. However, there is an exception provided in FRS 102, para 11.13A.

FRS 102, para 11.13A states:

As an exception to paragraph 11.13, the following financing transactions may be measured initially at transaction price:

FRS 102, para 11.13A

(a) a basic financial liability of a ***small entity*** *that is a loan from a person who is within a director's group of close family members[2], when that group contains at least one shareholder[3] in the entity; and*

(b) a public benefit entity concessionary loan (see paragraph PBE11.1A).

For completeness, the definition of 'close members of the family of a person' is:

Those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including:

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

(a) that person's children and spouse or domestic partner;

(b) children of that person's spouse or domestic partner; and

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[2] In this context, a director's group of close family members shall be the director and the close members of the family of that director (see glossary definition of **close members of the family of a person**). This includes a person who is the sole director-shareholder of an entity.

[3] For small LLPs this shall be read as a member who is a person.

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(c) dependants of that person or that person's spouse or domestic partner.

Hence, loans from directors or their close family members will qualify for the exemption if at least one close family member is a shareholder.

The relief is also available to small LLPs.

Please note that the exemption only applies in a **one-way direction** which is a loan **to** the small business **from** the director-shareholder/close family member that is a shareholder. It does not apply the other way round (i.e. a loan from the company to the director). Nor does the exemption apply to intra-group loans.

In practice the exemption from discounting would only apply to loans which are structured with formal loan terms in place. If there are no formal loan terms in place, the loan would be treated as being repayable on demand and hence there would be no need to impute a market rate of interest and discount the loan to present value.

Related party disclosure

It should be noted that where a director-shareholder, or a person within a director's group of close family members when that group contains at least one shareholder, provides a **material** loan to the small entity at below market rates of interest or at zero rates of interest, and the small entity chooses to apply the presentation and disclosure requirements of Section 1A, the loan will be caught by the related party disclosure requirements in FRS 102, para 1AC.35. Hence the loan must be disclosed as a related party transaction as it has not been concluded under normal market conditions (due to the below market rates of interest). The related party disclosure must include:

(a) the amount of the transactions;

(b) the nature of the related party relationship (note the names of the transacting related parties need not be disclosed); and

(c) other information regarding the transaction necessary for an understanding of the financial position of the entity.

4.8 Impairment

As with all other types of assets, management must consider whether financial assets are showing indicators of impairment at each reporting date. The impairment requirements for financial assets refer to the asset showing '… objective evidence of impairment'

An assessment for impairment is required in respect of all financial assets which are not measured at fair value through profit or loss, such as:

- Loans receivable from a third party
- Finance lease receivables

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- Trade receivables
- Investments in ordinary and preference shares

FRS 102, para 11.22 provides examples of loss events which may provide evidence that a financial asset is impaired and may need writing down to recoverable amount as follows:

Loss event	Explanation
Significant financial difficulty of the issuer or obligor	Significant financial difficulties indicate the risk of non-payment of a financial asset is higher
A breach of contract, such as a default or delinquency in interest or principal payments	When contractual terms have been breached, for example, the borrower has missed a payment(s), this is an indicator that the financial asset may be impaired and the full amount of the debt may not be recoverable
The creditor, for economic or legal reasons relating to the debtor's financial difficulty, granting to the debtor a concession that the creditor would not otherwise consider	The lender may agree to terms which they would otherwise not consider in the circumstances – for example, a payment break or a period of reduced payments. This would indicate impairment of the financial asset as the full amount may not be recoverable
It has become **probable** that the debtor will enter bankruptcy or other financial reorganisation	When a debtor enters into bankruptcy or other financial reorganisation (such as a Company Voluntary Arrangement (CVA)) or Individual Voluntary Arrangement (IVA), it may be unlikely that there will be funds available to repay the whole debt to the lender
Observable data indicating that there has been a measurable decrease in estimated future cash flows from a group of financial assets since the initial recognition of those assets, even though the decrease cannot yet be identified with the individual financial assets in the group, such as adverse national or local economic conditions or adverse changes in industry conditions	Where estimated future cash flows indicate a decline, this also indicates that the carrying amount of the financial asset in the balance sheet exceeds recoverable amount and hence a write-down to recoverable amount will be required

When an entity measures a financial asset at amortised cost and concludes that the financial instrumenrt is impaired, the impairment loss is the difference between the carrying amount of the financial asset and the present value of the estimated future cash flows, discounted at the original effective interest rate. The difference between the two is then recognised in profit or loss.

Where the financial asset attracts interest at variable rates, the impairment loss is measured using the current effective interest rate which has been determined under the contract.

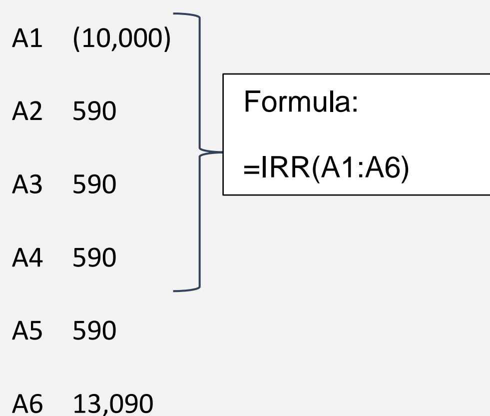
For instruments measured at cost less impairment, the impairment loss is measured as the difference between the asset's carrying amount and the amount for which the asset could be sold at the reporting date. The difference is recognised in profit or loss.

Example – Impairment of a financial asset

Churchill Ltd provides a loan to a third party for £10,000. The terms of the loan state that it is to be settled in five years at a premium of £2,500. The coupon rate of interest is 4.74% with interest of £590 paid each year. The loan is profiled as follows:

Year	Balance b/f	Interest (10%)	Cash flow	Balance c/f
	£	£	£	£
1	10,000	1,000	590	10,410
2	10,410	1,040	590	10,860
3	10,860	1,090	590	11,360
4	11,360	1,130	590	11,900
5	11,900	1,190	13,090	-

The interest rate of 10% has been calculated using the internal rate of return function in Excel as follows:



A1 (10,000)

A2 590

A3 590

A4 590

A5 590

A6 13,090

At the end of year 2, the amortised cost of the loan is £10,860 and on this date the directors of Churchill conclude that the debt instrument is impaired and no further interest payments will be received on this debt. The capital element will be received.

The company calculates that the present value of the principal repayment in three years' time is £9,391 (£12,500 / 1.1^3).

The impairment loss recognised is £1,469 (£10,860 less £9,391) and is recorded as:

Dr Impairment loss (profit and loss) £1,469

Cr Financial asset (loan receivable) £1,469

Reversing an impairment loss on a financial asset

When an impairment loss decreases, and the decrease can be related objectively to an event occurring after the impairment was recognised (such as a debtor's credit-rating improving), the entity reverses the previously recognised impairment loss.

Care must be taken with the impairment loss reversal. The amount of the reversal must not result in a carrying amount (net of any allowance account) which exceeds what the carrying amount would have been had the impairment loss not previously been recognised. All impairment reversals are recognised in profit or loss immediately.

After an impairment loss has been recognised, the asset must be continually assessed, not simply for any additional evidence of impairment, but also to assess whether the financial asset's value should be uplifted due to either a cessation of the circumstances giving rise to the original impairment loss, or other situations which mean the financial asset's amount is increased.

5 Dividends (Lecture A744 – 15.59 minutes)

There are strict rules in company law which must be complied with where dividends are concerned. If these rules are not followed correctly, a dividend may be unlawful and this, in itself, can have potentially serious consequences. In some cases, shareholders may be required to repay unlawful dividends.

HM Revenue and Customs (HMRC) will also be interested to see that dividends paid to shareholders have met the correct protocol. Tax consequences can arise where dividend protocol is not correctly followed as HMRC may deem the payments to be salary rather than dividend, hence attracting additional PAYE/NIC liabilities.

There are two types of dividends in practice:

- **Final dividends** which are paid once a year once the final accounts have been prepared. They are recommended by the directors and approved by the shareholders.

- **Interim dividends** are paid during the year and are usually declared by the directors.

Companies Act 2006, s830 states that dividends are lawful if they are paid out of accumulated released profits less accumulated realised losses.

TECH 02/17BL *Guidance on Realised and Distributable Profits Under the Companies Act 2006*, para 3.9 states that a profit is realised, as a matter of generally accepted accounting practice, where it arises from:

(a) a transaction where the consideration received by the company is ‘qualifying consideration’; or

(b) an event which results in ‘qualifying consideration’ being received by the company in circumstances where no consideration is given by the company; or

(c) the recognition in the financial statements of a change in fair value, in those cases where fair value has been determined in accordance with measurement guidance in the relevant accounting standards or company law, and to the extent that the change recognised is readily convertible into cash; or

(d) the translation of:

    (i) a monetary asset which comprises qualifying consideration; or

    (ii) a liability,

    denominated in a foreign currency; or

(e) the reversal of a loss previously regarded as realised; or

(f) a profit[4] previously regarded as unrealised (such as amounts taken to a revaluation reserve, merger reserve or other similar reserve) becoming realised as a result of:

  (i) consideration previously received by the company becoming 'qualifying consideration'; or

  (ii) the related asset being disposed of in a transaction where the consideration received by the company is 'qualifying consideration' or;

  (iii) a realised loss being recognised on the scrapping or disposal of the related asset; or

  (iv) a realised loss being recognised on the write-down for depreciation, amortisation, diminution in value or impairment of the related asset[5]; or

  (v) the distribution in kind of the asset to which the unrealised profit relates; or

  (vi) the receipt of a distribution in the form of qualifying consideration when no profit is recognised because the distribution is deducted from the book value of the investment to which the unrealised profit relates (eg, a distribution which is credited to the cost of the investment because it is in substance a return of capital), in which case the appropriate proportion[6] of the related unrealised profit becomes a realised profit; or

(g) the remeasurement of a liability, to the extent that the change is readily convertible into cash.

Example – Non-distributable profit

Zico Ltd has two properties which it rents out to third parties. At the balance sheet date 31 May 2021, the fair value of both properties increased by £30,000. Net of

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[4] Where the related profit has been capitalised, it will not be available for transfer from unrealised profit to realised profit.

[5] If the write down is subsequently reversed, an equal amount should be regarded as becoming realised. In other words, the amount of profit regarded as becoming realised is equal to the *cumulative* amount of any write down treated as a realised loss.

[6] In the case of (iii) and (iv), the loss is treated as a realised loss under paragraph 3.15 [of TECH 02/17BL]. However, part of this realised loss is compensated by a reclassification from unrealised to realised profit.

deferred tax the overall gain on both properties is £48,600 ((£30,000 x 2) – 19%).

The directors have enquired as to whether the gains on these investment properties can be distributed as a dividend.

Fair value gains on investment properties cannot be distributed as a dividend because they are not readily convertible into cash (hence the gain is not realised profit for distribution purposes). The gain would only become realised profit once the properties have been sold.

If the directors declare a dividend out of non-distributable profit, the dividend will be unlawful. TECH 02/17BL is clear that dividends can only be paid out distributable profit.

The treatment of non-distributable profits is not generally consistent across all reporting entities. Some entities ring-fence non-distributable profits into a separate component of equity, whereas others do not. There is nothing in company law that requires a separate component of equity to be created to take non-distributable profits. However, it is an efficient mechanism to have to keep a track of those profits which are distributable and those which are not. For entities that do not ring-fence non-distributable profits in a separate component of equity, a separate record will need to be maintained to ensure that no dividends are paid out of profits which are non-distributable.

5.1 The accounts

As noted above, dividends can only be paid out of distributable profit. Hence, the directors must have access to accounts which show there are sufficient distributable profits available to make the dividend. Those accounts must either be:

- the company's last accounts;
- if those accounts suggest there are insufficient distributable profits available to make the dividend, the dividend must be justified with regard to more up-to-date interim accounts; or
- if the dividend is being declared in the company's first accounting period, 'initial accounts' must be prepared.

The directors must consider the bigger picture because the accounts used as a basis of declaring a dividend are just one aspect that must be considered. The directors must also consider:

- the financial position of the entity at the time the dividend is declared;
- availability of cash in order to pay the dividend; and
- the future financial position once the dividend is declared. The directors must keep in mind that the entity must still be in a position to meet its ongoing obligations to creditors.

Global Corporate v Hale 2019

The case of Global Corporation v Hale surrounds the issue of unlawful dividends. In this case, Mr Dirk Hale was director and shareholder of Powersation UK Limited. Powerstation UK Limited had been in financial difficulty since 2008 before eventually going into liquidation in 2015.

Mr Hale was one of two shareholders and was paid a small salary to cover the national insurance contributions and dividends to supplement his remuneration, which is not an unusual remuneration structure. At the end of each financial year the company's profits would be assessed. If there were insufficient profits from which dividends could be declared in accordance with s830 of Companies Act 2006, the accountant would re-characterise the payments, so they were salary. Additional PAYE and NIC would then be paid to HMRC.

In November 2015, the liquidation of Powerstation UK Ltd was completed and the liquidators concluded that the company had insufficient distributable reserves from which the dividends could be paid. This led the liquidator to confirming that the dividends had been paid in breach of s830 of Companies Act 2006.

Mr Hale refused to repay the dividends back to the liquidator. The Appellant, Global Corporate Ltd, made a claim suggesting that the dividends paid to Mr Hale were unlawful.

High Court decision

The High Court ruled that Powerstation had not declared and paid dividends each month, even though such payments had been recorded as an 'interim dividend' and a 'dividend tax voucher' prepared. The High Court judge concluded that the director had taken a decision to declare and pay a dividend and the characteristics of this payment would be reviewed at the end of the financial year. As this advice had been given to Mr Hale from his accountant, Hale claimed that he did not know, nor intended to be in breach of, s830 of Companies Act 2006.

As these payments were not dividends, the provisions of s847 of Companies Act 2006 could not apply. The High Court held that there was no misfeasance because, even if Hale had an obligation to repay the money, he had an equal claim as *quantum meruit* (the 'amount he deserves' under law) for services rendered to the company. In other words, Hale had provided a service to Powerstation and he was entitled to be remunerated for his services. If Hale had not been remunerated for those services, then somebody else would have been.

It was on this basis that the High Court judge held that Powerstation would have been unjustly enriched if Hale had not been paid the additional sums each month in addition to his normal salary. The judge also concluded that the level of remuneration Hale had received was not excessive in the circumstances.

This case was then sent to the Court of Appeal.

Court of Appeal

The Court of Appeal disagreed with the High Court's decision. The Court of Appeal held that the payments were, in fact, dividends and fell within scope of s830 of Companies Act 2006. They cited three reasons:

- From a review of the available evidence, the payments were intended to be treated as dividends. This was clear from the fact that they were described as 'interim dividends' by the directors and were structured as dividends for tax purposes.
- The High Court judge had wrongly focussed on Hale's intention when authorising monthly payments to himself as dividends. Instead, consideration should have been given as to whether the payments were lawful distributions of the company's assets. The fact that the accountant could reclassify the nature of the payments did not stop them from being dividends at the time of payment.
- There was no such contract for remuneration in place and hence the conclusion that *quantum meruit* could act as an offset or defence against the claim by the company was wrong. In reaffirming the House of Lords case of *Guinness PLC v Saunders*, the Court of Appeal held that for such a defence to be available, a contract for remuneration would need to be in place. Perhaps more importantly was the fact that the company was also in liquidation and this would mean that any *quantum meruit* claim would be an unsecured claim requiring proof of debt in the liquidation.

This case highlights the importance of considering whether there is sufficient distributable profit in which to declare a dividend as well as having regard to the bigger picture. The company's financial statements for the year ended 30 April 2014 showed it did not have any distributable profit available from which to declare the dividends and hence they were paid unlawfully.

5.2 Sufficient documentation

Sufficient dividend documentation is critical. Without correct documentation, the dividend will not be lawful and can bring about serious consequences.

Dividend documentation must be properly prepared, including documenting the relevant minutes of meetings and tax vouchers. Interim dividends are normally paid by the directors at periodic intervals during the financial year and a final dividend is declared by the directors and approved by the shareholders. Interim dividends must also be properly documented.

Dividend documentation cannot be backdated. Any dividend declared after the year end for the previous year can only be deemed to be paid in the year of declaration. If dividend documentation is backdated, this will be tantamount to fraud.

5.3 Recognition of the dividend in the financial statements

Dividends are dealt with in FRS 102, Section 32 *Events after the End of the Reporting Period*. FRS 102, para 32.8 (FRS 105, para 26.10) does not allow a dividend to be recognised as a liability in the financial statements if that dividend has not been declared by, or at, the reporting date. This is because the entity has no legal obligation.

Dividends on ordinary shares are normally paid at the discretion of the entity. Therefore, just because a shareholder may have always received a dividend, does not mean that a dividend can just be recognised in the financial statements each year. Constructive obligations are irrelevant where dividends are concerned and there has to be a legal obligation in place.

If the obligation is not adequately documented (e.g. if there are no minutes or the shareholders have not approved the final dividend) there will not be a legal obligation at the reporting date and hence the dividend should not be recognised, although a proposed dividend can be disclosed.

6 Financial reporting for charities (Lecture A745 – 10.48 minutes)

The impact of Covid-19 has affected many charities adversely and while the Charities Statement of Recommended Practice (SORP) addresses many issues, it does not address every eventuality where the pandemic is concerned, or, where it does, the guidance is quite sparce.

This section of the course will focus on some issues the various charity regulators have reminded charities about where the Covid-19 pandemic is concerned.

6.1 Grants

In response to the pandemic, the Government have introduced a range of support available to businesses, including charities, to help them through the disruptive period. For example:

- Coronavirus Job Retention Scheme (CJRS) grant
- Statutory Sick Pay Rebate
- Small Business Grant Fund
- Retail, Hospitality and Leisure Grant Fund

Charities that are in receipt of these types of grants will need to ensure they correctly record them in their financial statements.

Grants will usually be recognised when the charity becomes entitled to receive them. CJRS grants will usually be received in the month to which the payment relates. The CJRS grant is intended to cover the payroll costs of staff and hence they will usually be included within the charity's restricted funds. Care must be taken here. Unless the terms of the grant are specific, the income is treated as unrestricted and costs will usually be taken to unrestricted funds or treated as restricted with a transfer between funds which should be explained in the notes to the charity's financial statements.

Grants received must be shown within income – in other words, grants such as the CJRS cannot be offset against the costs to which they relate.

Other grants such as the Small Business Grant Fund and Retail, Hospitality and Leisure Grant Fund are recognised in the charity's financial statements when the charity becomes entitled to receive them.

6.2 Waivers

There may be situations when the charity receives a concession from a third party, such as a rent concession (where rent due does not have to be paid) or loan interest. Deferrals (of rent or other payments) are not waivers or concessions, and such deferrals merely change the timing of the cash outflows, hence a liability will need to be

recognised in the charity's financial statements. Waivers represent income and they should be recognised as such in the financial statements.

Commercial discounts offered to the charity are not income and this is made clear in the SORP at paragraph 6.5. The reason for this is that the discount is intended to be an inducement to the customer to make the purchase by lowering the price paid.

6.3 Reclassifying trading income

There may be situations when a charity has received certain forms of income, such as subscription income, when no service could be performed by the charity due to the Government-imposed restrictions. The party providing the income may have allowed the charity to retain the income even though they have not received a service in exchange as a gesture of goodwill.

Where this is the case, the income would need to be reclassified as a donation, but the underlying contract and facts must be scrutinised carefully to ensure correct treatment.

Example – Reclassification of income after the reporting date

The XYZ Foundation (the Foundation) is a registered charity in England and Wales. As part of its activities, it provides four concerts a year in which subscribers pay a one-off fee at the start of the year and can attend all four concerts including receiving a two-course meal.

The Foundation had a year end of 31 March 2020. Due to the Government-imposed restrictions the Foundation decided, in April 2020, that it could not go ahead with any concerts until such time as the Government eased the restrictions.

On 10 April 2020, the Foundation offered its subscribers either a full refund or to allow the Foundation to keep the subscription and the subscriber receives a special acknowledgement in the programme as a 'thank you'. 90% of the subscribers have allowed the Foundation to retain the subscription.

As confirmation from the subscriber that the charity can retain their subscription was received after the reporting date of 31 March 2020, this should be treated as an adjusting post balance sheet event. The Government made the 'lockdown' announcement on 23 March 2020 and hence this is why it is an adjusting event. As a consequence, the income should be classified as a donation rather than as trading income.

6.4 Staff costs

Since the pandemic began, lots of entities (including charities) have had to furlough staff members. Where a charity has furloughed its staff, it will receive the CJRS as a contribution towards its payroll costs.

The CJRS grant currently allows an employer to apply for a grant of 80% of the hours not worked up to a maximum of £2,500 per month. An employer can top-up the staff member’s wage/salary up to 100% at their own cost.

Where the charity makes such payments, the full cost is treated as staff costs in the financial statements. In addition, the charity should include a disclosure note explaining the additional 20% top-up payment in accordance with the SORP, para 9.24 which states:

An ex-gratia payment is a payment, or the waiver of a right to an asset which the trustees have no legal obligation or legal power to make from a charity's funds but which they believe they have a moral obligation to make. For the purposes of disclosure, occasional gifts of small and inexpensive items such as flowers or chocolates should not be regarded as ex-gratia payments.

Charities SORP (FRS 102), para 9.24

Unpaid holiday pay accruals will also need to be considered and this will also include those staff which have been furloughed. Just because a staff member may have been furloughed does not mean their holiday entitlement has been affected.

6.5 Coronavirus Business Interruption Loans

The Chancellor introduced a number of loan schemes to help entities access finance much more quickly than normal and these loans are provided at favourable rates – often with no interest to pay or repayments to make in the first year of the loan. Such loan schemes have proved incredibly popular as one would expect.

These types of loans are intended to provide working capital – i.e. they are intended to provide finance to help an entity cover its costs. Hence, such loans will have an adverse effect on the charity's free reserves, and this would need to be explained in the notes to the financial statements.

6.6 Assets

A charity's assets must be reviewed each year for evidence of indicators of impairment. Where there are indicators of impairment, the charity must carry out an impairment test.

Impairment losses on assets (which are expected to be more prevalent during the Covid-19 crisis) should be charged to the relevant charitable expenditure heading. An additional sub-heading may be needed according to the SORP, para 4.56 which states:

Other expenditure includes all expenditure that is neither related to raising funds for the charity nor part of its expenditure on charitable activities. Where an amount is material or its presentation on the face of the SoFA is necessary for an understanding of a charity's financial performance, an additional sub-heading should be used.

Charities SORP (FRS 102), para 4.56

7 Tipping off (Lecture A746 – 8.20 minutes)

The 'tipping off' regulations are derived from the Proceeds of Crime Act 2002 (POCA 2002) and it is widely known that tipping off a client concerning a Suspicious Activity Report (SAR) is a criminal offence.

Tipping off means letting a third party (i.e. a client) know that their suspicious activity has been reported to a Money Laundering Reporting Officer (MLRO) or directly to the National Crime Agency (NCA). Where a client has been tipped off, they are likely to destroy any evidence connected with the offence, or they will disappear themselves.

Under s333A of POCA 2002, a person in the regulated sector commits an offence of tipping off if:

- (s)he knows or suspects that a disclosure to an MLRO, or by an MLRO to NCA under s337 or 338 POCA 2002 has been made; and
- (s)he makes a disclosure which is likely to prejudice any investigation which might be conducted following that disclosure.

Tipping off carries a maximum of two years' imprisonment, or a fine, or both.

The offence of tipping off does not arise unless a person knows or suspects that a SAR has been filed either internally or to the NCA, or alternatively knows or suspects that the relevant enforcement agency is carrying out a money laundering investigation.

There are exemptions contained in s333B to s333D of POCA 2002 to the rule of tipping off. These exemptions mean that a relevant person does not commit the offence of tipping off if s(he) makes a disclosure to:

- another person employed by the same undertaking or group (s333B);
- another person of the same professional standing as him/herself in another undertaking, such as another accountant or another lawyer (s333C); or
- an anti-money laundering supervisory authority (as defined in s333D) or to a client to dissuade the client from committing an offence (s333D).

A tipping off disclosure can be made in writing or orally, and either directly or indirectly. Including information about obligations under the anti-money laundering regulations in standard terms of engagement is not tipping off.

7.1 Resignation of accountant/auditor

Extreme care must be taken by accountants and auditors where their clients are concerned. An accountant or auditor may suspect that their client is engaged in money laundering and make the necessary report to either the firm's MLRO or, if the accountant/auditor is the firm's MLRO, the NCA.

Challenges will arise when it comes to resigning from acting for the client, and the need to file any resignation statements with Companies House (for auditors).

It is absolutely vital that auditors understand the rules about tipping off. Remember, this goes further than simply informing the client that you have/or may make a report to the firm's MLRO or NCA. If the client becomes aware that a report has been made, then this constitutes tipping off.

Sensitive cases such as resignation due to suspected money laundering will need careful consideration and discussion with the audit engagement partner, the firm's MLRO, the professional body to which the firm belongs or even the firm's legal counsel.

Professional bodies will be able to advise their member firms on how to deal with particularly difficult resignation situations (including advice on how to handle the client's queries as to the reasons for resignation). In addition, they will also be able to offer advice on how to word the relevant resignation letters – especially where these have to be placed on the Companies House record.

In all such cases, it is important to keep contemporaneous records of all conversations held in the event that the accountant/auditor is called to provide evidence in any subsequent investigation.

7.2 Covid-related issues

The issues related to Covid-19 and money laundering were examined in the quarter 1 audit and accounting update course. Again, it is important to understand the tipping off rules where fraud is suspected – for example, where a client may have fraudulently claimed the SEISS grant or deliberately inflated turnover levels on a CBIL/BBL application.

It is expected that SARs will increase significantly in 2021 due to Covid-related fraud and with professional bodies now carrying out money laundering monitoring visits on professional firms, having a sound understanding of anti-money laundering obligations is more important than ever.

8 Audit reform (Lecture A747 – 13.07 minutes)

There has been a lot in the professional press recently about the issue of audit in the UK. Well-publicised corporate collapses such as Thomas Cook, Carillion and Patisserie Valerie have led to a number of questions being asked about whether audit is 'fit for purpose' or whether it is 'broken'.

In 2019, Sir Donald Brydon completed his review into the auditing profession and made some quite dramatic recommendations as to how the profession could be improved. One of those suggestions was the creation of a separate audit profession away from accountancy. The purpose of this suggestion was to redefine and refocus the auditing profession.

The Brydon review was carried out alongside two other reviews:

- Sir John Kingman's review into the operational structure of the Financial Reporting Council; and
- The Competition and Market Authority's (CMA) Statutory Audit Services Market Study.

The Kingman review into the FRC found that the FRC lacked the necessary powers and clarity of purpose to hold auditors and directors sufficiently to account and made a recommendation that the FRC be replaced. This is currently ongoing and the FRC is due to become the Audit, Reporting and Governance Authority (ARGA) in due course. The CMA Market Study showed an unhealthy dominance of the audit market by larger firms and called for new measures to increase quality, competition and resilience in the delivery of audit.

The Government agreed with the findings of all three reviews.

8.1 Government proposals for company directors

Company directors have various duties enshrined in company law which they must comply with. It is the directors that are ultimately responsible for the company's accounts and reports and they have various statutory duties where these are concerned.

One of the Government's proposals is to ensure that directors are held to account where they have neglected their responsibilities. The current framework is such that the FRC has no power to enforce directors' duties other than when a director is a member of a professional accountancy body. The Government have also acknowledged in their consultation document that there are weaknesses in reporting and accountability in three key areas of management relating to:

- Internal controls over financial reporting
- Dividend and capital maintenance decisions

- Steps taken to consider and strengthen a company's future resilience

The above three areas of concern are addressed via Government proposals for new reporting and attestation requirements covering internal controls, dividend and capital maintenance decisions and resilience planning. These proposals are aimed at strengthening directors' accountability in these areas in the largest companies.

The Government have also outlined proposals to ensure that the FRC has effective investigation and civil enforcement powers to hold directors of large businesses to account for breaches of their duties in respect of corporate reporting and audit.

8.2 Government proposals for audit, auditors and audit firms

The Government consultation recognises that the annual statutory audit of an entity's financial statements is important in providing independent, professional scrutiny of directors' reporting of their business's financial position. It also recognises that the auditor has unique access to a company's information, people and processes which are enshrined in company law.

Auditors of public interest entities (PIEs) have additional obligations imposed on them to test and assure the financial reporting of companies whose failure would bring particular economic and social shocks.

Recent corporate collapses have brought into question the work of auditors. This is also compounded by recent findings by the FRC of sub-standard audit work being carried out by firms who they inspect. This has led to questions being asked as to whether the statutory audit function is performing the public interest function expected of it.

Of course, there is always the 'expectation gap' which is the difference between what the auditor does and what the general public perceive the auditor should do (or does). During his review of audit, Brydon found that the overall audit product had not changed for decades. In the broadest sense of the term, the audit function merely involves the auditor checking for directors' compliance with legal duties and accounting standards resulting in the auditor forming an opinion as to whether the financial statements are free from material misstatement.

While the expression of an opinion on the financial statements is clearly important (and will always remain an important function of the auditor), the Government consultation suggests that this does not address the increasing expectations of shareholders and other users of company reporting that the auditor's report should be more forward looking and informative.

The Government have also suggested that it is inappropriate that the UK audit market is so concentrated, with 97% of the FTSE 350 audits being undertaken by just four audit firms. In addition, these four firms also compete to provide a wide range of other business services to the largest companies.

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The Government therefore propose to create a new, stand-alone audit profession which is underpinned by a common purpose and principles. Those principles will include a clear public interest focus and with a reach across all forms of corporate reporting rather than just the financial statements. In addition, the Government is also proposing new regulatory measures aimed at increasing competition and reducing the potential for conflicts of interest by providing new opportunities for challenger firms and new requirements for audit firms to separate their audit and non-audit practices.

8.3 The audit regulator

During his review of the FRC, Sir John Kingman identified strengths but also significant weaknesses; notably in the effectiveness of overseeing and holding directors, auditors and investors to account for their roles within the regulatory and corporate governance function. The Kingman Review noted the absence of a meaningful statutory base for the regulator's work and the absence of clear statutory objectives. It also noted inadequacies in the FRC's enforcement powers in key areas of audit supervision, reporting and directors' accountability.

The weaknesses and inadequacies noted by the Kingman Review resulted in the conclusion that they hamper the FRC's ability to be a modern, proactive regulator which the UK needs.

The FRC have taken on board the recommendations outlined in the Kingman Review and have already started implementing some of them. The most notable recommendation was that the FRC needs to be disbanded and remodelled. To that end, the FRC have put in place a new board and (as mentioned earlier) will become the Audit, Reporting and Governance Authority (ARGA).

The transition to ARGA has been slow, although the impact of Covid-19 will of course have had an impact on the pace. However, there also has to be certain statutory instruments passed in Parliament to provide ARGA with the powers that it needs to meet its objectives. To that end, the Government's consultation document sets out the steps which the Government proposes to take to provide ARGA the formal duties, functions and powers it needs in order to be fully effective.

These powers include new statutory objectives and functions along with a new statutory levy to replace the existing voluntary levy. The Government is also proposing to provide ARGA with competition powers and new powers to strengthen its corporate reporting review function, its oversight of audit committees and to enforce the corporate reporting duties of directors. In addition, the consultation document includes proposals for ARGA to have responsibility in deciding which individuals and firms should be approved to audit PIEs.

8.4 Will the new regime help?

Some in the profession have criticised the Government's proposals for audit claiming it to be a 'knee jerk' reaction. There will always be corporate collapses and audit failures and it would be reasonable to say that virtually nothing is possible to prevent such collapses and failures. Unscrupulous directors may commit fraud, and in some cases this fraud may not be discovered for several years (even if at all). Introducing rigorous auditing standards and corporate governance practices are a way of deterring against unorthodox practices, but they will never eradicate the problem in its entirety.

The audit profession has increased in complexity significantly over the years and it is fair to say that auditing standards have become lengthier, include more responsibility on the part of the auditor and audits have become very expensive to carry out.

It is impossible to eliminate all risks. However, the new regime should hold more directors to account for bad practices and more auditors to account for failing to comply with ISAs and other regulatory requirements. Only time will tell if the new regime proves beneficial.

8.5 Comment period

The comment period on the reform of audit is open until 8 July 2021. If you would like to comment on the proposals, then you can respond online at:

https://beisgov.uk.citizenspace.com/business-frameworks/audit-and-corporate-governance-review.

Alternatively, you can respond via email to: audit.consultation@beis.gov.uk.

9 Reporting irregularities in the auditor's report (Lecture A748 – 12.00 minutes)

In the quarter one audit and accounting update, we reminded audit firms that ISA (UK) 700 (Revised January 2020) *Forming an Opinion and Reporting on Financial Statements* comes into mandatory effect for audits of financial statements for periods commencing on or after 15 December 2019 (i.e. 31 December 2020 year ends will be the first ones mandatorily affected by the new ISA (UK)). This requirement was previously only required by PIEs (as per the Audit Regulation), but ISA (UK) 700 (Revised January 2020) extends the scope of this requirement to all entities that have their financial statements audited.

This revised ISA (UK) requires the auditor's report to explain how the audit was considered capable of detecting irregularities, including fraud.

In April 2021, the Audit and Assurance Faculty of ICAEW issued a supplementary guide *How to report on irregularities, including fraud, in the auditor's report – Guide for auditors reporting for the first time*. This guide provides members with practical considerations for auditors who are required to report on irregularities, including fraud, for the first time.

It should be emphasised that illustrative wording used in examples and other guidance issued by professional bodies or other organisations should not be considered prescriptive. The wording in the auditor's report must be entity- and audit-specific and will usually cover a wide range of aspects rather than those used in illustrative scenarios.

The term 'irregularity' is not defined in company law. ISA (UK) 250 *Section A – Consideration of Laws and Regulations in an Audit of Financial Statements* defines the term 'non-compliance' which can be used instead. For clarity, the term 'non-compliance' is defined as:

> *Acts of omission or commission intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity, which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity.*

ISA (UK) 250A, para 12

9.1 Placement and factors to consider

Reporting on irregularities will be included underneath the 'Auditor's responsibilities for the audit of the financial statements'. The FRC and the ICAEW guidance suggest an opening paragraph as follows:

> *Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities, outlined above, to detect material misstatements in respect of irregularities, including fraud. The extent*

to which our procedures are capable of detecting irregularities, including fraud is detailed below:

[Explain as to what extent the audit was considered capable of detecting irregularities, including fraud].

The guidance is clear that the auditor must ensure such an explanation reports **matters of significance** clearly and concisely, without the user of boilerplate wording.

The level of detail required will vary among entities. Smaller and less complex entities may not go into anywhere near as much detail as a PIE. However, at the very least, the auditor would be expected to cover how they have assessed the risk of material misstatement in respect of irregularities, including fraud and non-compliance with laws and regulations (NOCLAR) as well as explaining the auditor's approach to responding to those risks as part of the audit.

The ICAEW's guide provides a list of (non-comprehensive) factors the auditor may consider as follows:

- The auditor's assessment of the susceptibility of the entity's financial statements to material misstatement, including how fraud might occur.
- Which laws and regulations the auditor identified as being of significance in the context of the entity.
- How the auditor obtained an understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- How the auditor obtained an understanding of the entity's policies and procedures on compliance with laws and regulations, including documentation of any instances of non-compliance.
- How the auditor obtained an understanding of the entity's policies and procedures on fraud risks, including knowledge of any actual, suspected or alleged fraud.
- The engagement partner's assessment of whether the engagement collectively had the appropriate competence and capabilities to identify or recognise non-compliance with laws and regulations, details of those matters about non-compliance with laws and regulations and fraud that were communicated to the engagement team, and any discussions with specialists on areas of the financial statements particularly susceptible to fraud.
- In the case of a group, how the auditor addressed these matters at both the group and component levels.
- Communications with component auditors to request identification of any instances of non-compliance with laws and regulations that could give rise to a material misstatement of the group financial statements.
- In the case of a regulated entity, how the auditor obtained an understanding of the entity's current activities, the scope of its authorisation and the effectiveness of its control environment.

9.2 Wording of the irregularity section

The wording of the irregularity reporting section must not be boilerplate – that is wording provided from examples in professional bodies' guidance or any guidance issued by the FRC. The danger with boilerplate wording is that some, or all, of it may not be relevant to the reporting entity.

Auditors are strongly advised to set aside an adequate amount of time to give careful consideration as to the wording of the irregularities section.

9.3 Key Audit Matters (KAM)

Only auditors of listed entities are required to include a KAM paragraph in the auditor's report (although auditors' reports for private entities can also include a KAM paragraph if the auditor deems it necessary even though it is not mandatory for a private entity auditor's report). KAM are dealt with in ISA (UK) 701 (Revised January 2020) *Communicating Key Audit Matters in the Independent Auditor's Report*.

Where an auditor is required to include a KAM section in their report, they may have also determined that certain matters concerning non-compliance with laws and regulations or fraud are also KAM. The ICAEW guidance confirms that this does not exempt the auditor from also including the required explanation in their auditor's report as to what extent the audit was considered capable of detecting irregularities, including fraud. This explanation can also be cross-referenced to a KAM where that KAM provides further explanation.

10 ISA (UK) 500 Audit Evidence (Lecture A749 – 16.11 minutes)

The most crucial aspect to any audit is audit evidence. Audit evidence is the basis on which the audit engagement partner (the senior statutory auditor) forms their opinion as to whether the financial statements give a true and fair view. It is also fair to say that a lack of audit evidence (or inappropriate audit evidence) is one of the most frequently criticised areas of audit files during file reviews.

ISA (UK) 500 (Updated January 2020) *Audit Evidence* deals with the auditor's responsibilities in obtaining audit evidence on which they will form their opinion. ISA (UK) 500 clearly outlines its objective at paragraph 4 which says:

> *The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.*

ISA (UK) 500 para 4

The key phrase used in this objective is *'… sufficient appropriate audit evidence'*. 'Sufficiency' is the measure of the quantity of audit evidence, whereas 'appropriateness' is the measure of the quality of audit evidence; that is its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Audit evidence is cumulative in nature and is generated primarily through audit procedures undertaken during the audit (for example through substantive procedures and tests of control). Audit evidence can also be obtained from prior year audits, but when considering the appropriateness of this evidence, the auditor must determine whether changes have occurred since the previous audit which may affect its relevance to the current audit.

10.1 Procedures for obtaining audit evidence

Two of the planning ISAs (UK) directly link into audit evidence; ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* and ISA (UK) 330 *The Auditor's Responses to Assessed Risks*. These two ISAs (UK) say that audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(a) risk assessment procedures; and

(b) further audit procedures, which comprise:

  (i) tests of controls, when required by the ISAs (UK) or when the auditor has chosen to do so; and

  (ii) substantive procedures, including tests of details and substantive analytical procedures.

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10.2 Recap on procedures to generate audit evidence

Audit evidence is frequently cited as a deficiency in audit file reviews and such a deficiency can result in the firm having either follow-up visits from professional bodies or more serious sanctions imposed on them.

For that reason, it is worthwhile recapping on the types of procedure the auditor can adopt to generate audit evidence.

There are two types of procedure which the auditor can use to generate sufficient and appropriate audit evidence:

- Tests of controls
- Substantive procedures which are then sub-divided into test of details and substantive analytical procedures

Tests of controls

An entity's system of internal control is a vital component of the organisation because they are the mechanism designed by the client to prevent, detect and correct misstatements. Keep in mind that internal controls are not there just to prevent misstatements arising in the financial statements; they are also there to safeguard the assets of the company and are also a requirement of good corporate governance.

If the client's system of internal control is sound, then control risk (the risk that a misstatement could occur and be material is not prevented or detected and corrected on a timely basis) is lower and this means that there is a lower risk of material misstatement in the financial statements.

Placing reliance on internal controls can go to reduce the detailed substantive procedures the auditor may adopt (and hence save time and costs). However, in order to place reliance on the entity's system of internal control, the auditor must:

- Find out how the system functions
- Record the system in the audit working papers
- Carry out tests on the operation of the system
- Evaluate the design and how effective the company's operations are in the use of the control system
- Find out about the impact on the audit approach for a specific class of transaction, account balance or disclosure

The focus of a test of control is **not** on the monetary amount of a transaction in the financial statements and a test of control does **not** test the figure (this is the purpose of a substantive procedure). A test of control provides evidence on whether a control

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procedure is operating correctly. A test of control provides *indirect* evidence over the financial statements and the auditor can assume that if the controls are working effectively, there is a lower risk of material misstatement in the financial statements.

If an internal control is deemed to be ineffective, the auditor will not place any reliance on it. There would be little to be achieved in relying on weak controls because the risk of material misstatement will be higher. Where internal controls are ineffective, or do not exist, the auditor will carry out more substantive procedures which aim to test for material misstatement at the financial statement assertion level.

Substantive procedures

Substantive procedures are audit procedures which are designed to detect material misstatement at the assertion level. There are two types of substantive procedure:

- Analytical procedures; and
- Tests of detail.

An auditor **must** carry out some substantive procedures even if a client's system of internal control is deemed to be good.

Analytical procedures

Analytical procedures are dealt with in ISA (UK) 520 *Analytical Procedures* and essentially involve the evaluation of financial information through analysis of plausible relationships between financial and non-financial data.

An analytical procedure is used to assess the reasonableness of a figure. For example, if the auditor is auditing purchases, the percentage change in purchases from the prior year could be recalculated and compared to the current year's percentage change in revenue to see if they move in line with each other as expected. Any significant variations from the auditor's expectation would need to be investigated further.

Analytical procedures as substantive tests are used to identify trends and understand relationships between sets of data.

Note – analytical procedures which are used to identify trends and understand relationships between sets of data do not, in themselves, detect misstatements. Instead, they will identify possible sources of misstatements. As a consequence, analytical procedures cannot be used in isolation; they are used with other forms of testing such as inquiry, recalculation and reperformance.

Audit firms are frequently criticised for using substantive analytical procedures inappropriately or not considering the relevant factors when determining their suitability as audit procedures. There are four factors which must be considered as follows:

1. The assertions being tested

Substantive analytical procedures should be suitable for the assertion being tested (e.g. classification, rights and obligations, occurrence etc). Analytical procedures are generally unsuitable for testing inventories (stock and work in progress) but are suitable for assessing the value of inventory in terms of the need for a potential allowance against inventory, such as for slow-moving, obsolete or damaged inventory which have been identified using the inventory holding period ratio (or inventory days).

Analytical procedures are suitable for testing balances which are likely to be predictable over time and hence relationships between the data can be used to identify fluctuations.

2. Reliability of the data

Where the auditor judges the controls over the financial data to be weak, there is a higher risk of misstatement and hence analytical procedures would be unsuitable as a basis for assessment.

3. Degree of precision possible

The auditor uses substantive analytical procedures as a high-level approach to test the balance as a whole. If the auditor requires a high degree of precision, then analytical procedures are unlikely to identify misstatements and hence would be unsuitable as a means of testing.

4. The amount of variation which the auditor is willing to accept

The amount of variation which is acceptable between the expected figure and the actual figure will impact on whether substantive analytical procedures provide sufficient appropriate audit evidence. When the level of variation from actual is higher than the level of variation which is acceptable, further audit procedures will be necessary so as to make sure the balance in the financial statements is not materially misstated.

Tests of detail

Tests of detail are used to verify individual transactions and balances.

A test of detail looks at the supporting evidence for an individual transaction. For example, the auditor may inspect a purchase invoice to verify the amount, date or classification of a specific purchase (such as classification as property, plant and equipment). However, if there are, say, 20,000 purchase invoices recorded during the accounting period, this one test of detail will only provide evidence for one of those transactions.

Combined approach

An auditor will usually apply a combined approach of tests of controls and substantive procedures. Where tests of control suggest that the client's internal control environment is operating effectively, then this usually means that the auditor can carry out less detailed substantive testing. This results in audit efficiencies and means the auditor can spend more time auditing higher risk areas of the financial statements.

However, if tests of controls suggest the client's system of internal control is weak, the auditor places less reliance on the controls and carries out more substantive testing.

It must be noted that the auditor must **always** carry out some substantive procedures on material items and carry out specific substantive procedures as required by ISA (UK) 330 *The Auditor's Responses to Assessed Risks* including:

- Agreeing the financial statements to the underlying accounting records
- Examining material journals
- Examining other adjustments made in preparing the financial statements

10.3 Obtaining audit evidence

Audit evidence corroborates the assertions made by management in the financial statements; however, some audit evidence obtained by the auditor during the course of the audit fieldwork can also contradict management's assertions.

Audit evidence from external sources is the most reliable form of evidence – however such evidence is also the most time-consuming and costly to obtain and therefore the auditor will apply other procedures to generate audit evidence, including:

- Inspection
- Observation
- Confirmation
- Recalculation
- Reperformance
- Analytical procedures

'Inquiry' is also another audit procedure which can be used (and is often used) in obtaining audit evidence. However, the problem with this source of evidence is that it is the weakest form of evidence and ISA (UK) 500, para A2 acknowledges that inquiry alone does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. As a result, audit evidence obtained via inquiry must complement other forms of audit evidence.

Inspection

Inspection involves the examination of records or documents which can be both internal and external. In addition, inspection can also involve physically inspecting an asset for existence and any evidence of impairment.

Inspection tends to be the most commonly used procedure and involves substantiating amounts in the accounting records by reference to documentation. Revenue, for example, will be audited in part by agreement to related contracts and invoices, together with any proof of delivery of goods or services.

Example - Inspection

The financial statements of a company show the addition of a large number of computers during the year amounting to £90,000 which is material to the financial statements. The audit senior has emailed the purchase ledger clerk and asked for a copy of the invoice to be scanned and sent to the audit firm so that they can verify the rights and obligations assertion relating to this equipment.

The invoice from the supplier could have been altered by the purchase ledger clerk. The audit senior should have inspected the original document whilst carrying out the detailed audit work at the company's premises as ISA (UK) 500 considers that original

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documents are more reliable than photocopies, scanned copies or copies transmitted by facsimile.

Observation

Observation involves looking at a process or procedure being performed by others. The most common observation test is the attendance at the year end stock count. This type of procedure provides audit evidence concerning the performance of a process or procedure, but it does have inherent limitations. For example, observation tests are of limited application because they are only valid at a point in time and, in some situations, there are no alternative procedures which can be carried out.

Example - Observation

The audit senior has attended the year end stock count of a client and is observing a team of counters checking the quantities and pricing of stock. The counters are organised into teams of two, with one person counting and another person recording the quantities on the stock sheets.

While errors or omissions may not be made whilst the audit senior is in attendance at the stock count, the procedures adopted by management may not be followed in their entirety once the auditor has left.

External confirmation

An external confirmation represents audit evidence because it will ordinarily be a direct written response to the auditor from a third party. The most common type of external confirmation is a bank audit letter (or bank certificate). While in practice it is more common to obtain external confirmations which relate to certain account balances and their elements, external confirmations can also be obtained for non-account balances, such as confirming the terms of agreements or transactions which an entity has with third parties.

Example – Confirmation letter

As part of the normal audit process, the audit senior has undertaken a trade debtors circularisation to confirm the amounts owed by customers.

Trade debtors circularisations are a common type of audit procedure. However, they are limited in their reliability because while they may satisfy the existence assertion, they do not satisfy the valuation assertion (confirming a debt exists does not confirm that the debt will be recoverable). Other audit procedures will need to be applied to confirm the valuation assertion, such as after-date cash receipts testing.

Recalculation

Recalculation consists of checking the mathematical accuracy of documents or records and this sort of procedure can be carried out manually or electronically.

Example - Recalculation

The accounting policy for the depreciation of plant and machinery for East Ltd is to depreciate on a pro-rata basis only in the year of acquisition. East has a year end of 31 March 2021 and on 1 July 2020 an item of machinery was purchased.

Recalculation will involve checking that the accounting policy in respect of depreciation has been correctly calculated by recalculating the depreciation charge on this asset based on 9/12 of a full year's depreciation charge. This type of test is also known as a 'proof in total' test or a 'reasonableness' test.

Reperformance

Reperformance involves the auditor independently undertaking a procedure which has previously been carried out by the client.

Example - Reperformance

The audit senior wants to confirm that the PAYE/NIC liabilities of a client have been correctly paid over during the year and that the year end liability is fairly stated. She decides to undertake a PAYE/NIC control account reperformance for the year ended 31 July 2021.

Reperforming the PAYE/NIC control account for the year will help to identify any potential over- or under-payments of taxes during the year or at the year end. It will also offer comfort to the auditor if her reperformance of the PAYE/NIC control account agrees to the year end financial statements.

Analytical procedures

Analytical procedures to be used as substantive procedures were examined earlier. They involve the analysis of the relationships between amounts included within the financial statements, either within the same period, or between comparable amounts from different periods, or in some circumstances through available industry statistics. In carrying out substantive analytical procedures, the auditors will develop their own estimate of the figures they expect to see, compare this estimate with the actual outcome, obtain an explanation for any differences and then corroborate this explanation by reference to other audit evidence or other information available from the entity.

Example – Analytical procedures

The audit senior has undertaken an analytical review of West's profit and loss account. He has noticed that gross profit margins in 2021 are 40% and in 2020 were 55%.

The fluctuation in gross margins would need to be investigated by the audit senior to ensure they are, in fact, correct and no errors (such as cut-off errors) have been made. Ordinarily gross margins remain static from one period to the next and the variation in gross margins could indicate inappropriate revenue recognition policies or errors in stock valuations.

10.4 Revenue recognition

The area of revenue recognition is frequently cited as being deficient when it comes to file reviews. One of the main problems with revenue recognition is the income completeness test that is carried out.

When carrying out substantive procedures on income completeness, the starting point should always be from 'outside' of the accounting system, hence the source transaction will often be the customer order. Often it is the sales invoice itself that is traced through the relevant ledgers into the financial statements.

Keep in mind the objective of the sales income completeness test is to ensure that all goods delivered/services rendered have been invoiced. If the auditor starts from the sales invoice, then the test is essentially a waste of time because it is clear that the sales order has been invoiced.

Another problematic area is the issue of fraud in relation to revenue recognition. ISA (UK) 240 *The Auditors Responsibilities Relating to Fraud in an Audit of Financial Statements* always considers the risk of fraud in relation to revenue recognition as a significant risk.

Only in very limited situations should the auditor rebut the presumption that there is a risk of material misstatement due to fraud related to revenue recognition. Where the auditor does rebut this presumption, ISA (UK) 240, para 47 requires the auditor to document the reasons for that rebuttal in the audit documentation.

11 ISA (UK) 501 Audit Evidence (Lecture A750 – 10.57 minutes)

There are certain items contained within an entity's financial statements which require specific considerations where audit evidence is concerned and these relate to:

- inventory;
- litigations and claims; and
- segment information.

The objective of ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items* is for the auditor to obtain sufficient appropriate audit evidence in relation to:

(a) the existence and condition of inventory;

(b) completeness of litigation and claims involving the entity; and

(c) presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

11.1 Inventory (stock and work in progress)

Where inventory is considered material to the financial statements, the auditor must attend the inventory count (unless impracticable – see later). Attending an inventory count is an observation procedure, primarily to evaluate the effectiveness of management's instructions and whether the inventory count is being carried out in such a way so as to reduce the risk of material misstatement in the closing inventory valuation.

When the auditor attends the inventory count, they have to carry out certain procedures to comply with ISA (UK) 501, para 4(a) as follows:

- *evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;*
- *observe the performance of management's count procedures;*
- *inspect the inventory; and*
- *perform test counts.*

ISA (UK) 501, para 4(a)(i) to (iv)

During the detailed audit fieldwork stage, the auditor will then perform audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

Attending the inventory count can serve as either a test of controls or substantive procedures depending on the overall risk assessment of the auditor, the planned approach and the specific procedures which have been carried out.

There are a number of factors which the auditor must consider at the planning phase of attending an inventory count, such as:

- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of the physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate. ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regards to attendance of physical inventory counting at a remote location.
- Whether the assistance of an auditor's expert is needed. ISA (UK) 620 *Using the Work of an Auditor's Expert* deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

Observing management's instructions

The primary aim where the observation of management's instructions is concerned is to evaluate whether these instructions will reduce the risk of material misstatement. ISA (UK) 501, para A4 outlines various factors which the auditor must also consider and whether management's instructions address:

- *The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory records, and count and re-count procedures.*

ISA (UK) 501, para A4

- *The accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment.*
- *The procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile.*
- *Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.*

Observing management's count procedures

The objective here is to enable the auditor to obtain audit evidence that management's instructions and count procedures are adequately designed and implemented so as to reduce the risk of material misstatement in the valuation of inventory. An example would be observing the control over the movement of inventory before, during and after the count.

During such tests, the auditor may obtain information relating to cut-offs to ensure that these have been correctly applied and obtaining details of inventory movement.

Inspecting the inventory

The auditor must inspect the inventory which will help to satisfy the existence assertion (although this will not necessarily satisfy the rights and obligations assertion). Inventory inspection will also help the auditor to evaluate the condition of the inventory and whether such inventory might need writing down to estimated selling price, for example if the inventory is damaged, obsolete or slow-moving.

Undertaking test counts of inventory

During the attendance at inventory count, the auditor must undertake test counts. These are usually performed in a two-way direction (sheet to floor and floor to sheet).

Tracing items from the floor to sheet provides the auditor with evidence concerning the completeness and accuracy of the inventory records. Tracing items from sheet to floor provides the auditor with evidence concerning the existence and the condition of inventory.

It is advisable to mark those items of inventory which have been tested by the auditor at inventory attendance to allow them to be checked to the final inventory valuation during the detailed audit fieldwork to ensure they have been included correctly in the final stock valuation.

Inventory count conducted other than at the year/period end

In certain situations, it might be the case that the inventory count is not undertaken as at the year end (or period end). For example, an audit client with a 31 December year end might close down for Christmas a week prior to the financial year end and hence undertake the inventory count on the last day before the Christmas break.

Where an inventory count is undertaken at a point other than at the balance sheet date, then the auditor must obtain sufficient appropriate audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

If a perpetual inventory system is in place, management may perform physical counts or other tests to ascertain the reliability of the inventory quantity information contained in

the stock valuation records. Where differences are noted between the perpetual inventory records and the actual physical count, care must be taken because this might indicate that controls over changes in inventory are not operating as effectively as they should. Factors which should be considered when designing audit procedures to obtain audit evidence concerning changes in inventory amounts between the date of the count and the balance sheet date include:

(a) Whether the perpetual inventory records are properly adjusted.

(b) The reliability of the entity's perpetual inventory records.

(c) The reasons for any significant differences between the information obtained during the physical count and the perpetual inventory records.

Where the audited entity does not operate a perpetual inventory system, the provisions in ISA (UK) 330 *The Auditor's Responses to Assessed Risks*, paras 22 and 23 are triggered. These two paragraphs provide guidance on substantive procedures which are to be performed at an interim date.

ISA (UK) 330, para 22 says that if substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:

(a) substantive procedures, combined with tests of controls for the intervening period; or

(b) if the auditor determines that it is sufficient, further substantive procedures only,

that provide a reasonable basis for extending the audit conclusions from the interim date to the period end.

ISA (UK) 330, para 23 then goes on to say that if misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified.

Essentially what the auditor is trying to achieve where the inventory count is conducted at a date which is not sequential to the balance sheet date is to establish whether the effectiveness of the design, implementation and maintenance of controls over changes in inventory will reduce the risk of material misstatement in the closing inventory valuation.

Attendance at inventory count is impracticable

Where inventory is deemed material to the financial statements, the auditor must make every attempt to attend the inventory count to observe the effectiveness of the count. There are occasions, however, when it is deemed impracticable for the auditor to attend the inventory count, for example because the location of the inventory may pose a

threat to the auditor. Reasons of impracticability are quite rare, and the ISA (UK) does acknowledge that general inconvenience would not be a valid reason for the auditor not to attend the inventory count. In addition, factors such as difficulty, time or cost involved are also not considered to be valid reasons not to attend the inventory count.

Where valid reasons do exist that give rise to the auditor not being able to attend the inventory count, then alternative audit procedures could be deployed. For example, inspection of documentation on the subsequent sale of specific items of inventory which have been purchased prior to the physical inventory counting may provide audit evidence towards satisfying the existence and condition of inventory.

Where it is not possible to obtain sufficient appropriate audit evidence relating to the existence and condition of inventory through alternative audit procedures, the audit opinion will need to be modified due to a scope limitation (insufficient evidence).

Inventory under the custody and control of a third party

Where inventory is under the custody and control of a third party, the provisions in ISA (UK) 505 *External Confirmations* will be triggered where external confirmations are considered necessary.

Where the auditor has concerns about the integrity and objectivity of the third party, other audit procedures will more than likely be necessary in addition to, or instead of, external confirmations. Such procedures could include:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.

11.2 Litigation and claims

Auditors are required to obtain sufficient appropriate audit evidence relating to the completeness of litigations and claims involving the audited entity. Quite often litigation can be contentious and disclosure of certain litigation and claims in the financial statements might be viewed as seriously prejudicial and hence can be quite a sensitive area for auditors (in some cases input from the entity's lawyers might be necessary where disclosures might prove prejudicial).

ISA (UK) 501, para 9 says that the auditor shall design and perform audit procedures so as to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. Such procedures involve:

(a) inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(b) reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(c) reviewing legal expense accounts.

These procedures are not comprehensive, and the auditor should also undertake other procedures, such as using information they have obtained via risk assessment procedures which have been carried out as part of obtaining an understanding of the audited entity and its environment.

There is an interaction between ISA (UK) 501 and ISA (UK) 540 (Revised December 2018) *Auditing Accounting Estimates and Related Disclosures*. This will happen where audit evidence relating to litigations and claims give rise to a risk of material misstatement which may call into question valuation or measurement issues relating to litigation and claims. Where this happens, then the provisions in ISA (UK) 540 provides guidance relevant to the auditor's consideration of litigation and claims which require accounting estimates or related disclosures within the financial statements.

Reviewing legal expense accounts

The auditor must consider whether it is appropriate to review legal expense accounts which might provide evidence concerning litigation and legal claims. Many 'off-the-shelf' audit programmes often include a test to review the nominal ledger accounts for such expense accounts during the audit of provisions and contingencies and hence in many cases this test will be carried out as a matter of routine.

Such a review can also provide indicators of any non-compliance with laws and regulations where legal bills have been received for such.

Communicating with the entity's external legal counsel

The auditor may consider it appropriate to enter into dialogue with the entity's legal counsel to obtain sufficient appropriate audit evidence concerning potentially material litigation and claims. Such communication will more than likely need the client's consent. In some cases, however, external legal counsel might not respond to a *non-specific* enquiry from the auditors because they are prohibited from so doing by The Council of the Law Society. It might be more beneficial, therefore, to seek direct communication through a letter of *specific* inquiry. A letter of specific inquiry includes:

(a) a list of litigation and claims;

(b) where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

(c) a request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

In rarer cases, it might be considered necessary for the auditor to meet with the audited entity's external legal counsel to discuss the likely outcome of the litigation or claims. Such meetings would be judged necessary where:

(a) The auditor determines that the matter is a significant risk.

(b) The matter is complex.

(c) There is disagreement between management and the entity's external legal counsel.

Where such meetings are judged necessary, management's permission will be needed, but in the UK, permission may be denied by those charged with governance.

The auditor is also required to date the auditor's report no earlier than the date on which they have obtained sufficient appropriate audit evidence on which to base their

audit opinion. As a result, the auditor might need to obtain updated information from the entity's external legal counsel.

11.3 Segment information

Certain entities might be required to disclose segment information (such as those reporting under EU-adopted IFRS/UK-adopted IFRS to comply with IFRS 8 *Operating Segments*).

Note: for accounting periods commencing on or after 1 January 2021, EU-adopted IFRS cannot be used. UK-adopted IFRS is used instead for IFRS reporters based in the UK.

The auditor's responsibility in respect of the presentation and disclosure of segment information is in respect of the financial statements taken as a whole. Therefore, the auditor is not required to express an opinion on the segment information presented on a stand-alone basis.

The *Application and other explanatory material* at ISA (UK) 501, para A27 outlines examples of matters which may be relevant when obtaining an understanding of the methods used by management to determine such segmental information and whether these methods will enable disclosure of segment information to be compliant with the financial reporting framework. Such matters include:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- Comparisons with budgets and other expected results, for example, operating profit as a percentage of sales.
- The allocation of assets and costs among segments.
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

12 Planning the audit (Lecture A751 – 12.48 minutes)

During file reviews there are often points arising in connection with the firm's planning documentation. In this section we will examine some of the more pertinent points concerning audit planning.

At the outset, it is worth noting that ISAs (UK) deal with audit planning in the 300 series of the standards as follows:

- ISA (UK) 300 *Planning an Audit of Financial Statements*
- ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment*[7]
- ISA (UK) 320 *Materiality in Planning and Performing an Audit*
- ISA (UK) 330 *The Auditor's Responses to Assessed Risks*

In practice, firms are often criticised for failing to undertake an adequate programme of audit planning or addressing responsibility issues adequately. Keep in mind that the audit file has to 'tell a story' and for quality control purposes audit documentation must be sufficient and appropriate. It may be the case that a procedure at the planning stage has been carried out (e.g. the audit team discussion), but if this procedure is not documented the only conclusion that someone reviewing the file can draw is that it has not been carried out. The key message here is to ensure that planning, fieldwork and completion procedures are all adequately documented.

According to ISA (UK) 300, audit planning benefits the audit of the financial statements in many ways, including the following:

- It helps the auditor to devote appropriate attention to important areas of the audit.
- It helps the auditor to identify and resolve potential problems on a timely basis.
- It helps the auditor to properly organise and manage the audit engagement so that it is performed in an effective and efficient manner.
- It assists in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- It facilitates the direction and supervision of engagement team members and the review of their work.

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[7] ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* is applicable for audits of financial statements for periods beginning on or after 15 December 2021.

- It assists, where applicable, in the coordination of work done by auditors of components and experts.

In practice, adequate planning will reduce the risk of performing a poor quality audit to an acceptably low level. Time taken to adequately plan the audit might be between 25%-40% of the entire budgeted audit hours, depending on the nature of the client.

However, carrying out adequate planning will not, on its own, achieve a high quality audit; this is achieved by compliance with all the ISAs (UK) and ensuring that audit procedures are responsive to the assessed levels of risk.

12.1 Engagement letters

The engagement letter must be up-to-date. Out-of-date or missing engagement letters are frequently cited as deficiencies on audit files. In addition, it is important to ensure that the **preconditions** for an audit are present as follows:

(a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable (this will usually be FRS 102 or FRS 101); and

(b) Obtain the agreement of management that it acknowledges and understands its responsibility:

    (i) for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;

    (ii) for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

    (iii) To provide the auditor with:

        (a) access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documents and other matters;

        (b) additional information that the auditor may request from management for the purposes of the audit; and

        (c) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Note: if the preconditions for an audit are **not** present, the auditor must withdraw or decline the engagement as necessary (if permitted by law or regulation).

12.2 Planning the audit

A high-level overview of audit planning is as follows:

1. Assess the risks and hold the audit team discussion
2. Develop the audit strategy
3. Develop the audit plan
4. Calculate materiality levels
5. Devise the audit procedures

During the team discussion, various matters concerning the client may be discussed. One issue that must be discussed is how the financial statements may be susceptible to fraud. This is an important consideration because it is not whether, or not, frauds have been discovered in the past – the discussion must surround **how** the financial statements **could** be susceptible to fraud. This is often overlooked or simply dismissed as 'not appropriate' or 'not considered necessary'.

It is also a requirement of ISA (UK) 550 *Related Parties* that the audit team considers the susceptibility of the financial statements to material misstatement due to fraud with related parties. Many audit firms have been criticised in the past for failing to consider this issue in the audit team meeting, citing an unawareness of the requirement.

Keep in mind that once the audit strategy and audit plan have been developed, they must be updated as necessary as the audit progresses. In other words, they are not forgotten about when the planning is completed – planning is a continual and iterative process.

12.3 Significant risks

The auditor must devote special attention to those risks which are considered to be **significant risks**. Where a risk may constitute a significant risk, ISA (UK) 315, para 28 provides guidance in the form of factors which the auditor must consider as follows:

- Whether the risk is a risk of fraud.
- Whether the risk is related to significant economic, accounting or other developments and, therefore, requires specific attention.
- The complexity of the transactions.
- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that would appear to be unusual.

The risk of management override of internal control is *always* considered to be a significant risk. In addition, fraud in relation to revenue recognition should also be considered a significant risk and this presumption must only be rebutted in very limited circumstances.

To simply state that fraud (not only in relation to revenue recognition, but in general) is unexpected because it has never been encountered before is demonstrating a lack of professional scepticism.

12.4 Documentation

ISA (UK) 315 requires the auditor to include the following in the audit documentation:

- The discussion among the engagement team where required by paragraph 10, and the significant decisions reached.
- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components identified in paragraph 14-24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed.
- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25.
- The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraph 27-30.

12.5 Materiality

Materiality is dealt with in ISA (UK) 320. Materiality is concerned with misstatements and omissions. Misstatements and omissions are material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

The focus of the auditor is identifying the significant risks of material misstatement and then designing audit procedures which are responsive to those risks.

Materiality is purely judgemental. There is no 'one-size-fits-all' where the concept of materiality is concerned; indeed, what could be material in one entity may not be material in another. In determining whether a misstatement or omission is material, the auditor must consider:

- Whether the misstatement would affect the economic decisions of the users.
- The size and nature of the misstatement (some misstatements may not be material in monetary terms (quantitative) but could be material in nature (qualitative).
- The information needs of the users as a group.

In practice, materiality is calculated using various benchmarks, the most common being:

- ½ to 1% of revenue
- 5 to 10% of pre-tax profit
- 1 to 2% of gross assets

These percentages are useful as a starting point, but it is worth emphasising that they are not prescriptive and different auditors may use different percentages depending on their risk assessment. However, it would usually be inappropriate to use percentages larger than these limits because otherwise materiality will end up being too high, thus increasing audit risk (audit risk being the risk that the auditor expresses the incorrect opinion on the financial statements).

Some firms also use the 'averaging method' so will calculate the above figures and then divide by three to arrive at a financial statement materiality level. Increasingly, regulators have indicated that this is not an appropriate method to reach a materiality figure, as it does not focus appropriately on where the risks arise. Therefore, the auditor should consider which of the above figures are the most pertinent and may make adjustments based on all three, if these are fully justified with the reasons documented.

Example – Misstatement identified

During the course of the audit of Woodward Ltd, the auditor noted an amount of research expenditure that had been capitalised as an intangible asset in contravention of FRS 102, Section 18 *Intangible Assets other than Goodwill*.

When calculating the materiality of this misstatement, the auditor could assess it against the performance materiality. However, for items that affect a particular balance, it may be appropriate to select a materiality figure based on the item that will be affected.

Hence, the auditor would assess the misstatement individually against the benchmark used for pre-tax profit and gross assets. If the misstatement was, for example, 2.5% of total assets and 3% of profit before tax, the misstatement would still be material in isolation because it goes over the 1-2% of total assets benchmark and would need to be corrected to avoid a modified audit opinion.

Materiality is not just concerned with the monetary values in the financial statements. There are some issues that could affect the financial statements and could be material by nature, for example:

- Disclosures about a material uncertainty related to going concern;
- Material related party disclosures that have not been adequately disclosed;
- Disclosures concerning transactions with directors;
- Contingent liability disclosures which, if omitted, may impact on the usefulness of the financial statements;

- Misstatements which, if adjusted, would cause a profit to turn into a loss; and
- Misstatements which, if adjusted, would cause net assets to turn into net liabilities.

12.6 Performance materiality

ISA (UK) 320, para 9 defines 'performance materiality' as follows:

> *For purposes of the ISAs (UK), performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.*

ISA (UK) 320, para 9

Where performance materiality is concerned, the auditor sets this at a lower level than the overall financial statement materiality level and uses this lower threshold when designing and performing audit procedures (in other words it is used as a basis for testing transactions). This reduces the risk that the auditor will fail to identify misstatements which are material when aggregated.

Example – Calculation of performance materiality

The audit engagement team is planning the audit of Harrison Ltd for the year ended 31 March 2021. The audit senior has calculated financial statement materiality to be £86,000 and the general level of performance materiality has been calculated at 85% of this (i.e. £73,100). The audit senior has identified work in progress and development expenditure to contain a high risk of material misstatement, hence a specific level of performance materiality needs to be applied to these areas.

The audit engagement partner has suggested that 75% of the financial statement materiality level be used in these high risk areas. Hence, when auditing work in progress and development expenditure, a performance materiality of £64,500 (£86,000 x 75%) should be applied.

Depending on the level of risk of material misstatement, the auditor could apply a higher or lower percentage to this 'haircut' of the financial statement materiality to give performance materiality, or even use a different calculation. This will be down to professional judgement and that judgement should be carefully documented.

In this example, specific performance materiality is £64,500. If the auditor had not used this specific performance materiality and had discovered a misstatement of, say, £70,000, in the work in progress valuation, the auditor might have concluded that the

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misstatement is not material when measured against financial statement materiality of £86,000. However, the audit may not have detected further misstatements which, when added to the £70,000 figure, could have resulted in material misstatement. By using performance materiality, the misstatement of £70,000 would be considered material by the auditor and hence the auditor would request management to correct the misstatement, and this reduces the risk of the auditor expressing an inappropriate opinion.

A general level of performance materiality is required to be used in planning and to determine the extent of testing required. The level of performance materiality is a matter of judgement but research[8] has shown the percentage reduction in financial statement materiality to get to performance materiality is usually between 20%-60%. First year audits typically require a lower level of performance materiality to mitigate the risks of auditing an unfamiliar set of accounts.

12.7 Use of analytical procedures at the planning stage

Analytical procedures can be used at all stages of the audit. However, ISA (UK) 315 requires the auditor to perform analytical procedures as risk assessment procedures in order to assist in gaining an understanding of the entity and assess the risk of material misstatement.

During the testing phase, the auditor may use substantive analytical procedures to obtain relevant and reliable audit evidence. However, the relationships being examined must be capable of a high enough degree of predictability and therefore accuracy to be useful. For instance, analytical review of fees for a private school based on pupil numbers could be expected to be accurate, whereas analytical review of revenue of a wholesaler of sports equipment is unlikely to have a predictable enough relationship to act as a substantive test. ISA (UK) 520, para 5 sets out the specific steps required where substantive analytical procedures are to be used as follows:

ISA (UK) 520, para 5

(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions; (Ref: Para. A6-A11)

(b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation; (Ref: Para. A12-A14);

(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and (Ref: Para. A15)

(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7. (Ref: Para. A16)

If the auditor decides to use such procedures it is vital that all of the steps are followed and documented. Quite often files are rendered deficient for incorrect documentation

[8] FRC Audit Quality Thematic Review Materiality December 2017

or failing to follow of the above steps. In addition, regulators often criticise the standard of substantive analytical procedures.

13 Audit completion (Lecture A752 – 12.56 minutes)

There are some aspects of audit completion that are frequently cited as deficiencies. This section of the course highlights some of these areas to assist firms in ensuring their files are as compliant as possible with the relevant ISAs (UK).

13.1 Subsequent events

Subsequent events are dealt with in ISA (UK) 560 *Subsequent Events*. This ISA (UK) requires the auditor to obtain sufficient appropriate audit evidence that events taking place between the balance sheet date and the date of the auditor's report have been appropriately accounted for in accordance with the applicable financial reporting framework.

FRS 102, Section 32 *Events after the End of the Reporting Period* provides for two specific types of event that the auditor must consider:

- **Adjusting events** which provide additional evidence relating to conditions that existed at the balance sheet date. Such events require adjustment in the financial statements.
- **Non-adjusting events** which relate to conditions arising after the balance sheet date, but which may be material and hence require disclosure in the financial statements to ensure they are not misleading.

ISA (UK) 560 provides a definition of 'subsequent events' as follows:

> *Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.*

ISA (UK) 560, para 5(e)

This definition means that the auditor has both an **active duty** and a **passive duty** where subsequent events are concerned. The auditor's active duty arises between the balance sheet date and the date on which the auditor's report is signed. During this period the auditor must obtain sufficient appropriate audit evidence that all subsequent events which require adjustment or disclosure have been identified.

The auditor's passive duty relates to the period between the date on which the auditor's report is signed and the date on which the financial statements are authorised for issue. The auditor has no obligation to perform audit procedures once the auditor's report has been signed; although circumstances may present themselves which mean the auditor has no choice but to carry out certain procedures.

In some cases, files are criticised either because a subsequent events review has not been carried out; or, where it has, it has not been carried out up to the date on which the auditor's report is signed. This means that ISA (UK) 560 will not have been complied with.

Auditor's duties between the balance sheet date and the date of the auditor's report

This is where the auditor has an active duty.

Typical procedures the auditor should adopt are as follows (note the list below is not comprehensive):

- Enquire of the directors if they are aware of any subsequent events which require adjustment in the financial statements.
- Enquire of management of their procedures for identifying subsequent events.
- Inspect minutes of board meetings for evidence of any subsequent events.
- Review budgets, forecasts, interim information and accounting records to identify any subsequent events.
- Inspect correspondence with legal advisers.
- If the financial statements show any provisions for liabilities or contingent liability disclosures, establish the status of the events giving rise to the liability or disclosure.
- Inspect after date cash receipts from debtors, especially those which are overdue to ensure the valuation assertion is properly addressed.
- Inspect sales invoices in respect of stock that has been slow-moving which may have been sold after the balance sheet date to establish if estimated selling price is less than cost.
- Obtain written representations from management that all subsequent events have been considered in the preparation of the financial statements.

If subsequent events have been discovered by the auditor that have not been properly reflected in the financial statements, the auditor must consider the implications on their auditor’s report.

Example – Adjusting event discovered

The audit of Taylor Ltd for the year ended 31 March 2021 is nearing completion and the audit senior has carried out subsequent events procedures. The draft financial statements report profit before tax of £2.4m and total assets of £11.5m.

During the course of the subsequent events review, the audit senior noted a trade debtor balance owing £425,000 that had gone into liquidation on 10 April 2021. Correspondence reviewed from the liquidator indicates that it is not expected there will be any funds available following the liquidation to pay any unsecured creditors. Taylor Ltd is one of those unsecured creditors.

The audit senior held a discussion with the finance director who confirmed that he is unwilling to remove the trade debtor balance from the financial statements. His argument is that as the debtor went into liquidation after the balance sheet date, the bad debt should be shown in the 2022 financial statements.

The finance director is incorrect to conclude that the debtor should be included in

next year's financial statements. The bankruptcy of a customer so soon after the reporting date is evidence that there was no realistic possibility that the company would receive payment, hence the conditions leading to the liquidation and subsequent non-payment existed at the balance sheet date (the customer would have had cash flow difficulties on 31 March 2021).

The trade debtor is material to the financial statements as it represents 17.7% (£425k/£2.4m) of profit before tax and 3.7% (£425k/£11.5m) of total assets. Materiality levels for this client have been calculated as 5% of profit before tax and 2% of gross assets. Both trade debtors and profit before tax will be materially overstated if the bad debt is not written off in the 31 March 2021 financial statements.

Auditor's duties between the date of the auditor's report and the date the financial statements are authorised for issue

The auditor is under no obligation to perform audit procedures on the financial statements once they have issued their auditor's report. However, where the auditor becomes aware of a fact which would have caused them to modify their opinion in any way, they must take the following courses of action:

- Discuss the facts with management and determine whether the financial statements require amendment.
- Where the financial statements require amendment, request that management actions the amendments.
- Perform audit procedures on the amendments to ensure they have been processed correctly.
- Extend the subsequent events procedures **to the date of the new auditor's report**.
- Issue a revised auditor's report.

If management does not amend the financial statements as requested by the auditor and the financial statements have not yet been issued, the auditor must notify management and those charged with governance not to issue the financial statements before the amendments have been made. If the financial statements have been issued, the auditor must take steps to prevent reliance on the auditor's report. This will usually involve the auditor seeking legal advice.

The auditor can still modify the opinion if management refuse to amend the financial statements and the auditor concludes the financial statements will be materially misstated if they are not amended.

In rare situations that the financial statements are not amended and are issued despite being requested not to issue the financial statements by the auditor, the auditor must take action to prevent reliance on the auditor's report. This will invariably require the

auditor to seek legal advice as to the steps they should take to prevent reliance on the auditor's report.

Example – Revised auditor's report issued

The financial statements of Scanlon Ltd for the year ended 31 March 2021 were approved by the directors on 3 June 2021 and the auditor's report was also signed on this date. The financial statements were not authorised for issue.

On 5 June 2021, a fraud was discovered which had gone undetected by the auditors despite their procedures being sufficient. It is an inherent limitation that an audit cannot be expected to detect all potential frauds that occur. The fraud materially affects the financial statements for the year ended 31 March 2021.

The directors have agreed to amend the financial statements for the effects of the fraud. The auditor performs relevant audit procedures on the amendments to ensure they have been processed correctly and also extends their subsequent events procedures to the date of the new auditor's report. Finally, the auditor provides a new auditor's report but will not date this any earlier than the date of approval of the amended financial statements.

13.2 Going concern

Auditors must keep in mind that ISA (UK) 570 (Revised September 2019) *Going Concern* comes into mandatory effect for 31 December 2020 year end audits and going forward.

A problem often noted in file reviews is the period of going concern assessment. Under UK GAAP, management are required to carry out an assessment of the entity's ability to continue as a going concern for a period of **at least** 12 months from the **date of approval of the financial statements**. The period is not 12 months from the balance sheet date.

The assessment of going concern involves making a judgement concerning future events which are clearly uncertain because the assessment is a forward-looking concept. The judgement involved in assessing going concern can only be made on the basis of information at the time of the assessment and subsequent events may overturn that assessment (for example, if a fire destroys part of the business and the business is unable to recover from the destruction).

Over the last year or so, many sets of financial statements include some reference to material uncertainties related to going concern due to the Covid-19 pandemic. Keep in mind that when the auditor is satisfied that any material uncertainties related to going concern are **adequate** then the auditor will include a Material Uncertainty Related to Going Concern paragraph in their auditor's report. An Emphasis of Matter paragraph is not used in this respect. Some audit firms are still using an Emphasis of Matter

paragraphs to flag up going concern disclosures and this is not technically correct under ISA (UK) 570.

Also, keep in mind that ISA (UK) 570 (Revised September 2019) is more arduous in its requirements and enhances the work that the auditor is required to do. In many cases the revised standard essentially provides further information on how existing responsibilities could be fulfilled. However, other aspects of the revised standard will change the reporting requirements in respect of going concern and so will require specific and obvious changes in a firm's methodology.

13.3 Written representations

Written representations are dealt with in ISA (UK) 580 *Written Representations*. Written representations are a form of audit evidence but should **not** be used as sole audit evidence (this is because they are internally generated by the entity). In some file reviews it is noted that written representations are sometimes the only audit evidence on file and this should not be the case as they serve to complement other forms of audit evidence.

Written representations are often scrutinised as part of file reviews and, quite often, there are deficiencies noted in the content of the representation itself. For the purposes of ISA (UK) 580, written representations do not include the financial statements or the assertions therein and also do not include the books and records supporting the amounts and disclosures in the financial statements.

Written representations should be produced on the client's letterhead and be signed by the client. It must be emphasised that the date of the written representation must be very close to, or (ideally) on the same date as, the date of the auditor's report. It must never be dated after the date of the auditor's report.

In addition, care must be taken to ensure that the written representation includes references to the following:

Relevant ISA (UK)	Paragraph
ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	39
ISA (UK) 250, Section A – *Consideration of Laws and Regulations in an Audit of Financial Statements*	17
ISA (UK) 450 *Evaluation of Misstatements Identified during the Audit*	14
ISA (UK) 501 *Audit Evidence – Specific Consideration for Selected Items*	12

ISA (UK) 540 *Auditing Accounting Estimates and Related Disclosures*	37
ISA (UK) 550 *Related Parties*	26
ISA (UK) 560 *Subsequent Events*	9
ISA (UK) 570 *Going Concern*	12-2(f)
ISA (UK) 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements*	9
ISA (UK) 720 *The Auditor's Responsibilities Relating to Other Information*	13(c)

Audit firms are encouraged to ensure that their written representation letters comply with ISA (UK) 570 and include management representations in respect of the above ISAs (UK).

It is also worth noting that written representations may be requested from management in respect of any areas of the financial statements which the auditor deems necessary.