Audit and Accounting Quarterly Update – Quarter 2

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1 FRED 83

On 5 April 2023, the Financial Reporting Council (FRC) issued FRED 83 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 101 Reduced Disclosure Framework – Pillar Two model rules*.

This Exposure Draft was issued in light of the OECD's Pillar Two model rules which introduce a global system of interlocking top-up taxes aimed to ensure that large multinational groups pay a minimum amount of income tax.

The FRC issued this Exposure Draft following the IASB® issuance of an equivalent Exposure Draft on the same issue. The FRC have done this now rather than waiting for the IASB's final amendments but will consider the IASB's final amendments when finalising the proposals in FRED 83.

FRED 83 proposes to introduce a temporary exception to the accounting for deferred taxes arising from the implementation of the Pillar Two model rules, alongside targeted disclosure requirements.

It is not expected that the Pillar Two model rules will have a significant impact on UK and Ireland GAAP preparers and comments on the Exposure Draft closed on 24 May 2023. It is expected that the FRED will be finalised in the summer of 2023.

2 Revenue (Lecture A820 – 29.36 minutes)

Revenue is dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 23 *Revenue* and in FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* in Section 18 *Revenue*.

At the outset it is worth noting that the Financial Reporting Council (FRC) propose to rewrite the revenue sections of FRS 102 and FRS 105 to align the sections more to that of IFRS® 15 *Revenue from Contracts with Customers* and introduce a five-step model approach to revenue recognition. These proposals are expected to be finalised towards the end of 2023 and were covered in previous updates.

The remainder of this section examines the principles in FRS 102 (January 2022).

2.1 Distinction between revenue and income

Revenue is defined in the Glossary to FRS 102 as:

> *The gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in **equity**, other than increases relating to contributions from equity participants.*

FRS 102 Glossary ***revenue***

The term 'income' is defined in the Glossary to FRS 102 as:

> *Increases in economic benefits during the **reporting period** in the form of inflows or enhancements of **assets** or decreases of **liabilities** that result in increases in **equity**, other than those relating to contributions from equity investors.*

FRS 102 Glossary ***income***

Revenue is distinguished from income because the definition includes reference to the company's 'ordinary activities'. Income is essentially any item which is credited to the profit and loss account (income statement) which includes revenue but also includes items such as a profit on disposal of fixed assets, sundry income and bank interest.

Section 474 of the Companies Act 2006 defines 'turnover' as the amounts derived from the provisions of goods and services after deduction of:

- trade discounts;
- value added tax; and
- any other taxes based on the amounts so derived.

It is notable that the definition of 'revenue' in FRS 102 continues to make reference to 'ordinary activities'. The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980) made amendments to the definition of turnover by removing references to '… falling within the company's ordinary activities'. This was due to the removal of extraordinary items from the statutory formats. The fact that FRS 102 continues to make reference to ‘ordinary activities’ in its definition of revenue does not give rise to any practical consequences.

2.2 Scope of FRS 102, Section 23

Section 23 applies to revenue arising from:

- the sale of goods;
- the rendering of services;
- construction contracts where the entity is the contractor; and
- the use by others of interest-yielding interest, royalties or dividends.

The table below outlines those areas which are not dealt with by FRS 102, Section 23:

Section 23 does not apply to:	Relevant applicable section/standard
Lease agreements	Section 20 *Leases*
Dividends/other income from investments accounts for under the equity method	Section 14 *Investments in Associates* and Section 15 *Investments in Joint Ventures*
The value of changes of financial assets and financial liabilities or their disposal	Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*
Fair value changes in investment property	Section 16 *Investment Property*
Initial recognition and changes in the fair value of biological assets related to agricultural activity	Section 34 *Specialised Activities*
Initial recognition of agricultural produce	Section 34
Incoming resources from non-exchange transactions for public benefit entities	Section 34
Transactions and events dealt with in FRS 103	FRS 103 *Insurance Contracts*

2.3 Micro-entities reporting under FRS 105

For micro-entities choosing to report under FRS 105, Section 18 *Revenue* applies. Section 18 is inherently shorter in scope than FRS 102, Section 23 and applies to:

(a) the sale of goods (whether produced by the micro-entity for the purpose of sale or purchased for resale);

(b) the rendering of services;

(c) construction contracts in which the micro-entity is the contractor; and

(d) the use by others of micro-entity assets yielding interest, royalties and dividends.

FRS 105, para 18.2 scopes out income arising from leasing agreements as this will be dealt with in FRS 105, Section 15 *Leases*.

2.4 General principles of revenue measurement

Revenue is measured at the fair value of the consideration received or receivable. This takes into account the value of trade discounts, prompt settlement discounts and volume rebates allowed by the entity.

The term 'fair value' is defined in the Glossary as:

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

*FRS 102 Glossary **fair value***

Example – Cash discount

East Ltd sells goods on credit to its customer, West Ltd for £1,000 and the balance is due within 30 days. If the customer pays within 15 days, it will receive a 2% discount on the total invoice.

The cash discount is viewed as a means to enhance collection within a short timescale. East Ltd should make a best estimate as to whether West Ltd will take the discount. Hence, if East thinks it is probable that West will take the discount, the sale is recorded at £980 (£1,000 less 2%). If not, the sale is recorded at £1,000. Any 'true up' for actual numbers will be recorded in the next accounting period.

It should be noted that FRS 105 takes a different approach to the measurement of revenue and requires revenue to be measured at the amount receivable, taking into account the amount of any trade discounts, prompt settlement discounts and volume rebates allowed to customers. References to '… fair value of the consideration received or receivable' are not contained in FRS 105 as micro-entities are unable to use the fair value accounting rules in company law.

2.5 Agent v Principal relationships

FRS 102, para 23.4 and FRS 105, para 18.4 deals with the issue of agent-principal relationships. FRS 102 defines the term 'agent' as follows:

> *An entity is acting as an agent when it does not have exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. One feature indicating that an entity is acting as an agent is that the amount the entity earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.*

*FRS 102 Glossary **agent***

The term 'principal' is defined in FRS 102 as follows:

> *An entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. Features that indicate that an entity is acting as a principal include:*
>
> *(a) the entity has the primary responsibility for providing the goods or services to the customer or for fulfilling the order, for example by being responsible for the acceptability of the products or services ordered or purchased by the customer;*
>
> *(b) the entity has **inventory** risk before or after the customer order, during shipping or return;*
>
> *(c) the entity has latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services; and*
>
> *(d) the entity bears the customer's **credit risk** for the amount receivable from the customer.*

*FRS 102 Glossary **principal***

Both FRS 102 and FRS 105 state that the agent must only recognise revenue to the extent of its commission. Amounts that are collected on behalf of the principal are not revenue of the agent. Amounts collected on behalf of the agent are recognised as a liability in the accounts of the agent if they are not paid over to the agent by the balance sheet date.

The definition of 'principal' above contains four features which indicate that an entity is acting as a principal. It should be noted that these features are not intended to be conclusive and other features may be present which indicate that an entity is a principal or is acting on behalf of a principal.

Example – Supermarket sells carrier bags
Fast Food Ltd is a supermarket chain located throughout the UK. It is required by law

to charge 50p for every plastic carrier bag sold. Legislation states that the proceeds from the carrier bag sales must be donated to a good cause.

In this scenario, Fast Food Ltd is acting in the capacity of principal where the carrier bag sales are concerned. This is because:

- The supermarket is not required to notify the customers which causes will receive the donations from the carrier bag sales.
- There are risks associated with the carrier bag sales. For example, if the bag breaks while the customer is packing their goods, the supermarket will have to replace the bag.
- The supermarket receives a reward from the sale of the carrier bags because the proceeds are donated to a good cause, hence Fast Food's brand will be associated with the good cause.
- The customer receives a benefit in the form of the carrier bag which can be reused by the customer if they wish.

The Appendix to FRS 102, Section 23 includes Example 27. This example offers guidance on determining whether an entity is acting as a principal or agent.

2.6 Deferred payment

When payment is deferred in respect of a sale, this will usually constitute a financing transaction. Although the Glossary to FRS 102 does not define the term 'financing transaction', such transactions are described in FRS 102, para 11.13, hence:

> *… 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. Except as set out in paragraph 11.13A[1], if the arrangement constitutes a financing transaction, the entity shall measure the financial asset or financial liability at the **present value** of the future payments discounted at a market rate of interest for a similar debt instrument as determined at initial recognition adjusted for transaction costs.*

Excerpt from FRS 102, para 11.13

The fair value of the consideration is the present value of all future receipts determined using an imputed rate of interest. A financing transaction will usually arise when payment is deferred beyond normal trading terms.

[1] FRS 102, para 11.13A sets out the exemption, in respect of certain loans from director/shareholder groups in small entities, to the requirement to discount the loans to present value.

Example – Deferred payment

Smith Ltd sells goods on credit to Jones Ltd for £43,000 under a financing agreement. Annual payments of £8,600 are due from Jones in each of the five years. If Jones had bought the goods outright, it would have paid £35,000.

Smith Ltd records the consideration at fair value. However, there is a difference between the amount that will be received under the financing arrangement (£43,000) and the cash sale value (£35,000) of £8,000. The consideration for the sale of the goods is the current cash sale price of £35,000. The difference of £8,000 is interest revenue for Smith Ltd and is recognised using the effective interest method.

Step 1: Calculate the effective interest rate

As this is a financing transaction it is necessary to establish the rate of interest which discounts the £43,000 to £35,000 over a five-year period.

This can be calculated using the internal rate of return function in Microsoft Excel which calculates the effective interest rate as 7.28%, as shown on the next page.

	A	B
1	(35,000)	
2	8,600	
3	8,600	
4	8,600	
5	8,600	
6	8,600	
7		7.28%

The formula in B7 is =IRR(A1:A6).

Step 2: Calculate the amount of interest earnt in each period

The total interest revenue is £8,000 (£43,000 less £35,000) and is recognised each year using the effective interest rate calculated in Step 1 above.

The financing transaction can be profiled as follows:

End of year	Balance b/f	Interest at 7.28%	Principal amount	Total payment
	A	(A x 7.28% = B)	(C-B)	C
1	35,000	2,548	6,052	8,600

2	28,948	2,107	6,493	8,600
3	22,455	1,635	6,965	8,600
4	15,490	1,128	7,472	8,600
5	8,018	582	8,018	8,600
Total		8,000	35,000	43,000

If the £8,000 interest was simply included on a level-spread method (which is not permitted under FRS 102), the interest revenue each year would be £1,600 which would show a disproportionate interest credit to the profit and loss account over the life of the financing arrangement. While the straight-line method would end up in the same place over the five-year period as the effective interest method, the straight-line basis could only be used if the amounts involved were immaterial.

2.7 Exchanges of goods or services

Where exchanges of goods or service are concerned, revenue cannot be recognised:

(a) when goods or services are exchanged for goods or services that are of a similar nature and value; or

(b) when goods or services are exchanged for dissimilar goods or services but the transaction lacks commercial substance.

A transaction is said to have 'commercial substance' when the exchange is for goods and services which are not similar in nature or value. No revenue is recognised when goods or services are exchanged or swapped for goods or services of a similar nature and value.

If goods or services are exchanged for dissimilar goods or services (in both nature and value), revenue is recognised.

Where the transaction does not lack commercial substance, revenue is measured as follows:

(a) Revenue is measured at the fair value of the goods or services received and is adjusted for any cash or cash equivalents made by either the buyer or the seller.

(b) If the fair value of the goods or services received cannot be reliably measured, the entity recognises revenue at the fair value of the goods or services given up (again adjusted for any cash (or cash equivalent) payments made or received).

(c) If the fair value of neither the goods or services received, nor the goods or services given up, can be measured reliably, revenue is measured as the carrying amount of the goods or services given up and adjusted for any cash (or cash equivalent) payments made or received.

2.8 Identifying a revenue transaction

A reporting entity must apply the recognition criteria to the **separately identifiable components** of a single transaction in order to report the substance of the transaction. For example, an entity could sell a machine but include servicing at periodic intervals. While the two elements of the sale may take place in a single transaction, the recognition criteria must be applied to the sale of the machine and the servicing element separately.

Conversely, an entity could apply the recognition criteria to two, or more, transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

Example – Sale of software and technical support

Stefan's Software Co sells bookkeeping software to its clients which are mainly accountancy firms. The company has a year end of 31 May 2023 and reports under FRS 102. On 1 May 2023 the company sold a piece of software to its customer for £5,000 plus VAT. Included in this transaction is one year's technical support which is charged at £1,200.

This single transaction has two components to it:

- The software product; and
- The technical support.

The sale of the software can be recognised as revenue at an amount of £3,800 (£5,000 - £1,200), but the technical support is for one year, hence only 1/12 should be recognised as revenue. The total sale will be recognised in the profit at loss account for the year ended 31 May 2023 as £3,900 (£3,800 software plus £100 (£1,200 / 12) technical support). The remaining £1,100 is presented as deferred income in the company's balance sheet within current liabilities and is recognised as revenue over the term of the support agreement.

Care will need to be taken with these sorts of transactions. In the example above, the customer could have purchased the software but chosen not to take up the one year's technical support (and this is common where software is concerned). In some instances, a seller may choose to sell a product as part of a 'bundle'; this does not mean that the component cannot be separately identified because the customer could obtain the product on its own from a different supplier.

2.9 Sale of goods

FRS 102, para 23.10 contains five conditions, all of which must be met before an entity can recognise revenue in respect of the sale of goods as follows:

FRS 102 para 23.10(a) to (e)

(a) *the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;*

(b) *the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;*

(c) *the amount of revenue can be measured reliably;*

(d) *it is **probable** that the economic benefits associated with the transaction will flow to the entity; and*

(e) *the costs incurred or to be incurred in respect of the transaction can be measured reliably.*

An assessment of whether the entity has transferred risks and rewards to the buyer will require professional judgement including an examination of the circumstances of the transaction. In practice, risks and rewards are transferred at the same time legal title is passed, which may arise when the goods are dispatched or received by the customer depending on the specific terms of the sale contract. In other cases, the transfer of risks and rewards of ownership may occur at a different time from the transfer of legal title or the passing of possession.

When the seller retains some of the significant risks and rewards of ownership, the revenue recognition criteria is not met and a sale is not recognised.

FRS 102, para 23.12 offers four examples of situations where the entity does **not** recognise revenue because it retains significant risks and rewards of ownership as follows:

FRS 102 para 23.12(a) to (d)

(a) *when the entity retains an obligation for unsatisfactory performance not covered by normal warranties;*

(b) *when the receipt of the revenue from a particular sale is contingent on the buyer selling the goods;*

(c) *when the goods are shipped subject to installation and the installation is a significant part of the contract that has not yet been completed; and*

(d) *when the buyer has the right to rescind the purchase for a reason specified in the sales contract, or at the buyer's sole discretion without any reason, and the entity is uncertain about the probability of return.*

Example – Machinery shipped awaiting installation

Aurora Co Ltd has a year-end of 31 March 2023. On 20 March 2023, the company sells five items of machinery to a customer based 150 miles away. The terms of the sale are that the company will ship the machines to the customer before 25 March 2023 so that they can be inspected for any damage. Aurora will then attend the customer's premises and install the machines so that they are at full working capacity. The fitters are expected to attend the customer on 4 April 2023 to commence the installation which is expected to last three days.

The sales invoice has been raised and has been included in sales for the year ended 31 March 2023.

The company is unable to recognise a sale in the 31 March 2023 financial statements because it still has an obligation to its customer to install the machinery to full working capacity. This is not scheduled to happen until after the year end. In this instance, the sale must be removed from revenue and included within deferred income as a current liability in the balance sheet. It can only be recognised as revenue once all the contractual obligations to the customer have been fulfilled (which is likely to take place once the machines are working to full capacity).

Important point. The timing of revenue recognition in instances such as in the example above is important because inappropriate recognition of revenue will not only mean a breach of the revenue recognition principles in Section 23 of FRS 102, but also that the company will effectively be paying corporation tax on the sale as it will have been included in revenue too soon. Careful scrutiny of the terms of sale may be necessary in certain circumstances.

Transfer of risks and rewards: other considerations to keep in mind

The transfer of risks and rewards from seller to buyer are not uniform across all entities and careful scrutiny of the sales contract (where applicable) may need to be carried out to ensure the company recognises revenue at the correct time.

Some companies may offer a 'cooling off' period whereby goods can be returned by customers within a certain timeframe if they are dissatisfied with them, for whatever reason.

Difficulties can be encountered when the seller does not have clear policies in place and relies on oral arrangements. Clients should be advised to have policies in place which are communicated to the buyer in the form of contractual terms, terms and conditions stated on the invoice or other written means to avoid any contentious issues further down the line.

Where an entity only retains an insignificant level of risks and rewards of ownership of the goods, revenue can still be recognised. FRS 102, para 23.13 and FRS 105, para 18.12 cite an example of where a company retains legal title to goods in a sales transaction to protect the collectability of the amount due (i.e. the seller can seize back the goods in the event of non-payment). A sale is still recognised, but title is reserved.

Worked examples of revenue recognition in FRS 102

The Appendix to FRS 102, Section 23 contains 13 examples illustrating how the revenue recognition criteria in respect of the sale of goods can be applied. These cover the following areas and care should be taken to check whether any of the examples apply to the entity's revenue, before formulating a revenue recognition policy:

1. Bill and hold sales
2. Goods shipped subject to conditions: Installation and inspection
3. Goods shipped subject to conditions: On approval
4. Goods shipped subject to conditions: Consignment sales
5. Goods shipped subject to conditions: Cash on delivery
6. Layaway sales
7. Orders when payment is received in advance of delivery for goods not yet in inventory
8. Sale and repurchase
9. Sales to intermediate parties
10. Subscriptions to publications and similar items
11. Instalment sales
12. Agreements for construction of real estate
13. Sale with customer loyalty award

2.10 Rendering of services

If the outcome of a transaction involving the rendering of services can be estimated reliably, revenue is recognised according to the stage of completion of the transaction (often referred to as the 'percentage of completion'). FRS 102, para 23.14 states that the outcome of a transaction can be estimated reliably when **all** of the following conditions are satisfied:

FRS 102 para 23.14(a) to (d)

(a) *the amount of revenue can be measured reliably;*

(b) *it is probable that the economic benefits associated with the transaction will flow to the entity;*

(c) *the stage of completion of the transaction at the end of the reporting period can be measured reliably; and*

(d) *the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.*

To enable a reliable estimate of the outcome to be determined, entities carrying out service contracts will need to have some form of monitoring system in place on which they can make reliable estimates. This will be essential in order to ensure that the correct amount of revenue is recognised only when it is appropriate.

Indeterminate number of acts

In some cases, services may be performed by an indeterminate number of acts over a specified period of time. When this is the case, revenue is recognised on a straight-line basis over the specified period unless another method better represents the stage of completion.

In other cases, a specific act may be much more significant than any other act. In this instance, revenue is not recognised until the significant act is executed as can be seen in the following example:

Example – Event management

Fantastic Festivals Ltd has a reporting date of 31 May 2023 and is an event management company. It is currently organising a large event consisting of 30 tribute bands which will be held over the course of a weekend in early July 2023. Tickets went on sale in February 2023 and have sold very well. It is expected that tickets will be sold out by the end of April 2023.

Revenue in respect of the ticket sales cannot be recognised in the 31 May 2023 financial statements. Revenue is dependent on a more significant act, being the main event taking place in July 2023. In this example, revenue for ticket sales is deferred and will not be recognised until the event has taken place in July 2023.

Outcome cannot be reliably estimated

If an entity is unable to establish the outcome of a transaction involving the rendering of services, revenue is only recognised to the extent of expenses recognised which are recoverable.

The outcome of this transaction would be that the entity recognises no profit because revenue is recognised to the extent of probable recoverable costs. Once the uncertainties have been resolved, revenue is recognised using the percentage of completion method, which may involve a one-off 'catch-up' of revenue.

2.11 Construction contracts

The Glossary to FRS 102 defines a 'construction contract' as:

> *A contract specifically negotiated for the construction of an **asset** or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.*

*FRS 102 Glossary **construction contract***

The definition above refers to a contract that is 'specifically negotiated'. This means that terms must have been agreed with the customer in respect of the contract including pricing, stage payments, anticipated completion dates, potential variations and any potential penalties (such as for late completion).

If the outcome of a construction contract can be estimated reliably, an entity recognises contract revenue and contract costs by reference to the stage of completion of the contract activity at the balance sheet date. FRS 102, para 23.17 confirms that a reliable estimation of the outcome of a construction contract requires reliable estimates of the stage of completion, future costs and collectability of billings.

Separating contracts

FRS 102, para 23.18 confirms that the requirements of paras 23.17 to 23.20 are usually applied to each construction contract. However, in some cases it may be necessary to apply these paragraphs to a separately identifiable component of a single contract or to a group of contracts together to reflect the substance of a contract/group of contracts.

The principle of combining and separating contracts is important because it can have a significant impact on the accounts.

Example – Separate contracts identified

A construction company has three contracts as follows:

	Contract 1	Contract 2	Contract 3	Total
	£'000	£'000	£'000	£'000
Contract revenue	120	200	650	970
Contract costs	70	250	420	740
Contract profit (loss)	50	(50)	230	230

Costs incurred at year end	35	210	315	560
Stage of completion at year end	50%	84%	75%	76%

If all the contracts were treated as one contract, the entity would recognise 76% of the total contract profit of £230,000 using percentage costs as its percentage of completion calculation (i.e. £174,800).

If each contract is treated separately, the following profits and losses are recognised:

	Contract 1	Contract 2	Contract 3	Total
	£'000	£'000	£'000	£'000
Profit (loss) expected	50	(50)	230	230
Stage of completion at year end	50%	84%	75%	
% of profit/(loss) recognised at year end	50%	100%	75%	
Profit (loss) recognised	**25**	**(50)**	**172.5**	**147.5**

Percentage of completion method

The percentage of completion method is outlined in paragraphs 23.21 to 23.27 of FRS 102. FRS 102, para 23.22 includes three possible methods in determining the stage of completion of a contract as follows:

- the proportion that costs incurred for work performed to date have in relation to the estimated total costs. Such costs do not include costs relating to future activity (e.g. for materials or prepayments);
- surveys of work performed; and
- actual completion of a physical proportion of the work or the completion of a proportion of the service contract.

When the entity receives a progress payment from the customer, these are credited to the contract account and not revenue. Progress payments do not reflect the work performed and hence are not regarded as revenue.

Example – Construction contract in progress

On 1 October 2022, a construction company with a reporting date of 31 March 2023 enters into a contract at a fixed price of £5 million.

Costs have been analysed at the start of the contract as follows:

	£'000
Materials to date plus additional costs	1,000
Labour and other overheads	1,200
Depreciation	900
	3,100

The estimated profit in the contract is expected to be £1.9 million (£5m fixed price less £3.1m costs).

At the year end 31 March 2023, the costs incurred were as follows:

	£'000
Purchase of materials	500
Labour and other overheads	600
Depreciation (£900 x 6/12)	450
Costs incurred at year-end	1,550

On 31 March 2023, the surveyor confirmed that the contract was 40% complete and the customer made a progress payment of £900,000 on that date.

As the surveyor has confirmed that 40% of the contract is complete at the year end, 40% of the price can be recognised as revenue with 40% of the contract costs being recognised as cost of sales, i.e.:

	£'000
Turnover (40% x £5m)	2,000
Cost of sales (40% x £3.1m)	1,240
Gross profit	760

In the balance sheet, the gross amount due from the customer is calculated as follows:

£'000

Costs to date:	
Purchase of materials	500
Labour and other overheads	600
Plant depreciation	450
Total costs to date	1,550
Contract profit recognised	760
	2,310
Less progress payment received	(900)
Gross amount due	1,410

Outcome of the contract is uncertain

If the outcome of a construction contract is uncertain (i.e. management do not know whether the contract will make a profit or a loss):

- revenue is recognised to the extent of contract costs incurred that it is probable (i.e. more likely than not) will be recoverable; and
- the entity recognises contract costs as an expense in the period in which they are incurred.

Example – Contract outcome is uncertain

The outcome of a project with a fixed price of £5m is uncertain. At the year end 31 March 2023, the surveyor confirms the contract is 60% complete. Recoverable costs incurred to date are £2m.

In this example, revenue can only be recognised equivalent to the amount of costs incurred to date (i.e. £2m). If recoverable contract costs incurred to date were £3m then 60% of the contract price (i.e. £3m) would be recognised and cost of sales would be £3m giving a zero profit. This is because there is uncertainty over the outcome of the contract so it is not appropriate to recognise a profit yet, but it is probable that at least the £3m costs will be recovered, so revenue up to that can be recognised.

Loss-making contract

If the outcome of a contract is that contract costs will exceed total contract revenue, the expected loss is recognised as an expense immediately with a corresponding provision for an onerous contract. Cost of sales will be a balancing figure to generate the required loss.

Example – Loss-making contract

The management of a construction company have estimated that one of its contracts at a fixed price of £5m will generate a £400,000 loss. At the year end 31 March 2023 the surveyor confirmed that the contract is 40% complete. Revenue and costs are recognised as follows:

	£'000
Revenue (£5m x 40%)	2,000
Cost of sales (balancing figure)	2,400
Loss	400

Costs incurred prior to the contract being awarded

FRS 102, para 23.17A allows costs that directly relate to a construction contract which have been incurred by the entity which can be separately identified and reliably measured, where it is probable that the contract will be obtained, to be included in contract costs. If contract costs are incurred and expensed in one accounting period and the contract is awarded in the subsequent accounting period, they are not included in contract costs in the subsequent period.

2.12 Potential bad debts

Impairment of trade receivables is dealt with in FRS 102, Section 11 *Basic Financial Instruments* at paras 11.21-11.24. These paragraphs require, where there is objective evidence of impairment, an impairment loss to be recognised in profit or loss immediately with a corresponding debit to bad debt provision.

FRS 102, para 11.24 requires that an entity individually assesses for impairment all equity instruments and other financial assets that are individually significant. Other financial assets may be assessed individually or be grouped on a basis of similar credit risks.

For trade debtors which are not individually significant, the entity will group them depending on their credit risks and establish the recoverable amount of the debtors to establish the value of the impairment (if any).

It is not appropriate under FRS 102 (or FRS 105) to just create a bad debt provision (i.e. a 'blanket' 5% of trade debtors). There must be objective evidence of an impairment - i.e. something having already happened though not necessarily known about in terms of which specific debts are affected that affects the recoverability of debtors. To that end, only **specific** bad debt provisions are permissible under FRS 102 and FRS 105.

2.13 Interest, royalties and dividends

Revenue is recognised as follows:

Interest: using the effective interest method. The effective interest rate calculation includes any related fees, finance charges paid or received, transaction costs and other premiums or discounts.

Royalties: on an accruals basis in accordance with the substance of the relevant agreement.

Dividends: when the shareholder's right to receive payment is established.

2.14 Disclosures

FRS 102 outlines the disclosure requirements in paragraphs 23.30 to 23.32.

General disclosures about revenue

Disclose:

(a) the accounting policies in respect of revenue recognition, including the methods which the entity uses to determine the stage of completion of transactions involving the rendering of services; and

(b) the amount of each category of the entity's revenue recognised during the period, showing separately, as a minimum, revenue that has arisen from:

- (i) sale of goods;
- (ii) rendering of services;
- (iii) interest;
- (iv) royalties;
- (v) dividends;
- (vi) commissions;
- (vii) grants; and
- (viii) other significant types of revenue.

Revenue from construction contracts

Disclose:

(a) the total amount of contract revenue recognised as revenue in the period;

(b) the methods employed by the entity to determine contract revenue recognised in the period; and

(c) the methods used to determine the stage of completion of construction contracts in progress.

In addition, the entity is required to present:

(a) the gross amount due from customers for contract work as an asset; and

(b) the gross amount due to customers for contract work as a liability.

FRS 102, para 23.33 clarifies that the gross amount due from customers for contract work is the net amount of:

(a) costs recognised as contract expenses plus recognised profits; less

(b) the sum of recognised losses and progress billings,

for all contracts in progress for which contract expenses plus recognised profits (less recognised losses) exceeds progress billings.

FRS 102, para 23.34 clarifies that the gross amount due to customers for contract work is the net amount of:

(a) costs recognised as contract expenses plus recognised profits; less

(b) the sum of recognised losses and progress billings,

for all contracts in progress for which progress billings exceed contract expenses plus recognised profits (less recognised losses).

FRS 102, paraph 23.35 confirms that costs incurred less costs recognised as contract expenses are to be presented as contract work in progress within inventories, unless the entity has chosen to adapt its balance sheet in accordance with paragraph 4.2A.

Disclosures required by The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (the Regulations)

The Regulations contain a specific requirement for companies outside the small companies regime to analyse turnover by class of business and geographical location (i.e. a 'segment analysis').

In addition, the Regulations (Sch 1, para 68(1)) also require where, in the course of the financial year, the company has carried on business in two or more classes which, in the opinion of the directors, differ substantially from each other, the amount of turnover deriving from each class must be stated together with a description of the class.

The Regulations at Sch 1, para 68(2) then go on to state that if the company has supplied markets which, in the opinion of the directors, differ substantially from each other, the value of turnover attributable to each market must be disclosed.

The Regulations at Sch 1, para 68(4) clarifies that classes of business which, in the opinion of the directors, do not differ substantially from each other, must be treated as one class and markets which, in the opinion of the directors, do not differ substantially from each other are to be classed as one market. Any amounts which are properly attributable to one class of business or market (as the case may be) which are immaterial may be included in the amount stated in respect of another.

The Regulations at Sch 1, para 68(5) says that if, in the opinion of the directors, the disclosure of any of the information required by paragraph 68 would be seriously prejudicial to the interests of the company, that information need not be disclosed.

Note: where the 'seriously prejudicial' exemption is concerned, companies should ensure that it is applied appropriately and only use it in justifiable circumstances.

FRS 102, Section 1A

For small companies applying the presentation and disclosure requirements of Section 1A, they must disclose the accounting policies adopted in respect of all relevant amounts shown in the financial statements, including revenue. However, there are no further requirements for disclosures in respect of revenue, other than the general requirement for the accounts to show a true and fair view.

FRS 105

For micro-entities choosing to apply FRS 105, there are no specific disclosure requirements in respect of revenue.

3 Small company exemption thresholds (Lecture A821 – 19.00 minutes)

It is surprisingly common to see financial statements where small company exemptions have been used despite the company not being eligible to take them. Where a qualified accountant was involved in the preparation of the financial statements this creates a major risk for them because their professional body expects them to check that a company is eligible for the small company exemptions that it applies.

Consequently, it is not unusual to see professional accountants being disciplined by ACCA or ICAEW for failings in this area.

This section is intended to remind accountants of the rules and how easy it is to get an assessment of eligibility wrong.

3.1 Small company exemption thresholds

The qualifying conditions to be small are met by a company (or group) in a year if it satisfies two or more of the following requirements:

- **Turnover** Not more than £10.2 million
- **Balance sheet total** Not more than £5.1 million
- **Average number of employees** Not more than 50

For groups, the thresholds are as follows:

Small groups

- **Turnover** Not more than £10.2 million net or £12.2 million gross
- **Balance sheet total** Not more than £5.1 million net or £6.1 million gross
- **Average number of employees** Not more than 50

Medium-sized groups

- **Turnover** Not more than £36 million net or £43.2 million gross
- **Balance sheet total** Not more than £18 million net or £21.6 million gross

- **Average number of employees** Not more than 250

Large groups

- **Turnover** More than £36 million net or

  £43.2 million gross

- **Balance sheet total** More than £18 million net or

  £21.6 million gross

- **Average number of employees** More than 250

In order to qualify as small in any financial year (other than its first) the entity must:

a) meet the qualifying conditions in the current year and the previous year; or

b) meet the qualifying conditions in the current year and qualify as small in the previous year; or

c) meet the qualifying conditions in the previous year and qualify as small in the previous year.

Note that, in the case of c), it does not have to meet the qualifying conditions the current period.

The examples of the companies/groups below are assumed to be ineligible.

Example 1

Wolves Ltd incorporates on 1 July 2019. These are its results for its five periods ending on 31 December:

	2019	2020	2021	2022	2023
Turnover	£6.5m	£11.2m	£9.2m	£8.0m	£8.5M
Balance sheet total	£6.1m	£7.5m	£5.5m	£4.5M	£5.5M
Headcount 40	45	51	45	45	

Is the entity eligible to apply the small company accounting exemptions?

Example 2

The following data applies to the H Group for the year ended 31 December 2022. The group consists of H Ltd (parent) and three wholly owned subsidiaries – A Ltd, B Ltd and

C Ltd.

	H Ltd	A Ltd	B Ltd	C Ltd
Turnover	£1m	£11m	£1m	£1m
Balance sheet total	£2m	£4m	£1m	£1m
Headcount	10	55	10	10

The figures for the years 31 December 2021 and 31 December 2020 were the same as those shown above. There is no trading within the group and no balances with other members of the group.

Which of the companies qualify as a small company in 2022 and which of them qualify for audit exemption?

Example 3

My firm is the auditor of a UK subsidiary of Spanish holding company. The UK company has turnover and gross assets below the audit exemption thresholds and the directors wish to take advantage of audit exemption in order to reduce costs. The holding company has not requested an audit and has stated that they will be satisfied with a compilation report from my firm. The holding company auditor has also not requested that the subsidiary is audited.

Can the UK company directors take advantage of audit exemption when the company is part of a group?

Example 4

Currently, my firm is considering whether to accept appointment as advisors for a UK company who takes advantage of audit exemption. The company is a subsidiary of a holding company incorporated in an offshore jurisdiction where financial statements are not publicly available. The UK directors say that they do not have access to financial information for the holding company or other group companies.

Is this company eligible for audit exemption?

The solutions to these examples are in the Appendix to these notes.

4 Cash flow statement (Lecture A822 – 6.07 minutes)

The cash flow statement (or statement of cash flows) is dealt with in FRS 102, Section 7 *Statement of Cash Flows*.

At the outset, it is worth noting that small companies are not required to include a cash flow statement in their complete set of financial statements and the vast majority of small companies do not produce one. FRS 102, Section 7 does not contain any exemption from the preparation of a cash flow statement for a parent entity. However, qualifying entities can take advantage of a reduced disclosure framework and this includes an exemption from the requirement to prepare a cash flow statement.

FRS 102 prescribes three cash flow classifications (being operating, investing and financing cash flows) and the standard does not mandate the order in which they are presented. In practice, the cash flow statement is usually presented in the order of operating activities, investing activities and financing activities as such statements are generally produced from automated accounts production software systems.

Under FRS 102, the reconciliation of operating profit to net cash flow from operating activities can be shown as part of the primary statement itself rather than as a note to the financial statements.

4.1 Structure of the cash flow statement

The cash flow statement provides the user with information about how the reporting entity has generated cash and what it has spent that cash on. The statement itself is prepared on a cash basis and forms a link between the profit and loss account and the balance sheet. This link allows the user to assess various factors which could affect the entity's liquidity, financial flexibility, profitability and overall risk.

Operating activities

Operating activities are the day-to-day revenue-producing activities of the business. FRS 102, para 7.4 contains the following examples of operating cash flows:

FRS 102, para 7.4

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions and other ***revenue****;*

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) cash payments or refunds of ***income tax****, unless they can be specifically identified with financing and investing activities;*

(f) cash receipts and payments from investments, loans and other contracts held for dealing or trading purposes, which are similar to ***inventory*** *acquired specifically for resale; and*

*(g) cash advances and loans made to other parties by **financial institutions**.*

*Some transactions, such as the sale of an item of plant by a manufacturing entity, may give rise to a **gain** or loss that is included in profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.*

Investing activities

Cash flows from investing activities arise from the acquisition and disposal of an entity's long-term assets and other investments which are not included in cash equivalents. FRS 102, para 7.5 provides the following examples of investing activities:

FRS 102, para 7.5

*(a) cash payments to acquire **property, plant and equipment** (including self-constructed property, plant and equipment), **intangible assets** and other long-term assets. These payments include those relating to capitalised **development** costs and self-constructed property, plant and equipment;*

(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

*(c) cash payments to acquire equity or debt instruments of other entities and interests in **joint ventures**, including the net cash flows arising from obtaining **control** of **subsidiaries** or other businesses (other than payments for those instruments classified as cash equivalents or held for dealing or trading);*

(d) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures, including the net cash flows arising from losing control of subsidiaries or other businesses (other than receipts for those instruments classified as cash equivalents or held for dealing or trading);

(e) cash advances and loans made to other parties (except those made by financial institutions – see paragraph 7.4(g));

(f) cash receipts from the repayment of advances and loans made to other parties;

(g) cash payments for futures contracts, forward contracts, (a)(option contracts and swap contracts, except when the contracts are held for dealing or trading, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge (see Section 12 Other Financial Instruments Issues), an entity shall classify the cash flows of the contract in the same manner as the cash flows of the item being hedged.

Financing activities

Financing activities are those activities which result in a change in the size and composition of the contributed borrowings and equity structure of the business.

FRS 102, para 7.6 provides the following examples of financing cash flows:

(a) *cash proceeds from issuing shares or other equity instruments;*

(b) *cash payments to* ***owners*** *to acquire or redeem the entity's shares;*

(c) *cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;*

(d) *cash repayments of amounts borrowed; and*

(e) *cash payments by a lessee for the reduction of the outstanding* ***liability*** *relating to a* ***finance lease****.*

4.2 Indirect and direct method

FRS 102, Section 7 provides for two possible methods for reporting cash flows from operating activities:

1. the indirect method; or
2. the direct method.

Indirect method

Under the indirect method, the net cash flow from operating activities is arrived at by adjusting profit or loss for the effects of non-cash items reported in profit or loss and fluctuations during the accounting period in stock, debtors and creditors as well as other items for which the cash effects relate to investing or financing activities of the entity.

Example – Indirect method		
	2023 (£)	2022 (£)
Operating profit	6,261	6,063
Depreciation charges	539	475
Loss on disposal of fixed assets	-	62
Gain on disposal of fixed assets	(125)	-

Equity-settled share-based payment expense	156	208
Decrease (increase) in trade and other debtors	(140)	139
Decrease (increase) in stock	27	(14)
(Decrease) increase in trade and other creditors	222	149
Cash generated from operations	**6,940**	**7,082**
Interest paid	(1,650)	(1,110)
Interest received	12	14
Tax paid	(1,254)	(1,657)
Cash flow from operating activities	**4,048**	**4,329**

Direct method

The direct method of preparing the cash flow statement is useful for the users because it reports the major classes of gross operating cash receipts and gross operating cash payments. However, the indirect method is the most common (and is equally acceptable).

Under the direct method, information is disclosed about the major classes of gross receipts and gross cash payments. An example is shown below:

Example – Direct method		
	2023	2022
	£	£
Collections from trade debtors	4,217	4,420
Payments to suppliers	(2,142)	(2,162)
Payments to employees	(657)	(569)
Payments of corporation tax	(64)	(138)
Payments relating to retirement benefits	(235)	(252)

Cash flows from operating activities	**1,119**	**1,299**

4.3 Non-cash transactions

The cash flow statement is prepared, by its very nature, using a cash-based rather than an accruals-based method to show the user how the entity has generated and spent cash during the period. On this basis, FRS 102, Section 7 requires the entity to exclude operating, investing and financing transactions that do not require the use of cash or cash equivalents. For such transactions, the standard requires disclosure of these transactions elsewhere in the financial statements in a way that provides all the relevant information.

Example – Disclosure of non-cash transactions

McCaffery Ltd has a year end of 31 March 2023. On 17 December 2022, it issued 100 new shares to convertible loan note holders in settlement of £50,000 capital and interest outstanding on the loan notes. The remaining capital and interest liabilities were satisfied through a rights issue: £5,000 was raised in cash with the remainder being an exchange of shares.

The non-cash transactions would be disclosed within the notes to the cash flow statement. Other examples of non-cash transactions, in addition to the conversion of debt to equity, include the acquisition of assets by assuming directly related liabilities or by means of a finance lease and issuing equity as consideration during a business combination.

4.4 Components of cash and cash equivalents

FRS 102, para 7.20 requires the entity to present the components of cash and cash equivalents as well as presenting a reconciliation of the amounts presented in the cash flow statement to the equivalent items presented in the balance sheet. FRS 102, para 7.20 does not require the entity to present this reconciliation if the amount of cash and cash equivalents presented in the cash flow statement is the same as the amount shown in the balance sheet.

4.5 Cash and cash equivalents not available for use by the entity

Where the entity holds significant cash and cash equivalent balances, which are not available for use by the entity, FRS 102, para 7.21 requires this to be disclosed. Such situations may arise due to legal restrictions or foreign exchange controls (meaning that money cannot be brought out of a country, for example).

4.6 Net debt reconciliation

FRS 102, para 7.22 requires the entity to disclose an analysis of changes in net debt from the beginning of the reporting period to the end, showing changes arising from:

(a) the cash flows of the entity;

(b) the acquisition and disposal of subsidiaries;

(c) new finance leases entered into;

(d) other non-cash changes; and

(e) the recognition of changes in market value and exchange rate movements.

FRS 102, para 7.22 states that when several balances (or parts thereof) from the balance sheet have been combined to form the components of opening and closing net debt, sufficient detail must be shown to enable the users to identify these balances. In addition, the analysis of net debt need not be presented for prior periods.

5 ICAEW disciplinary framework

On 1 June 2023, changes to the ICAEW's disciplinary framework will come into effect. These changes clarify the processes involved and improves overall transparency and accessibility. The changes will also provide greater efficiency by improving the speed of investigations and disciplinary proceedings.

The core aspects of the existing disciplinary framework and fitness regulations and processes will be maintained, while the new framework is simpler and easier to understand for all parties involved.

5.1 Reasons for the changes

Over recent years, ICAEW has made significant changes to its disciplinary arrangements for members, other regulated individuals and firms to improve consumer protection and access to justice. These include:

- the introduction of a fitness to practise process;
- a fixed penalty process for more minor compliance-type issues;
- a fast-track process for serious criminal conviction complaints; and
- provision for settlement orders and interim orders.

The above amendments have been introduced through a series of incremental amendments to existing disciplinary byelaws (DBLs).

The ICAEW Regulatory Board (IRB) was concerned that some of the language used in the DBLs was overly legalistic, and that governance requirements for changes to byelaws under ICAEW's constitution meant that procedural changes could not be implemented swiftly if issues and/or gaps were identified in the process.

The IRB resolved that the disciplinary and fitness to practise framework should be simplified to make it more accessible to users. Following a consultation and approvals process, the changes will come into effect on 1 June 2023.

5.2 Disciplinary cases commenced prior to 1 June 2023

The new framework will be launched on 1 June 2023. Ongoing disciplinary matters on this date will continue under the old framework until such time that it reaches a significant step in that process.

Those 'significant steps' are:

(a) All matters in assessment/investigation or before the Conduct Committee, will be subject to the procedure set out in the byelaws and regulations in force at the commencement of the assessment.

(b) All matters before the Tribunals Committee will be subject to the procedure set out in the byelaws and regulations in force at the time that the matter was referred to the Tribunal.

(c) All matters before the Appeal Committee will be subject to the procedure set out in the byelaws and regulations in force at the time that the matter was referred to the Appeal Panel, save where the period for appeal commences before, but expires on or after, 1 June 2023 and the notice of appeal is filed within that period.

All parties involved in current cases are being written to ahead of the 1 June 2023 date.

6 Employee ownership trusts and intermediate payment arrangements

Employee ownership trusts (EOTs) were introduced by the government in 2014. They are a special form of employee benefit trust that encourage shareholders to set up a corporate structure to facilitate wider employee-ownership via an indirect holding.

EOTs differ from Employee Benefit Trusts (EBTs) and Employee Share Ownership Plans (ESOPs) because the entity does not have control or *de facto* control over the trust. Consequently, EOTs are not accounted for as intermediate payment arrangements (see 6.1 below), so there is no quasi-consolidation in the entity's financial statements.

A distinct benefit of an EOT is that there are very generous tax breaks available to encourage shareholders to move to an employee-ownership model for their business. However, as is always the case with such schemes, the EOT must be structured in a particular way.

EOTs have become quite popular over recent years, especially since the pandemic as shareholders look to sell their companies in the future. EOTs have many benefits, notably:

- they allow shareholders and the directors to effect a smooth transition of the entity to the employees, which, in turn, allows management to focus their attention on running the business;
- they allow the shareholders to receive full value for the business on transfer without the complexities of earn-outs;
- employees are effectively 'locked in' and will be motivated to drive the business forward as it will be in their interests to do so;
- EOTs are less costly than traditional sales; and
- shareholders can claim exemption from UK capital gains tax on disposal of the business.

6.1 The mechanics

When forming an EOT, there are three key stages:

Step 1

A qualifying EOT is setup with a corporate as the trustee of the EOT ('the Trustee company').

Step 2

The shareholders sell their shares to the Trustee Company (which will hold the shares on behalf of the EOT) via a share purchase agreement. A professional valuation of the company will be carried out and the EOT will use this valuation as a basis for determining the purchase price. On sale of the shares, the purchase price will create a liability owed by the EOT to the shareholders which will remain outstanding. The Trustee Company would hold the shares on behalf of the EOT due to legal personality issues.

Step 3

The company continues trading in the normal way and profits will be used to make contributions to the EOT. These profits will be used to repay the outstanding purchase price that it owes to shareholders.

6.2 Qualifying conditions

There are five conditions that must be met:

1. The company whose shares are transferred must be a trading company or the principal company of a trading group.

2. The trustees of the EOT must restrict the application of any settled property (the shares) for the benefit of all eligible employees on the same terms.

3. The trustees must retain, on an ongoing basis, at least a 51% controlling interest in the company.

4. The number of continuing shareholders (and any other 5% participators) who are directors or employees (and any persons connected with such employees or directors) must not exceed 40% of the total number of employees of the company or group.

5. Trust property must generally be applied for the benefit of all eligible employees on the same terms, but the trustees may distinguish between employees on the basis of remuneration, length of service and hours worked.

6.3 Key advantages

EOTs are very advantageous for the shareholders, the company and its employees. Some of the main advantages are as follows:

- Employees can indirectly purchase the company from its shareholders without having to use their own funds.

- Shareholders can sell their shares for full market value, subject to an independent valuation being obtained.

- There should be no capital gains, income or inheritance tax liabilities on disposal of a controlling interest in a company to an EOT, or on the subsequent receipt of the purchase price by the former shareholders.
- The directors remain in office until the date of disposal.
- The costs of effecting an EOT are inherently lower than traditional sales routes.
- Employees will be better motivated which should, in turn, reduce absenteeism.
- Business performance is likely to be improved with a motivated workforce.
- Companies controlled by an EOT are able to pay tax-free cash bonuses to their employees of up to £3,600 per employee per year.

6.4 Accounting issues

The EOT holds the shares as well as the liability to finance the purchase. The EOT must have a controlling interest in the company and all employees must benefit from the trust.

When considering the accounting treatment under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, it is important to consider whether the EOT has been set up to serve the purposes of the trading company (in other words there is *de facto* control). FRS 102 provides no further elaboration on *de facto* control but the main issue to consider is that generally there is no *de facto* control on the grounds that the EOT benefits all employees equally and is not a means of rewarding (for example) senior management.

Example - EOT

Sunnie Enterprises Ltd is a trading company and has decided to establish an EOT. It establishes EOT Ltd to which the existing shareholders of Sunnie Enterprises sell their shares. The purchase consideration to the existing shareholders remains unpaid, so the EOT itself would record the transaction as follows:

- Dr Investment
- Cr Creditor

Keep in mind that EOT Ltd would not record the investment and creditor above since the corporate trustee is only acting in a trustee capacity.

There are no accounting entries made in Sunnie Enterprises as they are not a party to this arrangement.

As profits are generated by Sunnie Enterprises, distributions are made to the EOT (which follow the normal company law protocol). Each distribution is recorded in Sunnie Enterprises' financial statements as follows:

- Dr Retained earnings
- Cr Bank

The distributions received will be used by the EOT to clear out the creditor due to the previous shareholders as follows:

- Dr Creditor
- Cr Cash

6.5 Intermediate payment arrangements

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with intermediate payment arrangements in Section 9 *Consolidated and Separate Financial Statements*. FRS 102, para 9.33 states:

Intermediate payment arrangements may take a variety of forms:

FRS 102, para 9.33

(a) The intermediary is usually established by a sponsoring entity and constituted as a trust, although other arrangements are possible.

(b) The relationship between the sponsoring entity and the intermediary may take different forms. For example, when the intermediary is constituted as a trust, the sponsoring entity will not have a right to direct the intermediary's activities. However, in these and other cases the sponsoring entity may give advice to the intermediary or may be relied on by the intermediary to provide the information it needs to carry out its activities. Sometimes, the way the intermediary has been set up gives it little discretion in the broad nature of its activities.

(c) The arrangements are most commonly used to pay employees, although they are sometimes used to compensate suppliers of goods and services other than employee services. Sometimes the sponsoring entity's employees and other suppliers are not the only beneficiaries of the arrangement. Other beneficiaries may include past employees and their dependants, and the intermediary may be entitled to make charitable donations.

(d) The precise identity of the persons or entities that will receive payments from the intermediary, and the amounts that they will receive, are not usually agreed at the outset.

(e) The sponsoring entity often has the right to appoint or veto the appointment of the intermediary's trustees (or its directors or the equivalent).

(f) The payments made to the intermediary and the payments made by the intermediary are often cash payments but may involve other transfers of value.

Examples of intermediate payment arrangements are employee share ownership plans (ESOPs) and employee benefit trusts that are used to facilitate employee shareholdings under remuneration schemes. In a typical employee benefit trust arrangement for ***share-based payments****, an entity makes payments to a trust or guarantees borrowing by the trust, and the trust uses its funds to accumulate assets to pay the entity's employees for services the employees have rendered to the entity.*

Although the trustees of an intermediary must act at all times in accordance with the interests of the beneficiaries of the intermediary, most intermediaries (particularly those established as a means of remunerating employees) are specifically designed so as to serve the purposes of the sponsoring entity, and to ensure that there will be minimal risk of any conflict arising between the duties of the trustees of the intermediary and the interest of the sponsoring entity, such that there is nothing to encumber implementation of the wishes of the sponsoring entity in practice. Where this is the case, the sponsoring entity has de facto control.

FRS 102, para 9.33A then goes on to state:

It is possible for an entity to be owned by a trust established for the benefit of employees without the entity controlling the trust. An example is when the entity is a co-operative, owned by its employees, and all of the shares are held in a trust for the benefit of the employees but the shares never ***vest*** *in individual employees, with dividends from the company being distributed to employees solely in accordance with the provisions of the trust deed.*

FRS 102, para 9.33A

The accounting treatment for intermediate payment arrangements is outlined in FRS 102, paras 9.34 to 9.37

FRS 102, para 9.34 states that when a sponsoring entity makes a payment or transfers assets to an intermediary, there is a rebuttable presumption that the entity has exchanged one asset for another and that the payment itself does not give rise to an expense. This presumption can be rebutted at the time the payment is made, but in order to rebut this presumption, the entity must be able to demonstrate that:

a) it will not obtain future economic benefit from the amounts transferred; or
b) it does not have control of the right or other access to the future economic benefit it is expected to receive.

When assets are exchanged for other assets in an intermediate payment arrangement, assets acquired by the intermediary will be under the control of the entity. It follows that assets and liabilities of the intermediary must be accounted for by the sponsoring entity as an extension of its own business and hence recognised in its own financial statements. Assets cease to be recognised as assets when, for example, the asset of the intermediary vests unconditionally with identified beneficiaries.

Equity instruments may also be distributed to an intermediary to effect employee shareholders under a remuneration scheme. In such cases, FRS 102, para 9.36 states that where the entity has control, or *de facto* control, of the assets and liabilities of the intermediary, the substance is that the sponsoring entity is, for all practical purposes, in the same position as if it had purchased the shares directly.

FRS 102, para 9.37 outlines the accounting treatment when an intermediary holds the sponsoring entity's equity instruments. The sponsoring entity is required to account for the equity instruments as if it had purchased them directly. The sponsoring entity then accounts for the assets and liabilities of the intermediary in its individual financial statements as follows:

FRS 102, para 9.37

(a) *The consideration paid for the equity instruments of the sponsoring entity shall be deducted from equity until such time the equity instruments vest unconditionally with employees.*

(b) *Consideration paid or received for the purchase or sale of the sponsoring entity's own equity instruments shall be shown as separate amounts in the* ***statement of changes in equity****.*

(c) *Other assets and liabilities of the intermediary shall be recognised as assets and liabilities of the sponsoring entity.*

(d) *No gain or loss shall be recognised in profit or loss or other comprehensive income on the purchase, sale, issue or cancellation of the entity's own equity instruments.*

(e) *Finance costs and any administration expenses shall be recognised on an* ***accrual basis*** *rather than as funding payments are made to the intermediary.*

(f) *Any dividend income arising on the sponsoring entity's own equity instruments shall be excluded from profit and loss and deducted from the aggregate of dividends paid.*

Example – Accounting for an ESOP trust

On 1 April 2023, an ESOP trust purchased shares in the market for £2,000.

On initial recognition, the entries (assuming an ESOP reserve is maintained) are as follows:

	£
Dr ESOP reserve	2,000
Cr Bank	2,000

Options are then granted over these shares with an exercise price of £1,800. Upon exercise of the shares, the entries are as follows:

Dr Bank	1,800
Dr Retained earnings	200
Cr ESOP reserve	2,000

The difference between the amount on initial recognition and the exercise price is a realised loss according to TECH 02/17BL *Guidance on Realised and Distributable Profits under the Companies Act 2006*. This loss should be regarded as accruing over the vesting period. The trust would be advised to make an annual transfer between the ESOP reserve and retained earnings to avoid paying dividends out unlawfully. Hence, the annual transfer from retained earnings to the ESOP reserve would be £200. The balance on the ESOP reserve is reduced over the vesting period so that when the shares are exercised, the balance on the ESOP reserve equals the cash received resulting in the following entries:

Dr Bank	1,800
Cr ESOP reserve	1,800

In an equity-settled share-based payment arrangement, there will be a credit to equity with a corresponding expense in profit and loss. It is possible to take the credit to a separate reserve if this is considered appropriate or it can be taken to retained earnings. Share-based payment arrangements are dealt with in FRS 102, Section 26 *Share-based Payment* and the credit to equity is based on fair value at the grant date which would mean that this value is unlikely to be equivalent to the difference between the purchase price of shares by an ESOP and the option exercise price. If the credit is taken to the ESOP reserve, this will result in the ESOP reserve increasing each year without being eliminated, hence it is advisable to take the credit entry under FRS 102, Section 26 to retained earnings as it is a realised profit.

6.6 Cash flow statement classification

Cash flows that relate to the acquisition and disposal of shares held in an ESOP trust should be classified as 'financing' cash flows because they relate to increases and decreases in share capital.

7 Auditing the cash flow statement (Lecture A823 – 6.02 minutes)

The cash flow statement (or 'statement of cash flows' as it is referred to in FRS 102) is one of the primary financial statements. This means that it is given no more, and no less, prominence than the other primary statements (the profit and loss account, balance sheet, other comprehensive income statement and statement of changes in equity).

However, it is concerning that some audit files which have been reviewed reveals that no audit work (or very little audit work) has been carried out on the cash flow statement despite it being a primary financial statement.

For example, classification of debt and treatment of non-cash movements has led to files being failed when such items are material.

Generally, the cash flow statement provides an insight as to how an entity has generated and spent cash. However, it is also used to:

- assess the entity's ability to generate future cash flows;
- assess the entity's ability to pay dividends and to meet obligations (e.g. payment of interest and capital to lenders);
- understand the differences between the measure of profit used and the net cash flow from operating activities; and
- assess the cash and non-cash investing and financing activities during the period.

Whilst fraud at the financial statement level is usually associated with profit and loss account and balance sheet accounts, fraud in the cash flow statement can exist and is potentially significant.

This could happen, for example, if the entity boosts operating cash flows by shifting cash inflows from financing activities into it or shifting operating cash outflows into financing or investing activities.

The audit of cash and cash transactions is critical because cash is the primary target of employee (and management) fraud.

7.1 Audit procedures for the cash flow statement

For the majority of audited entities, the cash flow statement will be automatically calculated – usually from movements between the current year and prior year trial balance.

However, it is important that the auditor exercises professional scepticism throughout the audit and, where the cash flow statement is concerned, keeps in mind that there could be manipulation of the figures presented in the cash flow statement (e.g. to boost net cash inflows from operating activities or even to turn net cash outflows from operating activities into net cash inflows from operating activities).

Typical audit procedures for the cash flow statement include:

- agree and reconcile all amounts in the cash flow statement to amounts that appear elsewhere or to the auditor's working papers (e.g. tax paid and interest paid amounts to bank statements);
- agree the reconciliation of profit (loss) to net cash flow from operating activities to other areas of the financial statements, e.g.:
    - the measure of profit (loss) to the profit and loss account;
    - depreciation charge to the fixed assets lead schedule;
    - gain or loss on disposal of fixed assets to the reperformance of the disposal account; and
    - movements in working capital to the balance sheet items;
- reperform the cash flow statement from the audited profit and loss account, balance sheet and statement of changes in equity;
- cast the cash flow statement for mathematical accuracy;
- confirm that amounts reported in investing and financing activities have been correctly classified and that the amounts are reasonable;
- for foreign currency cash flows, ensure these have been translated using the exchange rate at the date of the cash flow (or an average exchange rate if exchange rates have not fluctuated significantly during the reporting period) – where average rates are used, recalculate the average rate and agree this to the one used;
- for unrealised gains and losses arising from changes in exchange rates, recalculate the effect of the exchange rate change on cash and cash equivalents held in a foreign currency and ensure this has been presented separately from cash flows from operating, investing and financing activities;
- agree non-cash transactions to supporting documentation and ensure they have been excluded from the cash flow statement (e.g. conversion of debt to equity);
- review the disclosures for non-cash transactions for adequacy;
- agree the components of cash and cash equivalents to the balance sheet including the components of the reconciliation of amounts presented in the cash flow statement to the equivalent items presented in the balance sheet; and
- agree the analysis of changes in net debt to supporting information and ensure sufficient detail has been shown to enable users to identify balances where several balances (or parts therefore) in the balance sheet have been used.

Auditors should bear in mind that the cash flow statement is a primary financial statement and hence should have audit procedures applied over it in the same way that the other primary financial statements do.

Remember, the auditor's report lists the cash flow statement as one of the statements that has been subject to audit and therefore it is important that adequate audit procedures are performed over it.

8 ISQM 1 – Part 8 (Lecture A824 – 7.48 minutes)

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

- ISQM (UK) 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements;* and

- ISQM (UK) 2 *Engagement Quality Reviews*.

As explained in previous quarters, the implementation date for ISQM (UK) 1 was 15 December 2022. An evaluation of the firm's system of quality management must take place within one year following this date.

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

- The firm's risk assessment process (see quarter 3 2021 notes)
- Governance and leadership (see quarter 4 2021 notes)
- Relevant ethical requirements (see quarter 1 2022 notes)
- Acceptance and continuance of client relationships and specific engagements (see quarter 2 2022 notes)
- Engagement performance (see quarter 3 2022 notes)
- Resources (see quarter 4 2022 notes)
- Information and communication (see quarter 1 2023 notes)
- The monitoring and remediation process

In this quarter, we will examine the final component being 'the monitoring and remediation process'.

8.1 The monitoring and remediation process

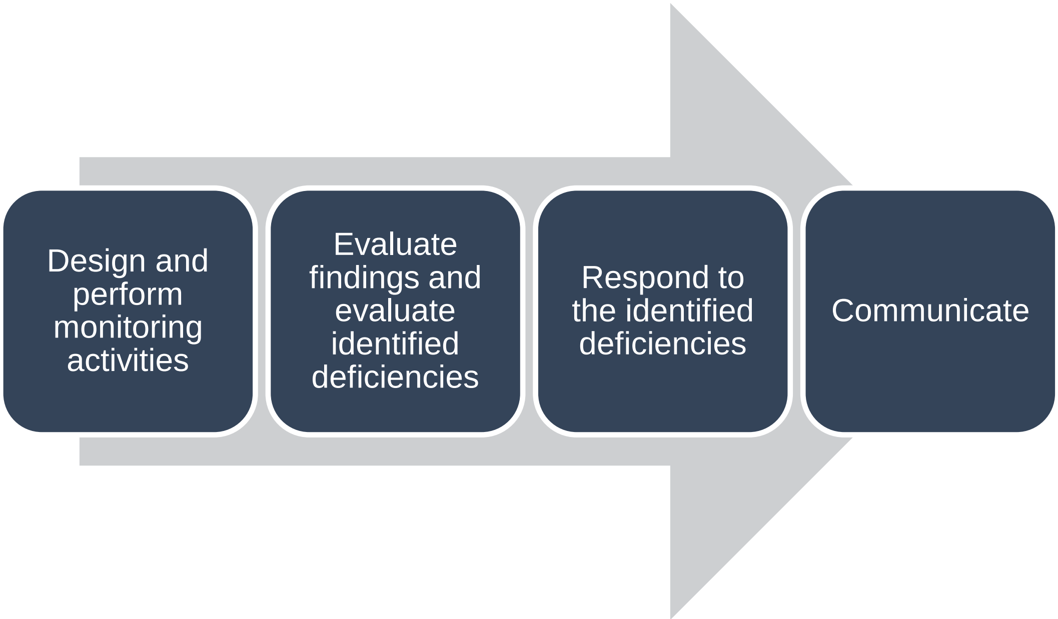
The objective of the monitoring and remediation process is twofold:

- To monitor the system of quality management (SoQM) so that the firm has relevant, reliable and timely information concerning the design, implementation and operation of the SoQM.

- To respond to identified deficiencies such that these deficiencies are corrected on a timely basis so that they do not reoccur.

In contrast to the old ISQC (UK) 1, ISQM (UK) 1 brings with it a new focus on monitoring the SoQM as a whole. In addition, there is a new framework for evaluating findings and identifying deficiencies as well as evaluating those identified deficiencies. There is also more robust remediation.

The monitoring and remediation process can be broken down into four parts:



The way in which the design of the monitoring and remediation process occurs will vary among firms. Most notably, the size, nature, complexity and circumstances of the firm will influence the design of the monitoring and remediation process. It is important that the firm monitors the SoQM **as a whole**, which may include monitoring:

- How responsibilities are assigned to leadership and whether the requirements of ISQM (UK) 1 have been met.
- The design and operation of the firm’s risk assessment process, i.e. how the firm establishes quality objectives, identifies and assesses quality risks, designing and implementing responses and identifying information related to changes in the nature and circumstances of the firm and the engagements it performs that may impact the quality objectives, quality risks or responses.
- The implementation and operation of the responses, including whether they operate according to how they have been designed and whether the responses effectively address the related quality risks.
- Whether the firm’s monitoring and remediation process is achieving its intended purposes.
- How the firm has addressed network requirements or network services and whether it complies with the requirements of ISQM (UK) 1.

- Leadership's evaluation of the SoQM and whether it has met the requirements of ISQM (UK) 1.

Example – IAASB

The International Auditing and Assurance Standards Board uses the following analogy when explaining the monitoring and remediation process.

Not so long ago, the only way you know that your motor vehicle needed a repair was when it broke down or when your motor vehicle went in for service. As motor vehicles developed, so did various onboard monitoring mechanisms. These were placed into motor vehicles resulting in various lights that could appear on the vehicle's dashboard. By having a more effective monitoring mechanism in place when various lights appeared, the driver would know if the issues were serious or not, can the motor vehicle be driven any further, or can the matter wait until the next service. Similarly, with the same analogy, the same should be able to be applied to the firm's quality management system through its monitoring and remedial activities.

8.2 Performing monitoring activities

ISQM (UK) 1 places more focus on monitoring all areas of quality management and the types of monitoring activities that are carried out. In order to monitor the system as a whole, the firm will need to consider all eight components. The objective is for the leadership team to conclude that the monitoring system is working as intended and can sufficiently identify deficiencies.

ISQM (UK) 1 notes that firms must design a system of quality management that provides a basis for the identification of deficiencies. To that end, the nature, timing and extent of monitoring activities will depend on the size, complexity and geographical dispersion of the firm.

If we consider a small firm with two audit partners, the system of quality management is likely to be straightforward and will primarily be focussed on how the two partners operate from a quality perspective. Conversely, one of the 'Big Four' will have a much more complex system of quality management in place, hence the firm's monitoring activities are scalable to the size and circumstances of the firm.

8.3 File reviews

File reviews ('hot' or 'cold' file reviews) are still a crucial aspect of quality management. Such reviews can provide the firm with a lot of information concerning the quality management processes in place. Under the previous ISQC (UK) 1, engagement partners were selected on a cyclical basis. ISQM (UK) 1 takes a different approach to this and the selection of audit partners can be done on a cyclical basis, but tailored to the specific circumstances of the firm.

Other factors may influence the selection of engagement files for review (for example, changes within the firm).

File reviews can also indicate whether the firm's system of quality management is working. For example, if the results of file reviews are highlighting an increased number of deficiencies, there may be a need to review the system of quality management and make necessary amendments.

8.4 Evaluation of the findings

Where the firm's monitoring activities have been sound, they should identify findings from these activities that need to be analysed. Findings can come from:

- monitoring activities;
- external inspections; and
- other relevant sources.

All these areas will produce results which will identify if there are any deficiencies in the firm's system of quality management. It is expected that monitoring activities will generate a lot of information concerning the firm's system of quality management. However, it is not necessarily the case that every piece of information will need a response because not every piece of information will indicate a problem with the system. Therefore, the firm will need to take the time to understand the information that has been gathered and analyse that information to ascertain whether any deficiencies have been uncovered within the system.

Evaluating identified deficiencies

Once a deficiency (or deficiencies) has been identified, the next step is to consider how serious those deficiencies are. Deficiencies which are viewed as significant must be remedied as quickly as possible to prevent their reoccurrence. Conversely, the monitoring activities can highlight issues that are working well within the system, which the firm should also carefully consider and assess them against areas in the system that may not be working so well.

8.5 Root cause analysis

Root cause analysis (RCA) has gathered much more prominence in recent years and is a key activity where identified deficiencies are concerned. RCA involves three questions:

- What is the problem?
- Why did it happen?
- What will be done to prevent it from happening again?

Where RCA is concerned, the key thing to understand is that the firm should not necessarily be concerned about the 'symptoms' of the deficiency but getting to the root cause of it.

For example, where there have been identified deficiencies in group audits, one of the deficiencies may be a lack of understanding of ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*. This could be due to a lack of training and hence the prevention of it happening again is to ensure that audit team members who are assigned to group audits have a sound understanding of the requirements of ISA (UK) 600.

8.6 Responding to deficiencies

Once deficiencies have been identified and RCA has been performed, the firm must then design and implement remedial measures which respond directly to the RCA.

ISQM (UK) 1 requires the firm to evaluate the remedial actions for effectiveness and ensure that they are appropriately designed to address the identified deficiencies and their related root causes.

All identified deficiencies will need a response by the firm. As noted above, any deficiencies which are judged as being serious or pervasive must be addressed quickly. Where time is needed to address serious deficiencies, the firm would be advised to put in interim measures to ensure the risk of reoccurrence of the deficiency is reduced as far as possible.

9 Professional scepticism (Lecture A825 – 17.18 minutes)

The term 'professional scepticism' is bandied around the auditing profession a lot. ISA (UK) 200 defines 'professional scepticism' as:

> *An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.*

ISA (UK) 200, para 13(l)

Professional scepticism is something that cannot be taught. However, professional bodies and regulators frequently criticise audit firms for failing to evidence that they have exercised professional scepticism during the audit.

Adopting an approach of professional scepticism will also involve a critical assessment of audit evidence and being alert for audit evidence that may contradict other audit evidence, or may call into question the reliability of the information gathered from management and those charged with governance.

Auditors must appreciate that professional scepticism is an integral part of their work and is closely interrelated to the fundamental concepts of independence, integrity and objectivity.

Training audit staff to be professionally sceptical is a fine art. Audit work must be undertaken to satisfy the relevant audit assertions and therefore creating an internal culture that recognises the importance of professional scepticism on all audits, regardless of past experiences with the audit client, is a pivotal activity that needs to be promoted within all firms so that it can be demonstrated that professional scepticism has been applied.

9.1 What is professional scepticism?

Professional scepticism allows the auditor to exercise professional judgement – especially concerning decisions relating to:

- the nature, timing and extent of audit procedures to be performed;
- whether sufficient appropriate audit evidence has been obtained and whether more needs to be done to achieve the objectives of the ISAs (UK);
- the evaluation of management's judgements in applying the entity's applicable financial reporting framework; and
- the drawing of conclusions based on the audit evidence obtained – for example, assessing the reasonableness of estimates made by management in preparing the financial statements.

As noted above, ISA (UK) 200 says that professional scepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error and fraud, and a critical assessment of audit evidence. The ISAs (UK) specifically require the auditor plans and performs the audit with professional scepticism and keep in mind that circumstances may be present which causes the financial statements to be materially misstated.

The problem that many auditors have with the concept of professional scepticism is that there is no single way of demonstrating its application. Notwithstanding this problem, professional scepticism is a mindset and a sceptical mindset will enable the auditor to question aspects of the entity and its financial statements rather than merely accepting information at face value. The concept of professional scepticism is very closely related to the concepts of independence and objectivity – two traits that are fundamental ethical principles in audit.

Professional scepticism can also be exercised by being alert to audit evidence that may contradict other audit evidence obtained. It can also be exercised by calling into question the reliability of documents or responses to enquiries and it also includes being alert to conditions that may indicate a potential fraud risk and thus developing audit procedures to adequately respond to that risk.

Applying professional scepticism when reviewing audit evidence is also important. Audit evidence must be sufficient and appropriate and adequately cover the relevant assertions. An auditor can demonstrate professional scepticism by questioning and considering both the sufficiency and appropriateness of the audit evidence gathered in light of the circumstances. Where the auditor has doubt concerning the reliability of information or where evidence points to a potential fraud risk, the ISAs (UK) require the auditor to investigate further and determine what additional procedures are necessary to resolve the issue.

Firms often run into difficulty with regulators and professional bodies during file reviews because they believe that management and those charged with governance are honest and their integrity is intact. While this may be the case in the majority of audits, a belief that a client is honest and has integrity does not relieve the auditor of their responsibility under the ISAs (UK) to maintain professional scepticism or be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

9.2 What firms can do to improve application of professional scepticism

The firm's leadership and the examples it sets will essentially drive the internal culture of the audit firm. Therefore, audit engagement partners must ensure that audit staff understand the importance of professional scepticism and the need to have a questioning mind. Audit firm must have policies and procedures that comply with the requirements of ISQM (UK) 1. Such policies and procedures should contain specific emphasis on the importance of exercising professional scepticism throughout the course of an audit.

Audit planning is an integral aspect of the audit and the audit team planning meeting is an ideal opportunity to re-affirm the importance of professional scepticism. An important part of the team meeting is for the team to discuss the susceptibility of the financial statements to material misstatement. This could be due to fraud and/or error and in the meeting it is the opportunity to discuss not only the susceptibility of the financial statements to material misstatement, but also **how** the financial statements **could** be materially misstated due to fraud or error. Many audit firms fall into the trap of relying on past experience concerning the honesty and integrity of clients and hence document that there are no issues relating to fraud or error on the grounds that no fraud or error was noted in prior year audits.

As well as fraud issues, the audit team must discuss how the financial statements could be materially misstated due to error. A sceptical mindset will approach the audit with an awareness that such misstatements due to fraud or error could have happened during the year.

The audit engagement partner should also demonstrate the application of professional scepticism when taking responsibility for:

- the direction, supervision and performance of the audit;
- reviews of work performed; and
- the engagement team undertaking appropriate consultation on difficult or contentious matters and considering the conclusions reached from such consultations.

Professional scepticism needs to be applied throughout the entire audit, even at the stage of accepting the engagement (for example, when considering the integrity of the principal owners and management). In addition, professional scepticism must be applied in:

- identifying and assessing the risks of material misstatement;
- designing the nature, timing and extent of further audit procedures which are responsive to the assessed levels of risk;
- evaluating audit evidence – such as recognising the need to increase the quantity of audit evidence or obtain evidence which is more relevant and reliable for areas which have a higher assessed risk;
- designing and performing substantive analytical procedures;
- addressing situations when management refuse to allow the auditor to send a confirmation request; and
- forming an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

It is also particularly important to apply professional scepticism when addressing areas of the financial statements that are complex, significant or contain a high degree of judgement on the part of the client and challenge management's assumptions, for example:

- Accounting estimates, including fair value accounting estimates and related disclosure – particularly:
    - evaluating the reasonableness of the significant assumptions used by management for accounting estimates that give rise to significant risks;
    - determining whether changes in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances; and
    - reviewing the judgements and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.
- Related party transactions and relationships and remaining alert during the audit for information which may indicate previously unidentified or undisclosed related party relationships or transactions.
- Significant transactions outside the ordinary course of business and evaluating whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into so as to engage in fraudulent financial reporting or to conceal misappropriation of assets or the reliability of external confirmation requests.
- Consideration of laws and regulations and remaining alert when performing the audit for instances of (suspected) non-compliance which may have a material effect on the financial statements, or that could have a fundamental effect on the operations of the client causing the business to cease trading or bring into question the entity's ability to continue as a going concern.
- Considering whether the going concern presumption is appropriate in the company's circumstances, such as evaluating management's plans for future actions and whether the outcome of these plans is likely to improve the situation and whether such plans are feasible.
- If the auditor is auditing significantly unusual or highly complex transactions, they must apply professional scepticism because the nature of such transactions may give rise to a material misstatement of the financial statements and hence will merit heightened attention by the auditor.

9.3 Evidencing professional scepticism

One of the main reasons an audit firm will receive criticism from a file review in respect of professional scepticism is the lack of evidence proving that the auditor has applied it. Where audit firms have documented certain points, it is often clear that the auditor is relying on past experience where the client's honesty and integrity is concerned and merely saying that because fraud/error was not noted in prior audits, then it can be assumed that the current year's financial statements will also not contain material misstatement due to fraud and/or error.

Care must be taken by audit firms when they rebut the presumption that fraud in relation to revenue recognition is not applicable to the client. Management override of internal controls is also recognised as a significant risk in ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* and hence the auditor must undertake the procedures laid down in ISA (UK) 240, para 33 (see section 10 of these notes) and not simply overlook these requirements because of past beliefs concerning the client's integrity and honesty.

An auditor can evidence professional scepticism in conversations they hold with those charged with governance. For example, it may be the case that the audit client has applied a certain accounting treatment which may be permissible under UK and Ireland GAAP, but which the auditor does not view as being appropriate in the company's circumstances. Challenging such practices and making sure that the notes of any discussions are documented are key in demonstrating that professional scepticism has been applied.

Audit documentation is critical because it demonstrates that the requirements of the ISAs (UK) have been applied. ISA (UK) 230 *Audit Documentation* requires the auditor to prepare sufficient audit documentation to enable an experienced auditor, having no previous connection with the audit, to understand, among other things, the significant decisions made regarding significant matters arising during the audit, the conclusions reached thereon, and significant judgements made in reaching those conclusions. Discussions of significant matters discussed with management and those charged with governance should also be documented, including the nature of the significant matters discussed and when, and with whom, the discussions took place. By ensuring such matters are properly documented, this will help the auditor demonstrate how significant judgements and key audit issues were addressed as well as how the auditor has evaluated whether sufficient appropriate audit evidence has been obtained.

The following is a non-comprehensive list of examples where appropriate audit documentation should be on file and where the matters and judgements are significant:

- The decisions reached during the audit team discussion concerning the susceptibility of the financial statements to material misstatement due to fraud.

- The decisions reached during the audit team discussion concerning the susceptibility of the financial statements to material misstatement due to fraud with related parties.

- Communication with management and those charged with governance, regulators and others in respect of fraud.

- Identified or suspected non-compliance with laws and regulations and the results of discussions with management and, where applicable, those charged with governance and other parties external to the entity.

- The basis for the auditor's conclusions concerning the reasonableness of accounting estimates and their disclosure which give rise to significant risks and any indicators of possible management bias.

- Identified information which is inconsistent with the auditor's conclusions concerning a significant matter and how that inconsistency was addressed.

- The basis for the auditor's conclusions concerning the reasonableness of subjective judgements.

- The basis for the auditor's conclusion about the authenticity of a document when the procedures applied by the auditor caused them to believe that the document may not be authentic.

10 Auditing journals (Lecture A826 – 15.20 minutes)

When it comes to the auditing of journals, the auditor is primarily concerned with detecting fraud. ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* deals with the issue of fraud and was last revised in May 2021 and applies for periods commencing on or after 15 December 2021.

ISA (UK) 240, para 33(a) states:

ISA (UK) 240, para 33(a)

> *Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:*
>
> *(a) Test the appropriateness of manual or automated journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including consolidation adjustments in the preparation of group financial statements*[2]*. In designing and performing audit procedures for such tests, the auditor shall:*
>
> *(i) Make inquiries of individuals with different levels of responsibility involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;*
>
> *(ii) Select journal entries and other adjustments made at the end of a reporting period and post-closing entries; and*
>
> *(iii) Consider the need to test journal entries and other adjustments throughout the period.*

10.1 Management override

ISA (UK) 240, para 32 sets out the presumed significant risk regarding the risk that management may override controls. The ISA (UK) tells us that even though the level of this risk will vary from entity to entity, the risk is nevertheless present in all entities. This is because management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

10.2 Response to the risk of management override of controls

As noted in the introductory section, ISA (UK) 240, para 33 requires the auditor to design and perform audit procedures over journal entries. The ISA (UK) also requires the auditor to perform audit procedures over accounting estimates and other significant transactions that are outside the ordinary course of business.

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[2] ISA (UK) 600 (Revised November 2019), paragraph 34.

With regards to journal entries and other adjustments, the auditor is required to make inquiries of individuals involved in the financial reporting process concerning inappropriate or unusual activity relating to the processing of journal entries and other adjustments. The auditor is also required to test a selection of journal entries and other adjustments made at the end of the reporting period and to consider the need to test journal entries and other adjustments throughout the period.

10.3 Testing journals

Auditors are required to test year-end journal entries and should consider testing journals throughout the remainder of the period.

The nature of the audit work over journal entries will vary from audit to audit. This will also depend on the size and complexity of the entity being audited.

Whilst random sampling of journals may sometimes be appropriate, more often the items to be tested should be determined using a more targeted method, such as looking for unusual items and items posted in an unexpected way.

Remember, that the testing of journals is intended to help identify fraud. The auditor must be appropriately unpredictable so that fraudsters cannot work around the auditor undetected.

Journals posted during the period

A fraudster may be aware that auditors are *required* to test year-end journals and so post the fraudulent entries <u>during</u> the period rather than towards the year end. The auditor must take this risk into consideration when planning their work.

Documentation

As with all other audit work, the testing of journal entries must be documented. There should be sufficient documentation to understand the nature of the work, the items tested and the conclusions reached. Where there are any doubts concerning the audit documentation, the auditor should refer to the provisions in ISA (UK) 230 *Audit Documentation*.

Data analytics

Many auditors are now making use of data analytics software in their audits. One of the most useful features of this approach is assisting in the audit of journals.

Commercially available data analytics software often includes a package that can test journals using bespoke algorithms to identify the higher risk transactions. This can drive a much more intelligent approach to testing journals and can lead to the production of extensive exception reports.

Auditors can easily produce these exception reports, but the exceptions will need to be evaluated and appropriately investigated. One obvious pitfall is that the auditor fails to do this.

10.4 FRC thematic review

In January 2014, the Financial Reporting Council (FRC) issued a thematic review *Fraud Risks and Laws and Regulations.*

A thematic review looks at a firm's policies and procedures in respect of a specific area of auditing and how they apply it in practice. The reviews themselves are quite narrow in their scope and the FRC conduct them in recognition of the fact that their general findings have shown areas for improvement. The thematic reviews go into further detail in a specific area so as to make comparisons between firms with a view to identifying both good and weak practices.

Whilst this review was published some time ago, its feedback is still mostly useful and relevant. It identifies that in some cases it was not always clear that the testing of journals was responsive to the fraud risks identified and that the use of computer-assisted audit techniques (CAATs) to test journal entries was limited. Of the 26 audits reviewed, seven audits used manual identification, nine used CAATs and four used specialists (three IT and one forensic) to run CAATs.

The FRC confirmed that in their opinion, because of the nature of the audits inspected (larger and more complex ones), they would have expected the use of CAATs to have been more extensive.

Where manual identification was used, the audit team tended to focus on journals that were for large or round sum amounts posted outside normal working hours. This limited criteria may not be the most appropriate fraud risk characteristic to use in order to select journals for testing.

In audits where the use of CAATs was employed, a wider criteria was used including analysing journals by user, journals targeted at specific balances (especially revenue) and searching for 'keywords'. Whilst the thematic review acknowledges that this criteria is more targeted to the fraud risks identified for the entity, it also acknowledges that there could have been better linkage from the fraud risk factors and fraud risks to the fraud characteristics selected to identify journals for testing.

Sample sizes for journal testing

The thematic review states that sample sizes for journals testing varied significantly and, in general, the rationale for sample sizes was not clear as well as it being unclear as to how the sample selection criteria linked to the fraud risks identified. Where CAATs identify very large sample sizes, the audit team should consider whether the criteria used are appropriate for the circumstances of the entity and consider the possibility of refining them to identify a smaller population for testing.

In 11 audits, the FRC noted evidence that journals selected for testing agreed to supporting documentation and/or discussed with management. However, the purpose and appropriateness of the journal was not always considered by the audit team. Discussions with management were noted, but not testing of journals had been undertaken. The thematic review criticises firms in this respect because discussion with management, without obtaining any corroboratory evidence, is not a sufficient audit response to address the risk of fraud.

No testing of journals performed

The FRC noted four instances where journals had not been tested by the audit firm. Out of these four audits, three files suggested the substantive audit procedures performed in relation to financial statement line items provided sufficient evidence that no further work was needed.

In this respect, the FRC noted:

- Substantive analytical procedures are unlikely to identify journals that have been posted by management to manipulate the amounts reported in order to meet expectations.

- Substantive audit testing is only required for material financial statement line items. Journals may be posted to accounts with immaterial or £nil balances and these should also be considered for testing.

The FRC’s advice is that it is not appropriate to rely on these audit procedures as an alternative to testing journals to address the risk of management override of internal controls.

11 ISA (UK) 315: Practical issues (Lecture A827 – 31.54 minutes)

The revised ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement* became effective for financial periods commencing on or after 15 December 2021 and so is mostly applicable for 31 December 2022 year ends, but will also apply to short periods of account.

The revised ISA (UK) 315 is vast, at nearly three times the size of its predecessor ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*. It places more emphasis on general controls and IT controls and requires separate assessments of **inherent risk** and **control risk**. It also contains the **spectrum of inherent risk** which is not necessarily new in the ISAs (UK) but is given more prominence, especially in ISA (UK) 315 (Revised).

The key theme that runs through ISA (UK) 315 (Revised) is risk assessment. This will ultimately drive the audit procedures that the auditor will apply to obtain sufficient appropriate audit evidence. It will also determine whether the auditor can place reliance on the client's system of internal control or whether a more substantive approach should be undertaken.

11.1 Understanding the entity's system of internal control

One of the crucial planning activities carried out by an auditor is understanding the system of internal control. This is covered by ISA (UK) 315 in Appendix 3 *Understanding the Entity's System of Internal Control*. It contains detailed guidance on understanding the client's internal control system and each relevant component as follows:

Component	Explanation
Control environment	The culture and 'top-down' commitment to integrity, ethics and nurturing competent and accountable staff.
Risk assessment process	How the entity identifies, assesses and responds to risks.
Monitoring process	How the entity monitors its system of internal control (such as via internal audit or other compliance checks).
Information processing and communication	How transactions are initiated and the relevant details captured and processed along with accounting records, financial reporting processes and IT resources. It also includes how accounting issues are communicated to management and (if

	separate), those charged with governance.
Control activities	Specific controls over significant risks, journal entries and any other controls that the auditor plans to test for operating effectiveness together with any related IT applications.

Appendix 3 to ISA (UK) 315 also contains examples of control activities under the following headings:

Authorization and approval

This control confirms that a transaction is valid. This will usually take the form of an approval by a responsible official within the organisation, such as a supervisor approving overtime or a manager approving an expense claim.

Reconciliations

These compare two, or more, data elements. For example, the bank reconciliation will highlight any differences between the balance per the bank statement at the end of an accounting period and the balance per the client's cash book.

Verifications

Verifications compare two, or more, items with each other or compare an item with a policy. Where the two items do not match, or it is inconsistent with a policy, the auditor will investigate further.

Physical or logical controls including those that address security of assets against unauthorized access, acquisition, use or disposal

Typical examples include the physical security of assets (e.g. high-value inventory) and other expensive assets, such as computer equipment. These controls also include restricting access to computer programs and data files (e.g. restricting access to payroll records or the online banking system) and the periodic counting of assets (e.g. a cash count, or physical inventory count for comparison to the accounting records).

Segregation of duties

This control ensures that no one person has too much responsibility for a key area of the accounting system. Segregation of duties intends to reduce the opportunity of fraud. For example, a payroll clerk may process the payroll and then another person in the finance team may review the payroll, followed by a detailed review by the finance director to ensure that payments are being made to *bona fide* employees.

11.2 IT controls

There is much more emphasis on IT controls in ISA (UK) 315 (Revised). They are split between two appendices in ISA (UK) 315 as follows:

- Appendix 5 *Considerations for Understanding Information Technology*; and
- Appendix 6 *Considerations for Understanding General IT Controls*.

These appendices are lengthy and intend to provide guidance to audit teams on the new requirements.

They detail various characteristics of commercial software applications which are relevant to financial reporting and show how these are found in:

- Non-complex software
- Mid-size and moderately complex software or IT applications
- Large or complex applications (such as Enterprise Resource Planning (ERP) systems)

Where the client has a non-complex IT environment (e.g. a smaller audit client), the requirements of ISA (UK) 315 are likely to give rise to more IT controls being tested than was the case under the old version of the ISA (UK).

Remember, ISA (UK) 315 is intended to be scalable, hence brief notes or assessments are likely to be sufficient for a client that uses an off-the-shelf package (e.g. SAGE/XERO or QuickBooks).

Where a client uses an ERP system, this is likely to be considered complex. It is likely that the client will be large and will have a separate department that maintains the ERP system.

The issue faced by auditors is that complying with the requirements of ISA (UK) 315 (Revised) is going to prove problematic because auditors will generally not have any experience of the 'mechanics' behind the system and so it is likely that the auditor will have to engage an expert with specific experience (or similar experience) of the ERP system.

11.3 Inherent and control risk assessments

ISA (UK) 315 (Revised) requires the auditor to carry out a **separate** assessment of inherent risk and control risk.

Inherent risk

This is the risk that the financial statements contain a material misstatement **before** the auditor considers any related controls over that risk.

Consider a client that has a material portfolio of financial instruments which are measured at fair value through profit or loss. Accounting standards, such as FRS 102, Section 12 *Other Financial Instruments Issues* and IFRS® 9 *Financial Instruments* are inherently complex. The inherent risk in this respect is that the client does not fully understand the requirements of these complex accounting standards and hence there is a risk of material misstatement.

Appendix 2 to ISA (UK) 315 provides some examples of the risk factors that may contribute to the inherent risk assessment.

Risk factor	Examples
Complexity	
Regulatory	• Operations that are subject to a high degree of complex regulation
Business model	• The existence of complex alliances and joint ventures
Applicable financial reporting framework	• Accounting measurements that involve complex processes
Transactions	• Use of off-balance sheet finance, special-purpose entities and other complex financing arrangements
Subjectivity	
Applicable financial reporting framework	• A wide range of possible measurement criteria of an accounting estimate. For example, management's recognition of depreciation or construction income and expenses. • Management's selection of a valuation technique or model for a non-current asset, such as investment properties.
Change	
Economic conditions	• Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies
Markets	• Operations exposed to volatile markets, for example, futures trading
Customer loss	• Going concern and liquidity issues, including loss of significant customers

Industry model	• Changes in the industry in which the entity operates
Business model	• Changes in the supply chain • Developing or offering new products or services or moving into new lines of business
Geography	• Expanding into new locations
Entity structure	• Changes in the entity, such as large acquisitions or reorganisations or other unusual events • Entities or business segments likely to be sold
Human resources competence	• Changes in key personnel, including the departure of key executives
IT	• Changes in the IT environment • Installation of significant new IT systems related to financial reporting
Applicable framework	• Application of new accounting pronouncements
Capital	• New constraints on the availability of capital and credit
Regulatory	• The inception of investigations into the entity's operations or financial results by regulatory or government bodies • Impact of new legislation related to environmental protection
Uncertainty	
Reporting	• Events or transactions that involve significant measurement uncertainty, including accounting estimates and related disclosures • Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees, and environmental remediation
Susceptibility to misstatement	

• Reporting	• Opportunities for management and employees to engage in fraudulent financial reporting, including omission or obscuring of significant information in disclosures
• Transactions	• Significant transactions with related parties • A significant amount of non-routine or non-systematic transactions, including intercompany transactions and large revenue transactions at period end • Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities

Control risk

Control risk is the risk that the client's system of internal control will not prevent and detect, on a timely basis, a misstatement that could be material.

The term 'controls' is defined in ISA (UK) 315 as follows:

Policies or procedures that an entity establishes to achieve the control objective of management or those charged with governance. In this context: *ISA (UK) 315, para 12*

i. *Policies are statements of what should not be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.*

ii. *Procedures are actions to implement the policies.*

ISA (UK) 315 provides the following examples:

Cash at a supermarket retailer would ordinarily be determined to be a high likelihood of possible misstatement (due to the risk of cash being misappropriated), however, the magnitude would typically be very low (due to the low levels of physical cash handled in the stores). The combination of these two factors on the spectrum of inherent risk would be unlikely to result in the existence of cash being determined to be a significant risk. *ISA (UK) 315, para A220*

An entity is in negotiations to sell a business segment. The auditor considers the effect on goodwill impairment and may determine there is a higher likelihood of possible misstatement and a higher magnitude due to the impact of inherent risk factors of subjectivity, uncertainty and susceptibility to management bias or other fraud risk factors. This may result in goodwill impairment being determined to be a significant *risk.*

ISA (UK) 315 then goes on to provide further examples of where significant risks may arise:

ISA (UK) 315, para A221

- Transactions for which there are multiple acceptable accounting treatments.
- Accounting estimates that have high estimation uncertainty or complex models.
- Complexity in data collection and processing to support account balances.
- Account balances or quantitative disclosures that involve complex calculations.
- Accounting principles that may be subject to differing interpretations.
- Changes in the entity's business, for example, mergers and acquisitions.

11.4 Risk spectrum

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

Inherent risk will be higher for some assertions and related classes of transactions, account balances and disclosures than for others and this will require the exercise of professional judgement by the auditor. The degree to which inherent risk varies is referred to as the **spectrum of inherent risk**.

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

When the auditor is planning responses to identified risks, risks may need to be prioritised as the auditor must plan to obtain more (persuasive) audit evidence in relation to significant risks. The higher on the spectrum of inherent risk a risk is assessed, the more persuasive the audit evidence will need to be. In addition, the auditor must identify the controls that address significant risks and whether those controls have been designed effectively and implemented.

12 Appendix: Small company exemption thresholds – solutions to examples

Example 1 - Solution

Wolves Ltd incorporates on 1 July 2019. These are its results for its five periods ending on 31 December:

	2019	2020	2021	2022	2023
Turnover	£6.5m	£11.2m	£9.2m	£8.0m	£8.5m
Balance sheet total	£6.1m	£7.5m	£5.5m	£4.5m	£5.5m
Headcount	40	45	51	45	45

Is the company eligible to apply small company accounting exemptions?

2019: No – NB pro-rate turnover for the six-month period

2020: No

2021: No

2022: No – it has to be small for two consecutive years

2023: Yes – this is the second year it is small

Is the company eligible for small company audit exemption:

2019: No

2020: No

2021: No

2022: No

2023: Yes

Note: Ignoring groups, if a company is small then it is also able to claim audit exemption. Small company audit exemption is not available to members of medium-sized or large groups.

Example 2

The following data applies to the H Group for the year ended 31 December 2022. The group consists of H Ltd (parent) and three wholly owned subsidiaries – A Ltd, B Ltd and C Ltd.

	H Ltd	A Ltd	B Ltd	C Ltd
Turnover	£1m	£11m	£1m	£1m
Balance sheet total	£2m	£4m	£1m	£1m
Headcount	10	55	10	10

The figures for the years 31 December 2021 and 31 December 2020 were the same as those shown above. There is no trading within the group and no balances with other members of the group.

Which of the companies qualify as a small company in 2022 and which of them qualify for audit exemption?

H Ltd – This company is the parent of a medium-sized group. Therefore, it cannot be small, it must be medium-sized. No audit exemption can be claimed unless it were a member of a larger group where the s479A group audit exemption might apply (if the conditions are met).

A Ltd – This company is clearly medium-sized – small company audit exemption is not available but s479A might be.

B Ltd & C Ltd – These companies are small for accounting purposes. Small company audit exemption is not available because it is a member of a medium-sized group. S479A audit exemption might be available but only if there is a UK parent.

Example 3

My firm is the auditor of a UK subsidiary of Spanish holding company. The UK company has turnover and gross assets below the audit exemption thresholds and the directors wish to take advantage of audit exemption, in order to reduce costs. The holding company has not requested an audit and has stated that they will be satisfied with a compilation report from my firm. The holding company auditor has also not requested that the subsidiary is audited.

Can the UK company directors take advantage of audit exemption when the company is part of a group?

Small company audit exemption is not available because the group is not small. The fact that the group includes overseas companies makes no difference; the overseas entities are included when considering the size of the group. Note s479A audit exemption could be available

Example 4

Currently, my firm is considering whether to accept appointment as advisors for a UK company who take advantage of audit exemption. The company is a subsidiary of a holding company incorporated in an offshore jurisdiction where financial statements are not publicly available. The UK directors say that they do not have access to financial information for the holding company or other group companies.

Is this company eligible for audit exemption?

Small company audit exemption is only available if the directors are satisfied that the conditions for the exemption are met. Ignorance is not an excuse for getting this wrong. S479A is probably not available because of the nature of the holding company and also it has an offshore parent.