Audit and Accounting Quarterly Update – Quarter 3

Contents Page

1 FRC issues updates to FRS 102 and FRS 105 (Lecture A713 – 15.40 minutes) 1

2 Charities SORP (FRS 102): New information sheet (Lecture A714 – 15.12 minutes) 5

3 SRA Accounts Rules 2019 9

4 Covid-19 and going concern disclosures (Lecture A715 – 32.59 minutes) 15

5 Revenue recognition (Lecture A716 – 28.16 minutes) 20

6 Audit criticisms: Lessons to be learnt (Lecture A717 - 24.36 minutes) 37

7 Audit firms' going concern policies and procedures (Lecture A718 – 16.36 minutes) 41

8 Accounting estimates: ISA (UK) 540 (Revised) (Lecture A719 – 18.21 minutes) 47

9 FRC issues revised ISA (UK) 315 (Lecture A720 – 6.59 minutes) 54

Publication date: **September 2020**

1 FRC issues updates to FRS 102 and FRS 105 (Lecture A713 – 15.40 minutes)

On 23 July 2020, the Financial Reporting Council (FRC) issued two Exposure Drafts which propose amendments to UK GAAP as follows:

- FRED 75 *Draft amendments to FRS 104 – Going concern*; and
- FRED 76 *Draft amendments to FRS 102 and FRS 105 – COVID-19-related rent concessions.*

The comment period for both FREDs ended on 1 September 2020. They were relatively short comment periods because the FRC needed to finalise the amendments as quickly as possible in order to minimise diversity in practice (particularly in respect of FRED 76).

1.1 FRED 75: Amendments to FRS 104 (going concern)

FRS 104 *Interim Financial Statements* is intended for use in the preparation of interim reports by entities which apply FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. Unlike other FRSs in the suite of UK GAAP, FRS 104 is not an accounting standard because it places no mandatory obligation on entities to produce interim financial reports; nor is its application mandatory. FRS 104 defines an 'interim financial report' as:

> *A financial report containing either a complete set of **financial statements** or a set of condensed financial statements for an **interim period**.*

FRS 104 Glossary ***interim financial report***

Where an entity prepares an interim financial report using FRS 102, FRS 104 sets out the content, recognition and measurement principles for those interim reports. FRS 104 itself is based on the international equivalent standard IAS 34 *Interim Financial Reporting* issued by the IASB.

IAS 34 does not contain any requirements which cover the assessment and reporting of going concern. However, the requirement itself is dealt with in IAS 1 *Presentation of Financial Statements*. IAS 1, para 4 acknowledges that IAS 1 does not apply to the structure and content of condensed interim financial statements prepared in accordance with IAS 34. The paragraph then goes on to cross-refer to paragraphs 15-35 which do apply to such financial statements. IAS 1, para 25 requires an entity to make an assessment of the entity's ability to continue as a going concern and prepare the financial statements on a going concern basis unless management intend to liquidate the entity, cease trading or have no realistic alternative but to do so. IAS 1, para 25 also requires relevant disclosures in respect of material uncertainties relating to going concern to be disclosed.

FRS 104 does not contain any such requirements which explicitly cover the assessment and reporting of going concern. FRS 104, para 16A(a) does require the entity to make a statement that the same accounting policies are applied in the interim financial statements as compared with the most recent financial statements. This statement would, of course, include any statement relating to the going concern basis of accounting.

Proposed changes to FRS 104

The FRC propose to amend FRS 104 by including specific requirements in new paragraphs 4A and 4B which:

- Require management to make an assessment of the entity's ability to continue as a going concern; and
- When management are aware (through their assessment) of material uncertainties related to events or conditions which cast significant doubt upon the entity's ability to continue as a going concern, to disclose those uncertainties; or
- If the entity does not prepare the interim financial statements on a going concern basis, it must disclose that fact, together with the basis on which the interim financial statements have been prepared and the reason why the entity is not regarded as a going concern.

In addition, the FRC propose to insert a definition of 'going concern' into the glossary to FRS 104.

Effective date

The changes proposed in FRED 75 are planned to be effective for interim periods commencing on or after 1 January 2021 with early adoption permissible. Where an entity early adopts the amendments, it must disclose that fact.

1.2 FRED 76: Amendments to FRS 102 and FRS 105 (Covid-19-related rent concessions)

Covid-19 has clearly caused a significant amount of disruption to businesses up and down the country and accountants have been at the forefront of handling this disruption on behalf of their clients. There have been several grants, reliefs and financing options made available throughout central and local government aimed at assisting businesses throughout this turbulent period.

One of those reliefs relates to rent concessions. Many businesses, such as retailers, which were forced to close on 23 March 2020 when lockdown restrictions were imposed by the government, were able to take advantage of a rent holiday. This is where the landlord does not charge the business rent for the period it has been forced to close due to the pandemic.

UK GAAP in its current form currently does not deal with the issue of rent concessions and there have been several debates as to how these concessions should be reflected in the financial statements. Some commentators have suggested spreading the rent concession over the remaining life of the lease in much the same way that a lease incentive is recognised in the financial statements. However, this treatment is inconsistent with the accounting treatment applied to other Covid-19-related grants and reliefs; most of which are recognised in the period that benefits from the grant/relief.

Proposed changes to FRS 102 and FRS 105

FRED 76 proposes changing FRS 102 and FRS 105 to spell out the accounting treatment for temporary rent concessions **which arise as a direct consequence of Covid-19**. This is expected to reduce diversity in practice.

Emphasis has been added to rent concessions arising as a direct consequence of Covid-19 because the changes proposed in FRED 76 will only apply to such concessions to minimise the risk of the treatment being applied too broadly, hence creating unintended consequences. The amendments only apply to changes in lease payments which result in a revision to the consideration for the lease which is less than the consideration for the lease immediately prior to the change.

Therefore, a concession which:

- incorporates significant changes to a lease agreement,
- is unrelated to the Covid-19 pandemic, and
- is negotiated at the same time as those related changes,

will not meet the conditions.

Lease payments which are deferred would also not meet the conditions because such an arrangement is only a change in the timing of the cash flows – there is no change to the overall liability in the lease.

FRED 76 proposes to include new paragraphs 20.15C and 20.15D which would require a lessee to recognise Covid-19-related rent concessions in the period that the change in lease payments is intended to compensate (i.e. the period which benefits from the concession). New paragraph 20.15D (which cross-refers to new paragraph 20.25B (see 'Lessors' below)) sets out conditions which have to be met in order to qualify for this accounting treatment. These conditions are as follows:

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

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

c) there is no significant change to other terms and conditions of the lease.

FRS 102, paragraph 20.16(c) is also proposed for amendment so that it requires such changes in lease payments to be disclosed.

Proposed changes to FRS 105

Similar changes to FRS 105, Section 15 *Leases* (excluding the disclosure requirements) are proposed as the operating lease accounting model in FRS 105 is the same as FRS 102.

Lessors

For lessors, the FRC are proposing to insert paragraph 20.25B into FRS 102 which would require a lessor to recognise changes in lease income arising from Covid-19-related rent concessions in the period the change in lease payments is intended to compensate. Essentially, the accounting treatments in both FRS 102 and FRS 105 for lessees and for lessors are the same (unlike in IFRS 16 *Leases* where the treatments are considerably different).

FRS 102, paragraph 20.30(c) requires a lessor to provide a general description of their significant leasing arrangements. Information related to Covid-19 rent concessions would be expected within this disclosure and so the FRC do not feel that any changes to this existing requirement are necessary.

Similar changes are proposed for lessors in FRS 105 by the inclusion of FRS 105, paragraph 15.25A.

The above changes will mean there is consistency for Covid-19-related rent concessions for all entities reporting under UK GAAP and hence will reduce diversity in practice. The requirement to reflect the rent concession in the period that benefits is more simpler rather than spreading the concession over the remaining life of the lease in the same way that a lease incentive would be treated (a Covid-19-related rent concession would not meet the definition of a lease incentive in any event).

The accounting treatments proposed in FRED 76 would also be consistent with other types of Covid-19 concessions, such as the rates relief and the Coronavirus Job Retention Scheme grant, all of which are recognised in the period in which the entity benefits.

Effective date of the proposals in FRED 76

The FRC have suggested the effective date of these changes will be for accounting periods commencing on or after 1 January 2020. Early adoption will be permissible. This would allow an entity an option to apply the amendments for accounting periods ending on or after 31 March 2020 which are not yet authorised for issue at the date the amendments are issued. The FRC plan to finalise these amendments during 2020.

2 Charities SORP (FRS 102): New information sheet (Lecture A714 – 15.12 minutes)

On 12 June 2020, a new Charities SORP information sheet applicable to larger charities was published on carbon reporting. Information Sheet 5 covers the new requirement for large UK charitable companies to include environmental information within the trustees' report as required by The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 (the Regulations). The Regulations were issued in November 2018 and came into force on 1 April 2018.

The Regulations extend the obligation to comply with the reporting requirements of the government's policy on Streamlined Energy and Carbon Reporting to large, unquoted companies and large LLPs registered in the UK.

There are no planned changes to the SORP (FRS 102) as the joint SORP-making body concluded that additional application guidance is likely to be useful to charities instead.

A UK charitable company qualifies as 'large' under the Regulations if two, or more, of the following criteria are met for two consecutive years:

- Gross annual income of more than £36 million
- Gross (total) assets of more than £18 million
- More than 250 employees

In respect of employee numbers, charitable companies will need to follow the same method in s465(6) of the Companies Act 2006 to determine the average number of employees, i.e.:

Section 465(6) Companies Act 2006

- *find for each month in the financial year the number of persons employed under contracts of service by the company in that month (whether throughout the month or not),*
- *add together the monthly totals, and*
- *divide by the number of months in the financial year.*

These requirements apply to reporting periods starting on or after 1 April 2019 (i.e. 31 March 2020 year ends).

2.1 The reporting implications

The Regulations require large, unquoted companies to report their UK energy use and associated greenhouse gas emissions as a minimum including an intensity ratio (see table below).

The Charities SORP (FRS 102) allows a charitable company to include a combined trustees' and directors' annual report if it meets all the reporting requirements for the trustees' annual report and applicable charity law. It will be left to the trustees to decide whether to present carbon reporting information in a separate or a combined report.

Where the charity includes the information within a merged report, the information should be presented within the 'Achievements and Performance' section of the trustees annual report. Alternatively, the information could be reported in a separate environmental report provided it is clearly marked as the relevant part of the charitable company's director's report. This will comply with paragraph 1.5 of the Charities SORP (FRS 102) (second edition).

Paragraph 4.4 of Information Sheet 5 contains a useful table which provides an outline of the disclosure requirements and additional commentary as follows:

Disclosure requirement	Commentary
UK energy use	Trustees (Directors) will need to report on energy use for the associated greenhouse gas emissions that relate to: • activities for which the charitable companies are responsible for involving the combustion of gas, or consumption of fuel for the purposes of transport; and • the purchase of electricity by the charitable company for its own use, including for the purposes of transport. The report must disclose a figure, in kWh, of the annual quantity of energy. Trustees should consider the charity's activities and supply chains to consider all other relevant energy sources. The 2018 Regulations set out that 'energy' means all forms of energy products where "energy products" means combustible fuels, heat, renewable energy, electricity, or any other form of energy.
Associated greenhouse gas emissions	The relevant report must state the annual quantity of emissions in tonnes of carbon dioxide equivalent (CO2e) resulting from total UK energy use from electricity, gas and transport from the sources used as above.
At least one intensity ratio	An intensity ratio is a measure of environmental impact, such as greenhouse gasses generated, divided by a relevant commercial metric. Common metrics are turnover or output but others might be sales revenue or square metres of floor space. Annex F to the SECR Reporting Guidelines provides some common intensity ratios.
Previous year's information	Information for energy use and greenhouse gas emissions must be provided for the previous financial year. This is with the exception of the first year of the application of the reporting requirements.

Information about energy efficiency action	If actions have been taken to improve the businesses' energy efficiency during the financial year covered by the relevant report, a description of the principal energy efficiency actions taken should be disclosed in the relevant report.
Methodologies used in calculation of disclosures	There is no methodology prescribed in legislation. However, the one adopted must be one based on robust and sound methodologies. The SECR Reporting Guidelines recommend that methodologies used are widely recognised independent standards.

Offshore entities which undertake wholly or mainly offshore operations as defined in the Regulations must disclose emissions and energy use for the UK and offshore areas.

2.2 Reporting formats

There are no prescribed reporting formats. The SECR Reporting Guidelines include reporting templates on pages 54 to 57 and the guidelines 'strongly encourage' their use to aid consistency in reporting.

2.3 Reporting exemptions

Low energy users

Charitable companies which meet the definition of 'low energy users' are not required to make detailed energy and carbon disclosures. The statutory *de minimis* level which exists for quoted or large unquoted companies and LLPs is 40MWh or less over the reporting period. These entities will still need to include a statement in their report that they are a low energy user.

When the charitable company is assessing whether or not the 40MWh is met, they must consider all the energy from gas, electricity and transport fuel. In the case of group accounts, then in order to claim the exemption for the group as a whole, the group's energy use must be less than 40MWh. Where this is not met for the group as a whole, the charitable parent/subsidiary reports separately to comply with the Regulations. Where the entity reports separately, it is recommended that a reference be made to where this information on energy and carbon information can be found in the notes to the group accounts.

Seriously prejudicial

If disclosing relevant energy and carbon information would be seriously prejudicial to the charitable company, the legislation allows non-disclosure. The charitable company must state in the relevant report that the energy and carbon information is not disclosed for that reason.

It should be noted that the SECR Reporting Guidelines state that an entity would only rely on this exemption in exceptional circumstances.

Information not being practical to obtain

The Regulations also allow a charitable company not to disclose energy and carbon information when it is not practical to obtain that information.

Where this exemption applies, the charitable company must state in the relevant report what energy and carbon information is not included in the report and why it has not been practical to obtain that information.

Subsidiaries

Certain subsidiaries could be exempt from reporting their own energy and carbon information if:

Information Sheet 5, para 4.12

- the company is a 'subsidiary undertaking' at the end of the relevant financial year;
- the company is included in the group report of a 'parent undertaking';
- the group report is prepared for a financial year of the parent that ends at the same time, or before the end of, the subsidiary's financial year; and
- the group report complies with the relevant obligations under the regulations on the parent to report energy and carbon information for themselves and their subsidiaries, but this provision does not apply where the group report relies on a seriously prejudicial option.

2.4 Financial and organisational control

Information Sheet 5 confirms that charities must report on all operations which lie within their organisational boundary (a 'boundary' being financial or operational).

Financial control is the ability to direct the financial and operating policies of the other entity with a view to gaining economic benefits. Information Sheet 5 confirms that for environmental reporting purposes, financial control exists when the company is fully consolidated in the financial statements of the organisation and the reporting will largely follow the requirements of UK GAAP.

Where an entity is an 'associate' undertaking (i.e. equity accounted in the group accounts), the associate will be excepted because the organisation does not retain full authority to introduce and implement policies in the operation (it only has significant influence over the entity as opposed to control).

Charities must therefore report on all companies which are fully consolidated in their group accounts (or where it retains full operational control) regardless of where the companies are registered.

3 SRA Accounts Rules 2019

On 25 November 2019, the SRA Accounts Rules 2019 came into effect replacing the SRA Accounts Rules 2011.

One of the most notable changes is the length of the rules. The 2019 rules are much shorter than the 2011 ones and contain no guidance notes. The SRA have removed many of the prescriptive rules in an attempt to reduce the burden on solicitors and law firms and allow solicitors greater freedom to use their professional judgement in considering how they meet the required standards.

For most law firms, there was not expected to be any significant changes despite the significant reduction in length of the rules. The new rules are more principles-based which has been widely encouraged because it now enables firms to develop their own systems and policies.

The new rules come into effect from 25 November 2019 (there is no transition period). Therefore, where a solicitor has an accounting reference date spanning 25 November 2019, the reporting accountant will have to consider compliance with both the 2011 rules and the 2019 rules. This issue will need to be factored into the reporting accountant's planning.

3.1 Structure of the 2019 rules

The SRA Accounts Rules 2019 contain four parts:

- Part 1: General
- Part 2: Client money and client accounts
- Part 3: Dealings with other money belonging to clients or third parties
- Part 4: Accountants' reports and storage and retention of accounting records

Each part contains the rules as can be seen in the following table which outlines the structure of the new rules:

Part	Rule
Part 1: General	Rule 1: Application section
Part 2: Client money and client accounts	Rule 2: Client money
	Rule 3: Client account
	Rule 4: Client money must be kept separate
	Rule 5: Withdrawals from client account
	Rule 6: Duty to correct breaches upon discovery
	Rule 7: Payment of interest
	Rule 8: Client accounting systems and controls
Part 3: Dealings with other money belonging to clients or third parties	Rule 9: Operation of joint accounts
	Rule 10: Operation of a client's own account
	Rule 11: Third party managed accounts

Part 4: Accountants' reports and storage and retention of accounting records	Rule 12: Obtaining and delivery of accountants' reports Rule 13: Storage and retention of accounting records

3.2 Summary of notable changes

A summary of the changes effective in the SRA Accounts Rules 2019 are as follows:

Responsibility for compliance

Rule 1.2 states that the 'authorised body's managers' are **jointly and severally** responsible for compliance by the authorised body, its managers and employees, with the SRA Accounts Rules. This changed from the consultation stage when it was planned to only be the COFA and the firm's managers that would be jointly and severally responsible for compliance.

Expenses incurred on a client's behalf

There is an optional exemption in Rule 2.2 whereby if the solicitor receives money from a client in payment of advance fees and disbursements (e.g. counsel fees) for which the firm is liable (Rule 2.2(a)) and the firm does not, for any other reason, maintain a client account (Rule 2.2(b)), such money can be paid into the office account.

In practice it is quite rare for a firm not to operate a client account where client monies of any description are received. Care must be taken with this optional exemption because it is intended to only apply to those firms which do not wish to operate a client account where this is the only type of money they hold. The exemption does not apply to a firm which receives money from clients or third parties (e.g. a house deposit, stamp duty land tax etc). Hence, monies received in advance of fees and disbursements must continue to be paid into the client account.

Definition of 'client money'

Rule 2.1 defines 'client money' and this changed from the consultation stage as the proposed definition received widespread criticism. The definition of client money is as follows:

SRA Accounts Rules 2019, Rule 2.1

> ***Client money*** *is money held or received by you:*
>
> *(a) relating to* ***regulated services*** *delivered by you to a* ***client****;*
>
> *(b) on behalf of a third party in relation to* ***regulated services*** *delivered by you (such as money held as agent, stakeholder or held to the sender's order);*
>
> *(c) as a trustee or as the holder of a specified office or appointment, such as donee of a power of attorney, Court of Protection deputy or trustee of an occupational pension scheme;*
>
> *(d) in respect of your* ***fees*** *and any unpaid* ***disbursements*** *if held or received prior to delivery of a bill for the same.*

The effect of (d) above means that money received in advance of services where no bill has been raised is still client money and must be placed in the client account. In addition, the rule infers that the firm must include paid disbursements on a bill prior to transferring monies from client account to cover those disbursements.

It should be noted that the definition of client money now includes monies received as:

- trustee; or
- holder of a specified office or appointment, such as:
  - a donee of a power of attorney;
  - Court of Protection deputy; or
  - trustee of an occupational pension scheme.

These monies must be paid into the client account unless to do so would conflict with the requirement of that office or appointment.

It should also be noted that there is no longer any distinction between 'disbursements' and 'professional disbursements'. The SRA Glossary defines a 'disbursement' as follows:

> *means any costs or expenses paid or to be paid to a third party on behalf of the* ***client*** *or trust (including any VAT element) save for office expenses such as postage and courier fees.*

SRA Glossary ***disbursement***

Legal Aid Agency payments

Legal Aid Agency payments no longer have a specific rule and hence can be placed into the office account.

Third party managed accounts (TPMA)

There is an option to operate a TPMA, although some criteria must be met before such an account is operated.

The SRA Glossary defines a 'TPMA' as follows:

> *means an account held at a* ***bank*** *or* ***building society*** *in the name of a third party which is an authorised payment institution, a small payment institution that has chosen to implement safeguarding arrangement in accordance with the Payment Services Regulations or an* ***EEA*** *authorised payment institution (as each defined in the Payment Services Regulations) regulated by the* ***FCA****, in which monies are owned beneficially by the third party, and which is operated upon terms agreed between the third party, you and your* ***client*** *as an escrow payment service.*

SRA Glossary ***third party managed account***

Rule 11.1 and 11.2 deal with TPMAs. Rule 11.1 states that the solicitor can use a TPMA only if:

> *(a) use of the account does not result in your receiving or holding the* ***client's*** *money; and*
>
> *(b) you take reasonable steps to ensure, before accepting instructions, that the* ***client*** *is informed of and understands:*
>
> *(i) the terms of the contractual arrangements relating to the use of the* ***third party managed account****, and in particular how any* ***fees*** *for use of the* ***third party managed account*** *will be paid and who will bear them; and*
>
> *(ii) the* ***client's*** *right to terminate the agreement and dispute payment requests made by you.*

SRA Accounts Rules 2019, Rule 11.1

Rule 11.2 requires the solicitor to obtain regular statements from the provider of the TPMA and ensure that these accurately reflect all transactions on the account.

Agreed fees

Rule 17.5 of the SRA Accounts Rules 2011 required a payment for an 'agreed fee' to be paid into the office account on receipt. The concept of agreed fees has been removed in the 2019 rules and hence all such fees must be paid into the client account.

Note: This is where some law firms may commit breaches of the 2019 rules. If the law firm pays an agreed fee into the office account prior to 25 November 2019 then it will not be in breach of the rules. If it pays such a fee into the office account from 25 November 2019 then effectively it will be in breach of the rules.

Client account reconciliations

There have been no changes made to the frequency of the client account bank reconciliation process. Rule 8.3 (2019 Rules) requires the client account bank reconciliation to be completed at least every five weeks (or more frequently). However, Rule 8.3 specifically requires the COFA or a manager of the firm to sign off the client account bank reconciliation. Differences on the bank reconciliation must be investigated and resolved promptly.

In addition, clients' own accounts are subjected to limited record-keeping and requirements. Rule 10.1(b) (2019 Rules) brings a client's own account in the scope of Rule 8.3 which requires client accounts to be reconciled on at least a five-week cycle. Such accounts are usually held outside client ledgers and so it can be unclear as to what these accounts are to be reconciled to. To demonstrate compliance with Rule 10.1(b) there should be some form of reconciliation of the balance per the bank statement less any outstanding payments plus any outstanding cash in transit to arrive at the cash book balance.

Residual balances

There is no reference to a £500 *de minimis* level in respect of making payments of residual balances to a charity without the need for prior approval from the SRA.

Guidance

The SRA Accounts Rules 2011 provided a lot of guidance in the form of 'guidance notes' throughout the rules. This guidance has been removed in the 2019 Rules. The SRA did say they would issue some toolkits to help guide firms through the changes but subsequently said they would not be issuing such toolkits. The SRA have now issued some guidance on the practical application of the SRA principles which can be downloaded from the SRA's website (www.sra.org.uk).

3.3 To qualify the report or not?

Since the outcomes-focussed regime was introduced in 2011, the SRA Accounts Rules have been simplified. The SRA only expects reports to be qualified where there has been a significant breach of the rules, such that money belonging to clients or third parties is, has been, or maybe, placed at risk.

Guidance issued by the SRA confirms that breaches that arise from administrative errors are unlikely to be significant. However, such breaches could be if they derive from a lack of controls or breakdown of existing controls and have put client money at risk.

Whether a report is to be qualified or not will largely be left to the reporting accountant's discretion and conclusions should always be documented as to when an unqualified report is issued but breaches have been noted.

Reporting accountants must always bear in mind that they are under a statutory duty (per section 34 of the Solicitors Act 1974 and section 5, schedule 2 of the Administration of Justice Act 1985) to immediately report to the SRA:

(a) any evidence of theft or fraud in relation to money held by a solicitor or a law firm for a client or any other person or in a client account or an account operated by the solicitor; or

(b) if they have concerns about whether a solicitor or law firm is fit and proper to hold money for clients or third parties or to operate any such accounts.

The SRA will also expect a reporting accountant to notify them of any termination of the accountant's appointment where this is based on their intention to issue a qualified accountant's report.

Other issues which the reporting accountant must report to the SRA include:

- where the work of the reporting accountant has been limited in scope to the extent that they are unable to make the declarations on the accountant's report form. In such cases the reporting accountant qualifies the report on that basis and makes a report to the SRA; and
- where the accountant has made checks with the SRA and discovers that the firm has failed to submit a qualified accountant's report.

Serious factors

The guidance issued by the SRA includes some serious factors which are likely to give rise to a qualified accountant's report. The list of factors is not exhaustive and other factors could also give rise to the accountant qualifying the report. The serious factors are as follows:

1. A significant and/or unreplaced shortfall (including client debit balances or business credit balances) on client account, including client money held elsewhere, for example a client's own account, unless caused by bank error and rectified promptly.
2. Evidence of any disregard for the safety of client money and assets.
3. Actual or suspected fraud or dishonesty by the managers or employees of the firm (that may impact on the safety of money belonging to clients or third parties).
4. Accounting records not available or significantly deficient or bank accounts/ledgers failing to include references to a client.
5. A failure to provide documentation requested by the reporting accountant.
6. Client account bank reconciliations not carried out.
7. The client account is improperly used as a banking facility.
8. Any other significant breaches not already reported to the SRA in accordance with the obligations placed on firms and their compliance officers under the SRA Code of Conduct for Firms.

Moderate factors

The following moderate factors may lead to a qualification depending on context:

1. A significant, fully replaced shortfall (including client debit balances or business credit balances) on client account, including client monies held elsewhere unless caused by bank error and rectified in a timely manner.
2. Actual or suspected fraud or dishonesty by third parties that have impacted or may impact on the safety of client money.
3. Serious breaches that have not been reported to the SRA promptly.
4. Accounting records insufficient or unreliable or not retained for six years.
5. Client account bank reconciliations not regularly carried out at least every five weeks.
6. Poor control environment.
7. Performance or review of client account bank reconciliations not adequate.
8. Longstanding residual balances due to clients.
9. Improper use of suspense accounts.

4 Covid-19 and going concern disclosures (Lecture A715 – 32.59 minutes)

Last quarter's Audit and Accounting Update was dominated by Covid-19. As financial statements for years ended 31 March 2020 continue to be prepared we take a look at some illustrative examples of how going concern disclosures may look in the financial statements.

FRS 102 (March 2018), paragraph 3.9 requires that when management is aware (through its assessment of going concern) of material uncertainties related to events or conditions which cast significant doubt upon the entity's ability to continue as a going concern, the entity must disclose those uncertainties. Small companies reporting under FRS 102, Section 1A *Small Entities* are encouraged to make such disclosures and during the Covid-19 pandemic, it will be a key decision by directors of small companies. If there is a material uncertainty related to the small entity's ability to continue as a going concern, then any non-disclosure of such uncertainties could mean the financial statements fail to present a true and fair view.

4.1 Management considerations

There is a variety of information which may be available to management in enabling them to assess going concern. FRS 102, para 3.8 requires management to take into account all available information concerning the future which is at least, but not limited to, 12 months from the date when the financial statements are authorised for issue (not 12 months from the balance sheet date).

Factors that management should consider are:

- Current and future levels of profitability
- Loan repayment schedules
- Up to date cash flow forecasts, focussing on any periods where these forecasts indicate net cash outflows
- Renewal of borrowing facilities where these are due for renewal
- Ability to continue to provide goods/services to customers

Example – Material uncertainty related to going concern

Raja's Retail Company Ltd operates from four outlets in the UK but has warehouses located in Spain and Italy. The company is preparing its financial statements for the year ended 31 March 2020 and the impact of Covid-19 has had an adverse effect on operations. The company has also experienced significant problems in sourcing goods due to border closures and manufacturers in overseas countries that have had to close down due to lockdown restrictions. In addition, on 27 March 2020, a large contract to supply goods was cancelled indefinitely. The company's overdraft was nearing its limit and the balance sheet as at 31 March 2020 is showing a large level of net current liabilities.

The company is required to have its financial statements audited and reports under full FRS 102.

An example disclosure is as follows:

Note 20: Going concern

The company has been materially and adversely affected by the effects of the Covid-19 pandemic. Demand for the company's products and services has reduced due to lockdown restrictions and customers' businesses being forced to close. Operating results have been negatively impacted.

The company's two warehouses in France and Italy have been subject to strict lockdown measures therefore impacting on the company's supply chain and significant delays have been experienced in receiving products from suppliers.

The company has incurred operating losses of (£X) in the year to 31 March 2020 (2019: Operating profit £X). In addition, the company has reported net current liabilities for the year ended 31 March 2020 amounting to (£X) (2019: net current assets £X).

Due to the rapid and ongoing nature of Covid-19, the directors are uncertain when, and if, the company will return to profitability and positive cash flows from operations. These uncertainties cash significant doubt on the entity's ability to continue as a going concern for the foreseeable future. The company has applied for additional borrowings to provide working capital but the outcome of these applications is yet unknown.

Auditor's report

Assuming the auditor is satisfied that the above going concern disclosures are adequate, they will make reference to such disclosures using a Material Uncertainty Related to Going Concern paragraph in their auditor's report (underneath the Basis for Opinion paragraph) which may be worded as follows:

Material Uncertainty Related to Going Concern

Without qualifying our opinion, we draw your attention to Note 20 of the financial statements which indicates a material uncertainty related to going concern. The effects of the Covid-19 pandemic has had a detrimental impact on the company's operations and cash flow and the directors have identified these issues as giving rise to a material uncertainty related to the going concern status of the company.

4.2 Going concern basis is inappropriate

Unfortunately there are going to be casualties of the Covid-19 pandemic and the directors may conclude that they have no alternative but to liquidate the business or cease to trade.

In these cases, FRS 102, para 3.8 requires a basis other than the going concern basis to be used. The 'break up' basis of accounting would not be consistent with UK GAAP as it is inconsistent with the accruals basis of accounting (as it recognises future costs to be incurred in winding down the business whereas UK GAAP only allows costs incurred up to and including the balance sheet date to be recognised). In these situations, UK GAAP does not specify what basis should be used to prepare the financial statements but it should be a basis which is compliant with UK GAAP but amended to reflect the fact that the going concern basis of accounting is not appropriate.

When an entity does not prepare its financial statements on a going concern basis, FRS 102, para 3.9 requires the entity to disclose that fact, together with the basis on which the financial statements have been prepared and the reason why the entity is not regarded as a going concern.

Example – Going concern basis of accounting is inappropriate

Pastures Ltd has experienced a significant decline in profitability and cash flow since the Covid-19 pandemic. The company has prepared its financial statements for the year ended 30 June 2020 but on 16 July 2020, the directors decided the company will cease to trade as the bank have confirmed they are unwilling to renew its borrowing facilities.

The financial statements for the year ended 30 June 2020 include the following note relating to the basis of preparation of the financial statements:

Basis of preparation of the financial statements

As explained in Note 13 to the financial statements, the company will cease trading on 16 July 2020 and the financial statements have been prepared on a basis other than that of the going concern basis. This basis includes, where applicable, writing the company's assets down to net realisable value. Provisions have also been made in respect of contracts that have become onerous at the balance sheet date. No provision has been made for the future costs of terminating the business unless such costs were committed to at the reporting date.

4.3 FRC Thematic Review of going concern disclosures

In July 2020, the FRC released their report on *Covid-19 Thematic Review: Review of financial reporting effects of Covid-19.* While this report primarily concerns entities that report under IFRS, some of its contents can be useful for private entities also that report under UK GAAP.

The FRC's report states:

FRC Covid-19 Thematic Review

- *Given the current uncertain environment, we expected company specific going concern disclosures to explain clearly the key assumptions and judgements that the board has made in determining whether or not the company is a going concern and whether or not there are material uncertainties.*
- *We expect going concern discussion in the strategic report to reflect the going concern information presented in the notes to the accounts.*
- *We also expect disclosure of the possible scenarios that could lead to failure and details of any mitigating actions available to the board. The disclosures presented should be sufficiently granular to enable a user to understand clearly the way in which the company intends to meet its liabilities as they fall due.*

Characteristics of 'helpful' going concern disclosures

The FRC's Thematic Review states that the most helpful going concern disclosures contained the following characteristics:

- Clearly explained whether there were any material uncertainties that may cast doubt on the company's going concern status.
- Clearly stated the period the going concern assessment covered.
- Explained the different going concern scenarios that had been considered. The best disclosures clearly stated the key Covid-19 assumptions within each forecast and how those assumptions affected the going concern conclusion.
- Indicated which inputs had been subject to stress tests and explained how these stress tests affected the going concern conclusions.
- Identified and explained any mitigating actions the board could take to improve liquidity.
- Explained any post balance sheet changes to liquidity, specifically the arrangement of new lending facilities, the extension of existing facilities or the renegotiation or waiving of bank covenants.
- Described the level of drawn and undrawn finance facilities in place.
- Stated what covenants were in place and whether they expected to breach them.
- Explained whether the company would need to make structural changes in order to continue to operate as a going concern.

FRC example of a better disclosure – Britvic Plc interim results (page 20)

As part of the directors' consideration of the appropriateness of adopting the going concern basis in preparing the interim report and financial statements, a range of severe scenarios have been reviewed. The assumptions modelled are based on the estimated potential impact of Covid-19 restrictions and regulations, along with our proposed responses over the course of the next 18 months. These include a range of estimated impacts primarily based on length of time various levels of restrictions are in place and the severity of the consequent impact of those restrictions on our At-Home and Out-of-Home channels.

For each of our markets we have sensitised the revenue, profit and cash flow impact of reduced trading activity in our Out-of-Home channel and a negative impact of changes in product mix for the At-Home channel. The scenarios are most sensitive to the assumptions made for GB and Ireland where exposure to the Out-of-Home is greater.

France and Brazil are predominantly At-Home markets and therefore drive less sensitivity. We have not assumed any uplift in the At-Home channel in any market, under any level of restrictions, for the purpose of the scenario modelling.

A key judgement applied is the likely time period of restrictions on trading activity in the Out-of-Home channel, movement of people and social distancing. The severe scenarios include an assumption that such restrictions will remain in place until March 2021 with only a small proportion of Out-of-Home outlets re-open during this time. Our Covid-19 impact range of £12m - £18m per month is based on assumptions for lockdown impacting the busiest trading period in 2020.

As the level of trading restrictions reduce, and as we exit both lockdown and our busiest trading periods, the Covid-19 impact should also reduce. Under each scenario, mitigating actions are all within management control, can be initiated as they relate to discretionary spend, and do not impact the ability to meet demand. These actions include reduced A&P and stopping all non-essential and non-committed capex in the next 12-18 months.

We believe that the risk of enforced plant closure is low and have implemented additional health and safety measures in each of our factories to reduce the risk of a major supply disruption. We have assumed no significant structural changes to the business will be needed in any of the scenarios modelled.

As at 31 March 2020, the condensed consolidated balance sheet reflects a net asset position of £432.8m and the liquidity of the Group remains strong. We have a recently re-financed £400m bank facility with a maturity date of November 2025 and approximately £625m of private placement notes, at contracted rates, with maturity dates between 2020 and 2035.

Since the half year date, we have received approximately £150m from the recent refinancing of private placement notes, increasing undrawn facilities to approximately £300m and the RCF also offers an accordion facility of £200m, with lender consent.

In all scenarios modelled our liquidity requirements are within the £400m RCF facility. Further, whilst we are confident of our liquidity position even under our Covid-19 stress test modelling scenario, given the uncertain environment we find ourselves in, and to give increased financial flexibility, we have deferred the decision on the dividend until later in the financial year. Debt covenant limits are set at a ratio of 3.5x (rolling 12-month EBITDA/Adjusted Net Debt) and 3.0x (rolling 12-month EBITDA/Net Interest Expenses) in all of our lending agreements.

At the half year, the net debt position was £664.5m, our covenant net debt EBITDA ratio was 2.5x and our covenant net interest EBITDA ratio was 15.0x. As part of our EBITDA and cashflow modelling, we tested the possibility of the debt covenants being breached in September 2020, March 2021, and September 2021. March 2021 is the most sensitive test point as the EBITDA modelling assumes a full 12 months of reduced trading due to the impact of restrictions and a working capital peak ahead of summer trading. Under all the scenarios modelled, after taking mitigating actions as needed, our forecasts did not indicate breach of any of those dates.

On the basis of these reviews, the directors consider it appropriate for the going concern basis to be adopted in preparing the interim report and financial statements.

The above disclosure relates to Britvic PLC’s interim results and while this is clearly for a large company, some of the concepts can be used in smaller entities. Key points the FRC made about this disclosure are as follows:

- The disclosure explains that they do not envisage making any structural changes to the business to remain a going concern.
- Disclosure explains the post year end measures put in place to improve liquidity.
- Disclosure clearly explains their going concern conclusion.
- Disclosure explains the scenarios modelled in the light of Covid-19 and what they are most sensitive to.
- Disclosures note the mitigating actions that can be taken to preserve liquidity.
- Disclosure explains the covenants attached and current position in respect of covenants.

On 29 June 2020, the FRC sent a letter to audit firms following a review of firms’ going concern policies and procedures. This will be considered further in section 7.

5 Revenue recognition (Lecture A716 – 28.16 minutes)

Revenue recognition practices have dominated the headlines over recent years and usually for the wrong reasons. In today's Covid-19 environment, revenue recognition will move up the ranks in terms of risk as some reporting entities continue to struggle in light of the restrictions.

Revenue recognition has always been a subjective area of financial reporting and while standard-setters continue to try and alleviate the problem by introducing new standards on revenue recognition (i.e. IFRS 15 *Revenue from Contracts with Customers*) such standards will not necessarily stop company directors from mis-applying the requirements and either deliberately accelerating revenue to increase profit or disproportionately delaying revenue recognition to reduce such profits to either reduce shareholder expectations in the next financial year or to mitigate tax liabilities.

Of course, inappropriate revenue recognition practices are not looked on favourably by the regulators (i.e. the FRC or the professional bodies) and such practices can carry severe penalties from fines to expulsion from professional bodies and withdrawals of practising certificates to prison sentences for auditors and accountants who may have not done enough work on revenue recognition.

All too often, file reviewers and professional bodies cite inadequacies where revenue recognition is concerned. This includes disclosure of accounting policies in respect of revenue recognition which are often software-driven or boilerplate and hence are not entity-specific.

It should also be noted that the FRC did indicate that they may align the requirements of UK GAAP to that of IFRS 15. However, as IFRS 15 is considered to be a 'major' change in IFRS, the FRC will need to receive implementation feedback from IFRS reporters in order to gauge whether, or not, the costs of aligning UK GAAP to IFRS 15 will outweigh the benefits. At the time of writing, there was no indication from the FRC as to when consultations in this respect will start and it is likely to be quite some time before any changes come into effect.

5.1 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.

5.2 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 an 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 arising from insurance contracts	FRS 103 *Insurance Contracts*

5.3 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*.

5.4 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 (March 2018) 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.

5.5 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:

FRS 102 Glossary ***principal***

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.*

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 – Agent-principal relationship

Stephanie is a solicitor who specialises in debt recovery and has agreed to take on a case where the client is owed £20,000 from its customer who has refused to pay claiming defective work was carried out. The matter went to court and the court found no defective work had been carried out and ordered the customer to make payment. Stephanie and her client have agreed she will charge a 5% commission for any monies she recovers.

Stephanie successfully recovers all the money due to her client.

Of the £20,000 (ignoring VAT issues), 5% will be deducted by Stephanie for her agreed commission, hence £1,000 is recognised in Stephanie's accounts as revenue. The remaining £19,000 will be recognised as a liability in Stephanie's accounts and will be held in her client account until the funds are remitted. If they are not remitted by Stephanie's balance sheet date, they will be presented as a current liability.

Example – Supermarket sells carrier bags

Fast Food Ltd is a supermarket chain located throughout the UK. It is required by law to charge 20p 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 (which was inserted as part of the FRC's triennial review in 2017). This example offers guidance on determining whether an entity is acting as a principal or agent.

5.6 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.

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 as it falls due 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

[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.

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%, i.e.:

	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 as it becomes due 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.

5.7 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.

5.8 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 August 2020 and reports under FRS 102. On 1 August 2020 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 software 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 August 2020 as £3,900 (£3,800 software plus £100 (£1,200 / 12) 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.

5.9 Sale of goods

Paragraph 23.10 of FRS 102 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.

Paragraph 23.12 of FRS 102 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 2020. On 20 March 2020, 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 2020 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 2020 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 2020.

The company is unable to recognise a sale in the 31 March 2020 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

5.10 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'). Paragraph 23.14 of FRS 102 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 (example assumes Covid-19 restrictions are not in place)

Fantastic Festivals Ltd has a reporting date of 30 June 2020 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 2020. Tickets went on sale in February 2020 and have sold very well. It is expected that tickets will be sold out by the end of April 2020.

Revenue in respect of the ticket sales cannot be recognised in the 30 June 2020 financial statements. Revenue is dependent on a more significant act, being the main event taking place in July 2020. In this example, revenue for ticket sales is deferred and will not be recognised until the event has taken place in July 2020.

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.

5.11 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. Paragraph 23.17 of FRS 102 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.

As part of the FRC's triennial review in 2017, a new paragraph 23.17A was inserted into Section 23 which relates to costs incurred in securing a contract. This paragraph states:

Costs that relate directly to a contract and are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs if the contract is obtained in a subsequent period.

FRS 102 (March 2018) para 23.17A

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. Paragraph 23.22 of FRS 102 outlines three potential 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 May 2020, a construction company 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 October 2020, 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 October 2020, the surveyor confirmed that the contract was 40% complete and the customer made a progress payment of £9,000 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	(9)
Gross amount due from customer	2,301

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 October 2019, 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. On 31 March 2020 (the company's year end date), 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.

5.12 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 has to 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.

5.13 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: accruals basis in accordance with the substance of the relevant agreement.

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

5.14 Disclosures

FRS 102 outlines the disclosure requirements in paragraphs 23.30 to 23.32 as follows:

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.

The FRC included an additional paragraphs 23.33 to 23.35 in FRS 102 (March 2018) as part of their triennial review in 2017. Paragraph 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.

Paragraph 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).

Paragraph 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 properly attributable to one class of business or market (as the case may be) and 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.

6 Audit criticisms: Lessons to be learnt (Lecture A717 - 24.36 minutes)

Grant Thornton (GT) has recently become another firm to be on the receiving end of a disciplinary sanction by the Financial Reporting Council (FRC) for audit failings. The FRC lambasted the firm stating that they had failed to take responsibility for establishing a control environment that placed adherence to ethical principles and compliance with ethical standards above commercial considerations. The case hinged on the audit work performed for their former client, Conviviality who owned the off-licence chain, Bargain Booze.

This is just one in an increasing list of disciplinary actions taken by the FRC and professional bodies against firms which fail to comply with either ethical standards or auditing standards.

In GT's case, the firm was hit with a £1.95m penalty (reduced from £3m for co-operating during the investigation). The former audit engagement partner, Kevin Engel, who handled the Conviviality audit also received a severe reprimand and a permanent ban on signing audit opinions.

A senior manager employed at GT was also in the firing line for taking a secondment to Conviviality to assist with their year end procedures which contravenes the FRC's Ethical Standard. In addition, the senior manager was also severely reprimanded for attempting to remove a 4.5 hour timesheet entry (although this was under the instruction of the engagement partner).

The breaches of the Ethical Standard arose in 2014 (hence the old ES 5 was in place at the time). Conviviality listed for the first time on the AIM exchange and the financial controller then left the company. The audit engagement partner at the time suggested that his manager could help with the year end process. This was a breach of ES5, para 160 which prohibits audit firms from providing non-audit services to a listed client.

The FRC highlighted two aspects of GT's failings:

- Deficiencies in the firm's control environment and processes to ensure compliance with the FRC's Ethical Standard.
- Ethical breaches which compromised the independence of the audit.

Conviviality collapsed in 2018 following a £15m adjustment to forecast earnings, including a £5m 'spreadsheet error' plus the fact the company had failed to budget for a £30m tax bill which fell due.

6.1 What lessons can be learnt from these audit scandals?

Unfortunately there does not seem to be a month that goes by without some form of disciplinary or fine being imposed on an audit firm for audit failings. Disciplinary pages of the professional bodies' magazines often contain reports of firms being disciplined for poor audit work or breaches of the Ethical Standard.

FRC Ethical Standard

The FRC issued a revised Ethical Standard (ES) which took effect on 15 March 2020. Key changes reflected in this revised ES include:

- A list of permitted non-audit services for UK public-interest entities (PIEs). Generally these will include non-audit services required by law and regulation, reporting on loan covenants and other assurance services which are closely related to the audit or annual report and reporting accountant services.
- Additional clarification of the 'objective, reasonable and informed third party test' which requires consideration of the perspective of public-interest stakeholders.
- An outright ban for all audited entities on internal audit services, secondments and contingent fee arrangements.

In respect of the third bullet point, there is a 'cooling in' period in respect of internal audit services provided to EU PIEs. A new external auditor will not be able to provide these services in the 12 months preceding the first period for which they are appointed as external auditor. The transitional provision means that this restriction does not have retrospective application.

There has also been an amendment concerning the ethics partner's function. There is now a requirement for the audit engagement partner to report to those charged with governance, the firm's independent non-executives and the FRC where the ethic's partner's advice is not followed.

It is important that audit firms understand the requirements of the revised ES to avoid any sanctions being imposed on the individual/firm through non-compliance with the standard.

Other audit-related concerns

Many smaller firms carry out audit services whose work is reviewed by their relevant professional body. Some professional bodies publish reports as to how firms are performing when it comes to audit work and there are a number of areas which seem to crop up frequently in reviews which can cause problems for firms when it comes to discussing the review. Some of the more common issues are as follows:

Fraud

- Concluding at the planning stage that there will not be any fraud detected. If a conclusion is drawn at the planning stage that fraud is not an issue, this demonstrates a lack of professional scepticism.
- Failing to test journals which address the risk of management override of controls. Management override of controls is always a significant risk and care must be taken to ensure that the risk is not inappropriately rebutted by the audit team. If it is rebutted, there has to be a strong enough justification.

Revenue and trade debtors

- Failing to test all material income streams or concentrating audit procedures on a significant income stream but leaving a smaller (but material) income stream untested.
- Starting income completeness testing from inside the accounting system (i.e. from the sales invoice) rather than from outside of the system (i.e. the customer order or other trigger point of the sale).

- Reliance on trade debtors circularisation letters as audit evidence. A debtors circularisation will only cover the existence and rights and obligations assertions – they do not address the valuation assertion. Just because the customer agrees a balance may be outstanding does not mean they are going to pay it, so additional procedures should be undertaken to corroborate the valuation of trade debtors at the balance sheet date.
- Testing older debtor balances for valuation but omitting those that are within credit terms. While older balances will need to be tested for the valuation assertion (as there is a higher risk they are irrecoverable if they are overdue), the auditor should also carry out procedures on balances which are within credit terms. If they do not do this, they could leave out a material amount of debtors that are within credit terms.

Going concern

- With the effects of Covid-19 still with us, the concept of going concern will move up the ranks of importance. More audited entities are expected to make some going concern disclosures in their financial statements which are Covid-19-related. Keep in mind that management must review a period of **at least** 12 months from the **date of approval of the financial statements** and not 12 months from the balance sheet date.
- Where adequate disclosure of going concern uncertainties have been made in the financial statements, the auditor's report should include a 'Material Uncertainty Related to Going Concern' (MURGC) paragraph. An Emphasis of Matter paragraph is no longer used to cross-refer to these disclosures. A MURGC paragraph is only used when the material uncertainties related to going concern have been adequately disclosed. If they have not been adequately disclosed (and management refuse to amend the disclosure so that it is adequate), this will result in the auditor expressing a modified audit opinion.

Related parties

- Professional bodies have reported there is often a lack of evidence that the audit firm has made appropriate inquiries of those charged with governance in respect of related parties. In addition, reviewers may have come across transactions with related parties that have not been disclosed in the financial statements properly.
- For smaller entities choosing to report under FRS 102, Section 1A *Small Entities*, such entities are only required to make limited related party disclosures; namely material transactions that have not been concluded under normal market conditions and have been entered into with:
    - owners holding a participating interest in the small entity;
    - companies in which the small entity has a participating interest; and
    - the small entity' directors or members of its governing body.

  The standard does not define 'normal market conditions' so it is always advisable that the auditor of the small entity (where the small entity has an audit for whatever reason) documents their own conclusions in this respect.

  In some cases, auditors of small companies have disregarded the related party requirements completely on the grounds that they are only 'encouraged' under FRS 102, Section 1A rather than mandated. This is incorrect and the auditor must apply the provisions of ISA (UK) 550 *Related Parties* in its entirety where there are related parties associated with the small entity.

Keep in mind that the small entity's financial statements are still required to give a true and fair view. The absence of related party disclosures (or inadequate disclosures) in the small entity's accounts could give rise to a modified audit opinion.

Written representations

- The danger with written representations is that they are relied upon as sole audit evidence. Written representations on their own are weak forms of evidence because they are internally generated and hence should complement other audit evidence.
- The date of the written representation should be as near to, or the same date as, the auditor's report. The written representation must not be dated after the date of the auditor's report.

7 Audit firms' going concern policies and procedures (Lecture A718 – 16.36 minutes)

In the spring of 2020, the FRC carried out a review of the seven largest firms going concern policies and procedures in light of the Covid-19 situation. On 29 June 2020, they sent a letter to the firms providing feedback on their revised policies and procedures. Smaller audit firms can take on board some of the feedback provided to the seven largest firms when reviewing their own procedures to ensure they are applying best practice.

7.1 Key findings

All the firms the FRC reviewed had enhanced their audit policies and procedures in respect of going concern from the end of March 2020 (which is when the Covid-19 pandemic began to increase the risk of material uncertainties related to going concern for reporting entities). Some of the audit firms inspected have referred to these as 'emergency measures'.

The seven audit firms have improved the consistency of execution in the audit of going concern, largely through additional central support.

For smaller firms

While additional central support may not be practicable in smaller firms, a review of the procedures (at the very least to ensure they are still appropriate) would be beneficial. Smaller audit firms wishing to apply best practice in light of Covid-19 would be advised to ensure that going concern procedures respond the additional risks of material uncertainties that may be present. Standardised audit programmes do, to a certain extent, provide generic audit procedures but it is important that smaller firms do consider the need to tailor procedures to be client-specific – especially for those clients who have seen a significantly detrimental impact where Covid-19 is concerned.

The FRC note in their letter that 'increased central oversight was necessary' because when the government implemented lockdown restrictions, some audits (including December 2019 year ends) were in the advanced stages of completion. The FRC's letter confirms that the potential benefits of increased central oversight included:

- Sharing up-to-date information about Covid-19;
- Providing additional support to audit teams, given the high degree of uncertainty and level of judgement in assessing the going concern assumptions and adequacy of the related disclosures;
- Upskilling audit teams on how to approach the assessment of going concern, in the context of heightened risks;
- Increasing the level of challenge to audited entities about their assumptions, stress testing and disclosures in the financial statements; and
- Drawing conclusions, including setting out the rationale for why there is a material uncertainty, or not.

The FRC notes that the additional measures implemented by the firms have been consistent with the requirements of ISA (UK) 570 *Going Concern* and the additional guidance published by the FRC in March 2020. Some firms had also used this as an opportunity to incorporate certain aspects of the revised ISA (UK) 570 which comes into effect for December 2020 year ends. Finally, the FRC noted that the additional policies and procedures were similar across the firms, with the intention of giving increased attention to responding to the heightened risks arising from Covid-19.

7.2 Appendix: Key messages from the FRC letter to the audit firms

We have reproduced the appendix to the letter from the FRC to the seven audit firms inspected for clarity and completeness. Smaller audit firms may wish to consider implementing some of the key messages in their own procedures, where practicable, to demonstrate good practice where Covid-19-related going concern issues are concerned.

Appendix to FRC letter to audit firms 29 June 2020

Continue to perform an appropriate level of consultations on going concern and Covid-19 matters

Background

All firms have enhanced their consultation requirements on going concern assessments since the end of March 2020. This provides support to audit teams in ensuring that there has been a sufficiently robust approach, particularly when considering a material uncertainty in relation to going concern.

Findings

Most of the firms have introduced a mandatory consultation policy in relation to going concern.

The firms have the following range of consultation procedures:

- Technical panel (comprising senior audit partners)
- Central technical review (usually a mix of audit partners and directors/managers in a central team)
- Reviews by a second or third partner (not a technical expert, but a peer)

Any consultation decisions need to take into account the technical knowledge and experience of the central team, or technical panel, and the audit team's entity specific knowledge of their specific circumstances.

Good practice

- Review by technical panels: These are used more frequently than others by two of the firms. They involve a more in-depth review process than other consultations.
- Review by central technical team: Most of the firms' consultations are performed by a central technical team, especially for listed entities. This has the benefit of their experience in reviewing a wide range of GC assessments.
- Going concern consultation documentation: Most firms require completion of a consultation document or work paper. This ensures that the key judgements and discussion points are recorded. Some firms have more comprehensive memoranda than others. Best practice is to include the completed documents in a central database.

Continue to provide regular communications to audit teams on Covid-19 matters

Background

Since March 2020 the extent of regular communications on Covid-19 has increased across the firms.

Findings

The types of communications have been fairly consistent across the firms, with regular bulletins and partner and staff briefings.

Good practice

Dedicated website and FAQs: All firms have developed dedicated websites and FAQs on going concern and other Covid-19 related matters to keep audit teams up to date with developments.

Continue to develop policies regarding the auditor's report and focus on going concern disclosures

Background

The Covid-19 situation is more likely to result in reference to going concern in the auditor's report, either related to Key Audit Matters (KAM) or a material uncertainty (MY). Where there is an MU, audit teams need to carefully consider the adequacy of the disclosures in the financial statements, including those required by IAS 1.

Findings

All firms either require, expect or have a rebuttable presumption for a going concern and/or Covid-19 related KAM.

One firm requires a rebuttable presumption for an MU, whereby audit teams need to explain the reasons for those situations where there is no MU for going concern, taking into account the particular circumstances of the entity.

Good practice

- Rebuttable presumptions – As explained above, some firms have this for KAMs and/or MU. This helps ensure that the audit team appropriately consider the risks relating to going concern, although it is important that the audit approach is proportionate to the particular risks of the individual entity.
- Examples of auditor's reports and disclosures on material uncertainty: Most firms publish examples of these (across the market) regularly for audit teams, to encourage consideration of GC disclosures.
- Avoiding boilerplate disclosures: All firms are encouraging audit teams to ensure that boilerplate disclosures are not used in the financial statements.

Continue to perform central risk assessment procedures of entities with higher Covid-19 risks

Background

Central risk assessment procedures can lead to several types of action, such as further partner support, more engagement of specialists or additional consultation procedures.

Findings

The central risk assessment procedures generally include consideration of Covid-19 related risks.

Good practice

Review of Covid-19 risks: We have identified elements of good practice in most firms. For example, one firm performed an additional exercise to identify the sectors and audits with the highest risks related to Covid-19. For those audits identified, the firm considered whether sufficient resources had been allocated and whether they were subject to sufficient central review.

Increase the extent of guidance on how to assess economic scenario-related assumptions

Background

For some companies, assumptions about the period of lockdown and the speed of economic recovery are key to going concern assessments currently. Depending on the strength of the balance sheet and availability of cash resources and other facilities, these assumptions may be critical in determining whether there is a material uncertainty.

Findings

None of the audit firms issued 'anchor scenarios' on these types of assumptions. Appropriately, the audit firms recognised that assumptions should differ depending on the circumstances of individual entities, for example the sectors and geographical regions they operate in. One firm provided more guidance than others on assumed periods of trading.

Good practice

- Published economic data: The four largest firms publish a range of economic assumptions, with input from internal economists. One of these firms has developed a tool to assist in the consideration of these assumptions.
- Guidance on government funding schemes: Most firms have issued guidance on government schemes, including the Covid Corporate Financing Facility (CCFF).

Increase the extent of guidance on reverse stress and scenario testing and related disclosures

Background

ICAEW guidance states that "a reverse stress test is a stress test that starts from the opposite end – with the identification of a pre-defined outcome. This might be the point at which an entity can be considered as failing, or the entity's business model becomes unviable. Severe, but plausible, scenarios that might result in this outcome are then explored." The guidance issued to companies by the FRC in March 2020 stated "Many companies already use scenario and stress testing in developing their statements and this should continue as far as practicable. The use of reverse stress testing, to identify future scenarios that could lead to corporate failures, is also good practice."

Findings

The firms have issued some guidance in relation to reverse stress testing and/or severe but plausible considerations, although the extent to which this is required, and the nature of the guidance, varies by firm.

Good practice

Audit procedures on stress testing: Some firms incorporate this into their work programs or consultation memos.

Increase the level of detail in Covid-19 specific work programs on going concern

Background

The firms updated their going concern work programs or papers (WP) at the end of March 2020 onwards, generally by supplementing them with additional WPs, templates, practice aids or checklists. The firms informed us that a supplemental approach was necessary, given many audits were either in progress or nearly completed at the time of the changes and also that the updates relating to the revised ISA (UK) 570 do not come into effect until the end of 2020 (and updated work programs would need to be issued during 2020 for this).

Findings

The level of detail on going concern was often at a high level in the supplementary work programs.

Good practice

- Risk based work program: The existing GC work program for one firm generates a risk score which requires input from specialists when above a certain risk score.
- Mandated workpaper: Most firms require the GC or Covid-19 workpapers to be completed and signed off by the audit partner and Engagement Quality Control Reviewer (EQCR).
- Prepared by entity questionnaire: One firm requires the entity to complete a questionnaire regarding their going concern assessments, including what they have considered in their assessment. This helps the audit team plan their audit approach and discuss any concerns with management about their approach at an early stage.
- Presumed significant risk: One firm expects a significant risk on Covid-19 or going concern. Another firm requires audit team to rebut if going concern is not a significant risk. In both cases, the audit approach needs to be tailored to the specific risks of the particular entity.

Increase the use of specialists and in-flight teams

Background

Internal specialists (such as economists and transactions advisory) can contribute their expertise in assessing the cash flow assumptions in going concern assessments. In-flight teams can review and challenge the audit work on a real time basis.

Findings

The decision to use specialists is generally the decision of the audit team. The extent of additional in-flight reviews (specifically for going concern and Covid-19 matters) has been limited.

Good practice

- Use of specialists and in-flight review: One firm requires the use of transaction advisory specialists and in-flight reviews for all high-risk audits (including Public Interest Entities/listed entities). Another firm has a large coverage of in-flight reviews for going concern.
- Involvement in developing guidance: Most firms use transaction services and/or advisory specialists to help develop the guidance provided to audit teams.

Start to monitor the number of delayed audit reports

Background

The Covid-19 situation has caused a delay in signing of auditor's reports, for a combination of reasons, including delays caused by entities, the level of uncertainty around going concern, or a backlog of consultations at some audit firms.

Findings

While the firms have informed us that there have been delays to audit reports (especially for non-listed entities) they have not been able to provide details of the number of delayed audit reports. The firms should monitor this.

8 Accounting estimates: ISA (UK) 540 (Revised) (Lecture A719 – 18.21 minutes)

Financial statements will always contain some degree of accounting estimate such as allowance for inventory obsolescence, useful lives of property, plant and equipment (for which the depreciation charge may be based), valuation of provisions and defined benefit pension schemes. The issue for auditors is that accounting estimates can be tricky to audit due to their inherent risk and the fact that they are dependent on what may happen in the future.

In December 2018, the Financial Reporting Council (FRC) issued ISA (UK) 540 (Revised) *Auditing Accounting Estimates and Related Disclosures*. This ISA (UK) applies mandatorily for audits of financial statements for periods beginning on or after 15 December 2019 and has been significantly overhauled in comparison to its predecessor standard. It is crucial that auditors understand the requirements of ISA (UK) 540 (Revised) to ensure the procedures applied comply with the new requirements.

In addition, the revision of ISA (UK) 540 triggered a number of other UK auditing standards being revised, notably:

- ISA (UK) 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)*
- ISA (UK) 230 *Audit Documentation*
- ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
- ISA (UK) 260 *Communication With Those Charged With Governance*
- ISA (UK) 500 *Audit Evidence*
- ISA (UK) 580 *Written Representations*
- ISA (UK) 700 *Forming an Opinion and Reporting on Financial Statements*
- ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report*

Details of the consequential amendments to each of the above ISAs (UK) can be found in the Annexure to ISA (UK) 540 (Revised).

8.1 Objective of ISA (UK) 540 (Revised)

ISA (UK) 540 (Revised), para 11 states:

> *The objective of the auditor is to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework.*

ISA (UK) 540 (Revised), para 11

The objective of the auditor itself is notably shorter than in the predecessor standard (ISA (UK) 540, para 6). The difference is that there is no longer a specific referral to 'fair value accounting estimates' as these are now included within the concept of 'accounting estimates' themselves. You will also note that the title of the revised ISA (UK) 540 does not refer specifically to fair value accounting estimates.

ISA (UK) 540 (Revised) now contains enhanced requirements for risk assessment procedures and the work effort that is required by the auditor in responding to the assessed risks of material misstatement.

8.2 Examples of accounting estimates

As noted in the introductory paragraph, all financial statements, to some extent, will contain accounting estimates. Examples of such accounting estimates include:

- Allowances for inventory obsolescence
- Depreciation and amortisation
- Impairment
- Provisions for liabilities
- Warranty obligations
- Dilapidation provisions
- Employee retirement benefits
- Share-based payments
- Fair values used in business combinations
- Valuation of financial instruments

The principal risk for the auditor is that an accounting estimate (or multiple accounting estimates) may give rise to a material misstatement in the financial statements. This could arise through error, management bias or fraud.

8.3 The impact of the changes

The FRC made revisions to ISA (UK) 540 due to the International Auditing and Assurance Standards Board (IAASB) making amendments to the international equivalent ISA 540. The main catalyst for the revisions by the IAASB was the introduction of IFRS 9 *Financial Instruments* and the 'expected credit loss model' approach within IFRS 9 for assessing the impairment of financial assets. The expected credit loss model does not currently apply to UK GAAP (it only affects IFRS reporters).

Following feedback from key stakeholders, it became apparent that there were other issues which needed addressing in respect of other complex accounting estimates. Hence, the IAASB decided that a full revision of ISA 540 was to be undertaken.

Although the main trigger for revising ISA 540 was the requirements of IFRS 9, the amendments made by the IAASB (and the FRC to ISA (UK) 540) seek to make the standard scalable. ISA (UK) 540 (Revised) will apply to all accounting estimates from the simplest depreciation calculation through to the most complex financial instruments. In practice, many of the simpler accounting estimates will not usually give rise to high audit risk; however, there are situations where many measurements (including fair value measurements) are imprecise and subjective and hence will give rise to **inherent risk**. Inherent risk is discussed in **8.4** below.

Auditors must obtain a sound understanding of ISA (UK) 540 (Revised) in order to apply the requirements properly. In all cases additional work will be involved in identifying risks associated with accounting estimates and devising appropriate procedures which respond to the assessed risks of material misstatement.

8.4 Key enhancements

The following provides a 'high-level' overview of the key enhancements to ISA (UK) 540 which auditors need to have an awareness of:

Spectrum of inherent risk

ISA (UK) 540, para 4 explicitly recognises the *spectrum of inherent risk* and requires a separate assessment of inherent risk for the purposes of assessing the risks of material misstatement at the assertion level for accounting estimates. This concept builds on existing concepts found in ISA (UK) 200, ISA (UK) 315 (Revised) and ISA (UK) 330) in order to drive scalability.

Inherent risk is defined as:

> *The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.*

ISA (UK) 200, para 13(n)(i)

The 'spectrum of inherent risk' is not specifically defined in the ISAs (UK) but it is the degree to which inherent risk varies. For example, inherent risk may be low for a simple depreciation calculation, but it could be (and usually is) high for a complex financial instrument valued at fair value through profit or loss/other comprehensive income.

Inherent risk factors

Continuing from the above, inherent risk factors are included in ISA (UK) 540 (Revised), paras 2, 4 and 16. Inherent risk factors include the following:

Factor	Explanation
Complexity	There may be inherent complications in making accounting estimates, for example where data to arrive at the estimate is difficult to obtain. Some complex accounting estimates may also need the involvement of experts with specialist skills/knowledge – for example where fair values for certain financial instruments are used.
Subjectivity	Management judgement may be required for certain matters which involve subjectivity. Subjectivity reflects the fact that the monetary amounts cannot be directly observed hence there are limitations about the available data.
Estimation uncertainty	Estimation uncertainty arises due to limitations in the data available or knowledge of that data. It will involve a lack of precision of monetary amounts subjected to the estimation. Auditors will need to develop their own estimates which are to be based on data that is supported by the audit evidence and which complies with the applicable financial reporting framework.
Other inherent risk factors	This 'catch all' factor relates to factors which include the extent to which the accounting estimate has, or may have, been subject to management bias, fraud, changes in financial reporting requirements or other factors.

Enhanced risk assessment procedures

ISA (UK) 540 (Revised) contains enhanced risk assessment procedures, the objectives of which are to provide a better basis for identifying and assessing the risks of material misstatement related to accounting estimates.

The auditor must obtain an understanding of the entity and its environment, including the entity's internal control. This is also a requirement of ISA (UK) 315 (Revised) which is discussed in section 9 of these notes hence there is close overlap between ISA (UK) 540 and ISA (UK) 315.

ISA (UK) 540 (Revised), para 13 specifically requires the auditor to carry out procedures when obtaining an understanding of the entity and its environment which will provide an appropriate basis for the identification and assessment of the risks of material misstatement at both the financial statement and assertion levels.

Separate assessments of inherent risk and control risk for accounting estimates

The term 'control risk ' is defined as:

> *The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.*

ISA (UK) 200, para 13(n)(ii)

ISA (UK) 540 (Revised), para 16 requires the auditor to separately assess inherent risk and control risk when carrying out risk assessment procedures. For significant risks (i.e. those risks which, in the auditor's judgement, require special audit considerations), the auditor must obtain an understanding of the entity's controls (including control activities), relevant to that risk.

Auditor's decisions about controls

ISA (UK) 540 (Revised) contains more emphasis concerning the importance of the auditor's decisions about controls relating to accounting estimates by overlapping with some of the requirements of ISA (UK) 315 (Revised) and ISA (UK) 330. ISA (UK) 540 (Revised), para 19 requires the auditor to design and perform tests to obtain sufficient appropriate audit evidence relating to the operating effectiveness of relevant controls where:

- the auditor's risk assessment includes an expectation that the controls are operating effectively; or
- substantive procedures (i.e. those procedures which aim to detect material misstatement) alone will not provide sufficient appropriate audit evidence at the assertion level.

In respect of significant risks relating to an accounting estimate, ISA (UK) 540 (Revised) requires the auditor to include tests of controls in the current period when the auditor plans to rely on those controls. If the auditor's approach to the significant risks consists only of substantive procedures, ISA (UK) 540 (Revised), para 20 requires those procedures to include tests of details. 'Tests of detail' are those tests which verify individual transactions and balances and are one of two procedures classed as 'substantive procedures'. The other substantive procedure is substantive analytical procedures.

Objectives-based work effort

ISA (UK) 540 (Revised), para 7 notes that the standard emphasises that the auditor's further audit procedures (including tests of controls, where applicable) must be responsive to the assessed levels of risk of material misstatement at the assertion level. This must take into account the effect or one, or more, inherent risk factors and the auditor's assessment of control risk (see above).

ISA (UK) 540 (Revised) includes the auditor's requirements in respect of testing how management arrived at the accounting estimate in paras 22 to 25, notably:

- testing the methods used;
- testing the significant assumptions; and
- testing the data.

The auditor's further audit procedures should then be responsive to the assessed risks of material misstatement at the assertion level. The further audit procedures could include any of the three testing approaches (individually or combined as follows):

- Evidence obtained through work carried out on subsequent events (post balance sheet events) which are performed up to the date of the auditor's report.
- Testing how management arrived at the accounting estimate using the procedures noted above.
- Developing the auditor's point estimate or range.

Professional scepticism (spelt 'skepticism' in the standard)

ISA (UK) 200 defines 'professional skepticism' 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)

It is vital that the auditor exercises professional scepticism where accounting estimates are concerned because they inherently pose a higher risk of material misstatement due to their subjective nature. This, in turn, increases audit risk which is the risk that the auditor expresses an inappropriate opinion on the financial statements.

ISA (UK) 540 (Revised), para 9 recognises that the importance of professional scepticism increases when the accounting estimates are affected by a greater degree of inherent risk factors, or where there is a higher risk of material misstatement due to management bias or fraud. This gives rise to an enhanced risk assessment requirement in respect of professional scepticism.

'Stand-back' requirement

The 'stand-back' requirement has been enhanced in ISA (UK) 540 (Revised) and relates to the application of professional scepticism by the auditor. Auditors must ensure they exercise professional scepticism where accounting estimates are concerned and the stand-back provision requires the auditor to evaluate the audit evidence obtained to determine whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or if they are misstated. This includes an evaluation of both corroborative and contradictory audit evidence.

The 'stand-back' requirements are outlined in ISA (UK) 540 (Revised), paras 33 to 36.

Disclosure requirements

Disclosures relating to accounting estimates are viewed as being critical to users' understanding of the accounting policies applied, the nature and extent of estimation uncertainty and the key judgements made by management. For example, some accounting estimates, such as fair values used in complex financial instruments or a material impairment loss, may have a significant impact on the financial statements and could involve management judgement. This applies to other sorts of accounting estimates, such as provisions for liabilities.

ISA (UK) 540 (Revised), para 31 requires the auditor to design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the disclosures related to an accounting estimate (other than those related to estimation uncertainty) which are addressed in ISA (UK) 540 (Revised), paras 26(b) and 29(b).

Essentially, the auditor is required to obtain sufficient appropriate audit evidence that the disclosure requirements are adequate in the context of the applicable financial reporting framework (e.g. FRS 102). The auditor must also confirm that the disclosures included are those necessary in order for the financial statements to give a true and fair view.

In respect of disclosure requirements, ISA (UK) 540 (Revised) includes the concept of 'reasonable'. While the term 'reasonable' is not specifically defined in the standard, ISA (UK) 540 (Revised), para 9 confirms that in the context of the applicable financial reporting framework it means that the relevant requirements of the framework have been appropriately applied, including those that address:

ISA (UK) 540 (Revised), para 9

- *The making of the accounting estimate, including the selection of the method, assumptions and data in view of the nature of the accounting estimate and the facts and circumstances of the entity;*
- *The selection of management's point estimate; and*
- *The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and source of estimation uncertainty.*

Communication with those charged with governance

ISA (UK) 540 (Revised), para 38 requires the auditor to consider matters regarding accounting estimates when communicating with those charged with governance. This is a new requirement.

ISA (UK) 260 *Communication With Those Charged With Governance* and ISA (UK) 265 *Communicating Deficiencies in Internal Control to Those Charged With Governance and Management* already contain requirements for the auditor to communicate with those charged with governance about significant qualitative aspects of the reporting entity's accounting practices and significant deficiencies in internal controls.

ISA (UK) 540 (Revised), para 38 now requires the auditor to communicate whether the accounting estimates and their related disclosures are impacted by the key factors identified by the standard including complexity, subjectivity or other inherent risk factors. In addition, the standard recognises that in certain circumstances the auditor is required by law or regulation to communicate about certain matters with other relevant parties, such as regulators or prudential supervisors.

Written representations

There are enhanced requirements in respect of written representations. ISA (UK) 540 (Revised), para 37 requires the auditor to request written representations from management and, where appropriate, those charged with governance about whether the methods, significant assumptions and the data used in making the accounting estimates and the related disclosures are appropriate to comply with the applicable financial reporting framework. The previous ISA (UK) 540 only required a written representation from management confirming that the significant assumptions used in making the accounting estimate are reasonable.

ISA (UK) 540 (Revised), para 37 also contains an additional requirement for the auditor to consider the need to obtain representations about specific accounting estimates, including in relation to the methods, assumptions or data used.

9 FRC issues revised ISA (UK) 315 (Lecture A720 – 6.59 minutes)

In July 2020, the FRC issued a revised ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement* which becomes effective for audits of financial statements for periods commencing on or after 15 December 2021. One of the most notable changes at the outset is the shorter name (from ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding of the Entity and Its Environment*).

The revised ISA (UK) 315 is more than three times the content of its predecessor so there is a lot of information that auditors will need to get to grips with and reflect in their audit methodologies.

ISA (UK) 315 is considered to be a 'foundational' standard because it contains the requirements for identifying and assessing the risks of material misstatement at the planning stage of the audit. Carrying out a thorough risk assessment at the planning stage will enable the auditor to design and perform audit procedures to address the risk.

The IAASB (who triggered the changes to ISA 315) wanted a standard which reflected a more robust risk identification and assessment process. In turn this will enable the auditor to undertake a more effective response to the identified risks.

The revised ISA is structured in such a way that it addresses **what** the auditor needs to do. The application material (which has been enhanced) then sets out **why** and **how** the auditor carries out the procedures.

9.1 What do the changes seek to achieve?

The changes to ISA (UK) 315 are extensive and they aim to:

- Promote consistency in the application of procedures for risk identification and assessment.
- Make the standard more scalable through revised principles-based requirements.
- Reduce the complexity of the standard and make it more usable by auditors of all entities, regardless of nature or complexity.
- Encourage a more robust risk assessment hence more focus is devoted to responses to identified risks.
- Support auditors using the standard by incorporating guidance material which recognises the evolving environment, including IT aspects.

9.2 Summary of the changes

A high-level summary of the changes brought in by ISA (UK) 315 (Revised July 2020) are:

- Five new inherent risk factors (subjectivity, complexity, uncertainty, change and susceptibility to misstatement due to management bias or fraud).
- A new concept of 'spectrum of risk' - is the degree to which inherent risk varies.
- Requiring the auditor to obtain sufficient and appropriate audit evidence from risk assessment procedures.
- Significantly more requirements on IT, including general IT controls.
- Distinguishing between 'direct and 'indirect' controls.
- Requiring inherent risk and control risk to be assessed separately.
- A new 'stand-back' provision when material classes of transactions, account balances and disclosures are not considered as significant.

We will examine some of the main changes in this session to enable auditors to plan for changes to their audit methodologies in good time before the revised ISA (UK) comes into mandatory effect.

9.3 Summarising 'what' the auditor needs to do (the 'what' bit)

At the outset it is worth noting that the revised ISA (UK) 315 is iterative in nature. This means that many of the standard's requirements are interrelated and therefore are not performed in a linear manner. It should also be kept in mind that the auditor is required to exercise professional judgement in determining the nature and extent of the work that is to be carried out (i.e. conclusive procedures are not contained in the standard that will apply to all audits).

At the planning stage of the audit, the auditor is required to obtain an understanding of the client's business, especially in relation to:

- the client's system of internal control;
- the entity itself and the environment in which it operates; and
- the application of the relevant financial reporting framework (e.g. FRS 102 or IFRS).

The requirements to obtain an understanding of the entity have been enhanced to ensure that the auditor carries out a thorough risk assessment. One of the changes to ISA (UK) 315 is escalating the requirements to obtain an understanding of the applicable financial reporting framework out of the understanding the entity and its environment in order to encourage an increased focus on the entity's financial reporting requirement (ISA (UK) 315.19(b)).

Once this understanding has been obtained, the auditor must then identify and assess the risk of material misstatement at both the financial statement and assertion level. In doing this, the auditor must identify the relevant assertions (e.g. completeness, accuracy, rights and obligations etc) and the related significant classes of transactions, account balances and disclosures. This requires the auditor to understand what is meant by a 'relevant assertion' and 'significant class of transactions, account balance and disclosure'.

Example

Taylor Ltd has prepared its draft financial statements for the year ended 31 March 20X3. During discussions with the finance director it became apparent that a large customer has gone into liquidation after the balance sheet date but owes Taylor Ltd a large sum of money that is unlikely to be recovered.

The relevant assertion in this instance is 'valuation'. The significant account balance is trade receivables/debtors. This is because if the debtor balance is not written off, trade receivables and profit before tax could both be materially overstated.

Also keep in mind that the determination of a relevant assertion is made **before** the auditor considers any related controls the client has in place which could minimise the risk (i.e. 'inherent risk').

9.4 Risk of material misstatement

Audit risk (the risk that the auditor expresses an inappropriate opinion on the financial statements) is made up of three components: **inherent risk**, **control risk** and **detection risk**). Out of all three risks, detection risk is the only risk under the control of the auditor. This 'model' has not been changed in the revised ISA (UK) 315).

Inherent risk assessment

The auditor must assess inherent risk at the assertion level by assessing the likelihood and size of misstatements. ISA (UK) 315 (Revised July 2020), para 31 says that in doing this the auditor must take into account how, and the degree to which:

ISA (UK) 315 (Revised July 2020), para 31 (a) and (b)

(a) *Inherent risk factors affect the susceptibility of relevant assertions to misstatement; and*

(b) *The risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level.*

To help auditors do this, the revised ISA (UK) 315 contains the concept of the 'spectrum of inherent risk'. This is a new concept which requires the auditor to understand what is meant by an 'inherent risk factor'.

Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to misstatement that could be material **before** the auditor considers any related controls. Inherent risk factors (individually or in aggregate) increase the inherent risk by varying degrees. ISA (UK) 315 (Revised July 2020), para 5 requires that for the identified risks of material misstatement at the assertion level, a separate assessment of both inherent risk and control risk (see below) be carried out. The paragraph then goes on to clarify that inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. Hence, the degree to which inherent risk varies is referred to as the *spectrum of inherent risk*.

The higher the combination of likelihood and magnitude, the higher the inherent risk and vice versa. It is also possible for a higher risk assessment to arise from different combinations of likelihood and magnitude. For example, a higher risk assessment may result from a lower likelihood, but higher magnitude.

ISA (UK) 315 (Revised July 2020), para 32 also requires the auditor to determine whether any of the assessed risks of material misstatement are significant risks. In addition, para 33 also requires the auditor to determine whether substantive procedures (i.e. the audit procedures which aim to detect misstatement at the assertion level) alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatement at the assertion level.

Control risk assessment

ISA (UK) 315 (Revised July 2020), para 34 only requires the auditor to carry out an assessment of control risk if they plan to test the operating effectiveness of controls. Where tests of controls are not planned, the assessment of control risk is such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.

The drafting of ISA (UK) 315 (Revised July 2020), para 34 seems a little odd. On the one hand the paragraph is initially saying that no assessment of control risk is required and then it goes on to set control risk at a specific level (i.e. the same as inherent risk).

Example

The auditor of Miller Ltd is not planning on testing the operating effectiveness of internal controls this year and has said there is no need to assess control risk per ISA (UK) 315 (Revised July 2020), para 34.

This is not true. The correct application of paragraph 34 would mean that when control risk is not assessed, the level of risk assessment which is assigned to control risk cannot be lower than that assigned to the level of inherent risk.

9.5 'Stand-back' provision

Once the auditor has obtained the required understanding and identified the significant classes of transactions, account balances and disclosures, ISA (UK) 315 (Revised July 2020), para 35 requires the auditor to evaluate the audit evidence arising from the risk assessment procedures. This has been coined the 'stand-back' provision and has been introduced to prompt the auditor to confirm the completeness of the identified risks. In other words, focussing their attention on material classes of transactions, account balances and disclosures that have not been determined as significant.

The stand-back provision aims to require the auditor to make sure that the audit evidence they have obtained at the risk assessment stage confirms that there are no risks of material misstatement relating to material classes of transactions, account balances and disclosures which should have been identified at the risk assessment stage.

9.6 Responses to assessed risks

The FRC's revisions to ISA (UK) 315 (Revised July 2020) has had a knock-on effect on other ISAs (UK) which have seen consequential amendments. One of those is ISA (UK) 330 *The Auditor's Responses to Assessed Risks*.

ISA (UK) 330, para A43 clarifies that the auditor need not design and perform further audit procedures where the assessment of the risk of material misstatement is low.

The application material to ISA (UK) 330 has also been enhanced in relation to general IT controls and to when substantive procedures must be designed and performed.