October 2021 Audit and Accounting Update

Contents

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1 Provisions and contingencies recap (Lecture A753 – 29.40 minutes)

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

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

In addition, as the Coronavirus Job Retention Scheme (CJRS) is drawing to a close (it is due to end at the end of September 2021), this is unfortunately likely to lead to more redundancies. Redundancy programmes can lead to provisions being recognised in the financial statements and hence it is important that they are only recognised when appropriate (i.e. when the recognition criteria in accounting standards are met).

The requirements for provisions and contingencies are outlined in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 21 *Provisions and Contingencies*. FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* contains the requirements in Section 16 *Provisions and Contingencies.*

1.1 Provisions for liabilities

FRS 102 defines a 'provision' as:

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

FRS 102 Glossary ***provision***

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

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

1.2 Recognition

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

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

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

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

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

Remember, it's all three criteria that must be met (it is not one or two out of the three). This is to stop companies from deliberately recognising provisions that are unlikely to crystallise. In many cases, professional judgement will be needed and where the entity is audited, the auditor must obtain sufficient appropriate audit evidence that a provision has, or has not been (as the case may be), recognised appropriately.

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

1.3 Creation of an 'obligation'

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

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

- by way of a **constructive** obligation.

Legal obligation

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

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

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

Example – No obligating event

An entity operates in a jurisdiction where legislation was passed in 2018 which requires those operating in the chemical industry to reduce their effluent levels by 40% by 31 October 2020 which means investing in additional denitrification processes (the process by which nitrogen is removed from water).

At 30 September 2020, which is the company's year end, the entity had not done anything to reduce its effluent levels. The financial controller has included a provision for the costs that she estimates will be needed to complete the work.

The provision should not be included in the accounts to 30 September 2020. This is because there is no obligating event (the investment in the additional denitrification processes).

At 30 September 2021, the company had still not made any attempts to reduce its effluent levels. The financial controller has made a provision again on the grounds that the date has now passed for the company to have completed this work.

There is still no obligating event at the year end 30 September 2021 because the company has still not done anything to invest in additional denitrification costs. However, the company may need to make a provision for fines and penalties for non-compliance with the legislation but this would only be the case if it were to be probable (i.e. more likely than not) that such fines and penalties will be imposed and a reliable estimate could be made of the penalties. There is an obligating event in respect of the fines and penalties which is the non-compliance with the legislation.

Constructive obligation

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

Example – Constructive obligation

On 30 September 2021, the CJRS is due to finish. Sunnie Ltd operates a chain of hotels that has been severely impacted by the pandemic. Since hospitality was allowed to re-open, they have continued to suffer because staff have been 'pinged' by the NHS Test and Trace app meaning more than a quarter of their workforce have had to self-isolate on an almost consistent basis.

Due to increasing cash flow difficulties, management took the decision on 10 September 2021 to make 20% of its workforce redundant. It made the announcement to the staff concerned on 20 September 2021 and the payroll department has calculated the costs of terminating the staff members' employment.

Sunnie Ltd has a constructive obligation as it has announced to those staff affected that it will be making them redundant and hence the staff will expect the company to discharge its obligations. The redundancies will result in an outflow of economic benefits in the form of redundancy payments and the payroll department is able to reliably estimate the amount of the obligation. In this example, Sunnie Ltd must recognise a provision as it has a constructive obligation.

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

1.4 Onerous contracts

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

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

FRS 102 Glossary ***onerous contract***

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

In a Covid-19 climate, there could be many contracts which have become onerous, so such transactions are likely to be more common in financial statements for 2021 year ends.

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

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

Example – Onerous contract in the Covid-19 pandemic

Bramley Ltd is in the manufacturing industry. It has a contract with a major customer to sell certain products at a fixed price. Due to the government's lockdown, it had to close its manufacturing division and could not deliver the goods itself without purchasing them from another supplier at a significantly higher cost.

In this example, the provision for the onerous contract will reflect the lower of the penalty for terminating the contract or the present value of the cost of fulfilling the contract. This is the excess of the cost to purchase the goods over the consideration to be received.

If, on the other hand, the contract could be cancelled whilst the lockdown is in place without paying any compensation to the other party, the contract does not become onerous and there is no obligation.

The impact of the Covid-19 pandemic means that entities will need to carefully review their contracts to establish if there are any special terms that may relieve the entity of its obligations (such as *force majeure* clauses). In some cases, entities may seek to take legal advice surrounding the obligations of such clauses.

1.5 Restructuring provisions

Some businesses may find themselves having to restructure due to the pandemic – particularly where the virus has had a serious impact on business operations, or where the cessation of the CJRS means that certain division(s) of an entity will cease.

A 'restructuring' is defined in FRS 102 as follows:

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

FRS 102 Glossary ***restructuring***

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

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

A restructuring gives rise to a constructive obligation (see 1.3 above), hence the need to recognise a provision, only when the entity:

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

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

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

(ii) the principal locations affected;

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

(iv) the expenditures that will be implemented; and

(v) when the plan will be implemented; and

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

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

In practice, the plan itself does not have to be in so much detail that it identifies each employee whose services will be terminated. However, the plan should be detailed enough that it at least identifies a group of employees who will be directly affected by the restructuring plan.

Generally, the entity would have to at least have set out the main features of the plan to those affected in order to create a constructive obligation.

Example – Sale of an operation

Drummond Ltd manufactures four products in different divisions of its manufacturing premises. Each division is a cash-generating unit in its own right. One of the divisions had been loss-making for a couple of years and losses have increased due to the pandemic. The directors have decided to sell that division as forecasts indicate that demand for the division's products will remain low.

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

FRS 102 does not go into specific detail relating to the sale of an operation as part of a restructuring plan. Keep in mind that management would not default to IFRS if UK GAAP does not deal with a specific transaction, event or condition, but FRS 102 does indicate that it may be useful as a starting point.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* confirms that no obligation would arise for Drummond Ltd until the entity is committed to the sale; in other words, there is a binding sales agreement. Until such an agreement is entered into, Drummond could change its mind or choose another course of action if a willing buyer cannot be found.

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

Example – Creation of a constructive obligation in a restructuring plan

Emery Ltd has five branches spread across the UK and the company has an accounting reference date of 30 September. Over the last two years the depots in Tyneside and Hull have been sustaining heavy losses and were closed during the height of the pandemic. Since reopening both depots have sustained month-on-month losses and the directors have taken the decision to transfer operations to its head office located in Glasgow. This decision was taken by the board on 16 September 2021.

The restructuring plan was communicated to all staff in the Tyneside and Hull depots on 17 September 2021 and staff were given redundancy notices. Both depots will close officially on 1 November 2021 and the payroll department has been able to calculate the value of the termination payments that will be paid to those staff who will be made redundant.

In addition, the depot in Hull is rented via an operating lease and the agreement is due to end on 31 October 2023. The landlord of the premises has agreed that Emery can come out of the lease on 1 November 2021 provided they pay an early termination fee of £35,000 to which the directors have agreed.

A provision for restructuring should be made in the 30 September 2021 financial statements for the total amount of the termination costs which the company will incur in closing both depots. In addition, the company should also make a provision for the £35,000 early termination fee which is to be paid to the landlord of the Hull branch as this represents the minimum expected obligation and arises as a direct result of the restructuring. This is because a valid expectation has been created in the mind-sets of those affected (the employees and the landlord) that the company will discharge its obligations.

1.6 Recognition of a provision in the financial statements

As noted earlier, the impact of Covid-19 is likely to result in more provisions for liabilities being recognised in the financial statements, especially when the CJRS ends on 30 September 2021, so it is worthwhile revisiting the accounting requirements for them.

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

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

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

Example – Provision for defective goods

Wolves Ltd is a well-established company selling electrical products such as dishwashers, washing machines, TV and audio equipment. It sells its products to the general public with a warranty which covers customers for the costs of repair that occur during the first six months from the date of purchase. The company is preparing its financial statements for the year ended 30 September 2021 and calculations carried out by the financial controller suggest that if all the products sold contained minor defects, the costs of repair would be £1 million. If major defects occurred in all the products, the costs of repair would be £4 million.

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

The provision for the year is calculated as follows:

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

Example – Single obligation

Wanderers Ltd is preparing its financial statements for the year ended 30 September 2021. Due to the Covid-19 pandemic, it has been unable to fulfil a large contract for one of its major customers. The customer has also suffered a loss and has made a claim for losses against Wanderers Ltd. The legal advisers acting for Wanderers have said there is 40% chance of successfully defending the claim with no costs or damages to pay, but there is a 60% chance that Wanderers will have to pay costs of £500,000 due to the wording of the contract.

Wanderers would not be able to use an expected value in this example, i.e. £300,000 (£500,000 x 60%) because the legal advisers have stated that they will either successfully defend the claim with no costs to pay, or be found liable and have costs to pay of £500,000. Hence the results are either £nil or £500,000.

As it is more likely than not that Wanderers will have to pay £500,000, this should be the value of the provision in the financial statements as at 30 September 2021.

1.7 Changes to the status of a provision

The definition of a provision is a liability of uncertain timing or amount. The fact that the liability is uncertain in terms of its timing and amount distinguishes it from other liabilities (e.g. trade creditors, sundry creditors and such like).

Over time, facts and circumstances can change and it may be the case that the amount payable under the obligation becomes certain. When this happens, the amount previously recognised as a provision must be reclassified to an appropriate category within liabilities (e.g. trade creditors or sundry creditors). Reclassification is necessary in these circumstances because the liability no longer meets the definition of a provision and so should not be presented as such in the financial statements.

1.8 Contingent liabilities

A 'contingent liability' is defined as follows:

A contingent liability is either:

FRS 102 Glossary ***contingent liability***

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not ***probable*** *that an outflow of resources embodying economic benefits will be required to settle the obligation; or*

(ii) the amount of the obligation cannot be measured with sufficient ***reliability****.*

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

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

Example – Contingent liability

Taylor Ltd has made a provision for damages amounting to £120,000 in its financial statements for the year ended 30 September 2021 in respect of a legal claim brought against the company by one of its customers for non-compliance with contractual terms of a service contract. The non-compliance was due to government restrictions as a result of the Covid-19 pandemic.

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

Taylor Ltd should not recognise a provision for damages because it is not 'probable[1]' that an outflow of resources will be required to settle the case. The legal advisers are unsure as to the outcome of the case. In such situations, disclosure of a contingent liability in the notes to the financial statements should be made because the case is considered material to the company.

1.9 Contingent assets

A 'contingent asset' is defined as:

> *A possible **asset** that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.*

*FRS 102 Glossary **contingent asset***

A contingent asset is directly the opposite of a contingent liability and, again, is not reflected in the financial statements of the reporting entity. Contingent assets will only become reimbursement assets and be recognised in the financial statements if it is 'virtually certain' that an entity will realise the asset (for example, an insurance company agreeing to pay out a claim to the company).

Remember, the recognition criterion for a reimbursement asset is stricter than that of a provision for a liability (which only has to be 'probable') because of the underpinning principle in financial reporting that assets cannot be stated in an entity's balance sheet at any more than recoverable amount.

1.10 Offsetting provisions

FRS 102, para 2.52 states:

> *An entity shall not offset assets and liabilities, or income and expenses, unless required or permitted by an FRS.*
>
> *(a) Measuring assets net of valuation allowances (for example, allowances for inventory obsolescence and allowances for uncollectible receivables) is not offsetting.*
>
> *(b) If an entity's normal **operating activities** do not include buying and selling **fixed assets**, including investments and operating assets, then the entity reports gains and losses on disposal of such assets by deducting from the proceeds on disposal the **carrying amount** of the asset and related selling expenses.*

FRS 102, para 2.52

[1] The term 'probable' is defined in the Glossary to FRS 102 as 'more likely than not'.

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

In these cases, it is important that the entity recognises the asset and the liability separately; they must **not** be offset in the balance sheet because this would mean assets and liabilities are both understated; thus, presenting a misleading financial position.

FRS 102, para 2.52 states '… unless required or permitted by an FRS.' FRS 102, para 21.9 does allow the expense relating to the provision in the profit and loss account to be offset, thus presenting the expense net of the reimbursement in the profit and loss account rather than showing the related expense gross with a related component of income.

1.11 Disclosures for provisions

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

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

(a) a reconciliation showing:

- (i) the carrying value at the beginning and end of the period;
- (ii) additions to the provision during the period, including any adjustments that have arisen due to changes in measuring the discounted amount;
- (iii) amounts charged against the provision during the period; and
- (iv) unused amounts which have been reversed during the period;

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

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

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

Comparative information for previous periods is not required.

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

1.12 Disclosures for contingent liabilities

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

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

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

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

(c) the possibility of any reimbursement.

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

1.13 Disclosures for contingent assets

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

1.14 Prejudicial disclosures

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

Paragraph 21.17 is heavily restrictive in that it says 'In extremely rare cases …'. The term 'extremely rare cases' is not defined in FRS 102 and in real life, there are a wide range of circumstances where entities may be in negotiation with third parties in respect of a provision, contingent liability or contingent asset.

The key point to emphasise is that paragraph 21.17 concerns **disclosure requirements only**. It follows, therefore, that paragraph 21.17 does not exempt a reporting entity from making, say, a provision for a liability. It might also be the case that a provision for liability is reimbursed from a third party (such as an insurance company) and where this is the case and a reimbursement asset has been recognised on the grounds that its receipt is virtually certain, the prejudicial disclosure exemption may extend to the reimbursement asset (although a reporting entity would disclose which asset balance is affected).

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

Prejudicial disclosures: provisions

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

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

FRS 102, para 21.17

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

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

Prejudicial disclosures: contingent liabilities

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

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

FRS 102, para 21.17

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

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

(ii) *any subsidiary of the entity; or*

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

shall each be stated separately; and

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

Prejudicial disclosures: contingent assets

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

2 Discontinued operations (Lecture A754 – 7.50 minutes)

As many businesses start to recover from the impact of the pandemic, the issue of discontinued operations has moved up the ranks.

FRS 102 defines a 'discontinued operation' as:

> *A **component of an entity** that has been disposed of and:*
>
> *(a) represented a separate major line of **business** or geographical area of operations;*
>
> *(b) was part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or*
>
> *(c) was a **subsidiary** acquired exclusively with a view to resale.*

An important point to emphasise where discontinued operations are concerned is that the operation **must** have been discontinued **by the reporting date**. An operation cannot be classed as discontinued if management merely intend to discontinue it at the reporting date.

The definition of above refers to a '… component of an entity…' which itself is defined as:

> *Operations and **cash flows** that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.*

*FRS 102 Glossary **component of an entity***

In other words, a component of an entity will have been a cash-generating unit (or a group of cash-generating units while being held for use).

In addition, the use of the words '… a separate *major* line of business' will inevitably require professional judgement to be applied. It is unlikely that a major line of business would encompass immaterial changes to an operation; it would have to be a material change.

In practice, it would seem unlikely that the definition of a discontinued operation would ever be met by a single fixed asset. It would more than likely relate to a 'disposal group' which is a group of assets to be disposed of as well as associated liabilities that will be transferred in the transaction.

Unlike IFRS, there is no specific standard/section of FRS 102 which deals with discontinued operations. FRS 102, para 5.7E states:

> *An entity shall also disclose on the face of the income statement (or statement of comprehensive income if presented) an amount comprising the total of:*

FRS 102, para 5.7E

> *(a) the post-tax profit or loss of discontinued operations; and*

> (b) *the post-tax gain or loss attributable to the impairment or on the disposal of the assets or disposal group(s) constituting discontinued operations.*
>
> *A line-by-line analysis shall be presented in the income statement (or statement of comprehensive income if presented), in a column identified as relating to discontinued operations, ie separately from continuing operations; a total column shall also be presented.*

In addition to the above, FRS 102, Section 5 *Statement of Comprehensive Income and Income Statement* contains an appendix (which is not an integral part of Section 5) which provides guidance on applying the above paragraph.

Example – Discontinued operation

Weaver Ltd has a reporting date of 31 December. The company manufactures pesticides for both commercial and domestic use. It has three divisions, each of which is a cash-generating unit in its own right. One of the divisions which manufactures the brand 'ClearPest' will close during 2022 as the Government have banned the use of certain chemicals that are used in the production of that brand.

In the financial statements for the year ended 31 December 2021, the results and cash flows of the ClearPest division will be treated as continuing operations. In the financial statements for the year ended 31 December 2022, the results and cash flows of ClearPest will be treated as discontinued operations and Weaver will be required to comply with FRS 102, para 5.7E.

The Appendix to FRS 102, Section 5 contains an example showing how continuing and discontinued operations are shown. The Appendix itself is not an integral part of Section 5 and is reproduced overleaf:

	20X1			20X0		
	Continuing operations CU	Discontinued operations CU	Total CU	Continuing operations (as restated) CU	Discontinued operations (as restated) CU	Total CU
Turnover	**4,200**	**1,232**	**5,432**	3,201	1,500	4,701
Cost of sales	**(2,591)**	**(1,104)**	**(3,695)**	(2,281)	(1,430)	(3,711)
Gross profit	**1,609**	**128**	**1,737**	920	70	990
Administrative expenses	**(452)**	**(110)**	**(562)**	(418)	(120)	(538)
Other operating income	**212**	**-**	**212**	198	-	198
Operating profit	**1,369**	**18**	**1,387**	700	(50)	650
Profit on disposal of operations	**-**	**301**	**301**	-	-	-
Interest receivable and similar income	**14**	**-**	**14**	16	-	16
Interest payable and similar expenses	**(208)**	**-**	**(208)**	(208)	-	(208)
PBT	**1,175**	**319**	**1,494**	508	(50)	458
Tax on profit or loss	**(390)**	**(4)**	**(394)**	(261)	3	(258)
P/(L) after tax and for the financial year						

	785	**315**	**1,100**	247	(47)	200
Other comprehensive income						
Actuarial loss on defined benefit pension plans			**(108)**			(68)
Deferred tax movement relating to actuarial losses			**28**			18
Total comprehensive income for the year			**1,020**			150

The above disaggregation may seem, to some, to be excessive when compared to the requirements of old UK GAAP and IFRS, especially when para 5.7E(a) and (b) require an amount comprising post-tax profit or loss and post-tax gain or loss attributable to the impairment/disposal of assets or disposal group(s) constituting discontinued operations.

The requirements in FRS 102 were lifted from *IFRS® for SMEs* but simply replicating the requirements under *IFRS for SMEs* would not comply with UK company law as certain items may not be included in the statutory formats. Hence, the FRC decided that a more practical way would be for discontinued operations to be presented using a columnar layout.

3 Future changes to UK GAAP (Lecture A755 – 15.38 minutes)

The Financial Reporting Council (FRC) currently has a consultation open until 31 October 2021 whose objective is to influence the next periodic review of UK GAAP. As mentioned in previous update courses, the FRC will carry out periodic reviews (rather than triennial reviews) of UK GAAP on a four- or five-year basis.

Interested stakeholders are encouraged to send in feedback using the email address ukfrsperiodicreview@frc.org.uk. It is also worth reiterating that practitioners at the smaller end of the scale are also encouraged to send in **constructive** feedback to the FRC because all feedback is looked at by the FRC. As UK GAAP is applied by private entities, all sizes of preparer are encouraged to send in comments which the FRC can take on board when considering the changes that may be made to UK GAAP.

Technical queries are common where UK GAAP is concerned, and we've extracted a couple of the more common issues to address in this quarter's update.

3.1 Default to another FRS

It is rare that an FRS in the suite of current UK GAAP does not deal with a transaction, event or condition. However, it is not unheard of, and situations will crop up where FRS 102 or FRS 105 does not deal with an issue at hand.

When a transaction, event or condition is not dealt with in an accounting standard, management must develop an accounting policy which results in financial information that is relevant and reliable. FRS 102, para 10.4 says:

If an FRS does not specially address a transaction, other event or condition, an entity's management shall use its judgement in developing and applying an accounting policy that results in information that is:

FRS 102, para 10.4

(a) relevant to the economic decision-making needs of users; and

(b) reliable, in that the financial statements:

*(i) represent faithfully the **financial position**, financial **performance** and **cash flows** of the entity;*

(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;

(iii) are neutral, ie free from bias;

(iv) are prudent; and

(v) are complete in all material respects.

FRS 102, para 10.4 inter-relates with that of para 10.5 which provides a list of sources which management must refer to in descending order when making the judgement described in paragraph 10.4 as follows:

FRS 102, para 10.5

(a) *the requirements and guidance in an FRS dealing with similar or related issues;*

(b) *where an entity's financial statements are within the scope of a* ***Statement of Recommended Practice (SORP)*** *the requirements and guidance in that SORP dealing with similar and related issues; and*

(c) *the definitions,* ***recognition*** *criteria and* ***measurement*** *concepts for* ***assets***, ***liabilities***, ***income*** *and* ***expenses*** *and the pervasive principles in Section 2 Concepts and Pervasive Principles.*

While full IFRS does not feature in the hierarchy, management may still consider IFRS as a useful starting point in developing an accounting policy (although they do not have to do this).

While some commentators suggest that old UK GAAP may provide some source of information, we are of the opinion that using an out of date accounting standard would not be appropriate as it could lead to inconsistencies in application or be incompatible with the requirements of company law.

SORPs may also provide some guidance to preparers in adopting a specific policy. Where the entity is within the scope of a particular SORP, but decides not to apply the requirements because another policy is more appropriate, the entity will need to demonstrate plausible reasons. For example, it will need to demonstrate that its particular circumstances are different from those of other entities which fall within the scope of the SORP.

Example – Revalued fixed asset

Morgan Ltd prepares its financial statements under FRS 102 and during the year to 30 September 2020 it revalued its freehold building.

FRS 102 is silent on how accumulated depreciation on an asset that has been revalued should be treated. Management can, if they choose, look to the provisions in IAS 16 *Property, Plant and Equipment* which deals with the issue at paragraph 35. IAS 16 allows a choice of one of two treatments:

Method 1: Adjust the gross carrying amount in a manner which is consistent with the revaluation of the carrying amount of the asset. The accumulated depreciation at the date of the revaluation is adjusted so that it is equal to the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses.

Method 2: The accumulated depreciation is eliminated against the gross carrying amount of the asset.

In practice, method 2 is the most common.

3.2 Mixing/matching GAAPs

It is inappropriate to 'mix and match' GAAPs when preparing an entity's financial statements. For example, if a private entity is applying UK GAAP, then it would not be appropriate to apply IFRS standards in those financial statements. As noted above, management may look to IFRS for guidance when developing an accounting policy to deal with a transaction, event or condition which is not dealt with in UK GAAP, but that is as far as they can go.

Example – Lease accounting

Stanley is a sole practitioner preparing the financial statements for his small company client, Frankie Ltd. Frankie prepares its financial statements under FRS 102, including Section 1A *Small Entities*.

Frankie has two finance leases and one operating lease. Stanley is concerned about the potential for the Financial Reporting Council to change lease accounting for operating leases in FRS 102 so that it is more aligned to that of IFRS 16 *Leases* (i.e. all leases for lessees, with some very limited exceptions, are recognised on balance sheet). He has therefore decided to apply the provisions in IFRS 16 to all leases for his clients.

Stanley is incorrect to do this. An entity cannot 'mix and match' GAAPs. IFRS is not UK GAAP and therefore to be able to state compliance with FRS 102, the entity must apply Section 20 *Leases* in full. This means accounting for finance leases on the balance sheet and accounting for operating lease payments as an expense via profit or loss on an arising basis.

Stanley's incorrect accounting treatment would also be likely to have tax implications for the client as well.

Another common question asked by practitioners is whether an entity can switch from one financial reporting framework (e.g. FRS 102) to another one (e.g. FRS 105). This is permissible provided the entity is eligible to apply the new framework. However, a transition up (from FRS 105 to FRS 102) or down (from FRS 102 to FRS 105) will have to be carried out. This will mean restating the opening balances of the comparative year and the closing comparative year to enable the financial statements to comply with the requirements of the new framework.

It would not be appropriate to keep switching from one framework to another on a regular basis. This would prove to be both costly and time-consuming as a transition exercise would have to be carried out each time the entity changes its financial reporting framework.

In addition, it is also not permitted to prepare one set of financial statements for the shareholders and HMRC under one framework (e.g. FRS 102) and another set of financial statements for filing at Companies House (e.g. FRS 105).

There is often confusion with the 'abridged' accounts regime. Remember, that abridged accounts are accounts prepared for the shareholders (and other stakeholders) following unanimous agreement by the shareholders to prepare abridged financial statements. They are **not** a replacement for the old abbreviated accounts regime.

A small entity preparing abridged financial statements can deliver 'filleted abridged' accounts to Companies House, i.e. the abridged accounts prepared for the shareholders less the directors' report, profit and loss account, statement of changes in equity (if prepared) and notes relating to the profit and loss account. Under the abridged accounts regime, the small entity would not be allowed to prepare 'full' accounts for the shareholders and then abridged accounts for Companies House as the entity must file what they prepare for the shareholders, subject to the exemptions from filing certain documents under s444(A) of Companies Act 2006.

3.3 Effects of IFRSs in the next periodic review

Many practitioners have asked the question as to whether the effects of 'major' IFRSs will be reflected in UK GAAP once the FRC has carried out its next periodic review. The simple answer to this is we are uncertain as to the direction the FRC will take where these major IFRSs are concerned.

The three IFRSs which are causing an element of nervousness among some practitioners are as follows:

Relevant IFRS	Why it is an issue
IFRS 9 *Financial Instruments*	This IFRS uses an 'expected credit loss model' rather than the 'incurred credit loss model' which UK GAAP uses. This will require a more forward-looking approach and it can involve some complex calculations.

IFRS 15 *Revenue from Contracts with Customers*	This IFRS uses a five-step model approach to revenue recognition. It also contains requirements for variable consideration and more emphasis on performance obligations as well as requiring far more extensive disclosure requirements.
IFRS 16 *Leases*	Probably the most controversial of them all is IFRS 16. This IFRS does not distinguish between a finance lease and an operating lease for lessees meaning the vast majority of leases are recognised on the balance sheet of lessees (with some very limited exceptions).

The FRC have said they are looking at implementation feedback from IFRS reporters as to how they implemented the above. In addition, the International Accounting Standards Board (IASB) are in the process of carrying out their second comprehensive review of *IFRS for SMEs* which currently does not contain the requirements of IFRSs 9, 15 and 16.

It will be interesting to see how (or if) the IASB incorporate the requirements of the above three IFRSs into *IFRS for SMEs* as this may provide a starting point for the FRC in deciding how they go about incorporating such requirements into UK GAAP.

If [emphasis added] the IASB and FRC do decide to change *IFRS for SMEs* and UK GAAP respectively to align the standards with the above major IFRSs, simplifications will have to be made. Full IFRS is designed for listed entities and so the requirements are far too complex for private entities. How the respective standard-setters will achieve this remains to be seen.

In any case, any proposed amendments will have to be consulted on and the FRC have said that there will not be a public consultation until at least next year. Any changes are also not currently planned to take effect until 1 January 2024 in any event (and this date is tentative).

The message for UK GAAP reporters is to carry on as normal. Respond to any consultations or exposure drafts as you see fit but ensure that any responses are constructive.

4 Size thresholds and audit exemption (Lecture A756 -18.23 minutes)

Section 475 of Companies Act 2006 *Requirement for audited accounts* states:

Companies Act 2006, s475

(1) A company's annual accounts for a financial year must be audited in accordance with this Part unless the company—

(a) is exempt from audit under—

section 477 (small companies),

section 479A (subsidiary companies) or

section 480 (dormant companies)

or

(b) is exempt from the requirements of this Part under section 482 (non-profit-making companies subject to public sector audit).

(2) A company is not entitled to any such exemption unless its balance sheet contains a statement by the directors to that effect.

(3) A company is not entitled to exemption under any of the provisions mentioned in subsection (1)(a) unless its balance sheet contains a statement by the directors to the effect that—

(a) the members have not required the company to obtain an audit of its accounts for the year in question in accordance with section 476, and

(b) the directors acknowledge their responsibilities for complying with the requirements of this Act with respect to accounting records and the preparation of accounts.

(4) The statement required by subsection (2) or (3) must appear on the balance sheet above the signature required by section 414.

It is well-known that small companies and small groups are eligible to claim exemption. While some small companies do have a voluntary audit, most small entities claim audit exemption under s477, Companies Act 2006. To recap, the size of a company or group is dictated by company law and the thresholds are summarised in the following table:

Size	Turnover	Balance sheet total	No of employees
Micro-entity	Not more than £632,000	Not more than £316,000	Not more than 10

Small company	Not more than £10.2m	Not more than £5.1m	Not more than 50
Small group	Not more than £10.2m net or £12.2m gross	Not more than £5.1m net or £6.1m gross	Not more than 50
Medium-sized company	Not more than £36m	Not more than £18m	Not more than 250
Medium-sized group	Not more than £36m net or £43.2m gross	Not more than £18m net or £21.6m gross	Not more than 250
Large company	More than £36m	More than £18m	More than 250
Large group	More than £36m net or £43.2m gross	More than £18m net or £21.6m gross	More than 250

The audit exemption limits are the same as those for a small company and group.

A company or group must meet two out of the three criteria for two consecutive years in order to be able to be classed as micro, small, medium-sized or large.

In addition, there are some important points to note in respect of the above thresholds:

- The term 'balance sheet total' is fixed assets **plus** current assets (i.e. gross assets). Care must be taken not to use net assets (i.e. shareholders' funds) because this is arrived at after the deduction of liabilities.

- The average number of employees is the average number employed throughout the year; not the actual number of employees in employment at the reporting date. Section 382(6) of Companies Act 2006 sets out the calculation as follows:

  (a) 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);

  (b) add together the monthly totals; and

  (c) divide by the number of months in the financial year.

- If the reporting period is not a full year, the turnover figure is proportionately adjusted.
- A subsidiary whose financial statements are consolidated with those of a parent cannot qualify as a micro-entity (charities also cannot qualify as a micro-entity).
- References to 'net' and 'gross' in respect of groups relate to the effects of intra-group trading and balances. 'Net' means the effects of intra-group trading have been eliminated whereas 'gross' means they have not.

Example – Presentation currency is not GBP

Molbert Ltd, a company based in the UK, has prepared its first set of financial statements in Euros. The finance director is unsure whether the company can be classed as small.

In situations where a company has a different presentation currency from GBP, the turnover figure is translated using the average rate and the balance sheet total is translated using closing rate.

This method of translation should also be used in a group context.

Example – Determining the size of a company

Extracts from the financial statements of Lothian Ltd, a standalone company based in the UK, prepared under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* are as follows:

	Year ended		
	30.09.2021	**30.09.2020**	**30.09.2019**
	£'000	£'000	£'000
Turnover	9,100	9,500	11,200
Fixed assets	7,250	7,140	10,400
Current assets	8,400	5,500	13,650
Average headcount	42	40	64

The accounts junior has asked whether the company qualifies as small or medium-sized for its year ended 30 September 2021.

Year ended 30 September 2019

This is the company's first year and all small company size thresholds are breached in this year, so the company is classed as medium-sized. As the company is not a subsidiary (which may be able to claim audit exemption via s479A, Companies Act 2006), it must also be audited as it breaches the audit exemption thresholds. It must prepare its financial statements under full FRS 102 (i.e. it cannot use Section 1A) and cannot prepare abridged financial statements.

Year ended 30 September 2020

While gross assets exceed £5.1m (they are £12.6m), turnover is under the £10.2m limit and the average number of employees is below 50. However, as the entity was medium-sized in the previous year, it still remains a medium-sized company for the year ended 30 September 2020. The company must also be audited as it cannot claim audit exemption. It must prepare its financial statements under full FRS 102 and cannot prepare abridged financial statements.

Year ended 30 September 2021

While gross assets exceed £5.1m (they are £15.7m), turnover is under the £10.2m limit and the average number of employees is below 50. This is the second consecutive year that two out of the three criteria for small company classification have been met and hence the company can be classified as small for the year ended 30 September 2021. The company is now eligible to prepare its financial statements under FRS 102, Section 1A *Small Entities* and it can also claim audit exemption under s477, Companies Act 2006.

In addition, if the entity has any loans from director-shareholders or loans from any member of the close family of the director when that group contains at least one shareholder, the entity can take advantage of the accounting policy option in FRS 102, para 11.13A(a). If it chooses to do so, it must apply the exemption retrospectively. **Note, this is the only measurement difference under FRS 102 between small and non-small entities.**

4.1 Individual companies that are parent companies

Individual parent companies must meet the size criteria shown above to qualify as micro, small or medium-sized on an individual company basis.

Example – Micro-entity which is the parent of a group
Microco Ltd has a 100% ownership interest in Subco Ltd and is seeking to prepare its financial statements under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Not only does Microco Ltd have to consider whether it meets the criteria to prepare its individual financial statements under the micro-entities regime, it must also consider the size of the group that it heads up. In this example, the group only needs to be a **small** group (as shown in the table above) in order for Microco Ltd to be able to prepare its financial statements under the micro-entities regime. This is possible because a small group does not have to prepare group accounts and there is no concept of a 'micro group' under s384A, Companies Act 2006.

Example – Small entity is a parent

Smallco Ltd has a 100% ownership interest in Subco Ltd and is seeking to prepare its financial statements under FRS 102 including applying the presentation and disclosure requirements of Section 1A.

Section 383(1), Companies Act 2006 states that a parent company can only qualify as a small company in a financial year if the group headed up by it qualifies as a small group.

If Smallco Ltd would qualify as a small company but Subco Ltd qualifies as a medium-sized company, Smallco would only be entitled to the exemptions available to a medium-sized company when preparing its individual financial statements.

In terms of group accounts, it would only be necessary for Smallco to consider the size of the group it heads up. This would be the case even if the group is small (hence not preparing group accounts) on the basis that it may be part of a larger group.

4.2 Small and medium-sized groups

Section 383 *Companies qualifying as small: parent companies* states:

S383, Companies Act 2006 (extract)

(1) *A parent company qualifies as a small company in relation to a financial year only if the group headed by it qualifies as a small group.*

(2) *A group qualifies as small in relation to the parent company's first financial year if the qualifying conditions are met in that year.*

(2A) *Subject to subsection (3), a group qualifies as small in relation to a subsequent financial year of the parent company if the qualifying conditions are met in that year.*

(3) *In relation to a subsequent financial year of the parent company, where on the parent company's balance sheet date the group meets or ceases to meet the qualifying conditions, that affects the group's qualification as a small group only if it occurs in two consecutive financial years.*

The qualifying conditions in (3) above are contained in the table in the introductory section of this section.

Section 466 *Companies qualifying as medium-sized: parent companies* outlines the requirements for medium-sized groups and the effect of s466 is the same as that cited in s383 above despite the different wording used:

S466, Companies Act 2006 (extract)

(1) *A parent company qualifies as a medium-sized company in relation to a financial year only if the group headed by it qualifies as a medium-sized group.*

(2) *A group qualifies as medium-sized in relation to the parent company's first financial year if the qualifying conditions are met in that year.*

(3) *A group qualifies as medium-sized in relation to a subsequent financial year of the parent company—*

(a) *if the qualifying conditions are met in that year and the preceding financial year;*

(b) *if the qualifying conditions are met in that year and the group qualified as medium-sized in relation to the preceding financial year;*

(c) *if the qualifying conditions were met in the preceding financial year and the group qualified as medium-sized in relation to that year.*

Again, the qualifying conditions for medium-sized group are outlined in the table in the introductory section of these notes.

4.3 Ineligible companies and groups

A company may meet the size limits to qualify as micro, small or medium-sized but they cannot be treated as such if they are ineligible.

Companies excluded from being treated as micro-entities

Section 384(B), Companies Act 2006 outlines those companies which cannot be treated as micro-entities even if they meet the qualifying conditions outlined in the table above. The table below describes these types of entities:

Ineligible company	Example
A company that was excluded from the small companies regime by virtue of s384	• A public company. • A company that is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company, or an entity that carries on insurance market

	activity, or a scheme funder of a Master Trust Scheme. • A member of an ineligible group.
An undertaking that would have been an investment undertaking as defined in Article 2(14) of Directive 2013/34/EU of 26 June 2013 on the annual financial statements etc of certain types of undertakings were the United Kingdom a member State	• Undertakings, the sole object of which is to invest their funds in various securities, real property and other assets, with the sole aim of spreading investment risks and giving their shareholders the benefit of the results of the management of their assets. • Undertakings associated with investment undertakings with fixed capital, if the sole object of those associated undertakings is to acquire fully paid shares issued by those investment undertakings without prejudice to point (h) of Article 22(1) of Directive 2012/30/EU.
An undertaking that would have been a financial holding undertaking as defined in Article 2(15) of [Directive 2013/34/EU] were the United Kingdom a member State	• A financial undertaking is defined as an undertaking the sole object of which is to acquire holdings in other undertakings and to manage such holdings and turn them to profit, without involving themselves directly or indirectly in the management of those undertakings, without prejudice to their rights as shareholders.
[For periods commencing on or after 1 January 2021] A credit institution within the meaning given by Article 4(1)(1) of Regulation (EU) No. 575/2013 of the European Parliament and of the Council, which is a CRR firm within the meaning of Article 4(1)(2A) of that Regulation	• A credit institution is defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.
[For periods commencing before 1 January 2021] A credit institution as defined in Article 3 of Directive	• A credit institution means a credit institution as defined in point (1) of Article 4(1) of Regulation (EU) No

2013/36/EU of the European Parliament and of the Council of 26 June 2013, other than one listed in Article 2 of Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and investment firms	575/2013.
A company that would have been an insurance undertaking as defined in Article 2(1) of Council Directive 91/674/EEC of 19 December 1991 on the annual accounts of insurance undertakings were the United Kingdom a member State.	• Insurance undertakings are defined as: ○ undertakings within the meaning of Article 1 of Directive 73/239/EEC, excluding those mutual associations which are excluded from the scope of that Directive by virtue of Article 3 thereof but including those bodies referred to in Article 4(a), (b) and (c) and (e) thereof except where their activity does not consist wholly or mainly in carrying on insurance business; ○ undertakings within the meaning of Article 1 of Directive 79/267/EEC, excluding those bodies and mutual associations referred to in Articles 2(2) and (3) and 3 of that Directive; or ○ undertakings carrying on reinsurance business.
A charity.	

In addition to the above restrictions, the micro-entity provisions do not apply to a company's accounts for a financial year if:

(a) *the company is a parent company which prepares group accounts for that year as permitted by section 399(4); or*

(b) *the company is not a parent company but its accounts are included in consolidated group accounts for that year.*

S384(B)(2), Companies Act 2006 (extract)

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Companies excluded from being treated as small companies

Section 384 *Companies excluded from the small companies regime*, Companies Act 2006 states that a company cannot qualify as small if it was, at any time within the financial year to which the accounts relate:

(a) *a public company,*

(b) *a company that—*

(i) *is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company, or*

(ii) *carries on insurance market activity, or*

(iii) *is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 (interpretation of Part 1), or*

(c) *a member of an ineligible group.*

In terms of (a), a 'public company' is any UK incorporated PLC regardless of whether its securities are traded on a market or are privately held.

Ineligible groups

Where an ineligible group is concerned, (i.e. in (c) immediately above), the test of whether a small company is a member of an ineligible group is in a two-way direction (i.e. up and down). It will therefore be necessary to look at the largest group of which the company is a member and consider whether it is ineligible. **This is not the same as the size tests described above**. In the size tests above, it is only necessary to consider the size of the company and, where relevant, any subsidiaries. For ineligible group purposes, a group comprises its parent and its subsidiary undertakings but excludes investments in associates and joint ventures as well as investors which account for the reporting entity as an associate or joint venture.

The term 'undertaking' is defined in s1161 *Meaning of "undertaking" and related expressions* as:

(a) *a body corporate or partnership, or*

(b) *an unincorporated association carrying on a trade or business, with or without a view to profit.*

S1161, Companies Act 2006 (extract)

The term 'body corporate' is not simply a company – the term itself is much broader. For the purposes of the Act, a body corporate includes a company outside of the UK. Where the Act uses the term 'company' this means a company that is incorporated under the Act (or one of its predecessors).

Section 1162 *Parent and subsidiary undertakings*, Companies Act 2006 states that an 'undertaking' is the parent undertaking of another undertaking (a subsidiary undertaking) if any of the following apply:

(a) it holds a majority of the voting rights in the undertaking, or

(b) it is a member of the undertaking and has the right to appoint or remove a majority of its board of directors, or

S1162, Companies Act 2006 (extract)

(c) it has the right to exercise a dominant influence over the undertaking—

(i) by virtue of provisions contained in the undertaking's articles, or

(ii) by virtue of a control contract, or

(d) it is a member of the undertaking and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the undertaking.

In addition, s1162 goes on to state that:

(4) An undertaking is also a parent undertaking in relation to another undertaking, a subsidiary undertaking, if—

S1162, Companies Act 2006 (extract)

(a) it has the power to exercise, or actually exercises, dominant influence or control over it, or

(b) it and the subsidiary undertaking are managed on a unified basis.

(5) A parent undertaking shall be treated as the parent undertaking of undertakings in relation to which any of its subsidiary undertakings are, or are to be treated as, parent undertakings; and references to its subsidiary undertakings shall be construed accordingly.

A group becomes an ineligible group if any of its members is:

(a) a traded company,

Companies Act 2006 sections 384(2) and 467(2)

(b) [For periods commencing on or after 1 January 2021] a body corporate (other than a company) whose shares are admitted to trading on a UK regulated market, or [For periods commencing before 1 January 2021] a body corporate (other than a company) whose shares are admitted to trading on a regulated market in an EEA State,

(c) a person (other than a small company) who has permission under Part 4A of the Financial Services and Markets Act 2000 (c. 8) to carry on a regulated activity,

(cA) *an e-money issuer;*

(d) *a small company that is an authorised insurance company, a banking company, a MiFID investment firm or a UCITS management company, or*

(e) *a person who carries on insurance market activity, or*

(f) *a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 (interpretation of Part 1).*

(a) above refers to a 'traded company'. This was changed from 'a public company' by virtue of *The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015* (SI 2015/980). Section 474 of Companies Act 2006 defines a 'traded company' as:

[For periods commencing on or after 1 January 2021] … unless the context otherwise requires, means a company any of whose transferable securities are admitted to trading on a UK regulated market … [For periods commencing before 1 January 2021] … unless the context otherwise requires, means a company any of whose transferable securities are admitted to trading on a regulated market …

S474, Companies Act 2006

Note, the reference to UK was inserted for periods commencing on or after 1 January 2021.

For periods commencing on or after 1 January 2021, section 1173 goes on to define 'UK regulated market' as follows:

"UK regulated market" has the meaning given in Article 2.1.13A of Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014 and amending Regulation (EU) No. 648/2012

S1173, Companies Act 2006

For periods commencing before 1 January 2021, section 1173 goes on to define 'regulated market' as follows:

"regulated market" has the meaning given in Article 2.1.13 of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 and amending Regulation (EU) No 648/2012.

S1173, Companies Act 2006

The amendments to the Act by virtue of SI 2015/980 narrowed the definition of an ineligible group. In practice it would mean that a private company which individually meets the qualifying conditions for exemptions will not be excluded if it is a member of a group that includes a PLC **unless** that company, or another entity in the group, has transferable securities admitted to trading on a UK regulated market (or for periods commencing before 1 January 2021, a regulated market rather than a UK regulated market).

Example – Subsidiary trades securities

Laggon Ltd is a wholly owned subsidiary of the Caledonian Group. Laggon trades its shares on the Alternative Investment Market (AIM).

AIM is not a UK regulated market and hence Laggon Ltd will **not** be ineligible for exemptions regardless of the size of the group.

If Laggon Ltd were to be trading its shares on the London Stock Exchange (which is a UK regulated market), then this would mean the entire group would be ineligible.

In practice, the effect of being an ineligible group means that exemptions for small and medium-sized companies are unavailable where a group member has shares admitted to trading on a UK regulated market (or for periods commencing before 1 January 2021, a regulated market rather than a UK regulated market).

Keep in mind that where ineligible groups are concerned, a 'group' comprises a parent and its subsidiary undertakings. Where the company is an associate or a joint venture of a company that is either an ineligible company or forms part of an ineligible group, the associate or joint venture company is not, in itself, part of that group.

4.4 Audit exemption

The audit exemption thresholds are the same as those for small companies. Hence small companies can usually claim audit exemption under Section 477 *Small companies: conditions for exemption from audit*. Most small companies do claim audit exemption, although there are some small companies that either have a voluntary audit or are required to have an audit because their articles require, or an audit has been imposed on the small company by financiers.

For periods commencing on or after 1 January 2021, section 479A *Subsidiary companies: conditions for exemption from audit* also provides audit exemption for companies which are subsidiaries whose parent undertaking is established under the law of any part of the UK. There are strict conditions that must be met where s479A is concerned which often means the subsidiary does not take advantage of the audit exemption.

The conditions are as follows:

S479A, Companies Act 2006 (extract)

(a) all members of the company must agree to the exemption in respect of the financial year in question,

(b) the parent undertaking must give a guarantee under section 479C in respect of that year,

(c) *the company must be included in the consolidated accounts drawn up for that year or to an earlier date in that year by the parent undertaking in accordance with—*

(i) *if the undertaking is a company, the requirements of Part 15 of this Act, or, if the undertaking is not a company, the legal requirements which apply to the drawing up of consolidated accounts for that undertaking, or*

(ii) *UK-adopted international accounting standards (within the meaning given by section 474(1)),*

(d) *the parent undertaking must disclose in the notes to the consolidated accounts that the company is exempt from the requirements of this Act relating to the audit of individual accounts by virtue of this section, and*

(e) *the directors of the company must deliver to the registrar on or before the date that they file the accounts for that year—*

(i) *a written notice of the agreement referred to in subsection (2)(a),*

(ii) *the statement referred to in section 479C(1),*

(iii) *a copy of the consolidated accounts referred to in subsection (2)(c),*

(iv) *a copy of the auditor's report on those accounts, and*

(v) *a copy of the consolidated annual report drawn up by parent undertaking.*

In practice, it is the guarantee under s479(c) *Subsidiary companies audit exemption: parent undertaking declaration of guarantee* that is the 'sting in the tail'. The guarantee is that the parent will guarantee the subsidiary's debts until they are satisfied in full. This guarantee will be enforceable against the parent undertaking by any person to whom the subsidiary is liable in respect of those liabilities.

Many parent companies are unwilling to guarantee the debts of their subsidiary and hence audit exemption cannot be taken under s479A. However, where the parent is willing to guarantee the subsidiary's liabilities and complies with the other protocol outlined in s479A, audit exemption can be claimed. In such cases, a statement must be made on the face of the subsidiary's balance sheet that audit exemption under s479A has been claimed.

For periods commencing before 1 January 2021, the s479A audit exemption was wider in scope and, with similar criteria, was available where a UK **or** EEA parent prepared the consolidated accounts and provided the guarantee.

Audit exemption for charities

It must be emphasised that audit exemption thresholds for charities are different than those for companies.

Charities incorporated in England and Wales whose gross income is less than £1million can claim audit exemption provided their gross assets are less than £3.26m. Hence, a charity whose income exceeds £1m **or** whose gross assets exceed £3.26m must have an audit.

For charities based in Scotland, the gross income figure is £500,000 (not £1m).

Where charities are incorporated under company law, then Companies Act audit exemption rules must also apply (see above).

5 ICAEW Practice Assurance Monitoring 2021 (Lecture A757 – 12.05 minutes)

Earlier this year, the ICAEW issued *Maintaining the quality of your practice – Practice Assurance Monitoring 2021* (‘the Report’). This document (available from the ICAEW’s website) outlines the focus of Practice Assurance (PA) monitoring.

Due to Covid-19, PA visits were adapted from onsite visits to online reviews via a secure portal.

The 2020 exercise focussed on firms’ compliance with the requirements of *Professional Conduct in Relation to Taxation* and how these requirements had been embedded into a firm’s processes and procedures. Findings in the Report are limited as PA were only able to review 51 of the largest firms.

5.1 Professional Conduct in Relation to Taxation (PCRT)

PCRT sets out the ethical standards which form the basis of the tripartite relationship between a tax adviser, a client and HMRC. It has been endorsed by HMRC as an acceptable basis for dealings between members and HMRC. Compliance with PCRT is mandatory for ICAEW members (as well as ACCA member firms and other professional bodies who have been involved in its production).

Findings

- The Report confirms that only 82% of firms confirmed that they had read the guidance. Despite this, most firms who had not read it had still been able to demonstrate they were following the guidance, primarily because the PCRT is based on good ethical practice.

- 69% of firms confirmed that they had a formal mechanism for monitoring compliance with PCRT and their own procedures.

- 96% of firms were found to tailor their letters of engagement to ensure that it sets out the scope of tax planning and compliance services.

- 90% of the firms inspected were found to only allow tax planning advice to be provided to clients only by authorised individuals.

- 98% of firms ensure that principals and staff undertake tax training which is conducive to the work they carry out.

- 96% of firms had procedures in place to monitor business or family connections with clients.

- Only 10% of firms in the sample receive commissions or referral fees relating to tax work and 16% pay referral fees for tax work referred to them.

- All firms in the sample confirmed they had obtained and retained evidence of the client's approval of tax returns, but 29% make filings which are not reviewed by the client (these relate to returns such as VAT and RTI returns). In these instances, the engagement letter makes it clear that filings will be based on the information provided by the client and that the client is responsible.

- 18% of firms did not have a procedure in place where a client is reluctant to disclose an error in a tax return. 41% told ICAEW that they had occasions where they could not resolve a disagreement with a client about making full disclosure to HMRC, although these instances were rare.

- Less than 30% of the firms in the sample were involved in complex tax planning and they had procedures in place to consider the potential application of GAAR, requirements for disclosure of tax avoidance schemes and the strength of legal interpretation relied on and the risk of challenge by HMRC.

Room for improvement

Out of the above findings, the following have been highlighted as room for improvement:

- That only 82% of firms had read the PCRT guidance.

- That only 69% of firms had a formal mechanism for monitoring compliance with PCRT and their own procedures.

- That 18% of firms did not have a documented procedure to follow where a client is reluctant to disclose an error.

5.2 Referrals to Practice Assurance Committee (PAC)

The Report confirms that 34 reports to PAC were made in 2020. The Report provides some reasons for committee reports as follows:

- 16 firms failed to address issued referred to them at their previous visits in respect of their approach to Anti-Money Laundering Regulations and six of these firms were found to have repeat issues from the previous visit. These repeat failings included failing to inform clients of the basis of fees and the firm's complaints procedure. One firm was referred to the Professional Conduct Department and 13 firms were given penalties of between £700 and £2,000 by PAC.

- Seven firms had used the designation *Chartered Accountants* when they were not permitted to do so.

- Two cases related to being in public practice without a practising certificate or PII.

- One firm was making regulated referrals for investment business advice to restricted advisors without a DPB licence.

- Other factors included a lack of co-operation, signing an independent examination report when the client required an audit and providing self-insured tax protection schemes.

The Report recommends that all firms review the points raised in their last PA review and ensure they have taken action to address all the issues raised.

5.3 Future areas of focus

The Report confirms that the ICAEW's focus for onsite and remote visits are assurance and other reports, including:

- SRA Accounts Rules
- Independent examination of charities
- Assurance reports on client assets to the FCA
- Service charge accounts

The Report confirms that PA will review the procedures which the firm has in place to carry out and record work on these assignments, training of staff and the monitoring of work completed.

6 Audit monitoring (Lecture A758 – 6.32 minutes)

On 23 July 2021, the Financial Reporting Council (FRC) issued their Annual Audit Quality Inspection Results for 2020/21. While these inspection results focus on public interest and listed entity audits, many of the findings can be applied to private entity audits to assist audit firms in maintaining audit quality.

The findings showed some improvement on the 2019/20 results, but Sir John Thompson (FRC CEO) commented that this improvement was marginal and significant change still needs to happen to meaningfully improve audit quality.

As many delegates will be aware, audit quality has been at the forefront of the profession's headlines over recent years. It was the subject of the Brydon review in 2019 and the FRC are implementing measures to address those deficiencies. In addition, Sir John Kingman's review into the operational structure of the FRC resulted in various recommendations which the FRC are implementing such as:

- Initiating operational separation of the 'Big Four' firms
- Introducing enhanced auditing standards in relation to ethics and fraud
- Building on the FRC's supervisory oversight
- Strengthening the FRC's enforcement capability

The FRC reviewed 103 audits. Out of these, 29% (2019/20: 33%) required improvement or significant improvement. 71% (2019/20: 67%) were assessed to be of a good standard or requiring only limited improvement.

Notably, KPMG came out the worst. The FRC lambasted the Big Four firm and said that it was unacceptable that, for the third year running, the FRC found improvements were required to KPMG's audits of banks and similar entities. In light of the systemic importance of banks and the UK economy, the FRC will be closely monitoring KPMG's actions to ensure findings are addressed in a timely manner. KPMG has agreed additional improvement activities which are to be delivered this year over and above its existing audit quality improvement plan.

BDO and Mazars were also required to put in place additional measures to support high quality audit as they continue to grow.

6.1 FRC findings overview

The FRC inspected seven firms as follows:

- BDO
- Deloitte
- EY

- Grant Thornton
- KPMG
- Mazars
- PwC

The FRC found recurring findings in relation to the audit of revenue, impairment of assets and group audit oversight. The FRC confirmed they had mixed findings in respect of the effective challenge of management of audited entities, with some examples of good practice being demonstrated but this was not on a consistent basis.

BDO

The individual findings of the audits performed by BDO include the following:

- Urgently improve the quality of the firm's audit of revenue
- Improve audit teams' understanding and assessment of significant and presumed fraud risks, together with the required audit response
- Improve, as a matter of urgency, the challenge and testing of estimates and assumptions in key areas of judgement
- Strengthen the audit work performed over the existence and valuation of assets within defined benefit pension balances
- Implement enhancements to improve audit quality in response to other issues driving lower audit quality assessments

Deloitte

- Improve the evaluation and challenge of management's key assumptions of impairment assessments of goodwill and other assets
- Enhance the consistency of group audit team's oversight of component audit teams
- Strengthen the effectiveness and consistency of the testing of revenue

EY

- Enhance the evaluation or challenge of aspects of management's impairment and going concern assessments
- Strengthen the testing or evidence over aspects of the assessment of the expected credit loss allowance
- Enhance the evidence and justification for the recoverability of deferred tax assets

Grant Thornton

- Improve the challenge and corroboration of key judgements and estimates

KPMG

- Urgently and comprehensively address the continuing deficiencies in the quality of audit work on banks and similar entities
- Improve the quality of the firm's audit work on certain areas of revenue
- Enhance the evaluation and challenge of management's impairment assessment for tangible and intangible non-current assets
- Implement enhancements to improve audit quality in response to other issues driving lower audit quality assessments

Mazars

- Improve the challenge of management's impairment assessments in relation to goodwill and other assets
- Strengthen the quality and effectiveness of audit work on revenue
- Enhance the oversight of component audit teams by the group auditor
- Take further steps to strengthen the quality of audit work on areas of judgement, including ECL

PwC

- Improve the evaluation of aspects of management's impairment and going concern assessments
- Enhance the testing for the valuation of certain pension assets
- Improve the audit procedures for the residual journal population in response to the risk of management override

7 New quality management standards issued (Lecture A759 – 23.53 minutes)

In July 2021, the Financial Reporting Council (FRC) published two new standards on quality management:

- ISQM (UK) 1 *(Previously International Standard on Quality Control (UK) 1 (Revised June 2016) Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements*; and

- ISQM (UK) 2 *Engagement quality reviews*

- ISA (UK) 220 (Revised July 2021) *Quality Control for an Audit of Financial Statements*

As noted in the title of ISQM (UK) 1, this standard supersedes the current ISQC (UK) 1. Key changes from ISQC (UK) 1 include:

- A more proactive and tailored approach to managing quality which is focused on achieving quality objectives by identifying risks to those objectives and developing responses to those risks.

- Enhanced requirements to address the firm's governance and leadership, including increased leadership responsibilities.

- Expanded requirements which aim to modernise the standard and reflect factors which affect the firm's environment, including requirements to address technology, networks and the user of external service providers.

- New requirements that address information and communication, including communication with external parties.

- Enhanced requirements for monitoring and remediation to promote more proactive monitoring of the system of quality management as a whole and effective and timely remediation of deficiencies.

Both ISQMs are mostly effective for periods beginning on or after 15 December 2022 and while this may seem quite a long time away, it is important that firms do start to consider the impact that ISQMs 1 and 2 will have on their audit work. ISQM 1 requires the systems of quality management to be designed and implemented by 15 December 2022.

Essentially, by 15 December 2022 the firm must have:

- Established the quality objectives, identify and assess the quality risks and design and implement appropriate responses; and

- Design and implement the monitoring activities.

The requirements surrounding the evaluation of the quality management system is required to be performed within one year following 15 December 2022.

The ISQM (UK) is mandatory for audits of financial statements for periods beginning on or after 15 December 2022 onwards, but early adoption of the revised standards is, according to the FRC, *strongly encouraged*. If the ISQM (UK) is early adopted, the audit firm must also adopt all three quality management standards at the same time (i.e. ISQM (UK) 1, ISQM (UK) 2 and ISA (UK) 220 (Revised July 2021)).

In practice, early adoption of all three standards is not expected to be widespread. This is because audit firms will need quite a long time to digest the new requirements as well as allowing sufficient time in order to change quality management processes to cater for the new requirements. However, audit firms will need to appreciate that these new standards bring about significant change and therefore sufficient planning will need to be carried out.

There is a close interaction between ISQMs (UK) 1 and 2 and that of ISA (UK) 220 (Revised July 2021) *Quality Management for an Audit of Financial Statements* so the ISQM (UK) should be read in conjunction with that ISA (UK). A summary of these interactions is as follows:

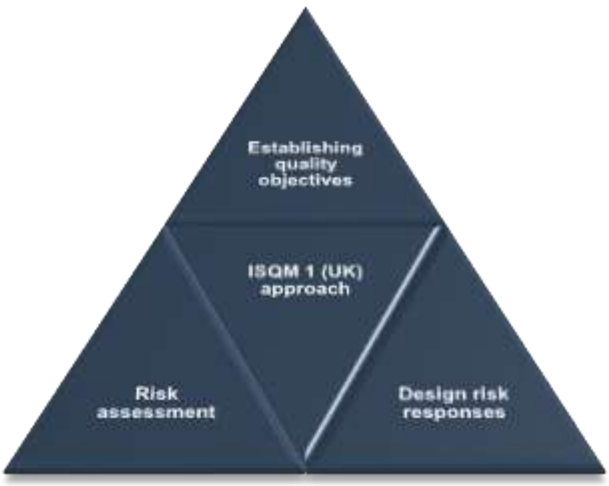
ISQM (UK) 1	ISQM (UK) 2	ISA (UK) 220 (Revised July 2021)
ISQM (UK) 1 requires the firm to design, implement and operate a system of quality management to management the quality of engagements carried out by the firm. The system of quality management creates an environment which enables and supports engagement teams in performing quality engagements.	Engagement quality reviews form part of an entity's system of quality management. ISQM (UK) 2 builds on ISQM (UK) 1 by including specific requirements for: • The appointment and eligibility of the engagement quality reviewer; • The performance of the engagement quality review; and • The documentation of the engagement quality review.	ISA (UK) 220 deals with the responsibilities of the auditor concerning quality management at the engagement level, and the related responsibilities of the engagement partner.

Over the forthcoming quarters, the Audit and Accounting Quarterly Updates will consider each component of ISQM (UK) 1 separately as there are eight components of a system of quality management according to the ISQM (UK) as follows:

- The firm's risk assessment process
- Governance and leadership
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Engagement performance
- Resources
- Information and communication
- The monitoring and remediation process

In this quarter, we will examine how the firm establishes quality objectives.

The ISQM (UK) takes a risk-based approach (primarily because auditing has evolved over the years to be risk-based). There are three components to this approach:



Establishing quality objectives

ISQM (UK) 1 clarifies that the quality objectives established by the audit firm consist of objectives in relation to the components of the system of quality management which are to be achieved by the firm.

There is no 'one-size-fits-all' where the establishment of quality objectives is concerned, and this will vary from firm to firm. Essentially, it is established by the nature and circumstances of the firm, including how the firm is structured and organised.

A system of quality management is effective when it achieves its objectives. ISQM (UK) 1 states:

The objective of the firm is to design, implement and operate a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements performed by the firm, that provides the firm with reasonable assurance that: *ISQM (UK) 1, para 14*

(a) The firm and its personnel fulfil their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements with such standards and requirements; and

(b) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.

These are high-level objectives and consequently, ISQM (UK) 1 contains more specific quality objectives for the various components of the system of quality control so that it is clear what outcomes need to be achieved by the firm in order to have an effective system of quality management. These are the eight components listed above (the firm's risk assessment process, governance and leadership, relevant ethical requirements etc.).

The quality objectives in each component help the firm in properly identifying and assessing quality risks because the quality objectives focus the firm more specifically on what needs to be achieved and what could go wrong in achieving quality objectives.

The firm will be required to establish the quality objectives specific for each component. However, ISQM (UK) 1 recognises situations when a quality objective, or an aspect thereof, is *not* relevant to the firm because of the nature and circumstances of the firm or its engagements.

Example – Sole practitioner with two audit clients

Lisa is a sole practitioner and has two audit clients which are private limited companies. Lisa has been considering how ISQM (UK) 1 is going to impact her practice and is concerned about paragraph 31(b) of the standard which states:

The firm shall establish the following quality objectives that address the performance of quality engagements:

(b) The nature, timing and extent of direction and supervision of engagement teams and review of the work performed is appropriate based on the nature and circumstances of the engagements and the resources assigned or made available to the engagement teams, and the work performed by less experienced engagement team members is directed, supervised and reviewed by more experienced engagement team members.

Lisa's concern is that as she is a sole practitioner, she will not be able to fully comply with the ISQM (UK) 1, para 31(b) requirement.

The standard takes a risk-based approach and so there may be circumstances when a quality objective, or part thereof, is not relevant to an audit firm due to the nature and circumstances of the firm and/or the engagement. In this example, paragraph 31(b) which addresses direction, supervision and review is likely to be irrelevant to a sole practitioner.

The standard does set out some comprehensive requirements and it is important that the firm does consider its quality objectives carefully in line with the requirements of the ISQM (UK).

Example – Partially developed objective

An audit firm's quality objective in respect of difficult and/or contentious matters is as follows:

> *Consultation on difficult or contentious matters is undertaken.*

This is an example of an incomplete quality objective because it only meets certain requirements of ISQM 1 (UK), para 31(d) which states:

> *Consultation on difficult or contentious matters is undertaken and the conclusions agreed are implemented.*

To achieve the quality objective in paragraph 31(d), the firm will need to expand on its quality objective.

Care also needs to be taken not to simply change ISQ**C** (UK) 1 to ISQ**M** (UK) 1 because there are significant differences between the two quality management standards and if a 'find and replace' exercise is carried out it is unlikely the requirements of ISQM (UK) 1 will be met.

Example – Key objective missed

An audit firm's quality objective for retention of audit documentation is as follows:

> *The audit firm assembles audit documentation no later than 60 days from the date of the auditor's report on the engagement and it will be retained for a minimum of six years from the auditor's report or, if later, the date of the auditor's report on the group financial statements (if applicable).*

There are two problems with this quality objective:

- ISQM (UK) 1, para 31(f) specifically requires the audit firm to ensure the audit documentation is **appropriately maintained**. The above quality objective does not mention how this is achieved.
- The above quality objective does not take into consideration that the retention period of six years may need to change as a result of changes within the firm, law, regulation, ethical standards or professional standards.

The quality objectives outlined in ISQM (UK) 1 are not conclusive and in recognition of the fact that firms' circumstances will vary, additional quality objectives may be needed. ISQM (UK) 1, para A42 recognises that law, regulation or professional standards may establish requirements which give rise to additional quality objectives and cites an example of a firm which may be required by law or regulation to appoint non-executive individuals to the firm's governance structure and the firm considers it necessary to establish additional quality objectives to address these requirements.

In addition, it should be noted that quality objectives, if achieved, collectively achieve the objectives of the firm's system of quality management. Hence, the quality objectives across the components are both interrelated and interdependent. For example, an objective in one component may overlap, be related to, support or be supported by a quality objective in another component.

Illustration

Two of the eight components of a system of quality management are:

- Relevant ethical requirements
- Information and communication

The quality objectives in the information and communication component address the information system, communication and exchange of information throughout the firm and with the engagement teams. These quality objectives are crucial in supporting the quality objectives in the relevant ethical requirements components because appropriate information which is communicated on a timely basis is essential to properly fulfilling the relevant ethical requirements.

8 ISA (UK) 220 (Revised July 2021) (Lecture A760 – 6.26 minutes)

In July 2021, the FRC issued a revised ISA (UK) 220 *Quality Management for an Audit of Financial Statements*. ISA (UK) 220 (Revised July 2021) is effective for audits of financial statements for periods commencing on or after 15 December 2022.

Significant revisions have taken place within ISA (UK) 220 which clarifies and strengthens the key elements of quality management at the engagement level. It includes a clear description of the audit engagement partner's responsibilities and how the engagement team, as a whole, manages and achieves audit quality. In addition, there is increased focus on taking into account the nature and circumstances of the audit engagement in managing quality at the engagement level.

8.1 Summary of the main changes to ISA (UK) 220

A summary of the main changes to ISA (UK) 220 which take effect for audits of financial statements for periods commencing on or after 15 December 2022 are as follows:

ISQC (UK) 1 to ISQM (UK) 1

References to ISQC (UK) 1 have been changed to ISQM (UK) 1 and paragraph 2(a) has been changed to include a requirement that the firm conducts engagement in accordance with such standards and requirements as opposed to just professional standards and applicable legal and regulatory requirements.

Extended material relating to the system of quality management and engagement teams

There is significantly more material dealing with the firm's system of quality management and the role of engagement teams.

ISA (UK) 220, para 4 is significantly longer than its predecessor and states:

> *The engagement team, led by the engagement partner, is responsible, within the context of the firm's system of quality management and through complying with the requirements of this ISA (UK), for:*

ISA (UK) 220 (Revised July 2021), para 4

> *(a) Implementing the firm's responses to quality risks (i.e., the firm's policies or procedures) that are applicable to the audit engagement using information communicated by, or obtained from, the firm;*
>
> *(b) Given the nature and circumstances of the audit engagement, determining whether to design and implement responses at the engagement level beyond those in the firm's policies or procedures; and*
>
> *(c) Communicating to the firm information from the audit engagement that is required to be communicated by the firm's policies or procedures to support the design, implementation and operation of the firm's system of quality management.*

ISA (UK) 220 (Revised July 2021), para 6 confirms that a quality audit engagement is achieved through planning and performing the engagement and reporting on it in accordance with professional standards and applicable legal and regulatory requirements.

The paragraph also confirms that achieving the objectives of those standards and complying with the requirements of applicable law or regulation involves exercising professional judgement and exercising professional scepticism.

ISA (UK) 220 (Revised) para 7 confirms that the engagement team is required to plan and perform the audit with professional scepticism and exercise professional judgement.

Scalability

There is a new requirement in ISA (UK) 220 (Revised), para 8 which refers to scalability. Scalability means that the requirements of ISA (UK) 220 (Revised) are intended to be applied in the context of the nature and circumstances of each audit and cites two example situations as follows:

(a) When an audit is carried out entirely by the engagement partner, which may be the case of a less complex entity, some requirements in this ISA (UK) are not relevant because they are conditional on the involvement of other members of the engagement team. (Ref: Para. A13-A14)

ISA (UK) 220 (Revised), para 8 (extract)

(b) When an audit is not carried out entirely by the engagement partner or in an audit of an entity whose nature and circumstances are more complex, the engagement partner may assign the design or performance of some procedures, tasks or actions to other members of the engagement team.

Engagement partner responsibilities

ISA (UK) 220, para 9 specifically outlines the audit partner's responsibilities as follows:

The engagement partner remains ultimately responsible, and therefore accountable, for compliance with the requirements of this ISA (UK). The term "engagement partner shall take responsibility for …" is used for those requirements that the engagement partner is permitted to assign the design or performance of procedures, tasks or actions to appropriately skilled or suitably experienced members of the engagement team. For other requirements, this ISA (UK) expressly intends that the requirement or responsibility to be fulfilled by the engagement partner and the engagement partner may obtain information from the firm or other members of the engagement team.

ISA (UK) 220 (Revised), para 9

Objective

The objective of ISA (UK) 220 (Revised) is for the auditor to manage **quality** at the engagement level as opposed to implementing quality control procedures at the engagement level. This objective is to ensure that the auditor has fulfilled their responsibilities, and has conducted the audit, in accordance with professional standards and applicable legal and regulatory requirements. The previous edition of the ISA (UK) required the auditor to obtain reasonable assurance that the audit complies with professional standards and applicable legal and regulatory requirements.

Definitions

Some defined terms have changed in ISA (UK) 220 (Revised) and some have been removed. Those which have been removed are:

- Inspection
- Key audit partner
- Listed entity
- Monitoring
- Public interest entity
- Staff
- Suitably qualified external person

The term 'response' has been defined in ISA (UK) 220 (Revised) as:

> *Policies or procedures designed and implemented by the firm to address one or more quality risk(s):*
>
> *(i) Policies are statements of what should, or should not, be done to address a quality risk(s). Such statements may be documented, explicitly stated in communications or implied through actions and decisions.*
>
> *(ii) Procedures are actions to implement policies.*

ISA (UK) 220, para 12(l) extract

Leadership responsibilities for managing and achieving quality on audits

Leadership responsibilities for managing and achieving quality on audits is dealt with in ISA (UK) 220 (Revised), para 13 (rather than para 8 as in the predecessor edition). These responsibilities have been significantly enhanced.

Among other things, ISA (UK) 220 (Revised) requires the audit engagement partner to take responsibility for creating an environment for the engagement which emphasises the firm's culture and expected behaviour of engagement team members. It requires the engagement partner to be sufficiently and appropriately involved in the audit such that the engagement partner has the basis for determining whether the significant judgements made, and the conclusions reached, are appropriate given the nature and circumstances of the engagement.

To that end, paragraph 14 requires the engagement partner to take such actions as determined necessary and emphasise:

> *(a) That all engagement team members are responsible for contributing to the management and achievement of quality at the engagement level;*
>
> *(b) The importance of professional ethics, values and attitudes to the members of the engagement team;*

ISA (UK) 220, para 14 (extract)

(c) *The importance of open and robust communication within the engagement team, and supporting the ability of engagement team members to raise concerns without fear of reprisal; and*

(d) *The importance of each engagement team member exercising professional skepticism throughout the audit engagement.*

Relevant ethical requirements

There are now six paragraphs of requirements in ISA (UK) 220 (Revised) as opposed to just two in the predecessor edition. ISA (UK) 220 (Revised) combines the independence requirements with the relevant ethical requirements rather than having it as a separate sub-requirement.

The effects of the changes to this section of the ISA (UK 220 (Revised) makes the requirements clearer and more succinct as well as expanding on the engagement partner's responsibilities, including, among other things:

- Taking responsibility in ensuring other members of the engagement team have been made aware of the relevant ethical requirements applicable given the nature and circumstances of the audit engagement, including the firm's related policies or procedures.
- Remaining alert throughout the audit assignment, through observation and enquiry as necessary, for breaches of relevant ethical requirements or the firm's related policies or procedures by members of the engagement team.
- Taking appropriate action where matters come to the engagement partner's attention via the system of quality management (or other sources) which indicate that relevant ethical requirements applicable to the nature and circumstances of the audit engagement have not been fulfilled.
- Prior to signing the auditor's report, the engagement partner must take responsibility for determining whether ethical requirements, including those related to independence, have been fulfilled.

Acceptance and continuance of client relationships and audit engagements

There is an additional requirement in ISA (UK) 220 (Revised), para 23 which requires the engagement partner to take into account information obtained in the acceptance and continuance process in planning and performing the audit engagement in accordance with the ISAs (UK) and complying with the requirements of ISA (UK) 220 (Revised).

Engagement resources

This section has been renamed (it was under the 'Assignment of Engagement Teams' section in the predecessor ISA (UK) 220) and there are enhanced requirements in ISA (UK) 220 (Revised).

The audit engagement partner is responsible for ensuring that the engagement team have been provided with sufficient and appropriate resources to perform the engagement in a timely manner. This includes ensuring that any external experts and internal audit who are not part of the engagement team also have the appropriate competence and capabilities, including sufficient time, to perform the engagement.

If the engagement partner determines that the resources are insufficient or inappropriate, they must take appropriate action. In addition, the audit engagement partner must also take responsibility for using the resources assigned or made available to the team appropriately, given the nature and circumstances of the audit engagement.

Engagement performance

There are enhanced requirements where engagement performance is concerned. Among other things, the audit engagement partner is responsible for ensuring that the nature, timing and extent of direction, supervision and review is responsive to the nature and circumstances of the audit engagement and the resources assigned or made available to the engagement team.

The audit engagement partner must also review audit documentation at appropriate times during the course of the audit, including documentation relating to:

- Significant matters
- Significant judgements, including those relating to difficult or contentious matters and the conclusions reached
- Other matters that, in the partner’s professional judgement, are relevant to the partner’s responsibilities

ISA (UK) 220 (Revised), para 33 requires that prior to dating the auditor’s report, the engagement partner must review the financial statements (including the description of Key Audit Matters[2], if applicable) and related audit documentation to determine that the report to be issued will be appropriate in the circumstances.

Paragraph 34 requires the audit engagement partner to review (prior to their issuance), formal written communications to management, those charged with governance or regulatory authorities.

Consultation

The consultation requirements of ISA (UK) 220 (Revised) are broadly consistent with the predecessor edition. However, while the audit engagement partner must continue to take responsibility for the engagement team undertaking consultation on difficult or

[2] See ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor’s Report* which is mandatory for listed entities.

contentious matters, the revised standard requires them to be those matters on which the firm's policies or procedures require consultation as well as those other matters which, in the partner's professional judgement, require consultation.

Engagement quality review

The title of this sub-section has been changed from 'Engagement quality control review'.

There is an additional requirement in ISA (UK) 220 (Revised), para 36(b) requiring the audit engagement partner to co-operate with the engagement quality reviewer and inform other members of the engagement of their responsibility to do so.

Most notably, this section of ISA (UK) 220 (Revised) has been reduced, rather than expanded. This is because there is no longer a section on 'Engagement Quality Control Review' as this has effectively been embedded into the requirements of ISQM (UK) 2.

Where differences of opinion arise, the engagement partner has additional responsibilities. In this respect, the engagement partner must

(a) Take responsibility for the differences of opinion being addressed and resolved in accordance with the firm's policies or procedures.

(b) Determine that the conclusions reached are documented and implemented.

(c) Not date the auditor's report until any differences of opinion are resolved.

Monitoring and remediation

This sub-section of ISA (UK) 220 (Revised) was previously titled 'Monitoring'. Under the revised ISA (UK), the audit engagement partner must take responsibility for:

(a) Obtaining an understanding of the information from the firm's monitoring and remediation process, as communicated by the firm including, as applicable, the information from the monitoring and remediation process of the network and across the network firms;

(b) Determining the relevance and effect on the audit engagement of the information referred to in paragraph 39(a) and take appropriate action; and

(c) Remaining alert throughout the audit engagement for information that may be relevant to the firm's monitoring and remediation process and communicate such information to those responsible for the process.

ISA (UK) 220 (Revised), para 39 (extract)

Taking overall responsibility for managing and achieving quality

An additional sub-section has been included in ISA (UK) 220 (Revised) outlining the audit engagement partner's responsibility for managing and achieving quality. ISA (UK) 220 (Revised), para 40 states:

Prior to dating the auditor's report, the engagement partner shall determine that the engagement partner has taken overall responsibility for managing and achieving quality on the audit engagement. In doing so, the engagement partner shall determine that:

ISA (UK) 220, para 40

(a) The engagement partner's involvement has been sufficient and appropriate throughout the audit engagement such that the engagement partner has the basis for determining that the significant judgments made and the conclusions reached are appropriate given the nature and circumstances of the engagement; and

(b) The nature and circumstances of the audit engagement, any changes thereto, and the firm's related policies or procedures have been taken into account in complying with the requirements of this ISA (UK).

Documentation

Documentation requirements are outlined in paragraph 41 of ISA (UK) 220 (Revised). Again, this section is notably shorter than the predecessor version of the standard because the quality control reviewer requirements have been moved into ISQM 2.

The audit documentation must contain:

(a) *Matters identified, relevant discussions with personnel, and conclusions reached with respect to:*

(i) *Fulfilment of responsibilities relating to relevant ethical requirements, including those related to independence.*

(ii) *The acceptance and continuance of the client relationship and audit engagement.*

(b) *The nature and scope of, and conclusions resulting from, consultations undertaken during the audit engagement and how such conclusions were implemented.*

(c) *If the audit engagement is subject to an engagement quality review, that the engagement quality review has been completed on or before the date of the auditor's report.*

The auditor must also include all significant threats to the firm's independence together with the safeguards that have been applied to mitigate those threats.

The documentation requirements above are different from the predecessor version of the standard so audit firms must ensure their audit documentation complies with the new requirements once ISA (UK) 220 (Revised) is implemented.

As with the ISQMs, the requirements of ISA (UK) 220 (Revised) must be thoroughly understood by audit firms prior to the mandatory implementation date (or earlier if early adoption has been applied) because the requirements are notably different than the previous edition of the standard.

9 Emphasis of Matter and Other Matter paragraphs (Lecture A761 – 14.54 minutes)

Emphasis of Matter paragraphs (EOM) and Other Matter paragraphs (OM) are dealt with in ISA (UK) 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.* There is often confusion surrounding the appropriateness of an EOM paragraph within the auditor's report.

At the outset, it is worth noting that an EOM paragraph **does not** qualify the auditor's opinion in any way. It merely flags the user to a disclosure note contained within the financial statements that the auditor considers is **fundamentally** important to users' understanding of the financial statements.

9.1 Definitions

There are two definitions contained in ISA (UK) 706, para 7 as follows:

ISA (UK) 706, para 7

(a) Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

(b) Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

9.2 EOM paragraphs

An EOM is used to refer to a matter which has been adequately presented or disclosed in the financial statements by the directors. When the auditor concludes that these matters are of **such fundamental importance** to users' understanding, the auditor draws attention to this matter through an EOM paragraph in their report.

Not every auditor's report will contain an EOM paragraph because not every matter disclosed in the financial statements will be fundamental. What is, and what is not, fundamental will be a matter of professional judgement for the auditor. However, examples of fundamental matters may include the following (note, the list below is not comprehensive):

- the client's financial statements have been prepared on a basis other than the going concern basis;
- there is an uncertainty relating to the future outcome of a legal case or regulatory action;

- a significant post balance sheet event occurs between the balance sheet date and the date of the auditor's report;
- the entity early adopts an accounting standard (or amendment to an accounting standard);
- a major catastrophe has occurred that has had a significant effect on the entity's financial position;
- corresponding figures have been restated; and
- the financial statements have been reissued and the auditor has provided an amended auditor's report.

ISA (UK) 706, para 9 states:

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

ISA (UK) 706, para 9

(a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Example – Incorrect use of an EOM paragraph (1)

The financial statements of Nelson Ltd for the year ended 31 July 2021 contain a disclosure relating to a material uncertainty in respect of going concern. The auditor is satisfied that the going concern disclosure in the financial statements is adequate.

The audit engagement partner considers the going concern disclosure to be fundamental to users' understanding of the financial statements and has included the following:

Emphasis of Matter

We draw your attention to note 20 in the financial statements which confirms the existence of a material uncertainty in respect of going concern. The directors are concerned about the ongoing impact of Covid-19 on the operations of the business. As stated in note 20, these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going *concern. Our opinion is not modified in this respect.*

Under ISA (UK) 570 *Going Concern*, where an entity has **adequately** disclosed a material uncertainty related to going concern, the auditor must not use an EOM paragraph. Instead, they must comply with ISA (UK) 570, para 22 and include a 'Material Uncertainty Related to Going Concern' section in the auditor's report.

Audit firms must keep in mind that an EOM paragraph is only used by the auditor to emphasis a point that has been adequately disclosed in the financial statements. It is not to be used for anything else. The EOM paragraph must cross-refer to the relevant disclosure note in the financial statements (ISA (UK) 706, para 9(b)).

Hence, if adequate disclosure of a material event has not been made in the financial statements, the auditor does not include an EOM paragraph; instead, the auditor's opinion is modified. Where the auditor's opinion is modified, a Basis for Modified Opinion paragraph is included underneath the Opinion paragraph which describes the matter giving rise to the modified opinion.

Example – Incorrect use of an EOM paragraph (2)

The audit of Classique Ltd for the year ended 31 July 2021 revealed a number of misstatements which the auditor has concluded as being immaterial both in isolation and in the aggregate. The directors decided not to adjust the financial statements on the grounds that the misstatements were immaterial.

The audit engagement partner has placed the following comment on the completion section of the audit file:

> *To err on the side of caution, I deem an Emphasis of Matter paragraph to be appropriate in these circumstances. When drafting the auditor's report, I suggest we refer to there being a number of unadjusted misstatements which are immaterial in isolation and in the aggregate and confirm that our opinion is not modified in respect of these misstatements.*

There are four fundamentally flawed points to the partner's logic in including an EOM paragraph within the auditor's report:

- An EOM paragraph can **only** be used when a **matter** has been **adequately disclosed** in the financial statements as the paragraph must cross-refer the user to the relevant disclosure note number.
- In this scenario, there is no disclosure note that can be cross-referred to as the company will not have made any disclosures concerning immaterial

misstatements remaining uncorrected.

- There is no need to include an EOM paragraph in the auditor's report in respect of immaterial misstatements because the mere fact that they are immaterial means they do not warrant the attention of shareholders.
- There would be no need to confirm that the audit opinion is not modified in respect of immaterial misstatements as an auditor's opinion would **never** be qualified for misstatements that are immaterial in isolation and in the aggregate.

Example – Post balance sheet event

The audit of the financial statements of Crusader Ltd for the year ended 31 July 2021 has drawn to a close and the auditor's report is being drafted. During the audit the audit senior discovered that one of the client's bonded warehouses had suffered a fire that had destroyed a large amount of the client's inventory. The fire occurred in mid-August 2021 and hence the inventory has not been written down to estimated selling price in the 31 July 2021 financial statements as the event is a non-adjusting post balance sheet event. The auditor has concluded that adequate disclosure has been made in the financial statements concerning this event and the event is fundamental to the users' understanding.

In this scenario, an EOM paragraph would be appropriate and may be drafted as follows:

Emphasis of Matter

We draw attention to note 34 of the financial statements, which describes the effects of a fire at the premises of a third party warehouse provider. Our opinion is not modified in respect of this matter.

9.3 Placement of the EOM within the auditor's report

ISA (UK) 706, para A16 states that the placement of an EOM paragraph will depend on the nature of the information to be communicated and the auditor's judgement as to the relative significance of such information to intended users compared to other elements required to be reported in accordance with ISA (UK) 700 *Forming an Opinion and Reporting on Financial Statements*.

In practice, it is common to include an EOM paragraph immediately after the Opinion paragraph.

9.4 EOM and Key Audit Matters (KAM)

For entities which are required, or choose to include a KAM section within the auditor's report under ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report*, the use of an EOM paragraph is **not** a substitute for a description of individual KAMs.

It may be the case that the auditor concludes that some matters which are KAMs may also be fundamental to users' understanding of the financial statements. Hence, a KAM can also satisfy the requirements of ISA (UK) 706 where an EOM paragraph may also be considered.

To do this, the auditor may consider highlighting or drawing further attention to its importance. This can be achieved by presenting the KAM more prominently (e.g. as the first KAM, or by including additional information which indicates how fundamental the matter is to users' understanding of the financial statements).

Example – Restructuring post-year end

The audit of the financial statements of Horizon PLC for the year ended 31 July 2021 is complete and the auditor's report is being drafted.

During the audit, the audit team were made aware of a significant restructuring that was communicated to staff members during the first week of August 2021. Disclosure as a non-adjusting post balance sheet event has been made and the auditor is satisfied this disclosure is adequate.

The restructuring did not require significant auditor effort and hence was not considered to be a KAM. However, in the engagement partner's opinion, the matter is fundamental to users' understanding of the financial statements.

In this scenario, an EOM paragraph would be appropriate, but it must be included in the auditor's either directly before or after the KAMs section – it cannot be included within the KAMs section of the auditor's report. Where it is presented is based on the auditor's judgement as to the relative significance of the information included in the EOM paragraph.

9.5 Other Matter (OM) paragraphs

When the auditor considers it necessary to communicate matters, other than those which are presented or disclosed in the financial statements which, in the auditor's judgement, are relevant to users' understanding of the financial statements, the auditor includes an OM paragraph in the auditor's report. Care must be taken to ensure correct application in the financial statements because an OM paragraph cannot be included in the auditor's report if:

- it is prohibited by law or regulation; and
- the company is a listed entity, applying ISA (UK) 701, and the matter has been included as a Key Audit Matter.

Example – OM paragraph

The group auditor of Bamber Group PLC (a PIE) includes an OM paragraph in the auditor's report for the year ended 31 July 2021 confirming that the audit firm has not carried out any non-audit services which are prohibited by the FRC's Ethical Standard as follows:

Other matters which we are required to address

We were appointed by Bamber Group PLC on 1 August 2020 to audit the financial statements for the year ended 31 July 2021. Our total uninterrupted period of engagement is three years, covering the periods ending 31 July 2018 to 31 July 2021.

The non-audit services prohibited by the FRC's Ethical Standard were not provided to the group or the parent company and we remain independent of the group and the parent company in conducting our audit.

Our audit opinion is consistent with the additional report to the audit committee.

Generally, OM paragraphs are included in the auditor's report if the auditor considers it necessary to communicate matters which are not presented or disclosed in the financial statements, but which are, in the auditor's judgement, relevant to an understanding of the audit, the auditor's responsibilities or the auditor's report.

Example of such matters include:

- Where prior period financial statements are not audited as required by ISA (UK) 710, para 14.
- Communication of audit planning and scoping matters where law or regulation require (in the UK, ISA (UK) 701, para 16-1 must be complied with).
- Explaining why the auditor has not resigned when a pervasive inability to obtain sufficient appropriate audit evidence is imposed by management and the auditor is unable to withdraw from the engagement due to legal restrictions.
- When law, regulation or generally accepted practice requires, or allows, the auditor to provide a further explanation of their responsibilities.

10 Auditing assets measured at revaluation (Lecture A762 - 12.56 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with property, plant and equipment under Section 17 *Property, Plant and Equipment*. This section requires an entity to initially recognise all items of property, plant and equipment (PPE) at cost. Cost includes the purchase price of the asset plus all directly attributable costs, such as irrecoverable taxes, freight costs and installation costs.

After initial recognition at cost, Section 17 allows the entity an accounting policy choice of measuring the item of PPE under the cost model (cost less depreciation less impairment) or the revaluation model. The distinct advantage of measuring items of PPE under the revaluation model is that the balance sheet can recognise increases in the asset's valuation and hence can serve to boost the balance sheet. In practice the most common type of asset to be measured under the revaluation model is a building.

Auditors should exercise caution where assets are measured under the revaluation model because often clients are reluctant to recognise any revaluation decreases which may result in assets being materially overstated in the financial statements.

An important point to emphasise is that where a client wishes to subject an item of PPE to the revaluation model, it must ensure that **all assets within that asset class** are subject to revaluation at the same time. This is to stop an entity from simply revaluing assets that have appreciated in value whilst ignoring those which may have decreased in value.

Auditors must ensure that where a client has carried out a revaluation exercise during the reporting period, that they have revalued all assets within that asset class. For clarity, the term 'class of assets' is defined as:

> *A grouping of **assets** of a similar nature and use in an entity's operations.*

*FRS 102, Glossary **class of assets***

10.1 Revaluation frequency

A notable problem for both auditors and clients is the fact that FRS 102 is not as specific in its requirements in terms of how often a revaluation exercise should be carried out. FRS 102, para 17.15B states that revaluations must be made with **sufficient regularity** to ensure that the carrying amount of the asset does not differ materially from that which would be determined using fair value at the balance sheet date.

Of course, this is going to involve professional judgement on behalf of the audit client in determining, at the balance sheet date, whether the carrying amount of the revalued asset does differ materially from its fair value. Auditors must also consider whether an asset being measured under the revaluation model is fairly stated in the balance sheet at the reporting date and this will also involve the auditor carrying out audit procedures to determine whether this is the case.

Auditors must also keep in mind that assets such as commercial and residential properties can experience volatile movements in their fair value – especially in light of the Covid-19 pandemic. As noted above, clients are sometimes reluctant to recognise revaluation decreases and hence this gives rise to a risk of material misstatement, especially where asset values have declined in the year.

10.2 Auditing the revalued asset

Auditors may need to have regard to ISA (UK) 500 (Revised January 2020) *Audit Evidence* where items of PPE have been revalued by a management's expert.

FRS 102, para 17.15C does say that the fair value of land and buildings is usually determined from market-based evidence by appraisal which is normally undertaken by **professionally qualified valuers**. The section does not, however, stipulate that professionally qualified valuers **must** (or **shall**) be used to value items of PPE. FRS 102's relaxed approach as to who may carry out the valuation suggests that an internal valuer could perform the valuation. However, this will cause issues for the auditor in the terms of independence (as internal valuations are clearly not independent) and this will also increase the risk of material misstatement (and potential use of management bias so a higher degree of professional scepticism must be applied in this respect).

Auditors must be prepared to challenge internal valuations and adequately document the work they have done in this area. A lack of management challenge is frequently cited by professional bodies and file reviewers as one of the main reasons why audits are deficient.

As noted above, if an internal valuation is carried out, the valuation will, of course, not be independent. The auditor must consider this as a risk of material misstatement and devise audit procedures to address this risk. In some cases, the auditor may deem it appropriate to obtain their own independent valuation to provide sufficient appropriate audit evidence as to the accuracy of the carrying amount in the financial statements. In this instance, auditors will need to have regard to ISA (UK) 620 (Revised November 2019) *Using the Work of an Auditor's Expert*.

Further audit procedures must include:

- Inspecting valuation reports and agreeing the amount included in the nominal ledger and the financial statements. Also assessing management's expert through:
    - Evaluating competencies, capabilities and objectivity of management's expert (e.g. whether the expert's work is subject to technical performance standards or other professional or industry requirements);
    - Obtaining an understanding of the work of that expert (e.g. evaluating the engagement letter between the expert and the entity); and

  - Evaluating the appropriateness of that expert's work as audit evidence for the relevant assertion (e.g. considering the relevance and reasonableness of assumptions used or sources of underlying data).

- Reviewing all other assets in the asset class to ensure they, too, have also been subject to revaluation at the same time.

- Performing a recalculation of the balance on the revaluation reserve for each asset subject to revaluation to ensure that gains/losses of other assets have not been offset against each other (a gain or loss of one revalued asset cannot be offset against a gain or loss of another revalued asset).

- Recalculating the balance on the revaluation reserve to ensure it is accurate and complete and that deferred tax has been correctly calculated and accounted for in respect of items of PPE subject to revaluation.

10.3 Other problems with revalued assets

File reviewers have noticed that there is a tendency for audit firms to audit revalued assets for **overstatement** without any consideration as to whether the asset is materially **understated**. The latter is wider in scope given there are no specific timescales in FRS 102 as to how often the revaluation exercise should be carried out.

However, in light of the current economic challenges following the global pandemic, some asset values may have decreased significantly from the previous year. Where assets are measured under the revaluation model (or fair value model in the case of investment property), auditors must factor in the risk of overstatement due to management's reluctance to record a revaluation loss.

Quite often there is a reluctance to challenge clients who may not wish to revalue the assets (due to inherent costs) which plays a large part in this. Auditors must also be aware that clients cannot claim undue cost or effort under FRS 102 as the standard contains no such exemptions. This is particularly the case where investment properties (which are not intra-group) have not been revalued to fair value at the reporting date.

Example – Investment property

Legion Ltd has an investment property on its balance sheet with a carrying value of £275,000 as at 31 July 2021 and the company prepares its financial statements under full FRS 102 as it is a medium-sized entity. There has been no movement in the carrying amount of this property since the prior year. The auditor is aware that property prices in Legion's area have decreased significantly due to the pandemic.

The finance director has told the audit manager that the board did not obtain an up-to-date valuation of the property on the grounds that it would incur undue cost or effort and, in any case, the fluctuations in fair value are immaterial.

There are two problems with the finance director's response:

- There are no undue cost or effort exemptions that can be relied upon under FRS 102 where the valuation of investment property is concerned. All investment property (excluding intra-group investment property) must be remeasured to fair value through profit or loss at each reporting date.
- The finance director cannot conclude that fair value fluctuations are immaterial if the entity has not obtained a fair value of the investment property at the reporting date. In order to conclude that a monetary amount (in this case the movement in fair value) is immaterial it has to be established first.

If the auditor concludes that the investment property is materially misstated (e.g. by obtaining comparable fair values for other properties in the same area) then this will impact on the auditor's opinion which is likely to be modified due to non-compliance with FRS 102, Section 16 *Investment Property.*

Accounting treatments often pose a problem for auditors as well (particularly where there is not a sound understanding of FRS 102, Sections 16 and 17). Clients can often account for a revaluation gain or loss incorrectly and sometimes this is overlooked by an audit firm meaning that there is a misstatement that has not been picked up.

Example – Incorrect accounting treatment for investment property

At the year end 31 July 2021, the fair value of McDonnell Ltd's investment property had decreased by £40,000. The value of its owner-occupied property (which is measured under the revaluation model) had increased by £60,000. The only entries to record these transactions were:

Dr Revaluation reserve £40,000

Cr Investment property £40,000

Being revaluation loss on the investment property

Dr Freehold property £60,000

Cr Revaluation reserve £60,000

Being revaluation gain on owner-occupied property

<u>Problem 1</u>

The first problem relates to the accounting treatment for the fair value loss on the investment property. FRS 102, Section 16 applies the Fair Value Accounting Rules in company law which require fair value gains and losses to be recorded in profit or loss. Recording them via the revaluation reserve applies the Alternative Accounting Rules which is incorrect as these would apply to the revaluation of property, plant and equipment under FRS 102, Section 17. As a consequence, expenses in profit and loss are understated and equity is understated.

Problem 2

Neither transaction has had the deferred tax consequences brought into account. Non-monetary assets subject to revaluation are within scope of deferred tax. FRS 102, para 29.12 requires deferred tax to be measured using the tax rates and laws that have been enacted or substantively enacted by the balance sheet. For balance sheet dates ending on or after 25 May 2021 the rate of deferred tax is 25% (25 May 2021 is the date the 25% corporation tax rate in the UK became substantively enacted following the Chancellor's Budget in the spring of 2021).

The deferred tax adjustment on the fair value loss on the investment property (ignoring indexation) is £10,000 (£40,000 x 25%). The deferred tax adjustment on the revaluation gain of the owner-occupied property is £15,000 (£60,000 x 25%). As a consequence of the incorrect accounting treatment:

- the deferred tax provision for the investment property is overstated by £10,000 (with a corresponding misstatement in tax expense); and

- the deferred tax provision for the owner-occupied property is understated by £15,000 (with a corresponding misstatement in the revaluation reserve).

A qualified auditor's report will be the last resort, of course, because of the impact such reports can have for clients (e.g. reduced credit-rating, inquiries by HMRC, increased insurance premiums, withdrawal of credit facilities from suppliers and all sorts of other disruptions). However, if the client refuses to comply with the accounting standard, and the errors are material, there is no alternative for the auditor other than to express a qualified opinion.

Care needs to be taken when the audit client has assets measured at revaluation because they can create problems for auditors. Keep in mind that where internal valuations have been carried out this will cause an issue for auditors because the valuation will not be independent nor objective and hence additional procedures will have to be carried out to address these risks. Also, it is crucial that the auditor ensures that the work they have performed on revalued assets satisfies the relevant assertions (e.g. completeness, classification, presentation and valuation). File reviewers and professional body inspectors are likely to focus their attention on areas such as revalued assets because it is an area which lends itself to many pitfalls.

11 Audits of less complex entities (Lecture A763 – 9.41 minutes)

On 23 July 2021, the International Auditing and Assurance Standards Board (IAASB) issued an Exposure Draft *Proposed International Standard on Auditing of Financial Statements of Less Complex Entities*. Comments on this Exposure Draft are open until 31 January 2022.

This Exposure Draft follows a raft of work carried out by the IAASB including issuing a discussion paper on how to address the challenges faced by auditors of less complex entities (LCEs) in implementing International Standards on Auditing (ISAs).

As many auditors will appreciate, the ISAs themselves have become very lengthy and their requirements have become more demanding over the years. Many audit firms find that they are on the receiving end of criticism because of a failure to apply certain requirements of an ISA, or misinterpreting the requirements (especially those audits at the smaller end of the scale).

The proposed standard is based on feedback from the discussion paper and various outreach. The IAASB state that the draft standard is proportionate to the typical nature and circumstances of an audit of a LCE and is responsive to stakeholder challenges and is a global solution.

So, what does the IAASB mean by a 'less complex entity'?

The IAASB has recognised there are challenges of applying the ISAs in smaller audits, but they are of the view that it is appropriate to focus on the **complexity** of an entity rather than its size. This is because in today's environment it is not only about size – indeed, there may be entities that are considered to be small but complex; whereas there may be other entities that would not be considered smaller but would be considered less complex.

As a starting point, the IAASB looked at their current definition of a 'smaller entity' because this sets out many of the qualitative characteristics which could be attributable to an LCE as follows:

IAASB discussion paper definition 'smaller entity'

An entity which typically possesses qualitative characteristics such as:

(a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and

(b) One or more of the following:

(i) Straightforward or uncomplicated transactions;

(ii) Simple record-keeping;

(iii) Few lines of business and few products within business lines;

(iv) Few internal controls;

(v) Few levels of management with responsibility for a broad range of controls; or

(vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

11.1 Scope of draft ISA for LCE

In the broadest terms, the draft ISA for LCE is appropriate for entities that are less complex. This means that if the entity has, for example, a complex accounting estimate the standard will not apply. This is because it will not be possible to apply the ISA for LCE to certain areas and then 'top up' other areas with the mainstream ISA – it is essentially an 'all or nothing' standard. If the entity has any area which is complex, the standard will not apply.

In addition, the IAASB plan to exclude the following types of entity from applying the draft ISA for LCE:

Specific prohibitions

- Jurisdictions where law or regulation prohibits the use of the standard or specifies the use of auditing standards other than the standard
- Listed entities
- The entity meets one of certain criteria (e.g. where banking or insurance is the main functions or where pensions or collective investment vehicles are the functions)
- Audits of group financial statements
- An entity in a class of entity that is prohibited in jurisdiction to use the standard

Qualitative considerations

- *Complex matters or circumstances relating to the nature and extent of the entity's business activities, operations and related transactions and events relevant to the preparation of the financial statements.*
- *Topics, themes and matters that increase, or indicate the presence of, complexity, such as those relating to ownership corporate governance arrangements, policies, procedures or processes established by the entity.*

Exposure Draft ISA for LCE, para 67 (extract)

A list of characteristics is provided in the draft standard to aid this and includes items such as where ownership or oversight structures are complex or where operations are subject to a higher degree of regulation or to significant regulatory oversight (e.g. public interest characteristics).

Each of the qualitative characteristics may not, on its own, be sufficient to determine whether the standard is appropriate or not. Therefore, the matters described in the list are intended to be considered both individually and in combination.

Other matters

- Entities outside any other qualitative criteria and quantitative thresholds established within jurisdiction
- Entities which are prohibited from using the standard under firm policies or procedures
- Entities that exhibit qualitative characteristics which would make the standard inappropriate to use

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements of an entity. This is achieved by obtaining sufficient appropriate audit evidence to reduce audit risk (the risk that the auditor will express an inappropriate audit opinion) to an acceptably low level in the circumstances of the engagement.

When developing the ISA for LCE, the IAASB carried out various consultations. This led to the intention by the Board that the ISA for LCE will provide a reasonable assurance opinion, using the concepts and principles already contained in an ISA audit. The Board also agreed that it needed to be clear in the auditor's report which standard(s) have been used so that users of the financial statements have transparency as to which standards have been applied in conducting the audit.

11.2 Essential explanatory information

The draft ISA for LCE has been developed as a separate, standalone standard which is designed to be proportionate to the typical nature and circumstances of an LCE. It is separate from the ISAs and there is no intended need to directly reference back to the requirements or application material in the ISAs in applying the ISA for LCE.

Because of the standard's target audience, the draft ISA for LCE does not address complex matters or circumstances. In addition, the draft ISA for LCE has not been scoped to include group audits hence there is no ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* equivalent within the standard.

A key objective of the design of draft ISA for LCE is to keep the standard as concise and succinct as possible. One of the key features of draft ISA for LCE is the 'essential explanatory material' (EEM) for selected concepts and requirements. This material differs from the application and explanatory material found in the ISAs which is much more educational in nature. Hence, the EEM is included in the body of the draft standard together with the related requirements.

While the EEM acts in much the same way as the application and explanatory material contained in the ISAs, it is much more limited in terms of how it is presented and is targeted at a higher level (i.e. a conceptual and contextual level) and takes into account the typical nature and circumstances of audits for which the draft standard has been designed.

EEM is presented in italics and highlighted in a light blue box. There are two types of EEM: general introductory EEM which explains the context of the section that follows and EEM which is specific to the requirement directly above it. There is no difference in the status of each type.

The EEM itself does not impose a requirement or expand any requirement. Instead, it is used when the explanation or guidance it provides is considered to be so important that including it in the proposed standard and positioning it alongside the requirement(s) is deemed necessary and informative for a proper understanding of the requirement(s). Paragraph 90 of the Exposure Draft states the following:

- *The EEM paragraphs do not create additional obligations for the auditor and do not include a 'shall'.*

ED ISA for LCE, para 90 (extract)

- *Not every concept or requirement is explained. EEM has only been provided when it is deemed to provide crucial support to the appropriate application of the concept or requirement(s).*

- *EEM is not intended to provide detailed examples about 'how' to apply a requirement – rather it contains descriptions of matters relevant to understanding and applying the concepts or requirements within the draft ISA for LCE. For example, it may explain more precisely what the requirement means or what the requirement is intended to cover.*

- *If deemed necessary, the EEM may explain 'why' a procedure is required to be undertaken. It may also be used to explain the iterative nature of the proposed standard where needed.*

- *The EEM, where appropriate, may illustrate how a requirement could be applied for different circumstances. This illustrates the scalability of the proposed standard to the spectrum of entities that would likely fall within its remit.*

- *The EEM does not include background information on matters addressed in ED-ISA for LCE.*

11.3 Structure of draft ISA for LCE

The structure of draft ISA for LCE follows the 'flow' of an audit engagement as opposed to being structured by subject matter or topic like the ISAs. The Parts are preceded by a Preface to the standard and the Authority as follows:

- Part 1: Fundamental Concepts, General Principles and Overarching Requirements

- Part 2: Audit Evidence and Documentation
- Part 3: Engagement Quality Management
- Part 4: Acceptance or Continuance of an Audit Engagement and Initial Audit Engagements
- Part 5: Planning
- Part 6: Risk Identification and Assessment
- Part 7: Responding to Assessed Risks of Material Misstatement
- Part 8: Concluding
- Part 9: Forming an Opinion and Reporting

An overview of each Part is as follows:

Part	Commentary
Preface	Explains the design, intended use and format of the proposed standard, the responsibilities of management and the approach to future maintenance of the standard, as well as other relevant matters that do not form part of the standard.
Authority (Part A)	Sets out the circumstances for which the proposed standard is prohibited or otherwise limited.
Parts 1 to 3	Sets out the broad concepts and overarching matters relevant to the audit performed using ED-ISA for LCE, including the overarching objective of the audit. Section 4E further explains the detailed content of each individual Part.
Parts 4 to 9	Sets out the core requirements for an audit of an LCE following the typical flow of an audit. Section 4E further explains the detailed content of each individual Part.
Appendices	Appendices 1 to 6 set out certain specific considerations and matters for an audit of an LCE, and also illustrative documents. Appendices presented within the ED-ISA for LCE have the same status as the EEM. Section 4E further explains the detailed content of each Appendix.

To help with consistency of application, the same structure has been used within each Part (Parts 1 to 9):

(a) An introductory box – setting out a summary of the content and scope of that Part. The material in the introductory box is not intended to create any obligations for the auditor. The IAASB considered the balance of information to include in these introductory boxes, and has the view they would likely be helpful to quickly understand what is included in each Part.

(b) Objectives.

(c) Requirements – detailing, in a straightforward manner, all of the requirements that need to be complied with, unless the requirements are conditional and the condition does not exist (these are clearly articulated as conditional, e.g. if the *xyz condition exists*, the auditor shall …). Requirements are expressed using 'shall'.

(d) Specific communication requirements (where applicable) – if there are any specific communication requirements related to the matters included in that Part, they have been grouped together so that it is clear what all the specific communications to management or those charged with governance are that need to be made.

(e) Specific documentation requirements (where applicable) – all the documentation requirements related to specific matters within that Part are also grouped together so that the specific matters that need to be documented are clear.

11.4 Use in the UK

It is hoped that the Financial Reporting Council/Audit, Reporting and Governance Authority will consider adopting the ISA for LCE for UK audits. The draft standard appears to be suitable for less complex entities and should hopefully address the many weaknesses that are identified by regulators, professional bodies and file reviewers in audits of less complex entities.