Audit and Accounting Quarterly Update – October 2022

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1 Loan arrangement fees (Lecture A794 – 8.31 minutes)

A common question asked by practitioners is how to treat transaction costs that arise when a client takes out a bank loan or other form of finance that attracts such costs.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with financial instruments in Section 11 *Basic Financial Instruments*. It is fair to say that Section 11 is a complex section to understand and some of the terminology used in the section can be difficult to interpret.

In developing FRS 102, Section 11, the Financial Reporting Council (FRC) have included various examples to aid clarity, and the examples are very useful.

The term 'transaction costs (financial instruments)' is defined in the Glossary to FRS 102 as:

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

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

In terms of initial recognition of a financial asset or a financial liability, FRS 102, para 11.12 states that an entity recognises such an instrument only when the entity becomes a party to the contractual provisions of the instrument.

1.1 Initial measurement of a loan

FRS 102, para 11.13 deals with initial measurement of a loan. This paragraph states:

> *When a financial asset or financial liability is recognised initially, an entity shall measure it at the transaction price (adjusted for transaction costs except in the initial measurement of financial assets and liabilities that are subsequently measured at fair value through profit or loss) unless the arrangement constitutes, in effect, a financing transaction. An arrangement constitutes a financing transaction if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate, for example, providing interest-free credit to a buyer for the sale of goods or an interest-free or below market interest rate loan made to an employee. Except as set out in paragraph 11.13A, if the arrangement constitutes a financing transaction, the entity shall measure the financial asset or financial liability at the present value of the future payments discounted at a market rate of interest for a similar debt instrument as determined at initial recognition adjusted for transaction costs.*

FRS 102, para 11.13

Hence, for a basic bank loan measured at amortised cost under FRS 102, Section 11, the liability is initially recognised net of transaction costs. This is further elaborated upon in the examples contained within FRS 102, para 11.13, one of which states:

For a loan received from a bank at a market rate of interest, a payable is recognised initially at the amount of the cash received from the bank less separately incurred transaction costs.

FRS 102, para 11.13 Examples

Some practitioners recognise loan arrangement fees, for example, in profit or loss as they have arisen. Other practitioners recognise such fees in prepayments and release them to profit or loss over the life of the loan. These treatments are inconsistent with the requirements of FRS 102, hence are technically incorrect. The loan arrangement fees are included in the loan amount initially recognised and this balance is then accounted for under the amortised cost method which uses an effective interest rate. Therefore, the transaction cost is recognised in profit or loss over the life of the loan via the amortised cost method as can be seen from the following example:

Example – Initial recognition and subsequent measurement of a loan

Dwyer Ltd takes out a five-year bank loan of £750,000 which is repayable in monthly instalments of £13,750 (hence a total of £825,000 is repayable). The bank charges a 1.25% loan arrangement fee which is non-refundable and is payable on inception of the loan.

The loan is initially recorded net of the transaction cost of £9,375 (£750,000 x 1.25%) as follows:

Dr Bank	£740,625
Cr Loan payable	£740,625

The loan is then subsequently measured using the amortised cost method, which uses an effective interest rate. In this example, the effective interest rate has been calculated at 3.71% using the Goal Seek function in Microsoft Excel (see **1.4** below). For simplicity, the repayments in the table below have been annualised.

Year	Opening balance	Cash flow	Interest at EIR	Closing balance
	£	£	£	£
1	740,625	(165,000)	27,459	603,084
2	603,084	(165,000)	22,360	460,444
3	460,444	(165,000)	17,071	312,515
4	312,515	(165,000)	11,587	159,101
5	159,101	(165,000)	5,899	-

In year 1, the journals to record the loan are:

	£
Dr Loan payable	165,000
Cr Bank	165,000

Being loan repayments made in the year

Dr Interest expense	27,459
Cr Loan payable	27,459

Interest calculated at the effective interest rate

The closing balance of £603,084 at the end of year 1 is then split between the portion falling due within one year of £142,640 (£603,084 - £460,444) and the portion falling due after more than one year of £460,444 to comply with the statutory formats of the balance sheet.

1.2 Effect of an incorrect accounting treatment

If we assume that the loan arrangement fee has been debited to the profit and loss account, i.e.:

	£
Dr Bank	740,625
Dr P&L	9,375
Cr Loan	750,000

The interest charges to profit and loss will be affected because the effective interest rate will essentially be lower (i.e. the effective interest rate will be 3.26% rather than 3.71%) as can be seen in the following table:

Illustration – Incorrect accounting treatment

Year	Opening balance	Cash flow	Interest at EIR	Closing balance
	£	£	£	£

1	750,000	(165,000)	24,476	609,476
2	609,476	(165,000)	19,890	464,366
3	464,366	(165,000)	15,155	314,521
4	314,521	(165,000)	10,264	159,785
5	159,785	(165,000)	5,215	-

This will also mean that the loan has not been accounted for in accordance with FRS 102, Section 11.

1.3 Effective interest rate

A quick way of proving the effective interest could be to use the Internal Rate of Return function in Excel.

Using the figures in the correct example above, this is how you would do it:

	A	B
1	(740,625)	
2	165,000	
3	165,000	
4	165,000	
5	165,000	
6	165,000	
7		3.71%

The formula to use in cell B7 would be =IRR(A1:A6). Make sure you have cell B7 formatted to be a percentage.

1.4 Amortised cost method in Excel

Alternatively, (and probably easier) is to use the Goal Seek function in Microsoft Excel to deal with the loan. This is done by profiling the loan as follows:

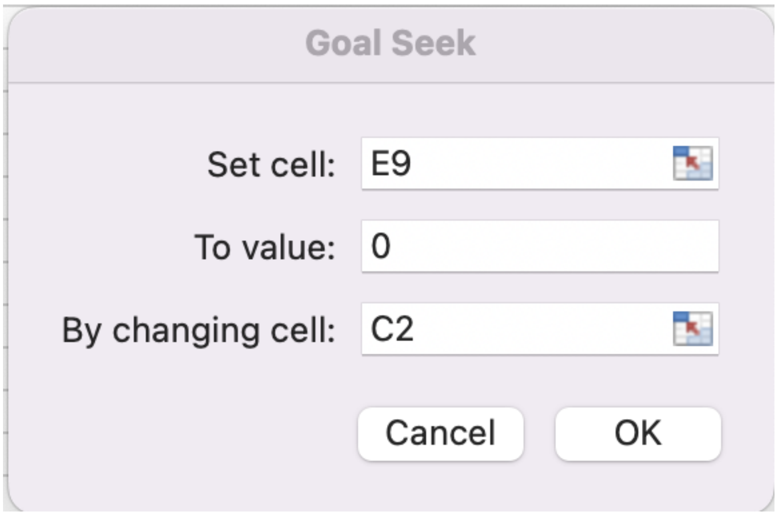
	A	B	C	D	E
1					
2	Effective interest rate				
3	**Year**	**Opening balance**	**Cash flow**	**Interest at EIR**	**Closing balance**
4		£	£	£	£
5	1	740,625	(165,000)	0	575,625
6	2	575,625	(165,000)	0	410,625
7	3	410,625	(165,000)	0	245,625
8	4	245,625	(165,000)	0	80,625
9	5	80,625	(165,000)	0	(84,375)

For clarity, the formulas used in the above are as follows:

	A	B	C	D	E
1					
2	Effective interest rate				
3	**Year**	**Opening balance**	**Cash flow**	**Interest at EIR**	**Closing balance**
4		£	£	£	£
5	1	740625	-165000	=C2*B5	=B5+C5+D5
6	2	=E5	-165000	=C2*B6	=B6+C6+D6
7	3	=E6	-165000	=C2*B7	=B7+C7+D7
8	4	=E7	-165000	=C2*B8	=B8+C8+D8
9	5	=E8	-165000	=C2*B9	=B9+C9+D9

Hence, cell C2 will be used to calculate the effective interest rate.

To use the Goal Seek function in Excel, go to the Data tab, select 'What-if Analysis' and then Goal Seek. A box will appear, and the following information is entered:



When you click 'OK', Excel automatically calculates the effective interest rate for you as follows:

	A	B	C	D	E
1					
2	Effective interest rate		3.71%		
3	**Year**	**Opening balance**	**Cash flow**	**Interest at EIR**	**Closing balance**
4		£	£	£	£
5	1	740,625	(165,000)	27,459	603,084
6	2	603,084	(165,000)	22,360	460,444
7	3	460,444	(165,000)	17,071	312,515
8	4	312,515	(165,000)	11,587	159,101
9	5	159,101	(165,000)	5,899	(0)

For most basic bank loans which incur arrangement fees, the amortised cost method will apply and hence the arrangement fee is taken directly to the loan account on initial recognition and not to profit or loss or prepayments. The arrangement fee is then recognised in profit or loss over the life of the loan via the effective interest charged to profit and loss. The exception to this rule would be where the loan is being measured at fair value through profit or loss as the fee would be expensed immediately because the payment does not result in any future economic benefit.

2 Impairment of assets

One of the underpinning principles in financial reporting is that assets should not be carried in the financial statements in excess of their recoverable amounts.

Impairment of assets has moved up the ranks of importance recently and continues to be an important issue as the economic challenges start to have an impact on businesses up and down the country, hence it is worthwhile revisiting this area to ensure that financial statements correctly reflect any impairment losses that may need to be recognised. Auditors are also required to pay particular attention to the carrying values of assets to ensure that any impairment losses have been appropriately reflected and impairment issues seem to crop up quite a lot during file reviews and audit monitoring visits.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with impairment of assets in Section 27 *Impairment of Assets*. FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* deals with the issue in Section 22 *Impairment of Assets*.

The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409) and The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) deal with impairment of assets in Sch 1, paras 19(2), 3(2) and (3). These paragraphs require a provision to be made against a fixed asset and charge to the profit and loss account where there is a permanent diminution of value. Where an entity complies with the impairment requirements of FRS 102 or FRS 105, they will also be compliant with company law.

2.1 Scope

FRS 102, Section 27 and FRS 105, Section 22 both apply to the impairment of assets and the recognition and measurement of impairment losses. There are certain assets which are outside the scope of these sections as follows:

FRS 102, Section 27 does not apply to	FRS 105, Section 22 does not apply to
Assets arising from construction contracts (see Section 23 *Revenue*)	Assets arising from construction contracts (see Section 18 *Revenue*)
Deferred tax assets (see Section 29 *Income Tax*)	Financial assets within the scope of Section 9 *Financial Instruments*
Assets arising from employee benefits (see Section 28 *Employee Benefits*)	Inventories (see Section 10 *Inventories*)
Financial assets within the scope of Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments*	

Issues
Investment property measured at fair value (see Section 16 *Investment Property*)
Biological assets which are related to agricultural activity measured at fair value less estimated costs to sell (see Section 34 *Specialised Activities*)
Deferred acquisition costs and intangible assets arising from contracts within the scope of FRS 103 *Insurance Contracts*

2.2 Process of impairment testing

At the outset it is worthwhile emphasising the order in which an impairment test is carried out:

- **First**: consider whether the asset(s) in question is showing indicators of impairment. If it is; then
- **Second**: carry out an impairment test.

If the asset is not showing indicators of impairment, there is no requirement to carry out an impairment test.

The impairment test involves establishing recoverable amount and comparing this recoverable amount to the asset's carrying amount to determine the level of impairment loss that is to be recognised.

FRS 102 defines 'recoverable amount' as:

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

*FRS 102 Glossary **recoverable amount***

Fair value less costs to sell and value in use are discussed in **2.7** below.

2.3 Impairment of inventories

Inventory (stock) is measured at the lower of cost and estimated selling price less costs to complete and sell. The latter part of this rule (i.e. estimated selling price less costs to complete and sell) refers to net realisable value.

At each balance sheet date, inventory must be assessed for indicators of impairment. FRS 102, para 27.2 clarifies that this is done by comparing the carrying amount of each item of inventory with its selling price less costs to complete and sell. Where it is impracticable to determine selling price less costs to complete and sell for inventories on an item-by-item basis, the entity may group items of inventory relating to the same product line, that have similar purposes or end users and are produced and marketed in the same geographical areas for the purpose of assessing impairment. In practice, it may often be impractical to look at individual items of inventory, especially where these are high in volume and low in cost. However, even if this is the case, groupings of items must be for those produced and marketed in the same geographical area because otherwise significantly different costs or selling prices may exist. For entities with large individual items of inventory, the assessment will normally be carried out on an item-by-item basis.

If an item of inventory (or group of similar items of inventory) is impaired, the entity must reduce the carrying amount to selling price less costs to complete and sell. That reduction is an impairment loss and is recognised immediately in profit or loss.

Example – Impairment of inventory

Sunnie Ltd had an item of inventory valued at cost of £200 in its year-end inventory count carried out on 31 August 2022. On 7 September 2022, it sold that item for £150.

The sale of inventory so soon after the balance sheet date provides evidence of fair value less costs to complete and sell of the inventory at the balance sheet date. The fact that sales proceeds were £50 lower than cost indicates that inventory is impaired at the balance sheet date (as no specific event occurred post-year end that caused the impairment). Hence, a write down by way of an impairment loss in the 31 August 2022 financial statements is recognised as follows:

	£
Dr Profit and loss account (cost of sales/impairment)	50
Cr Inventory	50

Being write down of inventory to selling price less costs to complete and sell

Example – Damage to inventory post-year end

Sunnie Ltd had an item of inventory valued at cost of £200 in its year-end inventory count carried out on 31 August 2022. A flood occurred on 7 September 2022 and damaged the inventory which has a scrap value of £150 following the flood.

While the flood has reduced the value of this inventory by £50, as the flood took place after the year end, the conditions did not exist then, hence the inventory is not written down as at 31 August 2022. It would, however, be considered a non-adjusting event and be dealt with under FRS 102, Section 32 *Events after the End of the Reporting Period* (FRS 105, Section 26) and will be disclosed if material.

2.4 Reversals of inventory impairment

It is possible to reverse a previously recognised impairment loss in respect of inventory. FRS 102, para 27.4 states that the entity must make a new assessment of selling price less costs to complete and sell at each balance sheet date. Where the circumstances which previously caused inventories to be impaired no longer exist, or when there is clear evidence of an increase in selling price less costs to complete and sell because of changed economic circumstances, the entity shall reverse the amount of the impairment.

Examples of situations when an impairment loss may be reversed include:

- A temporary halt on the sale of certain items due to health and safety concerns, which were then discovered to be unfounded.
- Changes in technological developments that meant that older components, previously impaired, could now be used in new products.
- Much improved economic prospects or significant demand for a previously impaired product.

An important point to emphasise is that **care must be taken to avoid overstating inventory post-impairment reversal.**

FRS 102 restricts the value of the impairment reversal up to the amount of the original impairment loss. Hence, if the original impairment loss was £100, it can only be reversed up to £100. Any further increase (for example, if the supplier has increased their prices of the same product) would result in inventory being recorded in the financial statements in excess of original cost, hence breaching the 'lower of cost and estimated selling price less costs to complete and sell' principle.

The result of the reversal is that the new carrying amount becomes the lower of the cost and the revised selling price less costs to complete and sell.

2.5 Impairment of assets other than inventory

FRS 102, para 27.5 is clear that if, and only if, the recoverable amount of an asset is less than its carrying amount, the entity must reduce the carrying amount of the asset to its recoverable amount. This shortfall is generally recognised in profit or loss unless the asset is measured under the revaluation model. In this case, the impairment loss is recognised as a revaluation loss in accordance with FRS 102, para 17.15F which says:

> *The decrease of an asset's carrying amount as a result of a revaluation shall be recognised in other comprehensive income to the extent of any previously recognised revaluation increase accumulated in equity, in respect of that asset. If a revaluation decrease exceeds the accumulated revaluation **gains** accumulated in equity in respect of that asset, the excess shall be recognised in profit or loss.*

FRS 102, para 17.15F

Example – Impairment on an asset measured under the revaluation model

Ratchford Ltd acquired a freehold property on 1 September 2020 at a cost of £125,000. The directors have elected to measure this property under the revaluation model in FRS 102, Section 17 *Property, Plant and Equipment*.

At the year end 31 August 2021, the property's value increased by £75,000 to £200,000 and the revaluation gain was recorded as follows:

	£
Dr Property, plant and equipment	75,000
Cr Revaluation reserve	75,000
Being revaluation gain at 31 August 2021	
Dr Revaluation reserve	18,750
Cr Deferred tax provision	18,750
Being deferred tax on revaluation gain at 25%	

The balance on the revaluation reserve at 31 August 2021 was £56,250 (£75,000 - £18,750).

On 31 August 2022, a surveyor confirmed that due to property prices in the area declining significantly, the fair value of the building at 31 August 2022 is now £110,000.

The revaluation loss is recorded as follows:

	£	
Dr Revaluation reserve	75,000	
Dr Impairment loss (P&L)	15,000	
Cr Property, plant and equipment	90,000	
Being write-down to fair value at 31 August 2022		
Dr Deferred tax provision	22,500	(£90,000 x 25%)
Cr Revaluation reserve	18,750	
Cr Deferred tax charge (P&L)	3,750	
Being adjustment to deferred tax re revaluation loss		

There is now a deferred tax asset of £3,750 (£18,750 - £22,500) due to the decline in the value of the property being below its original cost price. This deferred tax asset should only be recognised on the balance sheet if it is capable of recovery. If it considered **not** to be capable of recovery, then it should be offset against the deferred tax credit in profit and loss and no deferred tax asset is recognised.

Depreciation

Keep in mind that any depreciation charges should be adjusted when dealing with the impairment of a revalued asset. Generally accumulated depreciation up to the point at which the impairment loss is recorded is taken to the revaluation reserve as well and revised going forward.

The issue relating to revalued assets will not apply to micro-entities preparing their financial statements under FRS 105 because the revaluation model is outlawed.

2.6 Indicators of impairment

While there is no specific requirement to carry out an impairment test at each balance sheet date, there is a requirement for management to consider whether there are any indicators of impairment. Where there are indicators of impairment that an asset is impaired, FRS 102 and FRS 105 require the entity to estimate the recoverable amount of that asset. Conversely, where there is no indicator of impairment, there is no need to assess recoverable amount.

FRS 102, para 27.9 states that when an entity is assessing if there are any indicators that an asset may be impaired, the entity must consider as a minimum:

- External sources of information; and
- Internal sources of information.

External sources of information

During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.

FRS 102, para 27.9

This could be caused by a decrease in market prices, such as a fall in property or share prices.

Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.

Legislation may be passed by the government which bans the manufacture of certain products. In such cases, the assets which an entity uses to manufacture these products will be impaired.

Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect materially the discount rate used in calculating an asset's value in use and decrease the asset's fair value less costs to sell.

While FRS 102 does not mandate impairment tests each year, if there is a change in interest rates in respect of an asset that has previously suffered an impairment loss, and that change affects the discount rate used in the previous calculation, it is appropriate to revisit that calculation. The calculation would only need to be revisited where the change in interest rates affects the recoverable amount of the asset materially.

The carrying amount of the net assets of the entity is more than the estimated fair value of the entity as a whole (such an estimate may have been made, for example, in relation to the potential sale of part or all of the entity).

Share prices may have dropped causing the fair value of the entity to fall. This would trigger a formal review for impairment of assets to be carried out.

Internal sources of information

Evidence is available of obsolescence or physical damage of an asset.

FRS 102, para 27.9

Where an asset is damaged, for example a vehicle may have been involved in an accident, this is strong evidence that the carrying amount of the asset is impaired. Technological obsolescence will also play a part in triggering a requirement for an impairment loss.

Significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.

Where a business may, for example, decide to discontinue an operation, this provides indicators that the assets belonging to that specific operation are impaired and hence should be written down to recoverable amount. Restructuring of an entity may also provide indicators that an asset, or group of assets, is impaired.

Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected. In this context economic performance includes operating results and cash flows.

Forecasts may indicate that cash inflows from the use of an asset are high, but upon subsequent review these cash flows may be materially lower than expected. This would provide an indicator that the asset is impaired.

2.7 Estimating recoverable amount

The recoverable amount of an asset or CGU is the **higher** of its fair value less costs to sell and its value in use. When either of these amounts exceed the carrying amount of the asset, the asset is not impaired and hence it will not be necessary to determine the other amount.

When it is not possible to estimate the recoverable amount of an individual asset, the entity must estimate the recoverable amount of the cash-generating unit to which the asset belongs. The term 'cash generating unit' is defined as:

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

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

The focus of a cash-generating unit (CGU) is on cash flows. Identifying CGUs can be complex, especially where a large group is concerned, but examples of CGUs include:

- Individual hotels in a chain would be a CGU as each hotel generates its own revenue.
- Individual restaurants in a chain would be a CGU as each restaurant will generate its own revenue.
- Individual branches in a group selling products would be a CGU as each branch will generate its own revenue.
- Publishing titles for a publisher that are owned would be a CGU as each title will generate revenues for the publisher.

The key to identifying a CGU is to ensure that the unit's cash flows are **largely independent** from other assets or groups of assets. Hence, if one restaurant only ever acts as an overflow from another restaurant, its cash flows are not largely independent and the two restaurants **together** would be a CGU.

In most cases, it is not possible to ascertain the recoverable amount of an individual asset as the value in use cannot be ascertain for the individual asset.

Example – Individual asset within a training company

Revere Ltd is an accountancy and tax training company. It has a data projector with which to present courses. The fair value less costs to sell of the data projector may be very low and hence less than the carrying value in the accounts. However, the data projector is still fulfilling its function in the business, so the value in use may at least be equal to the asset's carrying amount.

However, the data projector on its own does not generate any revenue for the business directly, it only does so in combination with other assets such as the building in which it housed, the computer that is connected to it, the customer database that supplies the leads for marketing its accountancy and tax courses and so on.

To establish recoverable amount, it is necessary to look at the value in use of the cash-generating unit of which the data projector is part.

A data projector is unlikely to be a material asset, but of course there could be many such assets or larger assets, which nonetheless cannot be assessed for value in use individually, but only as part of a cash-generating unit.

Fair value less costs to sell

The term 'fair value less costs to sell' is defined as:

*The amount obtainable from the sale of an **asset** or **cash-generating unit** in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.*

*FRS 102 Glossary **fair value less costs to sell***

FRS 102, para 27.14 states that the best evidence of fair value less costs to sell of an asset is a price in a binding sale agreement in an arm's length transaction or a market price in an active market. An 'active market' is:

A market in which all the following conditions exist:

*FRS 102 Glossary **active market***

(a) the items traded in the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

Value in use

Value in use is the present value of the future cash flows which are expected to be generated from an asset. FRS 102, para 27.15 states that the steps required to be followed when carrying out a present value calculation are as follows:

(a) estimate the future cash inflows and outflows to be derived from continuing to use the asset and from its eventual disposal; and

(b) apply an appropriate discount rate to those future cash flows.

FRS 102, paras 27.16 to 27.20 provide specific requirements concerning the value in use calculation and the respective cash flows as follows:

Issue	Requirement
Calculation of an asset's value in use	The calculation must reflect the following: • The estimated future cash flows the entity expects to generate from the asset • The expectations about possible variations in the amount or timing of those cash flows

	• The time value of money represented by the current market risk-free rate of interest • The price for bearing the uncertainty inherent in the asset • Other factors such as illiquidity which market participants would reflect when pricing the future cash flows which the entity expects to derive from the asset
Measuring value in use	When measuring value in use, the estimates of future cash flows should include: • Projections of cash inflows from the continuing use of the asset • Projections of cash outflows which are necessary to generate the cash inflows from continuing use of the asset • Net cash flows, if any, expected to be received (or paid) for the disposal of the asset at the end of its useful economic life in an arm's length transaction between knowledgeable and willing parties
Estimates of future cash flows	These must not include: • Cash inflows or outflows from financing activities • Income tax receipts or payments
Future cash flows	Estimates of future cash flows for the asset in its current condition must not include cash inflows or outflows arising from: • A future restructuring to which the entity is not yet committed • Improving, or enhancing, the asset's performance
Discount rate(s)	The discount rate(s) used in the present value calculation must be a pre-tax rate(s) which reflects current market

	assessments of: • The time value of money; and • The risks specific to the asset for which the future cash flow estimates have not been adjusted The discount rate(s) used to measure value in use must not reflect risks for which the future cash flow estimates have been adjusted to avoid double-counting

Effectively, future cash flows are calculated as follows:

- Future cash flows = Cash inflows *less* cash outflows *plus* net proceeds on disposal

The cash flows used in value in use calculations are based on estimates. In practice, the use of budgets and forecasts will usually be the principal means of estimating future cash flows. These should be based on most recent budgets and forecasts which have been approved by management (and should not usually exceed five years from the date on which the impairment test is carried out). When estimating future cash flows, it is important that certain items are not double counted; for example, if the cash flows include the effects of inflation, the discount rate used should not be reduced by an inflation factor.

Example – Calculation of recoverable amount

Revere Ltd manufactures medical equipment. It has a large group of specialist machinery which manufacture a particular product. The fixed assets register shows that at 31 August 2022, this group of machinery had a book value of £140,000 and these machines are considered to be a CGU. The finance director has assessed the expected cash inflows and outflows for this group of machinery. The analysis is as follows:

	Revenues	**Costs**
Year	**£**	**£**
2022	70,000	27,000
2023	75,000	45,000
2024	85,000	65,000
2025	30,000	20,000

The manufacturer of the machines has sent in a quotation for the resale value of them in their current state which amounts to £82,150.

The directors have calculated value in use having regard to the above cash flows and have discounted them at a rate of 5% which is the entity's borrowing rate. Using this discount rate, the present value is calculated as follows:

Year	Cash flows	PV factor	Present value
2022	43,000	0.952	40,936
2023	30,000	0.907	27,210
2024	20,000	0.864	17,280
2025	10,000	0.823	8,230
Value in use			**93,656**

As value in use (£93,656) exceeds the manufacturer's quotation of £82,150, value in use is selected to represent recoverable amount. This is lower than the carrying amount of £140,000 per the fixed assets register and hence an impairment loss of £46,344 (£140,000 less £93,656) is recorded as follows:

	£
Dr Impairment loss (profit and loss)	46,344
Cr Property, plant and equipment	46,344

Being write down of machinery due to impairment

2.8 Recognising and measuring an impairment loss for a CGU

An impairment test for a CGU is based on an assessment of the total unit. FRS 102, para 27.21 states that an impairment loss is to be recognised for a CGU if, and only if, the recoverable amount of the CGU is less than carrying amount. The impairment loss is then allocated to reduce the carrying amount of the assets in the following order:

- First to goodwill; then
- To each of the other assets of the unit on a pro-rata basis of the carrying amount of each asset in the CGU.

Example – Allocation of an impairment loss in a CGU

Williams Ltd is a subsidiary of The Clarke Group Ltd and has been classed as a CGU. It has the following assets in its balance sheet as at 31 August 2022:

	£
Freehold property	60,000
Plant and machinery	90,000
Goodwill	30,000
	180,000

The finance director has calculated that the recoverable amount of the above assets is

£135,000.

The impairment loss amounts to £45,000 (£180k less £135k) and is first allocated to goodwill and then to the rest of the assets in the CGU on a pro-rata basis.

Goodwill of £30,000 is eliminated in total. £6,000 is allocated to the freehold property and the remaining £9,000 is allocated to plant and machinery.

Following the impairment, the balance sheet extract is as follows:

	£
Freehold property	54,000
Plant and machinery	81,000
Goodwill	-
	135,000

FRS 102, para 27.22 states that an entity must not reduce the carrying amount of any asset in the CGU below the *highest* of:

- its fair value less costs to sell (if determinable);
- its value in use (if determinable); and
- zero.

Example – Allocation of an impairment loss

The Greaves Group Ltd is a clothing manufacturer. One of its subsidiaries, Breary Clothing Ltd had to close due to a fire at the premises. Management has now decided that the store will close permanently and redeploy staff to other stores. 40% of the machinery was destroyed, but the remaining 60% can be sold.

The carrying amount of Breary's assets are as follows:

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

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

40% of the machinery was destroyed, hence 40% of the carrying amount should be written off immediately (i.e. £340,000) which leaves a carrying amount for the machinery of £510,000 (£850k - £340k). This remaining value is equal to the recoverable amount for the machinery.

The total carrying amount of the CGU after impairment of the machinery is £2.710m (see below). Recoverable amount is £2.5m so a further impairment loss of £210k is needed.

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

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

The impairment is allocated as follows:

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

2.9 Impairment of goodwill

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

FRS 102, para 27.24 recognises that goodwill, on its own, cannot be sold. Goodwill does not generate cash flows to an entity which are independent of the cash flows of other assets. Hence, the fair value of goodwill cannot be measured directly. Consequently, the fair value of goodwill must be derived from measurement of the fair value of the CGU to which it belongs.

FRS 102, para 27.26 says:

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

FRS 102, para 27.26

Therefore, where a parent does not wholly-own a subsidiary, FRS 102, para 27.26 requires the goodwill to be grossed up to include the goodwill attributable to the non-controlling interests (NCI).

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

Example – Notionally adjusted goodwill

Topco Ltd owns 80% of Subco Ltd and the group has an accounting reference date of 31 August each year. On 31 August 2022, the carrying amount of Subco's net assets were £880,000, excluding goodwill of £120,000 (net of amortisation). Management have decided to restructure the group and announced this restructuring exercise immediately prior to the reporting date.

The finance director has calculated recoverable amount of Subco's net assets to be £950,000.

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

	£'000	£'000

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

All £80 is allocated to the notionally adjusted goodwill, but as the subsidiary is only 80% owned, only £64 is actually booked as the other £16 is allocated to the NCI and will appear in their financial statements.

Important point relating to reversals of impairment losses on goodwill

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

2.10 Reversing an impairment loss

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

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

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

Example – Prior period impairment loss based on an individual asset

Chatsworth Ltd has an accounting reference date of 31 March. On 31 March 2020, an asset that cost £150,000 in 2017 had a net book value of £90,000 (depreciation is ten years on a straight-line basis). At the end of March 2021, stiff competition in the marketplace meant that the asset in question had a recoverable amount of £30,000 and hence in the financial statements for the year ended 31 March 2021, an impairment loss was recognised of £60,000 (£90,000 carrying amount brought forward less £30,000 recoverable amount). If there had not been any impairment, the carrying amount as at 31 March 2021 would have been £75,000 as the asset is being depreciated on a ten-year straight-line basis.

At the end of the 2022 financial year, the directors obtained evidence that competition is not as fierce, and some competitors have ceased trading during the year. The finance director is proposing to reverse the entire impairment loss of £60,000 in the financial statements for the year ended 31 March 2022.

If the asset had not suffered any impairment in 2021, the carrying value would have been £75,000, and £60,000 in 2022. Assuming that the carrying value of the asset is still at its post-impairment carrying amount of £30,000, the maximum amount of the reversal that can be recognised in 2022 is £30,000 (£60,000 net book value as at 31 March 2022 less £30,000 current carrying amount). This is because FRS 102, para 27.30(c) states that the reversal of a previously recognised impairment loss cannot increase the carrying value of an asset above the carrying amount that would have been determined (net of depreciation or amortisation) had no impairment loss been recognised for the asset in previous years.

The finance director should record the impairment loss as follows:

Dr Property, plant and equipment		£30,000
Cr Profit and loss	£30,000	

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

In the example above, the reversal had been recognised immediately in profit and loss. The exception to this rule would be where the asset had been subject to the revaluation model (see earlier) as the reversal would only be recognised in profit or loss to the extent of the previous revaluation loss. The remaining reversal would be taken to the revaluation reserve via other comprehensive income.

Reversal when the recoverable amount was estimated for a cash-generating unit

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

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

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

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

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

(i) *its recoverable amount; and*

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

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

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

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

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

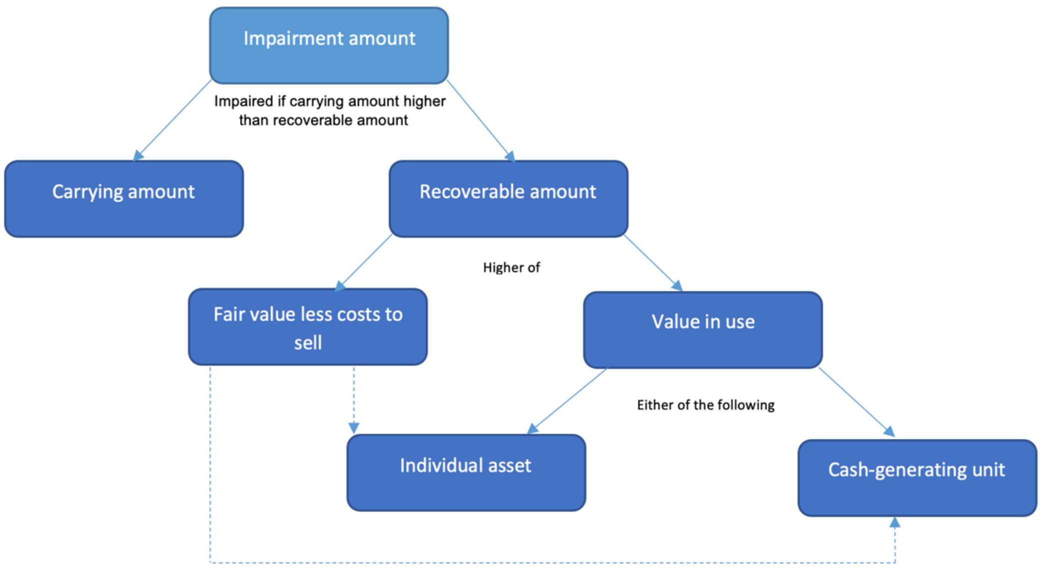
Therefore, any reversal of a previously recognised impairment loss is allocated between those assets against which the original impairment loss was allocated, although it may not necessarily be in the same proportions.

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

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

Summary of the impairment requirements

The diagram below provides an illustration of the impairment test requirements. Remember that an impairment review is **only** required where there is an indicator of impairment:



3 Events after the end of the reporting period (Lecture A795 – 18.42 minutes)

It is widely accepted that financial statements are prepared some time after the balance sheet date has passed. Most private companies have nine months from the year end to prepare financial statements before they must be lodged at Companies House otherwise filing penalties will be levied.

Events may take place between the balance sheet date and the date on which they are authorised for issue (approved) by management. Some of these events may need to be reflected in the primary financial statements; whereas others may need to be disclosed.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with events after the end of the reporting period in Section 32 *Events after the End of the Reporting Period*. FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* deals with them in Section 26 *Events after the End of the Reporting Period*.

3.1 Adjusting and non-adjusting events

FRS 102, para 32.2 states that 'events after the end of the reporting period are:

> *… those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the **financial statements** are authorised for issue.*

FRS 102, para 32.2 (extract)

Both FRS 102 and FRS 105 distinguish between those events which are 'adjusting' events and those which are 'non-adjusting'. Adjusting events are those which provide evidence of conditions existing at the balance sheet date and non-adjusting events are those which are indicative of conditions arising after the reporting period.

Events will only fall under the scope of FRS 102, Section 32 or FRS 105, Section 26 when they arise **after** the balance sheet date and **before** the financial statements are authorised for issue.

Adjusting events

Adjusting events are those events which provide evidence of conditions that existed at the balance sheet date, but which arose after the balance sheet date. Adjusting events are adjusted for in the financial statements.

Example – Liquidation of a customer post-year end (1)

The financial statements of Howard Ltd for the year ended 31 August 2022 recognise trade debtors of £1.2m on which no impairment has been recognised. Total assets in the financial statements are £2.5m. On 8 September 2022, the company received notification from a liquidator that a customer owing £375,000 has gone into liquidation.

This debtor equates to 15% (£375,000 / £2.5m) of total assets and hence is a material figure.

Even though the liquidation occurred post-year end, there was no sudden change in circumstances and the liquidation was therefore evidence that the company was unable to pay its debts at the year end.

Trade debtors should be reduced by the value of this debt so that current assets are not overstated with a corresponding bad debt expense in profit and loss.

Example – Liquidation of a customer post-year end (2)

On 20 July 2022, Woodward Ltd sold goods on 90-days credit amounting to £50,000 to Byrne Ltd and immediately recognised the sale as revenue. Byrne Ltd is a large company generating a high level of profit and there were no doubts as to Byrne's ability to pay at the date of sale. Woodward's year end is 31 August 2022.

Preparation of Woodward's financial statements commenced on 8 September 2022. A few days later, the directors became aware that Byrne had ceased trading following a fire that had destroyed their premises and the company was uninsured.

The mere receipt of information that a customer is going into liquidation is not, in itself, an adjusting event. In this example, there were no doubts about the customer's ability to pay at the year end and the culmination of events leading to the customer's liquidation occurred post-year end. This is therefore a non-adjusting event after end of the reporting period.

This example illustrates that it not impossible for the bankruptcy of a customer which occurs post-year end to be treated as a non-adjusting event and the facts and circumstances should be considered on a case-by-case basis.

FRS 102, para 32.5 provides examples of adjusting events after the end of the reporting period which would require an entity to adjust the amounts in the financial statements, or to recognise items which may not have been recognised previously as follows:

- The settlement of a court case after the year end which confirms the entity had a present obligation at the end of the reporting period.

- Receipt of information after the year end indicating that an asset may be impaired, such as:
    - the bankruptcy of a customer;
    - the sale of inventories after the year end which indicates that estimated selling price less costs to complete and sell is lower than cost;
    - the determination post-year end of the cost of assets purchased, or the proceeds from the sale of assets, before the end of the reporting period;
    - the determination post-year end of the amount of profit-sharing or bonus payments, if the entity had a legal or constructive obligation at the balance sheet date to make such payments because of events prior to that date; and
    - the discovery of fraud or error which indicate that the financial statements are incorrect.

3.2 Non-adjusting events

Non-adjusting events do not necessitate changes to the amounts recognised in the financial statements but are instead disclosed where they are material.

FRS 102, para 32.7 provides two examples of non-adjusting events as follows:

- A decline in the market value of investments between the balance sheet date and the date on which the financial statements are authorised for issue.

- An amount which becomes receivable as a result of a favourable judgement or settlement of a court case after the balance sheet date but before the financial statements are authorised for issue.

Example – Customer fails to pay an invoice

Weaver Ltd has a year end of 31 August 2022. On 6 June 2022, the company sold goods on credit to a customer. The customer has failed to pay in accordance with the credit terms and Weaver has therefore issued a claim in the small claims court in respect of the amounts owed plus interest.

The courts awarded Weaver judgement and confirmed that the customer is required to pay for the goods plus interest to the date of payment. The awarding of judgement by the court indicates that Weaver had a receivable at the year end which was not impaired.

If the customer disputed the invoice, then careful consideration would need to be given as to whether there is a debtor or a contingent asset. If the customer disputes the invoice, but the courts find in favour of Weaver, the asset should continue to be recognised. Any awards by the court in respect of interest or penalties will be non-adjusting events if they occur after the balance sheet date but before the financial statements are authorised for issue.

Example – Material decline in the foreign exchange rate

Emery Ltd sells a large amount of goods to its overseas customer based in Farland and has a year end of 31 August 2022. At the year end, Emery correctly translates the debtor using the closing rate as required under FRS 102, Section 30 *Foreign Currency Translation*.

Due to political unrest in Farland, the country's currency was significantly devalued on 30 September 2022 which is after Emery's balance sheet date but before the financial statements are authorised for issue. The effect of the devaluation is material to the financial statements.

In this example, Emery has correctly translated the debtor using the closing rate at the balance sheet date. The fact that the overseas currency has been significantly devalued after the balance sheet date but before the financial statements are authorised for issue does not constitute an adjusting event. As the matter is material, Emery should disclose a non-adjusting event.

Example – Decline in the value of an investment

Walker Ltd has a significant portfolio of investments on its balance sheet as at its balance sheet date of 31 August 2022 which are measured under FRS 102, Section 11 *Basic Financial Instruments* at fair value through profit or loss. On 10 September 2022, the value of the investments fell considerably.

The fall in the market value of the investments occurs after the balance sheet date, but before the financial statements are authorised for issue. As the fall in fair value occurs after the year end, the entity does not alter the carrying amount of the investments, but as the fall in market value is material it discloses a non-adjusting event.

The overarching objective of non-adjusting events disclosures is to ensure that the user of the financial statements is made aware of material events that arise after the reporting date but before the financial statements are authorised for issue. As the conditions in respect of non-adjusting events did not exist at the balance sheet date, the amounts recognised in the financial statements are unaffected.

FRS 102, para 32.11 provides further examples of non-adjusting events which take place after the balance sheet date but before the financial statements are authorised for issue as follows:

*(a) a major **business combination** or disposal of a major **subsidiary**;*

(b) announcement of a plan to discontinue an operation;

FRS 102, para 32.11

(c) major purchases of assets, disposals or plans to dispose of assets, or expropriation of major assets by government;

(d) the destruction of a major production plant by fire;

*(e) announcement, or commencement of the implementation, of a major **restructuring**;*

(f) issue or repurchases of an entity's debt or equity instruments;

(g) abnormally large changes in asset prices or foreign exchange rates;

*(h) changes in tax rates or tax laws enacted or announced that have a significant effect on current and **deferred tax assets and liabilities**;*

(i) entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees; and

(j) commencement of major litigation arising solely out of events that occurred after the end of the reporting period.

3.3 Going concern

'Going concern' is defined as follows:

An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

*FRS 102 Glossary **going concern***

The going concern basis of accounting is a fundamental concept and the determination of whether, or not, an entity is a going concern is an important issue. Going concern is considered in FRS 102, paras 32.7A and 32.7B as well as in paras 3.8 and 3.9. FRS 105 covers the issue in paras 26.6 and 26.7 as well as in para 3.3.

Under UK GAAP, management are to assess the entity's ability to continue in operational existence as a going concern for a period of at least 12 months from the date of approval of the financial statements (not 12 months from the balance sheet date).

Example – Company to cease trading in 18 months' time

Heyes Ltd is a husband and wife run company with an accounting reference date of 31 August each year and prepares its financial statements under FRS 102. The financial statements for the year ended 31 August 2022 are going to be approved on 31 October 2022. The directors are planning on retiring in 18 months' time at which point the business will cease trading. The directors have assessed the company's ability to continue as a going concern for 12 months from 31 October 2022 and the financial statements have been prepared on a going concern basis.

FRS 102, para 3.8 states that the appropriateness of the going concern basis of accounting must be assessed for a period of at least, **but not limited to**, 12 months from the date on which the financial statements are authorised for issue. As the directors intend to cease trading in 18 months' time, the going concern basis of accounting is inappropriate and the financial statements should be prepared on a basis other than the going concern basis (but not the break-up basis as this is inconsistent with the requirements of FRS 102 which is discussed below).

FRS 102, para 32.7B states:

> *If the going concern assumption is no longer appropriate, the effect is so pervasive that this section requires a fundamental change in the basis of accounting rather than an adjustment to the amounts recognised within the original basis of accounting and therefore the disclosure requirements of paragraph 3.9 apply.*

FRS 102, para 32.7B (extract)

Neither FRS 102 nor FRS 105 elaborate as to what the alternative basis of accounting should be. Many accountants are familiar with the concept of the 'break-up basis' of accounting (a concept which has never been defined nor discussed in UK GAAP). The break-up basis of accounting is inconsistent with the requirements of FRS 102 and FRS 105 because it recognises future costs of winding down the business. Under UK GAAP, only those costs that have been committed to at the balance sheet date can be recognised.

In practice, the basis to be applied when the going concern basis of accounting is no longer appropriate will not be too dissimilar to that of FRS 102.

Even when a company is experiencing serious cash flow difficulties, the default position is to prepare the financial statements on a going concern basis unless management intend to cease trading, liquidate the entity, or have no realistic alternative but to do so. The fact that the company is experiencing cash flow difficulties does not mean that the going concern basis automatically ceases to be appropriate, but the entity will make disclosure of the material uncertainties related to going concern.

3.4 Dividends

Dividends are dealt with in FRS 102, para 32.8 and FRS 105, para 26.10.

Dividends cannot be recognised as a liability at the balance sheet date if the entity declares such dividends after the reporting date. This is because no liability exists at the balance sheet date where the entity has discretion over whether, or not, to pay dividends. It is possible to segregate the component of distributable reserves at the balance sheet date which will be used to pay the dividend. Where the entity declares a dividend after the balance sheet date but before the financial statements are authorised for issue, it should provide disclosure in the financial statements of the dividend.

Where dividends are declared prior to the balance sheet date but are not paid until after the balance sheet date, care should be taken to ensure that such a liability is binding on the entity. Dividends declared should be appropriately authorised and will no longer be at the discretion of the entity if they are binding on the reporting entity.

Guidance on when a dividend becomes legally binding is outlined in TECH 02/17BL *Guidance on Realised and Distributable Profit under the Companies Act 2006*.

Dividends become binding, and hence a liability of the business, when they are declared by the company in a general meeting. For private companies, a dividend becomes legally binding when a written resolution is passed.

It is not uncommon for companies to declare an interim dividend to shareholders. Interim dividends are usually authorised by the Articles of Association and will normally be authorised when they are paid. Accordingly, interim dividends declared prior to the year end but not paid until after the year end will not usually result in a liability at the balance sheet date.

3.5 Repayment of dividends

S847, Companies Act 2006 makes provision for shareholders to repay the company in respect of distributions if, at the time the distribution was made, the shareholders were aware (or had reasonable grounds to be aware) that the distribution was in contravention of the law.

If the directors become aware that a distribution contravenes company law, they should seek legal advice. Whether the shareholder is liable to repay a distribution will depend on the facts of the case. In a group context, if a parent company received a dividend from its subsidiary out of reserves which are not distributable, then it is likely that the parent would be required to repay the unlawful dividend.

In some private companies, dividends may be paid to shareholders at the detriment of creditors, or dividend may be regarded as unlawful. It is likely that in the event of a liquidation, where it can be proven that dividends are unlawful, or they have been paid at the detriment of creditors, that the liquidator forces the shareholder to repay the dividend to redress the inequity. In more serious cases, shareholders could be forced to sell personal assets to raise funds to repay the liquidator.

Conversely, a dividend may be paid to the shareholders which is, in fact, lawful at the time it is paid. However, circumstances could arise where the shareholders are requested to pay the dividend back to the company (for example, if the company runs into cash flow difficulties).

Example – A lawful dividend is repaid

On 31 August 2022, the directors of Humphries Ltd declared a dividend to ordinary shareholders. This dividend was also paid on 31 August 2022 resulting in no liability being recognised at the balance sheet date. The financial statements for the year ended 31 August 2022 are to be authorised in a board meeting to be held on 20 October 2022.

On 15 September 2022, the company's property was damaged following a storm and the company has had to incur additional cash expenditure to repair the damage which has caused the company to experience cash flow difficulties. The bank is unwilling to extend the company's overdraft facility.

The directors ask the shareholders to repay some of their dividend so that the company can continue to meet its obligations with creditors.

The return of the dividends is a non-adjusting event because the circumstances surrounding the request for the dividends to be returned (i.e. the damage to the building) occurred post-year end. In addition, the portion of the dividends that have been returned should not be treated as a reduction to the amount of dividend paid; instead, they are treated as a capital contribution as follows:

Dr Cash at bank

Cr Capital contribution (within equity)

The example above relates to shareholders that are returning a portion of their dividend which has been lawfully paid. In situations where dividends are returned because they are unlawful (for example where the law has not been correctly followed), the dividends returned should be accounted for as an adjusting event. They become an adjusting event if they are unlawful because the event provides evidence of conditions that existed at the balance sheet date as the dividends declared at that date were, in fact, unlawful, hence a debtor is recognised in the financial statements.

Dividends receivable

Dividends which are receivable are accounted for when the shareholder's right to receive payment is established.

In most cases, dividends receivable will arise in a group context where, for example, the parent company may have an investment in a subsidiary, associate or joint venture, which may declare dividends from time to time.

If dividends are declared by the investee after the balance sheet date, similar principles as discussed above will apply. No liability has arisen at the balance sheet date on the part of the investee; conversely no debtor arises to the investor so the financial statements of both the investee and the investor are not adjusted following declaration of the dividend after the balance sheet date.

If the dividend is declared prior to the balance sheet date, a debtor is recognised in the investor's individual financial statements. On consolidation, where appropriate, intra-group dividends are eliminated and only the non-controlling interest's portion of the dividend liability is recognised in the group accounts.

4 Covid support schemes (Lecture A796 – 4.16 minutes)

On 18 July 2022, HM Revenue and Customs (HMRC) issued a policy paper *Tackling error and fraud in the Covid-19 support schemes*.

The policy paper recognises that the total claims for the Coronavirus Job Retention Scheme (CJRS) amounted to £28.1 billion. 2.9 million individuals received a grant, and 10.4 million total grants were claimed.

HMRC were aware at the outset that these schemes would be a target for fraud (especially considering how quickly they had to launch the scheme). HMRC also recognised that they would also be a target for error because individuals were operating at pace and under pressure to ensure resources were available to employees.

HMRC blocked more than 65,000 claims which were worth a total of £425 million via pre-payment checks. Other claims that were flagged as 'high risk' were subject to post-payment compliance checks. HMRC have stated in their policy paper that their checks have prevented more than £775 million from being lost through fraud and error. This has been achieved through preventing losses through compliance checks or by recovering overclaimed grants.

In addition, taxpayers have also made unprompted decisions to repay £970m. These decisions were twofold: the taxpayer either decided to repay the money because they no longer needed it; or because they recognised an error and returned the money.

4.1 Taxpayer Protection Taskforce

HMRC confirmed that the government has invested over £100 million in a Taxpayer Protection Taskforce whose objective is to combat fraud through Covid-19 support schemes. Up to 31 March 2022, this taskforce has opened nearly 41,000 one-to-one compliance interventions and contacted over 63,000 people via one-to-many campaigns.

The taskforce is made up of tax specialists who have a wealth of experience in responding to fraud and error. HMRC have stated that tackling Covid-19 fraud is a major priority and hence they require skilled and experienced staff from tax compliance.

HMRC have also insisted that they are not prepared to write anything off where fraud or error is concerned, and they will continue to prioritise the most serious cases of abuse. HMRC have legal powers to recover fraudulent claims up to 20 years after the event.

4.2 Estimates of fraud and error

HMRC have gathered information via data through a Random Enquiry Programme which means they can revise their error and fraud estimates with more certainty.

The most likely estimate for the value of error and fraud in the CJRS, the Self-Employed Income Support Scheme and the Eat Out to Help Out scheme during 2020 and 2021 is now £3.9 billion (estimated range between £2.8 billion and £5.5 billion). This was down from the previously published most likely estimate of £5.8 billion. HMRC's most likely estimate of the rate of error and fraud in the schemes in 2020 and 2021 is 4.8%, whereas their previously published estimate was 7.2%.

These estimates have been put together by experienced statisticians, with input and peer review from the UK's Office for National Statistics and international colleagues.

For the CJRS, HMRC have stated that new data from the Random Enquiry Programme and compliance cases shows that the overall level of error and fraud in claims made by individual employers is generally low.

Of course, all estimates (by their very nature) come with a degree of uncertainty. HMRC have recognised this uncertainty by using recognised statistical techniques to determine ranges for their estimates as opposed to using single figures. This has allowed them to account for the uncertainty involved in estimating how many employees were working while their employers claimed from the CJRS as well as any measurement or sampling error in the Random Enquiry Programme.

5 Strategic reports and directors' reports (Lecture A797 – 15.50 minutes)

On 16 June 2022, the Financial Reporting Council (FRC) issued an *Update to the FRC's Guidance on the Strategic Report*. This update was primarily issued to incorporate the new climate-related financial disclosures following changes to company law earlier this year. In addition, several other amendments were made to the guidance to maintain alignment with legislation.

ICAEW have published a helpsheet on the strategic report and directors' report which will assist firms in preparing these reports in accordance with legislative requirements.

5.1 Steps for preparing a strategic report and directors' report

Over time, the reporting requirements for the strategic report and directors' report have become more complex. In larger companies gathering the required information can be a difficult task but the following diagram illustrates how this may be achieved:

Determine the scoping categories: This will help to determine whether a strategic report and/or directors' report is needed and the level of information to be presented

Understand the content requirements: This will help to iddentify what information is needed in both reports and how they may interact

Consider the presentation of information: This will help the company to think about the best way to communicate the significant matters in a clear and concise way

Approval: Both the strategic report and directors' report must be approved by the board of directors and signed on behalf of the board by a director or company secretary

5.2 Directors' report

All companies (except for micro-entities) must prepare a directors' report for each financial year.

For small companies the directors' report will be very brief but medium-sized and large companies (and groups) will have to prepare a more detailed directors' report. Small companies are subject to the requirements of The Small Companies and Groups (Accounts and Directors' Report) Regulations (SI 2008/409); whereas non-small entities are subject to The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410).

It is important to emphasise that company law categorises companies not only on their size, but also on their nature so different disclosures will be needed for different categories of company.

Page seven of the ICAEW's helpsheet provides a table outlining the content requirements for the directors' report.

5.3 Presentation of information

Depending on the size of the business, a directors' report is likely to include a wide range of information on various matters. If any matters are of strategic importance to the company or group, they may be included in the strategic report. Where this is done, the directors' report must state this fact and outline the information that has been included in the strategic report, with appropriate cross references.

5.4 Materiality

Most of the required disclosures for the directors' report must be made regardless of materiality. However, some disclosures are 'automatically' restricted to ensure that neither too little nor too much information is included. For example, an entity is only required to include *principal* risks and uncertainties and *key* performance indicators.

5.5 Content of the directors' report

The table below provides the content of the directors' report by category of company:

Type of company	Disclosure requirement
All companies	• The names of the persons who, at any time during the financial year, were directors of the company • Qualifying third party indemnity provisions in force for the benefit of one or more directors of the company • A statement in respect of disclosures provided to the auditors
Company which is not a wholly owned subsidiary of a UK company	• Information on political donations and expenditure including contributions to non-UK political parties
Any company not entitled to apply the small companies' regime	• Certain information relating to the risks associated with the company's use of financial instruments • Details of any important events affecting the company which have

	occurred since the balance sheet date • An indication of likely future developments in the business of the company • An indication of the activities (if any) of the company in research and development
Company not entitled to the small companies' exemption	• A statement as to the amount (if any) that the directors recommend by way of a dividend • An indication as to the existence of branches of the company outside of the UK (not applicable for unlimited companies or similar)
Limited company not entitled to the small companies' regime	• An indication as to the existence of branches of the company outside of the UK
Publicly traded company with securities that carry voting rights (voting rights mean rights to vote at general meetings of the company, including rights that arise only in certain circumstances)	• Information on share capital and securities including, among other things, details of how the company's capital is structured and details of people with significant direct or indirect holdings of securities in the company
Public company	• Details of the acquisition of own shares including, among other things, the number and nominal value of the shares so purchased, the aggregate amount of the consideration paid by the company for such shares and the reasons for their purchase
Company with more than 250 employees in the year	• Information on the employment of disabled persons including, among other things, the company's policy for ensuring that disabled persons are given full and fair consideration when applying for employment by the company
Company with more than 250 employees on a two-year rolling basis	• Employee engagement statement that describes the action taken during the financial year to introduce,

	maintain or develop arrangements aimed at: ○ providing employees systematically with information on matters of concern to them as employees; ○ consulting employees or their representatives on a regular basis so that the views of employees can be taken into account in arriving at decisions which are likely to affect their interests; ○ encouraging the involvement of employees in the company's performance through an employees' share scheme or by some other means; ○ achieving a common awareness on the part of all employees of the financial and economic factors affecting the performance of the company; and ○ summarising how directors have engaged with employees and had regard to employee interests, and the effect of that regard, including on the principal decisions taken by the company during the financial year
Large company based on size thresholds only	• A statement of engagement with suppliers, customers and others
Very large company (a company which in the year meets either or both of the following on a two-year rolling basis: • More than 2,000 employees • Turnover of more than £200m and a	• A statement of corporate governance arrangements

balance sheet total of more than £2bn Companies exempt from this category are: • Companies required to provide a corporate governance statement • Community interest companies • Charitable companies)	
Unquoted large company based on size thresholds and more than 40,000 kWh energy use	• Streamlined Energy & Carbon Reporting – Greenhouse gas emissions, energy consumption and energy efficiency
Quoted company and more than 40,000 kWh energy use	• Streamlined Energy & Carbon Reporting – Greenhouse gas emissions, energy consumption and energy efficiency

5.6 Strategic report

The purpose of the strategic report is to inform shareholders and help them to assess how the directors have performed their duty under s172 Companies Act 2006 to promote the success of the company.

All companies must prepare a strategic report for each financial year, except:

- Companies eligible to prepare financial statements for the year in accordance with the small companies' regime; and
- Companies that would be so eligible save for being, or having been at any time within the financial year to which the accounts relate, a member of an ineligible group.

Information provided in the strategic report will vary depending on the size or nature of the company or group.

The ICAEW guide provides a useful overview of different categories of company which is relevant for the strategic report as follows:

Table 2: Overview of different categories of company relevant for the strategic report – see section 7 for further detail

	A	B	C	D	E
	All companies[10]	Large company	Quoted company	Public interest entities (PIEs) with > 500 employees[11]	PIEs, AIM companies and high turnover companies[12] with > 500 employees
Fair review of the business including principal risks and uncertainties	✓				
Key performance indicators – financial	✓				
Reference to and explanations of amounts included in the annual accounts	✓				
Key performance indicators – non-financial		✓			
Section 172(1) statement		✓			
Information on trends, company strategy and business model.			✓		
Gender split			✓		
Information on environmental matters, the company's employees, and social, community and human rights issues			✓		
Non-financial information statement – information on environmental matters, the company's employees, social matters, respect for human rights and anti-corruption & anti-bribery matters				✓	
Non-financial and sustainability information statement – all of the information required by the non-financial information statement plus additional climate-related disclosures[13]					✓

Practical tip: overlapping content

Some of the disclosures required by categories C, D and E overlap with each other. Companies should be careful to ensure that they are fully complying with the requirements that are applicable to them.

Section 6 of the FRC guidance provides a set of communication principles which are intended to assist companies when preparing their strategic report.

These are as follows:

- The strategic repot should be fair, balanced and understandable.
- The strategic report should be clear and concise, yet comprehensive.
- Where appropriate, information in the strategic report should have a forward-looking orientation.
- The strategic report should provide information which is company specific.
- The strategic report should highlight and explain linkages between pieces of information presented within the strategic report and in the annual repot more broadly.
- The structure, presentation and content of the strategic report should be reviewed annually to ensure that it continues to meet its purpose and only contains information that is relevant.

5.7 Materiality

The strategic report contains information which is material to the shareholders of the company. The FRC's guidance on the strategic report provides practical help on the concept of materiality and the strategic report. It explains how materiality is entity-specific and is a wholly judgemental issue. The guidance also recommends that materiality is reviewed annually to ensure that the information included in the strategic report continues to be material over time considering changes in facts and circumstances affecting the business.

5.8 Content of the strategic report

This table provides a summary of the content of the strategic report by company category:

Type of company	Disclosure requirement
All companies	• Fair review of the business including principal risks and uncertainties • Financial key performance indicators • References to, and explanations of, amounts included in the annual accounts
Large company	• Non-financial key performance indicators • Section 172(1) statement
Quoted company	• Information on trends, company strategy and business model • Gender split • Information on environmental matters, the company's employees and social, community and human rights issues
Public interest entities (PIEs) with more than 500 employees	• Non-financial information statement • Overlapping requirements
PIEs, AIM companies and high turnover companies and groups with more than 500 employees ('high turnover' is more than £500m in the financial year)	• Non-financial and sustainability information statement

6 ISQM 1 – Part 5

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

- ISQM (UK) 1 *Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements*; and
- ISQM (UK) 2 *Engagement quality reviews*.

As explained in previous quarters, it is important that firms start to consider the impact these two ISQMs (UK) will have. ISQM (UK) 1 requires the system of quality management to be designed and implemented by 15 December 2022, with an evaluation of this within one year following this date.

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

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

In this quarter, we will examine engagement performance.

6.1 Engagement performance

ISQM (UK) 1, para 31 states:

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

ISQM (UK) 1, para 31

(a) Engagement teams understand and fulfil their responsibilities in connection with the engagements, including, as applicable, the overall responsibility of engagement partners for managing and achieving quality on the engagement and being sufficiently and appropriately involved throughout the engagement.

(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.*

(c) *Engagement teams exercise appropriate professional judgment and, when applicable to the type of engagement, professional skepticism.*

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

(e) *Differences of opinion within the engagement team, or between the engagement team and the engagement quality reviewer or individuals performing activities within the firm's system of quality management are brought to the attention of the firm and resolved.*

(f) *Engagement documentation is assembled on a timely basis after the date of the engagement report, and is appropriately maintained and retained to meet the needs of the firm and comply with law, regulation, relevant ethical requirements, or professional standards.*

ISQM (UK) 1 differs from ISQC (UK) 1 as follows:

- ISQM (UK) 1 contains principles-based requirements to establish quality objectives which address engagement performance. As noted above, there are still principles-based requirements on consultation, differences of opinion and the assembly, maintenance and retention of engagement documentation.
- There is a new requirement addressing the engagement team's responsibilities in connection with engagements, including the overall responsibility of an engagement partner for managing and achieving quality on an engagement and being sufficiently and appropriately involved throughout.
- There is an enhanced requirement addressing direction and supervision of engagement teams and review of the work performed. This enhanced requirement is focussed on what is appropriate considering the nature and circumstances of the engagement and the resources assigned or made available to the engagement team.
- There is a new requirement addressing the exercise of professional judgement and, when applicable to the engagement, professional scepticism.
- Requirements that deal with engagement quality reviews are contained in ISQM (UK) 2.

6.2 Smaller audits

It is important to bear in mind the principles-based approach of ISQM (UK) 1. In a smaller audit (or small audit firm) there may be no engagement team members other than the engagement partner (e.g. for a sole practitioner). Therefore, in these situations the quality objectives that address direction, supervision and review may be irrelevant. The firm's quality risks related to the engagement partner's responsibility for managing and achieving audit quality on the engagement and being sufficiently and appropriately involved throughout the entire audit may be assessed as being fairly low.

A small audit firm may not have internal personnel with the competence and capabilities to provide consultation (e.g. on complex tax matters or complex valuation techniques). The firm may determine it appropriate to make use of an external expert for the purposes of consulting on difficult or contentious matters.

There may be challenges within the firm to have individuals who are responsible for resolving differences of opinion. The firm may determine it appropriate to use external service providers for the purposes of receiving and resolving differences of opinion.

6.3 Professional judgement and professional scepticism

A firm may design and implement several responses to address professional judgement and professional scepticism which are related with other quality objectives (e.g. including responses which deal with direction, supervision and review and differences of opinion).

Examples of other aspects of the firm's system of quality management which may support engagement teams in exercise appropriate professional judgement and professional scepticism include:

- Embedding a culture that demonstrates the firm's commitment to quality.
- Members of the firm's leadership taking responsibility and accountability for quality and demonstrating their commitment to quality through their actions and behaviours.
- Assigning appropriate resources to engagements, including HR, technological and financial resources.
- Developing appropriate intellectual resources, including creating alerts for engagement teams on circumstances giving rise to the need for professional judgement and professional scepticism and providing guidance for engagement teams in these circumstances.
- Managing the assignment of personnel to engagements and ensuring that they have the time required to carry out their work properly and fulfil their responsibilities.

- Making appropriate judgements concerning acceptance and continuance of engagements, such as considering whether the audit firm has appropriate resources to perform the engagement and whether the firm has the time to carry out the engagement given the firm's other commitments.
- Providing necessary training.

7 Auditing subsequent events (Lecture A798 – 11.33 minutes)

ISA (UK) 560 *Subsequent Events* provides guidance to the auditor in auditing those events that arise after the balance sheet date but before the date of the auditor's report. The overall objectives of the auditor according to ISA (UK) 560 are:

> *To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statement are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework; and*
>
> *To respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.*

ISA (UK) 560, para 4(a) and (b)

As covered earlier in the course, in almost all cases, the financial statements of an entity will not be finalised until a period of time has elapsed between the balance sheet date and the date on which the financial statements are authorised for issue. It is important that the auditor has regard to events which take place between these dates as they could have an impact on the amounts reported, or disclosed, in the financial statements.

The auditor must carry out audit procedures which are designed to obtain sufficient appropriate audit evidence that all events which take place between the date of the financial statements and the date of the auditor's report which require adjustment of, or disclosure in, the financial statements have been identified.

It is important to understand that it is **not** the auditor's responsibility to identify events after the end of the reporting period – this responsibility rests with management. It is the auditor's responsibility to ensure that such events are properly reflected in the financial statements as either adjusting or non-adjusting events.

The auditor must clearly understand their objectives and the work that needs to be done in respect of subsequent events. This is an area that lends itself to a lot of criticism by file reviewers and professional body monitoring officers who have complained in the past that auditors have failed to carry out adequate subsequent events procedures, or there is insufficient evidence on the audit file that demonstrates compliance with ISA (UK) 560.

It is necessary to carry out procedures on subsequent events **up to the date of the auditor's report** because the auditor is providing reasonable assurance that all subsequent events which need reflecting, or disclosing, in the financial statements have been considered up to the date of the auditor's report. If procedures are not carried out up to the date of the auditor's report, a material adjusting, or non-adjusting event may not be properly reflected in the financial statements meaning audit risk (the risk that the auditor expresses an inappropriate audit opinion on the financial statements) is increased.

7.1 Audit procedures for subsequent events

The types of audit procedures the auditor will carry out on an entity's subsequent events will, of course, be driven by the risk assessment (i.e. the risk of material misstatement in the financial statements). All audits are inherently different, and some audits will require more detailed audit procedures than others.

However, as a minimum, the auditor should at least carry out the following:

- Obtain an understanding, and consider the effectiveness, of the procedures that management has established to ensure that subsequent events are identified. Where management have not established procedures to identify subsequent events, the risk of material misstatement is heightened.

- Enquire of management and, where appropriate, those charged with governance, as to whether any subsequent events have taken place. Inquiry is a valid audit procedure under ISA (UK) 500 *Audit Evidence*, however, in itself, inquiry is a weak procedure and should only be used to complement other forms of audit evidence.

- Read minutes of meetings of management and those charged with governance. Meeting minutes will often provide an indication of subsequent events that have arisen such as the commencement of legal proceedings, the incurrence of a bad debt or restructuring of the organisation.

- Consider the external environment in which the entity operates in case it indicates there are factors that management have not considered. These may indicate legal, regulatory, societal, political, or technological changes which could impact the company.

- If the reporting entity is going through a legal case, inquire of the legal advisers as to whether there is a likelihood of the claim being successful and hence considering whether a provision for liabilities should be recognised, or a contingent liability disclosed. For ongoing legal claims, it is important that the auditor receives timely updates.

- Obtain the latest interim financial statements (where applicable) and carry out a review of these to identify any subsequent events.

- Review accounting records, including budgets and forecasts.

- Ask the directors about the progress of reported provisions and contingencies.

Example – Contingent liability becomes a provision

The audit of the financial statements of Cahill Ltd for the year ended 31 July 2022 is nearing completion. Final audit procedures are being carried out and the auditor's report is due to be signed in a week's time.

During the audit, the auditor became aware of a legal claim against the company for an injury sustained by a former employee. The employee is claiming damages of £10,000 and loss of earnings of £6,000. The auditor held discussions with the finance director who confirmed that the legal advisors had suggested the claim will be dismissed but a contingent liability had nonetheless been disclosed in the draft financial statements. The finance director was also able to show the auditor written notification from the legal advisers to corroborate this assertion.

The case was heard by the court three days prior to the auditor's report being signed and the judge awarded the former employee damages and loss of earnings totalling £15,000. The amount is not material in isolation but becomes material when aggregated with other misstatements identified during the audit.

The awarding of damages and costs to the former employee is evidence of an adjusting event because the conditions giving rise to the liability existed at the balance sheet date. Consequently, the financial statements for the year ended 31 July 2022 should be adjusted to reflect a provision for a liability for £20,000 with a corresponding expense in profit or loss. As the amount is material in the aggregate, if the directors refuse to amend the financial statements the auditor must express a qualified opinion as the financial statements will not comply with FRS 102, Section 32 *Events after the End of the Reporting Period*. A basis for qualified opinion paragraph would also be included underneath the opinion paragraph which would explain the incorrect treatment of the adjusting event.

7.2 Written representation

Written representations are dealt with in ISA (UK) 580 *Written Representations*. Appendix 1 to ISA (UK) 580 contains a list of paragraphs within the other ISAs (UK) which should be included in the written representation letter requested from management and, where appropriate, those charged with governance. ISA (UK) 580 requires a written representation to be obtained from management that all events occurring subsequent to the balance sheet date and which either require reflecting in the financial statements themselves, or disclosed because they are non-adjusting events, have been reflected or disclosed accordingly.

It must be emphasised that a written representation cannot be regarded as sufficient appropriate audit evidence on its own in respect of subsequent events. This is because written representations are internally generated by management and those charged with governance so should serve to complement other forms of audit evidence.

Example – Extract from a written representation relating to subsequent events

All events subsequent to the date of the financial statements and for which FRS 102, Section 32 *Events after the End of the Reporting Period* require adjustment or disclosure have been adjusted or disclosed.

7.3 Facts become known to the auditor after the date of the auditor's report

Once the auditor has signed their report on the financial statements, they are under no obligation to perform additional procedures on those financial statements. However, if facts become known to the auditor after they have signed the auditor's report (but prior to the financial statements being issued) which, had those facts been known to the auditor at the time of issuing the auditor's report, would have caused the auditor to amend the report, the auditor is required to carry out the following steps:

(a) Discuss the fact(s) with management and, where appropriate, those charged with governance.

(b) Establish whether, or not, the financial statements need to be amended in light of the fact(s).

(c) Enquire with management how they intend to address the issue(s) in the financial statements.

Example – Discovery of a material error

The audit of the financial statements of Freya Ltd for the year ended 30 April 2022 has been completed and the auditor signed their report on 14 August 2022. The financial statements are due to be issued on 19 August 2022.

On 17 August 2022, the new financial controller discovered that the company had been incorrectly claiming VAT on certain purchases which were either exempt from VAT or which the company was ineligible to claim the VAT back on. This resulted in an amount of £65,000 being owed back to HMRC and an immediate voluntary disclosure was made to HMRC.

The error is material to the financial statements and relates to the year ended 30 April 2022 resulting in liabilities being understated and profit before tax being overstated. The finance director has concluded that the financial statements will need amendment as the amount in question is material.

In this example, the financial statements have not been issued. The auditor's report has been signed but management have amended the financial statements and hence ISA (UK) 560, para 11 will apply which requires the auditor to:

- carry out audit procedures on the amendment;
- extend the subsequent event audit procedures to the date of the new auditor's report; and

- provide a new auditor's report on the amended financial statements.

In the above example, management had amended the financial statements for the effects of facts that became known to them after the auditor's report had been signed but before the financial statements had been issued. ISA (UK) 560, para 11(b)(ii) requires the auditor to then provide a new auditor's report on the amended financial statements. However, it is important that the new auditor's report is not dated any earlier than the date of approval of the amended financial statements.

Important point in the engagement letter

The terms of an audit engagement must include the agreement of management to inform the auditor of any facts which may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued. In practice, the date of the auditor's report and the date of approval of the financial statements are often the same date. Once management have approved the financial statements, it is usually common practice to authorise them for issue on the same date.

If management are not prohibited by law or regulation from restricting the amendment of the financial statements to the effects of the event causing that amendment (i.e. in the example of Freya Ltd above with the additional VAT that has become payable) and those responsible for approving the financial statements are not prohibited by law or regulation from restricting their approval to that amendment, the auditor is then permitted to restrict their audit procedures to that amendment. Putting this into perspective, the auditor of Freya Ltd above would only need to restrict their audit procedures to the additional VAT that has become payable following their audit.

Where the circumstances above arise, the auditor amends the auditor's report to include an additional date which is restricted to the amendment. The date of the auditor's report on the financial statements prior to the amendment being made is unchanged as this informs the user of the date on which the audit work on those financial statements was completed. The auditor must, however, include an additional date in the auditor's report which informs the user that the audit procedures on subsequent events were restricted to the matter giving rise to the amendment.

ISA (UK) 560, para A12 includes an illustrative example as follows:

> *(Date of auditor's report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y).*

ISA (UK) 560, para A13

The auditor could also provide a new or amended auditor's report which includes a statement in an Emphasis of Matter paragraph, which explains that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

Example – Emphasis of Matter paragraph in respect of subsequent events

Emphasis of Matter

As described in note 34 to the financial statements, additional audit procedures have been performed subsequent to the original date of the auditor's report which was 28 November 2022. The procedures performed on the subsequent event described in note 34 are restricted solely to the amendment of the financial statements after the date of our original report.

7.4 If management do not amend the financial statements

ISA (UK) 560 recognises that in some jurisdictions there may be no requirement by law, regulation, or financial reporting framework to amend the financial statements. In such cases, the auditor does not have to provide an amended or new auditor's report thereon. This should not, however, be taken as absolute because the auditor may feel that the subsequent event is sufficiently material to warrant the financial statements needing amendment. This could arise, for example, where a material fraud or error is discovered after the auditor's report has been signed, but before the financial statements are authorised for issue. There are two scenarios relevant to this situation:

1. where the auditor has not yet provided the auditor's report to the reporting entity, the opinion is modified accordingly as required by ISA (UK) 705 *Modifications to the Opinion in the Independent Auditor's Report* and then provide the auditor's report; or
2. where the auditor has already provided their report, the auditor notifies management and those charged with governance not to issue the financial statements to third parties before the necessary amendments have been made. If the entity has already issued the financial statements, the auditor must take appropriate action to stop those third parties from placing reliance on the auditor's report. In these situations, the auditor would be advised to seek legal advice.

7.5 Facts become known to the auditor after the date of the auditor's report and after they have been issued

As noted earlier, the auditor is under no obligation to perform additional audit procedures on the financial statements once the auditor's report has been signed and the financial statements have been issued. Nonetheless, facts may become known by the auditor which, had they been known at the date they signed the auditor's report, would have caused the auditor to amend the auditor's report accordingly. In such instances, the auditor is required to take specific action as follows:

- Discuss the matter with management and, where appropriate, those charged with governance.
- Determine if the financial statements require amendment.
- If the financial statements do require amendment, discuss with management how they intend to address the matter in the financial statement.

If management choose to amend the financial statements to reflect the subsequent event, the auditor should then carry out the necessary audit procedures on the amendment. The auditor should also review the steps taken by management to ensure that anyone in receipt of the previous version of the financial statements and auditor's report thereon is informed of the situation.

In the UK, the auditor of a company has a legal right to attend the Annual General Meeting and be heard on any aspect of the business of that meeting which concerns them as the company's auditor. This would also include making a statement about the facts which have been discovered after the date of the auditor's report.

The auditor may perform full subsequent events procedures on the period between the date of the previous auditor's report and the date of the next auditor's report following the subsequent event. Where this does happen, the date of the new auditor's report must be no earlier than the date of approval of the financial statements.

Management may not be restricted from amending the financial statements to the extent of only the matter giving rise to the amendment and those approving the financial statements may not be restricted in approving that amendment. Where this is the case, the auditor only needs to perform subsequent events procedures on that amendment. Again, the auditor could choose to provide a new auditor's report or amend the previous auditor's report. In any event, the auditor must include in the new, or amended, auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph which refers to a note in the financial statements which explains the reasons for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

Management does not amend the financial statements

If the auditor concludes that the financial statements should be amended to reflect the additional facts that have become known to them, and management does not make the amendment, the auditor must notify management and those charged with governance that they will seek to prevent future reliance on the auditor's report. The course of action taken by the auditor will depend on their legal rights and obligations but the need to seek legal advice should be borne in mind.

The auditor may make an appropriate statement in the company's Annual General Meeting, but they do not have the legal right to communicate in writing with the shareholders. However, if the extent of the circumstances is such that they choose to resign, or are removed or not reappointed, the auditor does have various duties under the Companies Act 2006. In addition, s519 would require the auditor to issue a statement in relation to their ceasing to hold office.

8 Materiality (Lecture A799 – 10.48 minutes)

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

Essentially, if the financial statements contain material misstatement, they cannot be said to give a true and fair view. The Companies Act 2006 prohibits the directors from approving financial statements that do not give a true and fair view.

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

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

- whether the misstatement would affect the economic decisions of the users;
- the size and nature of the misstatements (some misstatements may be immaterial in monetary terms (quantitative) but could be material in nature (qualitative); and
- the information needs of the users as a group.

8.1 Material by size

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

- ½ to 1% of revenue
- 5 to 10% of profit before tax
- 1 to 2% of total assets

These percentage figures are useful as a starting point, but it is worth emphasising that they are **not** prescriptive and different auditors may use different percentages depending on their risk assessment. However, it would usually be inappropriate to use percentages larger than these limits because otherwise materiality will end up being too high and audit risk will increase.

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

Example – Misstatement identified

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

When calculating the materiality of this misstatement, the auditor could assess it against the performance materiality. However, for items that affect a particular balance, it may be appropriate to select a materiality figure based on the item that will be affected. Hence, the auditor would assess the misstatement individually against the benchmark used for pre-tax profit and total assets. If the misstatement was, for example, 2.5% of total assets and 3% of profit before tax, the misstatement would still be material in isolation as it goes over the 1-2% of total assets benchmark so would need to be corrected to avoid a modified audit opinion.

8.2 Material by nature

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

- Disclosures about a material uncertainty related to going concern
- Material related party transactions that have not been adequately disclosed
- Disclosures concerning transactions with directors
- Contingent liability disclosures which, if omitted, may impact on the usefulness of the financial statements
- Misstatements which, if adjusted, would cause a profit to turn into a loss
- Misstatements which, if adjusted, would cause net assets to turn into net liabilities

Materiality levels are calculated at the planning stage, but they must be revised throughout the course of the audit if issues arise that cause the audit plan to be changed. The level of adjustment to the materiality levels will all depend on the issues that have arisen, but consultation with the audit engagement partner must be undertaken prior to any revisions to ensure that any amendments to materiality are appropriate.

In addition, the materiality levels must be reassessed at the end of the audit to ensure that they remain appropriate. In certain situations, it may be necessary to perform further audit procedures at the completion stage, particularly if the level of uncorrected adjustments approaches materiality.

8.3 Performance materiality

Performance materiality is defined in ISA (UK) 320, para 9 as follows:

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

ISA (UK) 320, para 9

Where performance materiality is concerned, the auditor sets this at a lower level than the overall financial statement materiality level and uses this lower threshold when designing and performing audit procedures (in other words, it is used as a basis for testing transactions). This reduces the risk that the auditor will not identify misstatements which are material when aggregated.

Example – Calculation of performance materiality

The audit engagement team is planning the audit of Harper Ltd for the year ended 31 August 2022. The audit senior has calculated financial statement materiality to be £86,000 and the general level of performance materiality has been calculated at 75% of this (£64,500). The senior has identified work in progress and development expenditure as having a high risk of material misstatement, hence a specific level of performance materiality needs to be applied to these areas.

The audit engagement partner has suggested that 50% of the financial statement materiality level be used in these high-risk areas. Hence, when auditing work in progress and development expenditure, a performance materiality of £43,000 (£86,000 x 50%) should be applied.

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

In the example above, specific performance materiality is £43,000. If the auditor had not used this specific performance materiality and then discovered a misstatement of, say, £70,000 in the work in progress valuation, the auditor may have concluded that the misstatement is immaterial when measured against financial statement materiality of £86,000. However, the auditor may not have detected further misstatements which, when added to the £70,000 figure, could have resulted in material misstatement. By using performance materiality, the misstatement of £70,000 would be considered material by the auditor and hence the auditor would request management to correct the misstatement, and this reduces the risk of the auditor expressing an inappropriate opinion.

It is worth noting that ICAEW guidance suggests a performance materiality of 75% for low risk areas of the audit and 50% for those considered high risk. In the FRC thematic review, the vast majority do not go over 75% and only one listed audit went above 80%.

A general level of performance materiality is required to be used in planning and to determine the extent of testing required. The level of performance materiality is a matter of professional judgement but research in the form of the FRC *Audit Quality Thematic Review – Materiality* issued in December 2017 has shown the percentage reduction in financial statement materiality to get to performance materiality is usually between 20% and 60%. First year audits typically require a lower level of performance materiality to mitigate the risks of auditing an unfamiliar set of accounts.

As with financial statement materiality levels, performance materiality levels are revised during the audit work, where necessary. A reduced level of performance materiality would be appropriate when facts come to light which the auditor was not previously aware and which increases the risk of material misstatement (for example, an undisclosed related party).

8.4 Clearly trivial misstatements

As well as documenting the levels of financial statement and performance materiality, the auditor is also required to document the level below which misstatements are clearly trivial. This is part of the requirements of ISA (UK) 450 *Evaluation of Misstatements Identified During the Audit* which requires all misstatements found during the audit (other than those which are clearly trivial) to be accumulated.

9 Evaluating misstatements (Lecture A800 – 8.05 minutes)

During the audit, the auditor will document all misstatements identified on an 'audit error schedule' or 'summary of unadjusted errors schedule' and will discuss these errors with management and, where applicable, those charged with governance.

The auditor must consider the effect of uncorrected misstatements on the financial statements as a whole in line with ISA (UK) 450 Evaluation of Misstatements Identified During the Audit. This is achieved by:

- Recording all uncorrected misstatements identified during the detailed audit fieldwork on an unadjusted error schedule unless the misstatements are clearly trivial. The 'clearly trivial' benchmark is set at the planning stage of the audit and must be documented on file.
- Consider whether the identified misstatements indicate the presence of other misstatements within the financial statements which may be material when aggregated. If this is the case, the audit plan and audit strategy should be revised accordingly. Where the audit plan and strategy has been revised, the reasons for such revision should be documented.
- Assess the materiality of the uncorrected misstatements keeping in mind that it is not just about the numbers where materiality is concerned. If a material disclosure is either inadequate or has not been made (for example, a material related party disclosure), this will also be regarded as an uncorrected misstatement which should be corrected. Disclosures which are inconsistent with the financial statements (including those in the directors' report and/or strategic report) should also be corrected.
- Report all misstatements identified to an appropriate level of management or, where applicable, to those charged with governance.
- Request that all misstatements are corrected.
- If management refuse to correct some, or all, of the misstatements, the auditor must consider their reasons for refusing to correct them and take these into account when establishing whether the misstatements are material both in isolation and in the aggregate.
- Revisit the materiality levels calculated at the planning stage and, where applicable, revised during the detailed audit fieldwork to assess whether they remain appropriate at the completion stage having regard to the audit conclusions and evidence in each area.
- Report any uncorrected misstatements to those charged with governance and explain the effect that this may have on the audit opinion.

- Request a written representation from those charged with governance that they believe the effects of uncorrected misstatements are immaterial.

- A copy of the uncorrected misstatements must be supplied to those charged with governance. This usually accompanies the letter of comment or is supplied beforehand.

Reporting

Once the above procedures have been completed, the auditor must consider the impact of the uncorrected misstatements on the audit opinion. Where the impact is immaterial, an unqualified opinion can be expressed. Where the impact is material, the qualification will all depend on the materiality and pervasiveness of the uncorrected errors.

If the uncorrected misstatements are material but not pervasive, a qualified 'except for' opinion may be expressed. If the uncorrected misstatements are material and pervasive an adverse or disclaimer of opinion may be expressed.

Uncorrected misstatements which are immaterial do not need to be dealt with in the auditor's report by way of an Emphasis of Matter paragraph. Some audit files have been criticised for including an Emphasis of Matter paragraph dealing with uncorrected misstatements. This is technically incorrect on two counts:

Immaterial misstatements do not need to be brought to the attention of the shareholders because they are immaterial.

An Emphasis of Matter paragraph is only used to draw attention to a fundamentally important issue that has been adequately presented or disclosed in the financial statements.

10 FRC guidance on professional judgement

In June 2022, the FRC issued *Professional Judgement Guidance*. This guidance is non-authoritative and is intended to be persuasive rather than prescriptive and is judged to enable best practice to be achieved on an audit.

ISA (UK) 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)* defines 'professional judgement' as:

> *The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the course of action that are appropriate in the circumstances of the audit engagement.*

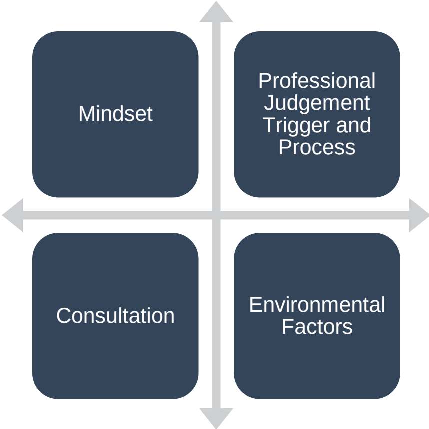
ISA (UK) 200, para 13(k)

It is quite unusual for the FRC to issue specific guidance on these kinds of areas, and they have said that it is their intention that this guidance can be used in a variety of ways. For example:

- At a firm-wide level where it can be incorporated into the firm's training, methodology and other intellectual resources.
- It may be used as an important consideration when designing, implementing and operating a system of quality management in accordance with ISQM (UK) 1 *Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements*.
- It may be used by individual practitioners of any level of seniority when conducting an audit or assurance engagement.
- The intended audience is auditors, but it may also be used by others in the financial reporting exercise, or for specialists in other fields which provide expert input into an audit when making their own professional judgements.
- Audit committees may find the guidance useful as well as those charged with governance in enhancing their understanding of the auditor's judgement process.

10.1 Professional judgement framework

The professional judgement framework consists of four main components:



Mindset

An appropriate mindset for auditors exercising professional judgement. This section of the guidance highlights five aspects of mindset which are relevant to exercising professional judgement in an effective manner. The mindset aspects are not only useful for longer, more considered judgement processes but can also improve the quality of quicker and more intuitive judgements.

Professional Judgement Trigger and Process

A suggested professional judgement process, together with a reminder to remain alert to situations which may require professional judgement.

This section of the framework provides a series of steps which may assist in structuring the way in which professional judgement is carried out and documented, as well as a 'trigger' step which provides guidance on the importance of remaining alert to situations when professional judgement may be called upon and when a more formal judgemental process may be warranted.

This section of the framework is not meant to be linear despite the process being split into discrete steps. The guidance recognises that it may be appropriate at any step in the process to return to a previous step (for example if new information comes to light).

Consultation

Effective communication with a range of relevant parties.

An auditor's professional judgement may be significantly enhanced by regularly consulting with others. The guidance recognises that regular consultation can promote a culture of healthy debate and challenge as well as facilitating the input of those with relevant experience and expertise. It can also help to mitigate the risk of bias and provide the opportunity to train more junior or less experienced members of the audit engagement team in how to effectively exercise professional judgement.

Environmental Factors

Factors that may be present in the environment of those making a judgement, that can impact on how challenging it is to exercise professional judgement in an appropriate manner.

Environmental factors are some of the issues which may be found in the environment of the person or team making the judgement call and which may impact on how challenging it may be to exercise professional judgement in a quality manner.

10.2 Illustrative examples

The guidance provides some useful examples on how professional judgement may be exercised. The examples are simplified and abbreviated and are not based on 'real life' situations hence caution should be taken when considering them for real life situations.

11 Auditor resignation (Lecture A801 – 10.52 minutes)

When an auditor ceases to hold office from a non-public interest entity (i.e. a private entity), there is a process which must be followed in order to ensure correct protocol is followed.

ICAEW has produced a helpsheet designed to assist audit firms in ensuring the correct process is followed which can be downloaded at *https://www.icaew.com/technical/tas-helpsheets/audit-and-assurance/auditor-resignation-auditor-and-company-responsibilities/auditor-resignation-auditor-responsibilities*

11.1 Company law requirements

Section 519 of Companies Act 2006 states:

An auditor ("A") of a non-public interest company who is ceasing to hold office must send to the company a statement of the reasons for doing so unless A satisfied the first or second condition. *S519 (2), CA 2006*

The first condition is that A is ceasing to hold office— *S519 (2A), CA 2006*

(a) in the case of a private company, at the end of a period for appointing auditors;

(b) in the case of a public company, at the end of an accounts meeting.

The second condition is that— *S519 (2B), CA 2006*

(a) A's reasons for ceasing to hold office are all exempt reasons (as to which see section 519A(3)), and

(b) there are no matters connected with A's ceasing to hold office that A considers needs to be brought to the attention of members or creditors of the company.

When an auditor ceases to hold office, the first question that should be asked is whether the cessation of office amounts to a resignation. If the circumstances do not indicate a resignation, then a section 519 statement of circumstances will not be necessary.

The outgoing auditor must then consider whether the reasons for ceasing to hold office are exempt or non-exempt reasons. If the reasons are exempt reasons (see below) there will only be a s519 statement if there are matters to report. If there are matters to report, there will always be a s519 statement.

11.2 Exempt reasons or non-exempt reasons

Exempt reasons are dealt with in s519A(3) of Companies Act 2006 and are as follows:

- The auditor is no longer able to carry out statutory audit work within the meaning of Part 42 (section 1210 (1)).

- The company is, or is to become, exempt from audit under section 477, section 479A or section 480, or from the requirements of this part under section 482, and intends to include in its balance sheet a statement of the type described in section 475(2).

- The company is a subsidiary undertaking of a parent undertaking that is incorporated in the UK, the parent undertaking prepares group accounts and the auditor is being replaced by an auditor who is conducting, or is to conduct, an audit of the group accounts.

- The company is being wound up under Part 4 of the Insolvency Act 1986 or Part 5 of the Insolvency (Northern Ireland) Order 1989 or a petition under Part 4 of that Act or Part 5 of that Order has been presented and not finally dealt with or withdrawn.

11.3 Auditor resigns from the client

When an auditor resigns, they must send a letter of resignation to the client as required under section 516 Companies Act 2006.

In addition, the auditor may need to send a section 519 statement of circumstances or no circumstances to the company. Where a statement of circumstances is required, the auditor must lodge a copy with Companies House and the appropriate audit authority for non-public interest companies (e.g. ICAEW or ACCA). The table below summarises the requirements:

Nature of reasons and matters	Exempt reasons with no matters	Exempt reasons with matters	Non-exempt reasons and no matters	Non-exempt reasons with matters
Does the auditor send a s519 statement to the company?	No (CA 2006, s519(2B))	Yes, send a statement of reasons including matters for members and creditors (CA 2006, s519(3A))	Yes, send a statement of reasons with a statement that there are no matters that need to be brought to the attention of members or creditors (CA 2006,	Yes, send a statement of reasons including matters for members and creditors (CA 2006, s519(2B) and (3A))

			s519(3B))	
Does the auditor need to send the s519 statement to the appropriate audit authority?	No (CA 2006, s522)	Yes, at the same time as sending the s519 statement to the company and email a copy to the audit authority (e.g. ICAEW or ACCA)	Yes, at the same time as sending the s519 statement to the company and email a copy to the audit authority (e.g. ICAEW or ACCA)	Yes, at the same time as sending the s519 statement to the company and email a copy to the audit authority (e.g. ICAEW or ACCA)
Does the auditor file a copy of the s519 statement at Companies House?	No (CA 2006, s521)	Yes, but the auditor must wait 21 days to see if the company makes an application to court. If no notice is received or if the courts decide the statement is not defamatory, the auditor must file the statement within seven days (CA 2006, s521(1))	No (CA 2006, s 521(A1))	Yes, but the auditor must wait 21 days to see if the company makes an application to court. If no notice is received or if the courts decide the statement is not defamatory, the auditor must file the statement within seven days (CA 2006, s521(1))

11.4 Content of the s519 statement

When a section 519 statement of circumstances is considered necessary, it must include the following (s519(3), CA 2006):

- The auditor's name and address
- The number allocated to the auditor on being entered into the register of auditors
- The company's name and registered number

S519(3A) of CA 2006 also requires details of matters which are connected with the auditor's ceasing to hold office which need to be brought to the attention of members or creditors to be included in the statement.

Auditors may wish to consider seeking legal advice to ensure that any statement is not defamatory as there is likely to be repercussions where a statement is defamatory. Where there are no matters connected with the auditor's ceasing to hold office which need to be brought to the attention of members or creditors, the s519 statement must include a statement to this effect (s519(3B), CA 2006).