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DIRECTORS LOAN ACCOUNTS AND FRS 102 (LECTURE A520 – 21.06 MINUTES)

As the impact of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* begins to bite, many practitioners are starting to ask questions as to the impact that the new financial reporting regimes will have on their clients' financial information. Notwithstanding the new financial reporting frameworks, which are about to take mandatory effect for accounting periods commencing on or after 1 January 2016, there are some requirements in the Companies Act 2006 (CA06) which are often forgotten about by practitioners, particularly where loans to directors are concerned which are worth revisiting to ensure that correct protocol is followed.

Shareholder approval

Many companies in the UK and Republic of Ireland have directors' current accounts in operation and information concerning directors' current accounts is required to be disclosed under section 413 of CA06 *Information about directors' benefits: advances, credit and guarantees*. The implementation of section 413 has not been short of controversy since its arrival, largely because of the way that it was drafted.

Section 197(1) of CA06 makes a general prohibition on loans to directors and also related guarantees or provisions of security where the approval of the shareholders (often referred to as 'members') is not obtained. However, such approval is not required for 'minor' loans; i.e. if the aggregate value of the transaction(s) does not exceed £10,000, and hence companies are not prohibited under CA06 to make such loans.

If a company makes advances to a director personally and the aggregate exceeds £10,000 at any time, there is a legal requirement for the advance that takes the total over £10,000 to be approved by the shareholders BEFORE it takes place. Most small companies will probably not know about this issue until someone tells them, however failure to follow correct protocol could cause problems if there is a fallout between shareholders (for example in a husband and wife run company where the husband and wife divorce) or if the company goes into liquidation.

Advances to a director

When an advance to a director takes place, section 413 of CA06 requires the following details to be disclosed:

(a) its amount;

(b) an indication of the interest rate;

(c) its main conditions; and

(d) any amounts repaid.

The notes to the financial statements must also disclose:

- the total amounts stated in (a); and
- the total amounts stated in (d).

Disclosure is also required in respect of guarantees of any kind entered into by the company on behalf of the director(s), which disclose:

(a) the main terms;

(b) the amount of the maximum liability that may be incurred by the company (or its subsidiary); and

(c) any amount paid and any liability incurred by the company (or its subsidiary) for the purpose of fulfilling the guarantee (including any loss incurred by reason of enforcement of the guarantee).

In respect of advances to a director, confusion surrounded the requirements of section 413 when it was first introduced because the wording of this particular section indicates that every advance needs to be disclosed. For companies where the directors' current accounts are overdrawn, making disclosure of every individual entry would, in practice, be impractical and result in excessive information being disclosed.

Disclosures relating to advances to a director

Financial statements must be prepared that give a true and fair view and this concept will still apply for small companies under the new financial reporting frameworks (although micro-entities' financial statements are *presumed* to give a true and fair view if they are prepared to the legally required minimum).

In a lot of cases, advances to directors consist of several items which make up an overdrawn balance as at the year-/period-end. However, consider a company that simply makes a £50,000 advance to the director for the purpose of a house purchase. In this case, the related party disclosure could be as simple as:

'During the period, the company made a short-term loan to the director amounting to £50,000 for the purposes of a house purchase. Interest at the rate of 4.5% per annum is payable half-yearly and the loan is repayable on 31 December 2018.'

An issue that was raised when section 413 became mandatory was the disclosure of transactions where a director's current account was made up of several items. The wording of section 413 was subjected to a lot of criticism by accountants and various commentators and the professional bodies concluded that many companies would find it impractical to comply with the 'letter of the law' and hence came up with a solution whereby the accountant would determine the materiality of advances and repayments; aggregate the immaterial transactions and disclose separately material transactions, using the following 'template':

	£
Opening balance	X
Plus loans made in the period (advances)	X
Plus private expenditure in the period	X
Less undrawn remuneration	(X)
Less loan repayments in the period	(X)
Less dividends declared in the period	(X)
Closing balance	X

Where items of expenditure or repayment are considered to be material to the financial statements, or are dissimilar in terms of those expenses which have been aggregated, these should be disclosed separately. Care, however, should be taken where such a template for disclosing directors' transactions are concerned. This is because it can be tricky to template disclosures because client circumstances vary so much and therefore the template is generally persuasive rather than prescriptive. Indeed, auditors of companies where overdrawn directors' current accounts are in operation would need to ensure that the disclosures enable the financial statements to give a true and fair view in order to avoid any potential audit qualification.

Credit balances and withdrawals

Any withdrawals made by the director from bona fide credit balances on their current accounts cannot be constituted as an advance because these are simply repayments of funds previously invested in the company by the director and therefore should not be treated as an advance. Whilst such transactions are not considered to be advances to directors, they might be caught under the related party provisions and hence might need disclosure as a related party transaction (although the scope for this is less under FRS 102 with reduced disclosures which only requires limited related party disclosures to be made).

Director resigns part-way through the accounting period

Section 413(6) says that references to a director in section 413 relate to any persons who were a director **at any time** in the financial year to which the accounts relate. Therefore, if a director resigns part-way through the accounting period, then section 413 will still apply to that person. In addition, section 413(7) says that the requirements of section 413 apply in relation to every advance, credit or guarantee subsisting at any time in the financial year to which the accounts relate:

(a) whenever it was entered into;

(b) whether or not the person concerned was a director of the company in question at the time it was entered into; and

(c) in the case of an advance, credit or guarantee involving a subsidiary undertaking of that company, whether or not that undertaking was such a subsidiary undertaking at the time it was entered into.

The impact of FRS 102 on directors' current accounts

Loans to or from a director are caught under the rules in Section 11 *Basic Financial Instruments* in FRS 102 and this will also apply to small companies who use FRS 102 with reduced disclosures as their financial reporting framework for accounting periods commencing on or after 1 January 2016.

Very often, a company will make a loan to a director and this loan can either be at below market rate, or interest-free (usually the latter). Where such a loan is made to or from a director, it will often fall to be treated as a financing transaction and the consequence of this is where the loan is below market rate, a measurement difference will arise. The measurement difference is the difference between the fair value of the loan and the present value. However, care must be taken because the initial recognition of the loan will depend on whether the transaction is conducted with the director in the director's capacity as a shareholder of the entity, or if it is in the capacity of an employee (directors may not necessarily have shares in the business).

Example – Measurement difference arising on a loan to a director-shareholder

Smallco Ltd makes an interest-free loan to a director (who is also a shareholder) amounting to £5,000 on 1 January 2016. The director has agreed to pay this loan back to the company on 31 December 2017 and the market rate for a similar loan would be 5.5% per annum. The net present value of the loan is £4,492 (£5,000/1.055^2). The measurement difference is the difference between the fair value and the present value which is £508 (£5,000 - £4,492).

Under the provisions of FRS 102, any measurement difference which arises on financing transactions has to be reflected in the financial statements. This is because the only permissible method of accounting for such transactions under Section 11 is the amortised cost method, which in turn uses the effective interest rate method.

Example – Accounting for a measurement difference

Using the example above, the measurement difference of £508 represents a distribution to the director in their capacity as a shareholder (as, in substance, the director-shareholder has benefitted by the company providing a loan at below market rate) and the entity would therefore record the transaction as follows:

DR director's current account	£4,492
DR distribution to shareholder (equity)	£508
CR cash at bank	£5,000

Being loan to director

The above scenarios were based on a loan TO a director-shareholder. It is commonplace for the reverse to apply, i.e. where the director-shareholder will make a loan to the company.

Example – Loan from a director-shareholder

On 1 January 2016, Sarah makes an interest-free loan to her business amounting to £5,000. Sarah is a shareholder in the business and her bank would have charged interest at 5.5% on this loan. The loan terms state that the loan will be repaid on 31 December 2017. A measurement difference has arisen amounting to £508 (£5,000 – (£5,000/1.055^2)).

This measurement difference will be treated as an additional investment by Sarah into the business. This is because Sarah has provided a loan at below market rates and has, in substance, made an additional contribution to the business. The loan will be recorded as follows:

DR cash at bank	£5,000
CR director's current account	£4,492
CR capital contribution (equity)	£508

Being loan from director-shareholder

Directors' loans in their capacity as employees

It is not always the case that a director has shares in the business and hence where a director is solely an employee, it is less likely that they would provide an interest-free loan to the entity because they would not derive any benefit from doing this. However, it is not uncommon for a company to make a loan to a director who does not have any ownership interest in the business, and this loan might well be interest-free (or at below market rates of interest).

Where a company makes a loan to a director who does not have any ownership interest in the business, the accounting treatment will be the same as if the transaction was conducted between unrelated parties.

Loans where no formal terms have been agreed

It is often the case that a loan will be made to or from a director-shareholder and no formal loan terms will be agreed. Care must be taken to ensure that section 197 protocol is followed for loans in excess of £10,000 to a director.

Where there are no formal loan terms in existence, the loan will fall to be classed as 'on demand' and hence will be recognised as current.

This might pose a problem for some companies where directors' current accounts are in credit and have been classed as long-term under outgoing UK GAAP (e.g. the FRSSE). Under FRS 102 principles, where the directors' current account is in credit and there are no formal terms in existence, then it will need to be reclassified to current liabilities (in much the same way that a bank overdraft is treated). This will have an impact on the company's net current assets which will reduce (or might even turn into net current liabilities) and hence an impact assessment must be undertaken prior to the transition to FRS 102 with reduced disclosures to understand the impact of such loans.

Where loan terms do exist, it is quite difficult to retrospectively change the terms of the loan and this should also be taken into consideration prior to the date of transition. However, it should be noted that in many cases, a client's date of transition will have already been and gone.

INVESTMENTS IN ASSOCIATES (LECTURE A521 – 9.59 MINUTES)

Section 14 *Investments in Associates* in FRS 102 deals with the accounting and disclosure requirements where an entity makes an investment in another entity which gives rise to 'significant influence' and hence the acquisition of an associate. Section 14 also applies to the accounting for associates in the consolidated financial statements as well as the individual financial statements of an investor which is not a parent. Where an entity is a parent, then it must account for its investments in associates in its own separate financial statements in accordance with the provisions in paragraphs 9.26 and 9.26A of FRS 102 as appropriate.

Definition of an associate

Paragraph 14.2 of FRS 102 says that an associate is an entity, including an unincorporated entity such as a partnership, over which the investor has **significant influence** and that is neither a **subsidiary** nor an interest in a **joint venture**. Note – words which are shown as bold type in FRS 102 means that the term is defined in the Glossary to FRS 102.

Associates are distinguished by reference to the term 'significant influence'. Significant influence is not control, because if a control relationship existed then the investment would fall to be classed as a subsidiary. Significant influence means that the investor has the power to participate in the financial and operating policy decisions of the associate. It does not give the investor the power to control (or exercise joint control) over those policies.

Paragraph 14.3 offers three indicators where significant influence is achieved as follows:

(a) If an investor holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the associate, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case.

(b) Conversely, if the investor holds, directly or indirectly (e.g. through subsidiaries), less than 20 per cent of the voting power of the associate, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated.

(c) A substantial or majority ownership by another investor does not preclude an investor from having significant influence.

It is likely that in the majority of cases, a company that has made an investment in another entity and has acquired an ownership interest of between 20% and 50% will have acquired an associate (any ownership interest in excess of 50% will mean a subsidiary has been acquired). Care must be taken with numeric benchmarks, however, because notwithstanding an ownership interest of less than 20% it might be the case that an investment does fall to be classed as an associate because the investor has obtained significant influence through other means. This might be the case where:

- the investor participates in the policy-making process, including participation in decisions about dividends or other distributions;
- has representation on the board of directors or equivalent governing body of the investee;
- material transactions take place between the entity and the investee; or
- there is interchange of managerial personnel.

Therefore, whilst in many cases it might be clear that significant influence has been achieved by the investor, there may be some arrangements where this indicator is not as clear-cut and the terms of the arrangement might need careful scrutiny to ensure correct accounting treatment.

Accounting policy options for associates

The accounting policy considerations for an associate will depend on whether, or not, the investor is a parent.

Investor is not a parent

An investor which is not a parent, but has an investment in one or more associates accounts for its investments in associates in its own individual financial statements using either:

(a) the cost model;

(b) the fair value model; or

(c) at fair value with changes in fair value being recognised in profit or loss.

Investor is a parent

Where the investor is a parent and prepares consolidated financial statements, it must account for all its investments in associates using the equity method of accounting (see later). However, where the investor is a parent and has an associate which is held as part of an investment portfolio, the associate must be measured at fair value and changes in the associate's fair value are taken to profit or loss in the consolidated financial statements.

Associates held under the cost model

This is likely to be the model which is the most common. Where the investor is not a parent and opts to use the cost model, the associate is measured at cost less any accumulated impairment losses which have been recognised in accordance with the provisions in Section 27 *Impairment of Assets*.

Where the investor receives dividends (and other forms of distributions) from its associate, then these are recognised as income regardless of whether the distributions have been made from accumulated profits of the associate which arose prior to the date of acquisition.

Equity method of accounting

The equity method of accounting is a method of accounting whereby the investment in an associate is initially recognised at transaction price (transaction price being cost). Any incremental costs associated with the associate are also recognised (for example legal fees). Incremental costs are referred to in Section 14 as 'transaction costs' and are generally those costs which would have been avoided had the investor not acquired the associate.

Under the equity method of accounting, the cost of the associate is then adjusted to reflect the investor's share of profit or loss, other comprehensive income and equity of the associate.

Example – Equity method of accounting

On 31 December 2016, Indigo Investments invests a sum of £10,000 in Purple Associates in return for a 25% ownership interest. On 31 December 2017, the resulting profit of Purple Associates was £7,000.

On 31 December 2016, Indigo Investments' accounting entries will be:

DR investment in associate	£10,000
CR cash at bank	£10,000

Being initial recognition of investment in associate

Indigo Investments then needs to reflect its share of Purple Associates' profit in its own profit and loss account and hence the entries will be:

DR investment in associate	£1,750 (25% x £7,000)
CR profit and loss	£1,750

Being share of profit from associate

The example above assumed no dividends had been distributed to the investor. Where the associate pays dividends, then under the equity method of accounting such dividends will reduce the carrying amount of the investment as they are deemed to be a return on the investment.

Example – Associate paying a dividend

On 31 December 2016, Blue Investments acquired a 35% holding in Amber Associates at a cost of £80,000. On 31 December 2017, the profit of Amber Associates was £70,000 and it had proposed a dividend (immediately prior to the year-end) amounting to £10,000.

On initial recognition, Blue Investments will recognise the investment in associate at cost of £80,000 and this is then increased for Blue's share of the profit of £24,500 (£70,000 x 35%). The investment is then reduced by the value of the dividend paid by Amber Associates of £3,500 (£10,000 x 35%) because the dividend represents a return on this investment, hence it decreases the investment's carrying value in Blue's balance sheet. Therefore, the carrying amount of the investment in Blue's balance sheet as at 31 December 2017 is:

	£
Initial cost of investment in Amber	80,000
Share of Amber's profit	24,500
Dividend received	(3,500)
Carrying amount as at 31 December 2017	101,000

Equity accounting: points to note

Paragraph 14.8 gives detailed guidance on issues that may arise when equity accounting is applied as follows:

(a) *Distributions and other adjustments to carrying amount*. Distributions received from the associate reduce the **carrying amount** of the investment. Adjustments to the carrying amount may also be required as a consequence of changes in the associate's equity arising from items of other comprehensive income.

(b) *Potential voting rights*. Although potential voting rights are considered in deciding whether significant influence exists, an investor shall measure its share of profit or loss and other comprehensive income of the associate and its share of changes in the associate's equity on the basis of present ownership interests. Those measurements shall not reflect the possible exercise or conversion of potential voting rights.

(c) *Implicit goodwill and fair value adjustments*. On acquisition of the investment in an associate, an investor shall account for any difference (whether positive or negative) between the cost of acquisition and the investor's share of the fair values of the net identifiable assets of the associate in accordance with paragraphs 19.22 to 19.24. An investor shall adjust its share of the associate's profits or losses after acquisition to account for additional **depreciation** or **amortisation** of the associate's depreciable or amortisable assets (including **goodwill**) on the basis of the excess of their fair values over their carrying amounts at the time the investment was acquired.

(d) *Impairment*. If there is an indication that an investment in an associate may be impaired, an investor shall test the entire carrying amount of the investment for impairment in accordance with Section 27 as a single **asset**. Any goodwill included as part of the carrying amount of the investment in the associate is not tested separately for impairment but, rather, as part of the test for impairment of the investment as a whole.

(e) *Investor's transactions with associates*. The investor shall eliminate unrealised profits and losses resulting from upstream (associate to investor) and downstream (investor to associate) transactions to the extent of the investor's interest in the associate. Unrealised losses on such transactions may provide evidence of an impairment of the asset transferred.

(f) *Date of associate's financial statements*. In applying the equity method, the investor shall use the **financial statements** of the associate as of the same date as the financial statements of the investor unless it is **impracticable** to do so. If it is impracticable, the investor shall use the most recent available financial statements of the associate, with adjustments made for the effects of any significant transactions or events occurring between the accounting period ends.

(g) *Associate's accounting policies*. If the associate uses **accounting policies** that differ from those of the investor, the investor shall adjust the associate's financial statements to reflect the investor's accounting policies for the purpose of applying the equity method unless it is impracticable to do so.

(h) *Losses in excess of investment*. If an investor's share of losses of an associate equals or exceeds the carrying amount of its investment in the associate, the investor shall discontinue recognising its share of further losses. After the investor's interest is reduced to zero, the investor shall recognise additional losses by a **provision** (see Section 21 *Provisions and Contingencies*) only to the extent that the investor has incurred legal or **constructive obligations** or has made payments on behalf of the associate. If the associate subsequently reports profits, the investor shall resume recognising its share of those profits only after its share of the profit equals the share of losses not recognised.

(i) *Discontinuing the equity method*. An investor shall cease using the equity method from the date that significant influence ceases and, provided the associate does not become a subsidiary in accordance with Section 19 *Business Combinations and Goodwill* or a joint venture in accordance with Section 15 *Investments in Joint Ventures*, shall account for the investment as follows:

(i) If the investor loses significant influence over an associate as a result of a full or partial disposal, it shall derecognise that associate and recognise in profit or loss the difference between the proceeds from the disposal and the carrying amount of the investment in the associate relating to the proportion disposed of or lost at the date significant influence is lost. The investor shall account for any retained interest using Section 11 Basic Financial Instruments or Section 12 Other Financial Instruments Issues, as appropriate. The carrying amount of the investment at the date that it ceases to be an associate shall be regarded as its cost on initial measurement as a financial asset; and

(ii) If an investor loses significant influence for reasons other than a partial disposal of its investment, the investor shall regard the carrying amount of the investment at that date as a new cost basis and shall account for the investment using Sections 11 or 12, as appropriate.

The gain or loss arising on the disposal shall also include those amounts that have been recognised in **other comprehensive income** in relation to that associate, where those amounts are required to be reclassified to profit or loss upon disposal in accordance with other sections of this FRS. Amounts that are not required to be reclassified to profit or loss upon disposal of the related assets or liabilities in accordance with other sections of this FRS shall be transferred directly to retained earnings.

Equity method of accounting and the Companies Act 2006

The revised Companies Act 2006 came into effect on 6 April 2015 and now allows the use of the equity method of accounting in individual financial statements as opposed to cost-based and fair value methods.

Accounting for associates under the fair value model

Where an investor that is not a parent chooses to account for investments in associates using the fair value model, the investment is initially recognised at transaction price (i.e. at cost to the investor). At each reporting date, the investor must then measure investments in associates at fair value with fluctuations in the associate's fair value being taken to other comprehensive income.

The cost model should be used where obtaining fair value reliably would incur undue cost or effort.

Example – Associated carried at fair value

Silver Investments (Silver) has an associate which is carried at fair value at each reporting date through other comprehensive income and has an accounting reference date of 31 December. On 31 December 2016, Silver received a dividend from its associate and the bookkeeper has credited this dividend against the value of the investment in the balance sheet.

The bookkeeper is incorrect in crediting the dividend to the balance sheet as the investment is carried at fair value. Dividends and other distributions received from the investment must be recognised in profit or loss as income. Had the investment been accounted for using the equity method of accounting, then it would have been appropriate to take the dividend to the cost of the investment in the balance sheet.

Presentation and disclosure in the individual and consolidated accounts

In both the individual and the consolidated financial statements, investments in associates are shown as fixed assets (unless otherwise required under the Regulations).

Disclosure requirements (individual and consolidated financial statements)

Paragraphs 14.12 to 14.15A of FRS 102 outline the disclosure requirements in relation to investments in associates in both the individual and the consolidated financial statements. Small companies reporting under FRS 102 with reduced disclosures should have regard to the disclosure requirements in Section 1A *Small Entities*.

In respect of the individual and consolidated financial statements, the entity should disclose:

(a) the accounting policy for investments in associates;

(b) the carrying amount of investments in associates; and

(c) the fair value of investments in associates accounted for using the equity method for which there are published price quotations.

For investments in associates accounted for in accordance with the cost model, an investor shall disclose the amount of dividends and other distributions recognised as income.

For investments in associates accounted for in accordance with the equity method, an investor shall disclose separately its share of the profit or loss of such associates and its share of any **discontinued operations** of such associates.

For investments in associates accounted for in accordance with the fair value model, an investor shall make the disclosures required by paragraphs 11.43 and 11.44.

The individual financial statements of an investor that is not a parent shall disclose summarised financial information about the investments in the associates, along with the effect of including those investments as if they had been accounted for using the equity method. Investing entities that are exempt from preparing consolidated financial statements, or would be exempt if they had subsidiaries, are exempt from this requirement.

INVESTMENTS IN JOINT VENTURES (LECTURE A522 – 10.00 MINUTES)

Section 15 *Investments in Joint Ventures* outlines the accounting and disclosure requirements in respect of joint ventures. The section applies to joint ventures in both the individual financial statements of a venturer which is not a parent and for investments in jointly controlled operations and jointly controlled assets in the individual financial statements of a venturer which is a parent.

Definition of a joint venture

Paragraphs 15.2 and 15.3 outline the definition of a joint venture and it is important that a venture complies with this definition to ensure that Section 15 is applied correctly. Paragraph 15.2 says that:

*'**Joint control** is the contractually agreed sharing of **control** over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).'*

This definition must be applied correctly to avoid incorrect application of Section 15. There must be a **contractually agreed** sharing of control. In other words, no one party in the venture can make unilateral decisions without the other party/parties because if this was the case then a control relationship would exist giving rise to a subsidiary being created rather than a joint venture. In a joint venture, control is shared among the venturers.

Paragraph 15.3 acknowledges that a joint venture can take the form of various vehicles. It says:

'A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. Joint ventures can take the form of jointly controlled operations, jointly controlled assets, or jointly controlled entities.'

Example – Incorrect classification as a joint venture

Mr Smith entered into an agreement with Mr Jones and Mr Howard on 1 December 2016 and each of the parties owns one-third of the equity of Holdco Ltd (Holdco) which is an incorporated entity in England. Any decisions relating to Holdco must be approved by two-thirds of the venturers. Mr Smith wishes to account for the interest in Holdco as a joint venture using the equity method of accounting.

To be treated as a joint venture, joint control is needed. As per paragraph 15.2 of FRS 102, joint control is the contractually agreed sharing of control over an economic activity and requires the unanimous consent of the parties sharing control. In this scenario, the decision-making relating to Holdco can be made by a majority of the three equity holders and therefore it would appear that the investment in Holdco cannot be regarded as being a joint venture under Section 15 principles. Because this arrangement does not meet the definition of a joint venture in paragraph 15.2, it would appear that Section 14 *Investments in Associates* would be more applicable as the parties are all able to exercise significant influence.

There are three types of joint venture mentioned in paragraph 15.3 of FRS 102:

(1) jointly controlled operations;

(2) jointly controlled assets; and

(3) jointly controlled entities.

Jointly controlled operations

In a jointly controlled operation, each venturer will use its own property, plant and equipment and carry its own inventories (stock and work in progress). It will also incur its own expenses and liabilities and raise its own finance. In other words, the venturer will operate as a standalone business. However, the joint venture agreement (the contract) will usually outline how revenue arising from the sale of the joint product and any expenses incurred in common will be shared among the venturers.

In terms of accounting requirements, in its own individual financial statements, each venturer must recognise:

(a) the assets that it controls and the liabilities that it incurs; and

(b) the expenses that it incurs and its share of the **income** that it earns from the sale of goods or services by the joint venture.

Example – Jointly controlled operation

Two companies, X Ltd and Y Ltd enter into a contractual arrangement under which they will combine their operations, resources and technical expertise in order to manufacture, market and distribute a new bookkeeping application (app) aimed at smaller businesses.

The two companies will carry out different parts of the manufacturing process. X and Y will incur its own costs and be entitled to a share of the revenue from the sale of the app. The contract will determine the share of the revenue.

X and Y have joint control over the manufacturing operations and the joint venture takes the form of a jointly controlled operation.

Jointly controlled assets

Some joint ventures will involve an asset that is jointly controlled and jointly owned by the venturers. Where a jointly controlled asset exists, a venturer recognises in its own financial statements:

(a) its share of the jointly controlled assets, classified according to the nature of the assets;

(b) any liabilities that it has incurred;

(c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;

(d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

(e) any expenses that it has incurred in respect of its interest in the joint venture.

Example – Jointly controlled asset

A Ltd and B Ltd are independent oil production companies operating in the North Sea with adjacent oil wells. A and B enter into a contractual agreement to control and operate an oil pipeline jointly.

Both companies use the pipeline to transport oil to an on-shore oil refinery which is owned and operated by C Ltd (a third-party oil company). C Ltd will take up any surplus capacity of oil stocks. A and B will each bear an agreed proportion of the expense of operating the oil pipeline.

This is a joint venture which takes the form of jointly controlled assets

A and B will each account for its share of the jointly controlled asset (the oil pipeline) and for its share of the expenses of maintenance of the pipeline and storage costs, and its share of revenues from sales by C Ltd.

Jointly controlled entities

Jointly controlled entities are generally more complicated to account for. A jointly controlled entity is a joint venture which involves the creation of an incorporated company, a partnership or another form of vehicle in which each venturer has an interest. The jointly controlled entity will operate in much the same way as other entities, but the exception is that a contractual arrangement will exist between the venturers which establishes joint control over the economic activity of the entity (note in all joint ventures, there has to be a contractually agreed sharing of control).

Accounting for interests in a jointly controlled entity

Where a venturer (that is not a parent) has one, or more, interests in jointly controlled entities, it accounts for such interests in its individual financial statements using either:

(a) the cost model in accordance with paragraphs 15.10 to 15.11 of FRS 102;

(b) the fair value model in accordance with paragraphs 15.14 to 15.15A; or

(c) at fair value with changes in fair value going through profit or loss (guidance on fair value is outlined in paragraphs 11.27 to 11.32 of FRS 102).

Where the venturer is a parent that produces consolidated financial statements, then it must account for all its investments in jointly controlled entities using the equity method of accounting. However, there is an exception to this rule which is where the venturer who is a parent that holds interests in jointly controlled entities as part of an investment portfolio. Where this applies, then the parent must measure its investments in jointly controlled entities at fair value with changes in fair value being recognised in profit or loss in the consolidated financial statements.

Applying the cost model

A venturer that is not a parent can choose to adopt the cost model and where the cost model is applied, the venturer measures its investments in jointly controlled entities at cost less accumulated impairment losses which have been recognised in accordance with Section 27 *Impairment of Assets*.

Example – Dividend received from a jointly controlled entity

North Ltd has a 50% interest in a jointly controlled entity, South Ltd which is accounted for under the cost model. On 31 December 2016, North Ltd received a dividend from South Ltd and the bookkeeper is unsure where to recognise the dividend received.

Paragraph 15.11 of FRS 102 says that any distributions received from the investment are recognised as income. This applies regardless of whether the distributions are made from accumulated profits of the jointly controlled entity which arose prior to the date of acquisition.

Applying the equity method

If a venturer elects to use the equity method to account for its investment in a jointly controlled entity, then it must apply the provisions in paragraph 14.8 of FRS 102 (see the earlier section in these notes under the ***Investments in Associates*** section as the equity method of accounting applies equally to investments in jointly controlled entities).

As paragraph 14.8 refers to 'significant influence', then for the purposes of jointly controlled entities, the term 'significant influence' is substituted for 'joint control'. In addition, references to 'associate' are substituted for 'jointly controlled entity' in the context of joint ventures and jointly controlled entities.

Applying the fair value model

A venturer which is not a parent choosing to apply the fair value model for a jointly controlled entity will recognise the investment at transaction price. Thereafter, at each reporting date, the venturer measures the investment in the jointly controlled entity at fair value and changes in fair value are recognised in profit or loss. Where it is impracticable to determine fair value without undue cost or effort, a venturer should use the cost model.

Any dividends received from the jointly controlled entity are recognised as income in the venturer's financial statements, regardless of whether the distributions are from accumulated profits of the jointly controlled entity which have arisen prior to the date of acquisition.

Dealing with transactions between a venturer and a joint venture

Transactions can take place between a venturer and a joint venture and it is important that the substance of the arrangement is carefully considered.

If a venturer contributes or sells assets to a joint venture, then any gain or loss from the transaction must reflect the substance. Provided the venturer has transferred the significant risks and rewards of ownership of the asset to the venture, the selling venturer only recognises that portion of the gain or loss which is attributable to the interests of the other venturers. However, where the contribution or sale provides evidence of an impairment loss, then the venturer must recognise the full amount of any loss.

Conversely, when a venturer purchases assets from a joint venture, the venturer must not recognise any profit in respect of the purchase until it resells the asset to an unconnected third party. Paragraph 15.17 says that a venturer should also recognise its share of the losses arising from such transactions in the same way as profits, except that losses are recognised immediately when they are representative of an impairment loss.

Venturers without joint control

In situations where an investor in a joint venture does not have joint control, the venturer accounts for its investment in accordance with Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues*. Where joint control is not obtained, but the venturer has significant influence, then it must account for the joint venture in accordance with the provisions in Section 14 *Investments in Associates*.

Disclosure requirements

Small companies entering into joint ventures are directed to Section 1A *Small Entities* in FRS 102. The disclosure requirements in respect of both the individual and the consolidated financial statements are as follows (words in bold type mean they are defined in the Glossary to FRS 102):

(a) the **accounting policy** for recognising investments in jointly controlled entities;

(b) the **carrying amount** of investments in jointly controlled entities;

(c) the fair value of investments in jointly controlled entities accounted for using the equity method for which there are published price quotations; and

(d) the aggregate amount of its commitments relating to joint ventures, including its share in the capital commitments that have been incurred jointly with other venturers, as well as its share of the capital commitments of the joint ventures themselves.

For jointly controlled entities accounted for in accordance with the equity method, the venturer shall disclose separately its share of the profit or loss of such investments and its share of any **discontinued operations** of such jointly controlled entities.

For jointly controlled entities accounted for in accordance with the fair value model, the venturer shall make the disclosures required by paragraphs 11.43 and 11.44.

The individual financial statements of a venturer that is not a parent shall disclose summarised financial information about the investments in the jointly controlled entities, along with the effect of including those investments as if they had been accounted for using the equity method. Investing entities that are exempt from preparing consolidated financial statements, or would be exempt if they had subsidiaries, are exempt from this requirement.

IMPAIRMENT OF ASSETS (LECTURE A523 – 14.25 MINUTES)

It is widely accepted within the accountancy profession that assets should not be carried in the balance sheet at any more than their recoverable amount as to do so would mean the financial statements are misleading. Asset impairment issues are dealt within FRS 102 at Section 27 *Impairment of Assets* and in Section 22 in FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* (these notes will focus on the requirements in Section 27 although similar (but reduced) principles will also apply to micro-entities under Section 22 of FRS 105).

Scope of Section 27

Section 27 deals with the accounting requirements for asset impairment; however, there are certain assets which are not within the scope of Section 27 and are noted in the following table:

Type of asset	Relevant section of FRS 102
Assets arising from construction contracts	Section 23 *Revenue*
Deferred tax assets	Section 29 *Income Tax*
Assets arising from employee benefits	Section 28 *Employee Benefits*
Financial assets	Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues*
Investment property measured at fair value	Section 16 *Investment Property*
Biological assets related to agricultural activity measured at fair value less estimated costs to sell	Section 34 *Specialised Activities*

In addition to the above, any impairment of deferred acquisition costs and intangible assets which arise from contracts that fall under the scope of FRS 103 *Insurance Contracts* will be dealt with by FRS 103 rather than Section 27.

When is an asset impaired?

Section 27 says that an asset is impaired, and hence needs writing down to recoverable amount, when the carrying amount of an asset exceeds its recoverable amount. The term 'recoverable amount' is defined in the Glossary to FRS 102 as:

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

In respect of inventories (stock and work in progress), these are dealt with separately in Section 27 at paragraphs 27.2 to 27.4.

Impairment of inventories

FRS 102 uses the terminology 'selling price less costs to complete and sell' which is the new term for 'net realisable value' used in the FRSSE/SSAP 9 *Stocks and long-term contracts*. Paragraph 27.2 says that at each balance sheet date, the entity must carry out an assessment to determine whether any inventories are impaired. An entity will make this determination by comparing the carrying amount of each item of inventory (or groups of similar items) with its selling price less costs to complete and sell. An item of inventory is said to be impaired when selling price less costs to complete and sell is lower than the carrying value. Where selling price less costs to complete and sell is lower than carrying value, the entity must write-down the carrying amount through an impairment loss which is recognised immediately in profit or loss.

Example – Inventory suffering from impairment

A company has carried out an inventory count as at 31 July 2016 and it has a batch of chemical products where the chemical mix was incorrect. This batch of chemicals has a carrying amount of £120,000 but the laboratory have said that whilst the chemical mix is wrong, the batch can still be used in other products but at a discounted selling price of £70,000.

In this example it is clear that the batch of chemicals needs to be written down to recoverable amount because estimated selling price less costs to complete and sell is lower than the carrying value. As a result, the company must recognise an impairment loss of £50,000 (£120,000 less £70,000) in profit or loss for the period.

In some, more complicated, scenarios, it might not be practicable to determine the selling price less costs to complete and sell for inventories on an item-by-item basis. Where this proves to be the case, paragraph 27.3 allows the entity to group items of inventory which relate to the same product line and have similar purposes or end uses and are produced and marketed in the same geographical area for the purposes of assessing impairment.

Reversing an impairment loss for inventories

It is possible to reverse a previously recognised impairment loss in respect of inventories. At each balance sheet date, the entity must make a new assessment of selling price less costs to complete and sell. If there is evidence that the situation giving rise to the previous impairment loss no longer exist, or there is clear evidence that selling price less costs to complete and sell has increased, then the previously recognised impairment loss can be reversed.

Care needs to be taken in such cases, because the reversal is limited to the amount of the original impairment loss so that the new carrying amount of the inventories is the lower of the cost and the revised selling price less costs to complete and sell. Reversals of previously recognised impairment losses are recognised in profit or loss.

Impairment of other assets

Other assets, such as fixed assets, trade debtors and sundry debtors all need to be assessed for impairment at each reporting date to ensure that the carrying amount is not higher than recoverable amount. Where recoverable amount is less than an asset's carrying amount, the entity must recognise an impairment loss. Quite often, an impairment loss will be recognised in profit or loss, but there might be situations when the impairment loss is recognised elsewhere, for example if the asset is carried at revaluation under Section 17 *Property, Plant and Equipment*.

Example – Asset carried at revaluation

A company carries its freehold building at revaluation in accordance with the revaluation model in Section 17. The finance director has commissioned a valuation of this building and the surveyor has confirmed a fall in value of £20,000. The balance on the revaluation surplus in respect of this building is £52,000.

The impairment loss of £20,000 is treated as a revaluation decrease in accordance with Section 17 and hence is taken to the revaluation reserve because there is enough within that account to utilise the impairment loss. Had the associated revaluation surplus only been, say, £10,000, then £10,000 of the impairment loss would be recognised via the revaluation surplus (hence bringing the revaluation reserve to £nil) and the remaining £10,000 would be recognised in profit or loss.

Indicators of impairment

It can usually be obvious when an asset is suffering signs of impairment. For example, if a trade debtor is experiencing serious cash flow difficulties, then that debtor will need writing down to recoverable amount (usually through a specific provision). Some entities maintain a general bad debt provisions (sometimes referred to as an ‘allowance for receivables’ or an ‘allowance account’) and it may be appropriate to increase this provision to reflect any increased credit risk.

Entities must carry out an assessment at each balance sheet to identify if any assets are carried in the balance sheet in excess of recoverable amount. However, if there is no indication that an asset is impaired then it will not be necessary to arrive at a recoverable amount.

There are two sources of information which an entity must use when assessing whether an asset (or a group of assets) is/are impaired:

(a) external sources; and

(b) internal sources.

External sources of information

Paragraph 27.9 of FRS 102 gives four external sources of information an entity should use to assess whether there are indicators of impairment (words in bold type mean the term is defined in the Glossary to FRS 102):

(a) 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.

(b) 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.

(c) 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**.

(d) 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).

Internal sources of information

There are three internal sources of information which could give an indication that an asset is suffering from impairment:

(a) Evidence is available of obsolescence or physical damage of an asset.

(b) 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 the 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.

(c) 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.

Example – Review of remaining useful life/depreciation method or residual value

An entity undertakes an impairment review at its balance sheet date and establishes that a group of assets is impaired.

Where there is evidence of impairment, paragraph 27.10 also highlights the possibility that the entity should undertake a review of the remaining useful life, the depreciation/amortisation method or the residual value for the asset. Such lives, depreciation/amortisation methods or residual values will then need to be adjusted in accordance with relevant sections of FRS 102 (e.g. Section 17 *Property, Plant and Equipment* or Section 18 *Intangible Assets other than Goodwill*) even if no impairment loss is subsequently recognised for the asset(s) concerned.

Measuring recoverable amount

The 'recoverable amount' of an asset is the *higher* of the asset's fair value less costs to sell and its value in use. In reality, fair value less costs to sell is easier to determine than value in use and it is not always necessary to calculate both figures because if either of these amounts exceeds the asset's carrying value, then the asset is not impaired and hence it will not be necessary to estimate the other figure.

Example – Fair value less costs to sell or value in use

An entity is undertaking an impairment test on a group of assets. The financial controller has obtained a fair value less costs to sell and does not believe that the value in use figure would materially exceed fair value less costs to sell.

Paragraph 27.13 of FRS 102 says that if there is no reason to believe that an asset's value in use materially exceeds its fair value less costs to sell, the asset's fair value less costs to sell may be used as its recoverable amount (and this will usually be the case for assets that are held for disposal).

Fair value less costs to sell

The term 'fair value less costs to sell' is basically the amount which an asset could be sold for in an arm's length transaction between knowledgeable and willing parties. Deducted from this value are the incremental costs associated with the disposal (incremental costs being those costs which would not otherwise be incurred had the asset been retained by the business).

Obtaining a fair value price can be done having regard to an 'active market' in which the asset is frequently traded. Alternatively, the price might also be stipulated in a binding sale agreement. Paragraph 27.14 refers to an 'active market' and this is defined as:

'A market in which all the following conditions exist:

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

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

(c) prices are available to the public.'

In situations where there is no binding sales agreement, or an active market, then fair value less costs to sell will be based on the best information available to reflect the amount which an entity could obtain in an arm's length transaction between knowledgeable and willing parties less the incremental costs of disposal. Paragraph 27.14 requires an entity to factor into account the outcome of recent transactions for similar assets within the same industry.

If there are any restrictions on the asset (for example if the asset cannot be sold without another party's permission), then the entity must bring into account the costs of obtaining permission to sell the asset (i.e. the costs of relaxing the restriction).

Value in use

Value in use calculations can become very complicated because they involve discounting future cash flows expected to be obtained from an asset to present value. In practice it is less arduous to obtain fair value less costs to sell for the purposes of impairment testing. However, where value in use calculations are concerned, there are two steps which have to be undertaken:

(1) estimate the future cash inflows and cash outflows to be derived from continuing use of the asset as well as from its ultimate disposal; and

(2) apply the appropriate discount rate to those future cash flows.

Example – Value in use calculation

North Ltd (North) manufactures chemicals for use in domestic cleaning products and has four brands that is manufactured by a separate manufacturing division. Each manufacturing division is classed as a cash-generating unit for the purposes of impairment testing. North acquired brand X through the acquisition of a small company several years ago and at the year-end the value of goodwill attributable to this brand was £140,000. Demand for brand X has significantly declined over the last few years, but demand for the other three brands has increased.

The directors have undertaken an exercise relating to the expected cash inflows and outflows of brand X using forecasts and the analysis is shown below:

Year	Cash inflows	Cash outflows
	£	£
2016	70,000	27,000
2017	75,000	45,000
2018	85,000	65,000
2019	30,000	20,000

The company's accountants have placed a value on the goodwill attached to brand X using the 'whole company approach' and this value was £83,000. The external accountants have also undertaken a further exercise to calculate value in use, using an assumed interest rate of 5% and this has resulted in the following:

Year	Net cash flows (£)	Present value factor	Present value (£)
2016	43,000	0.952	40,936
2017	30,000	0.907	27,210
2018	20,000	0.864	17,280
2019	10,000	0.823	8,230
Value in use			**93,656**

Value in use exceeds the whole company approach valuation of £83,000 and hence value in use becomes recoverable amount.

An impairment loss has arisen on the goodwill valuation amounting to £46,344 (£140,000 less £93,656) and this impairment loss is to be recognised in profit or loss as an operating expense within the amortisation charge.

Other considerations for value in use calculations

There are some additional considerations that need to be borne in mind when dealing with value in use calculations and these are outlined in paragraphs 27.16 to 27.20A of FRS 102 as follows:

Paragraph 27.16 says that the following elements are to be reflected in the calculation of an asset's value in use:

(a) an estimate of the future cash flows the entity expects to derive from the asset;

(b) expectations about possible variations in the amount or timing of those future cash flows;

(c) the time value of money, represented by the current market risk-free rate of interest;

(d) the price for bearing the uncertainty inherent in the asset; and

(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Estimates of future cash flows

Estimates of future cash flows used in the value in use calculation should include:

(a) projections of cash inflows from the continuing use of the asset;

(b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

(c) net cash flows, if any, expected to be received (or paid) for the disposal of the asset at the end of its useful life in an arm's length transaction between knowledgeable, willing parties.

In respect of estimating future cash flows, paragraph 27.17 recognises that an entity might use recent financial budgets or forecasts (where these are available). Where they are available, the entity can then extrapolate the projections based on the budgets or forecasts using a steady (or declining) growth rate for subsequent years. If an increasing growth rate is used, this must be able to be justified.

When estimating future cash flows, the entity must **not** include:

(a) cash inflows or outflows from **financing activities**; or

(b) income tax receipts or payments.

In addition to the above, the future cash flows must be estimated in respect of the asset's **current** condition. It follows, therefore, that estimated future cash inflows or outflows which are expected to arise from:

(a) a future restructuring to which an entity is not yet committed; or

(b) improving or enhancing the asset's performance,

are not included in the estimate of future cash flows.

Discount rate to be used in value in use calculations

The discount rate which an entity uses in value in use calculations is to be a pre-tax rate(s) that reflect(s) current market assessments of:

(a) the time value of money; and

(b) the risks specific to the asset for which the future cash flow estimates have not been adjusted.

To prevent double-counting, the discount rate(s) used to measure an asset's value in use must not reflect risks for which the future cash flows estimates have been adjusted for.

Assets held for service potential

Where an asset is held for its service potential (for example a school building), then a cash flow driven valuation will probably not be appropriate. For such assets, value in use is determined by the present value of the asset's remaining service potential plus the net amount the entity will receive from its disposal. Paragraph 27.20A recognises that 'depreciated replacement cost' might be a suitable measurement model, but other approaches can be used where they are judged to be more appropriate. The term 'depreciated replacement cost' is defined in the Glossary to FRS 102 as:

*'The most economic cost required for the entity to replace the **service potential** of an **asset** (including the amount that the entity will receive from its disposal at the end of its **useful life**) at the **reporting date**.'*

Impairment losses in a cash-generating unit

A 'cash-generating unit' is defined in the Glossary to FRS 102 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.'*

A cash-generating unit does not have to be, say, a branch or a subsidiary of a reporting entity. Indeed a group of assets can also constitute a cash-generating unit (such as a group of machinery).

In respect of a cash-generating unit, an impairment loss is recognised if, and only if, the recoverable amount of the unit is less than the carrying amount of the unit. Where this is the case, there is a certain order in which the impairment loss has to be recognised:

(a) first, to reduce the carrying amount of any **goodwill** allocated to the cash-generating unit; and

(b) then, to the other assets of the unit pro rata on the basis of the carrying amount of each asset in the cash-generating unit.

Care must be taken when dealing with an impairment loss in a cash-generating unit because the carrying amount of any asset cannot be reduced below the highest of:

(a) its fair value less costs to sell (if determinable);

(b) its value in use (if determinable); and

(c) zero.

Example – Allocating an impairment loss in a cash-generating unit

A manufacturing company has a group of assets which it classes as a cash-generating unit. Financial statement extracts for the year-ended 31 December 2016 are as follows:

	£
Goodwill	130,000
Property, plant and equipment	200,000

The cash-generating unit has suffered an impairment loss of £150,000 due to adverse press reports concerning its products. The external accountancy firm has calculated fair value less costs to sell and value in use of goodwill. They have established that the fair value less costs to sell amount is £60,000 and the value in use is £50,000. The directors do not consider it practicable to arrive at a figure for fair value less costs to sell or value in use for its property, plant and equipment.

The impairment loss of £150,000 will first be allocated to goodwill with the remainder being applied to the property, plant and equipment. However, neither the goodwill nor any asset in the cash-generating unit can be reduced below the higher of:

(a) fair value less costs to sell (if determinable);

(b) value in use (if determinable); and

(c) zero.

As fair value less costs to sell is higher than value in use, goodwill is to be carried at £60,000, so of the £150,000 impairment, £70,000 (£130,000 less £60,000) will be allocated to goodwill and the remainder of £80,000 will be charged against property, plant and equipment. Financial statement extracts will then be:

	£
Goodwill	60,000
Property, plant and equipment	120,000

Goodwill and impairment issues

Section 27 acknowledges that goodwill, on its own, cannot be sold, nor can it generate cash flows which are independent of other cash flows. In view of this, fair value of goodwill cannot be measured directly and as such the fair value of goodwill is established from the fair value of the cash-generating unit(s) of which the goodwill forms part.

When a business combination takes place, goodwill is allocated to each of the acquirer's cash-generating units which are expected to benefit from the synergies of the business combination regardless of whether other assets or liabilities of the acquiree are assigned to those units.

When the parent acquires a subsidiary with non-controlling interests (previously known as 'minority interests'), part of the recoverable amount of the cash-generating unit will belong to the non-controlling interests. As a result, when the entity is undertaking an impairment test on a cash-generating unit which is not wholly-owned, the entity must notionally adjust the carrying amount of that unit before comparing that value with recoverable amount. This is done by grossing up the carrying amount of goodwill which is allocated to the unit so as to include the goodwill that is attributable to the non-controlling interest. Once this grossing up exercise has been done, the grossed up value is then compared to recoverable amount so as to determine whether the cash-generating unit is impaired.

Example – Notionally adjusting goodwill

North Ltd acquires 60% of South Ltd on 1 January 2016 which is a cash-generating unit (CGU) and on the date of acquisition goodwill amounting to £24,000 arose. At the year-end 31 December 2016, the carrying value of the South's identifiable net assets is £130,000 and the recoverable amount of the subsidiary is £143,000.

For the purposes of impairment testing a CGU which is not wholly-owned, the carrying amount of the CGU must be notionally adjusted before being compared with its recoverable amount by grossing up the goodwill which is attributable the non-controlling interest. Once this is done, the value of the impairment can be calculated as follows:

	£
Identifiable net assets	130,000
Goodwill grossed up (£24,000 x 100/60)	40,000
Total carrying value of the CGU	170,000
Less recoverable amount	(143,000)
Impairment	27,000

In situations where goodwill cannot be allocated to individual cash-generating units (or groups of cash-generating units) on a non-arbitrary basis, paragraph 27.27 says that for the purposes of testing goodwill for impairment, the entity determines the recoverable amount of either:

(a) the acquired entity in its entirety, if the goodwill relates to an acquired entity that has not been integrated. Integrated means the acquired **business** has been restructured or dissolved into the reporting entity or other **subsidiaries**; or

(b) the entire group of entities, excluding any entities that have not been integrated, if the goodwill relates to an entity that has been integrated.

To correctly apply the provisions in paragraph 27.27(a) and (b), the entity must separate goodwill into goodwill that relates to entities which have been integrated and goodwill relating to entities that have not been integrated. In addition, the entity should also follow the requirements for cash-generating units in Section 27 when calculating the recoverable amount of, and allocating impairment losses and reversals to assets belonging to, the acquired entity or group of entities.

Reversing an impairment loss

It is possible to reverse a previously recognised impairment loss. However, it is not possible to reverse previously recognised impairment losses for goodwill.

In respect of assets, excluding goodwill, where the reasons giving rise to the previously recognised impairment loss have ceased to exist, then the impairment loss can be reversed in a subsequent accounting period.

As well requiring entities to carry out tests to determine whether assets have indicators of impairment, paragraph 27.29 also requires entities to assess (at each balance sheet date) whether there is any indication that an impairment loss which the entity recognised in previous accounting periods may no longer exist, or may have decreased. Where there are indicators that a previously recognised impairment loss may no longer exist, or has decreased, then all or part of the previously recognised impairment is reversed. There are two situations that need to be considered where impairment loss reversals are concerned:

(a) if the previously recognised impairment loss was based on the recoverable amount of the individual asset; or

(b) if the previously recognised impairment loss was based on the recoverable amount of the cash-generating unit to which the asset belongs.

Impairment loss based on recoverable amount of an individual asset

When the previously recognised impairment loss was based on the recoverable amount of an individual asset, then there are four requirements which apply and are outlined in paragraph 27.30 as follows:

(a) The entity shall estimate the recoverable amount of the asset at the current reporting date.

(b) If the estimated recoverable amount of the asset exceeds its carrying amount, the entity shall decrease the carrying amount to recoverable amount, subject to the limitation described in (c) below. That increase is a reversal of an impairment loss. The entity shall recognise the reversal immediately in profit or loss unless the 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) The reversal of an impairment loss shall not increase the carrying amount of the asset above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

(d) After a reversal of an impairment loss is recognised, the entity shall adjust the depreciation (amortisation) charge for the asset 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.

Recoverable amount was estimated for a cash-generating unit

When a previously recognised impairment loss was based on the recoverable amount of a cash-generating unit, there are five requirements which apply in paragraph 27.31 as follows:

(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 its 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 amounts 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 are 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.

Example – Prior impairment loss based on recoverable amount of an individual asset

On 31 December 2014, a company had an asset costing £100,000 with a carrying value of £70,000 and it had suffered an impairment loss of £35,000 and therefore in the financial statements to 31 December 2014, the profit and loss account was charged with £35,000 representing the impairment loss on the asset concerned. If the asset had not been impaired, then it would have had a carrying value of £60,000 as the company is depreciating this asset over a ten-year period on a straight-line basis. Evidence has been obtained by the directors that the circumstances giving rise to the original impairment loss have been reversed and the market has returned back to where it was. The finance director wishes to reverse the entire impairment loss of £35,000 in the 31 December 2015 accounts.

If the asset had not been impaired in 2014 then the carrying value would have been £60,000 and in 2015 it would have been £50,000. On the basis that the carrying amount prior to the reversal of the impairment loss is £35,000, the maximum amount of the impairment reversal can only be £15,000 (£50,000 less £35,000). This is because paragraph 27.30(c) says that the reversal of an impairment loss must not decrease the carrying amount of the asset above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

As a consequence, the finance director can only debit the carrying amount of the asset with £15,000 with a corresponding credit to the profit and loss account. Once this has been done, the finance director must then adjust the depreciation charge for the asset in future periods to allocate the asset's depreciable amount over its remaining useful life.

Disclosure requirements for impairment

The disclosure issues for impairments are contained in paragraphs 27.32 to 27.33A and are as follows (words in bold type are defined in the Glossary to FRS 102):

An entity shall disclose the following for each **class of assets** indicated in paragraph 274.33:

(a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) in the **statement of comprehensive income** (or in the **income statement**, if presented) in which those impairment losses are included; and

(b) the amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) in the statement of comprehensive income (or in the income statement, if presented) in which those impairment losses are reversed.

An entity shall disclose the information required by paragraph 27.32 (i.e. as above) for each of the following classes of asset:

(a) inventories;

(b) **property, plant and equipment** (including investment property accounted for by the cost method);

(c) goodwill;

(d) **intangible assets** other than goodwill;

(e) investments in **associates**; and

(f) investments in **joint ventures**.

An entity shall also disclose a description of the events and circumstances that led to the **recognition** or reversal of the impairment loss.

AUDITING NEW UK GAAP – INTRODUCTION AND BACKGROUND
(LECTURE A525 – 13.15 MINUTES)

One of the hottest topics in auditing at the moment is auditing financial statements prepared under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. The auditing standards have not changed neither have the APB Ethical Standards or Part 16 of the Companies Act 2006. Nonetheless, auditors who audit financial statements prepared under UK GAAP are experiencing very significant new challenges.

Auditors with experience of auditing IFRS financial statements will be better placed to take on the challenges presented by FRS 102, because FRS 102 is so closely based on IFRS. But even then there are different requirements which will present different challenges for auditors. Also, auditors of IFRS financial statements tend to be auditing listed groups where the independence requirements for auditors are very different. So whilst the lessons learnt by those auditing IFRS financial statements are of some use there are new issues to contend with, as well.

The problem for auditors

It is important to remember that for periods commencing 1 January 2015, virtually the entirety of old UK GAAP is withdrawn and replaced, to a large extent, with a single new standard. This is not a copy and paste exercise; it is all 100% new and it marks a major revolution in UK accounting. Because the financial statements are prepared differently it is inevitable that auditing those financial statements will have to be approached differently.

Why does FRS 102 present such a challenge for auditors? This is not a straightforward question to answer as there are so many different facets to the issues created by applying FRS 102. The following is a useful summary of the issues:

Fair values – old UK GAAP is largely based on historical cost accounting, with many assets measured at cost less impairment. FRS 102 demands much greater use of fair values. Historic cost is relatively simple to audit as evidence is easy to obtain of what an asset cost. Impairment, however, is more difficult to audit but impairment reviews are not always needed. Obviously, auditing fair values will be considerably more challenging and possibly time- consuming.

Detail – whilst the saying the ‘devil is in the detail’ is a cliché, it is true of FRS 102. There are a myriad of detailed requirements that are different from old UK GAAP. The opportunity to make errors in preparing the financial statements are significantly increased. Auditors will have to be more vigilant and they will almost certainly have to deal with more errors.

The learning curve – for those unfamiliar with IFRS, the task of obtaining a mastery of the requirements FRS 102 is not to be underestimated. It is a fearfully steep and long learning curve. This is not helped by the fact that the requirements and scope of the standard has been continually updated, even before its mandatory application date. It might take a considerable amount of time for financial statement preparers to fully understand the requirements of the standard and the relevant implications. Again this increases the likelihood of there being errors in the financial statements for the auditor to detect.

This assumes of course that the auditors have ‘summited’ the learning curve, themselves. If the auditors are still struggling to come to grips with the requirements of FRS 102 then the chances of all errors being detected are reduced.

Changes to the Companies Act – in addition to new UK accounting standards, there are some significant changes to the accounting requirements in Part 15 of Companies Act 2006. These changes are driven by the EU Accounting Directive and seek to simplify the financial statements for small companies. Most of these changes effect the preparation and filing of

financial statements for small companies but there are some changes that will more directly affect the auditor.

Auditor independence – the big issue here is the increase in the provision of non-audit services by auditors so as to help audited entities with the application of FRS 102. This is clearly a big issue when entities first apply FRS 102 because many entities will require considerable assistance from their auditors with transition and related issues. What is sometimes less well understood is that there will also be an increase in the demand for non-audit services on an ongoing basis because it is often more complex preparing financial statements under FRS 102.

New UK GAAP

The focus of this is on auditing financial statements prepared under FRS 102, rather than the requirements of that accounting standard itself, or the new UK GAAP accounting framework more generally.

However, it is useful to set out an outline of the new accounting framework.

From periods commencing ***1 January 2015***, virtually the entirety of existing UK GAAP is withdrawn. The replacement standards are:

FRS 100 Application of Financial Reporting Requirements – this standard sets out which entities may apply or are required to apply which standards.

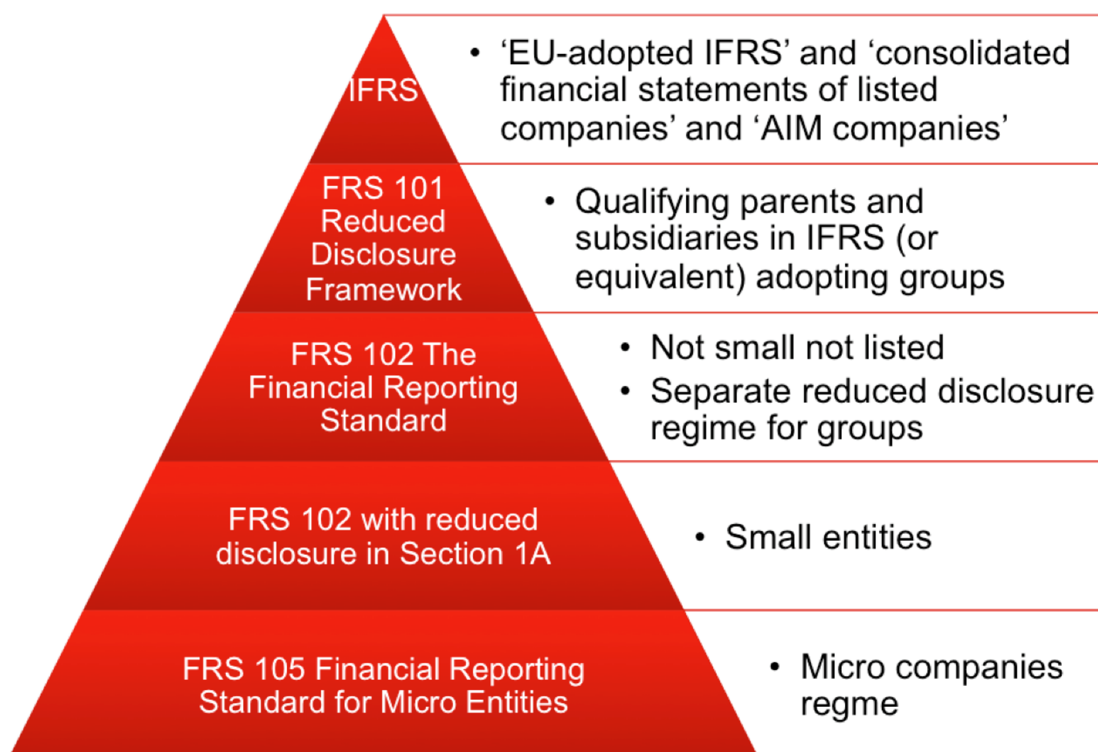
FRS 101 Reduced Disclosure Framework – this is an optional standard for entities who want to use the recognition and measurement requirements of IFRS but with very substantial disclosure exemptions.

FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – this single standard replaces the old SSAPs, FRSs and UITF Abstracts. It is based upon IFRS for SMEs with a number of significant differences. The vast majority of UK audits, going forward, are expected to be of financial statements prepared using FRS 102.

FRS 103 and **FRS 104** deal with accounting for insurance contracts and interim accounts, respectively.

For periods commencing on or after 1 January 2015 small companies may still apply the Financial Reporting Standard for Smaller Entities (the FRSSE) in the form of the FRSSE (effective January 2015).

From periods commencing on or after ***1 January 2016***, the FRSSE (effective January 2015) is withdrawn and smaller entities will apply either FRS 102 (with presentation and disclosure exemptions in Section 1A of the standard) or the new standard, FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. The framework will then look like this:



Early adoption provisions apply for most of the new standards.

ETHICS, AUDITORS AND FRS 102 (LECTURE A524 – 18.32 MINUTES)

The main ethical issues that auditors will have to manage arise because of the provision of non-audit services related to the adoption and continued application of FRS 102. There are other issues, such as the intimidation threat referred to below, but these are relatively minor.

1. Non-audit services: introduction

On the transition to FRS 102, many entities will require some assistance or more assistance than usual from their auditors. This could involve the provision of the following services:

- **assistance with the process of transition:** this will include advice on systems, accounting policy choices and generally educating management on the requirements of the standard and how it affects the entity;

- **accountancy services:** principally help with the mechanical process of preparing the accounts in compliance with FRS 102, including assistance with presentation, disclosure and making the right accounting policy choices for the entity;

- **tax services:** in addition to routine compliance work such as tax computations and CT600 returns, auditors might be asked to help with tax planning issues arising from the application of FRS 102;

- **valuation services:** FRS 102 uses the fair value basis more frequently and auditors may be asked to assist by providing valuations of investments in shares, derivatives, share options, etc.

Some of these services will be one-offs at transition; others might be required annually.

When auditing **unlisted** entities, most of these non-audit services are not prohibited, provided appropriate safeguards are put in place. The audit of **listed** entities is not considered here.

However, auditors of unlisted entities, will need to be vigilant for circumstances where the threats to independence are too large to be properly addressed by safeguards or where the APB Ethical Standards have restrictions, which is the case with valuation services (see below).

2. Assistance with the process of transition

This service is different to the provision of accountancy services. Smaller entities might require significant assistance with their preparation for applying FRS 102 for the first time. This might include:

- reporting to management how FRS 102 will affect the financial statements;

- identifying areas where there are accounting policy choices and supporting management in making those decisions;

- advising on, and assisting with, changes to internal controls, such as changing sales and purchase ledger systems to deal with foreign exchange in accordance with the requirements of FRS 102;

- early stage assurance engagements.

This area may turn out to be a minefield. Entities may ask for audit firm staff to be seconded to them for lists of accounting policy options together with recommendations, and for reviews of the opening balance sheet, for example. Whatever auditors do in this area, they must make it clear that the services provided are separate from the audit, and that the provision of advice or services does not guarantee a clean audit report, or that the audit will not uncover matters which will render the advice given inappropriate. In practice, however even if many safeguards are put in place, it will easily look as if the firm is backtracking if decisions made with the support of the firm turn out not to be right during the audit. Most of the time this will not happen but auditors need to proceed with some caution here.

As is the case when providing any non-audit service, auditors should identify the nature of the threats to independence and address them with safeguards. Common safeguards include having a team separate from the audit team assisting with transition, or the non-audit service being overseen by a partner not involved in the audit.

Auditors should also be alert to the possibility of threats that are so significant that they **cannot** be addressed with safeguards.

Example - assistance with transition (Coventry Ltd)

The auditors of Coventry Ltd are asked to report to management on the accounting policy choices that can be made to maximise reported profits when applying FRS 102.

This could create significant management threats to independence, which might not be compatible with continuing with the audit. The auditors might appear to be colluding with Coventry Ltd to manipulate the presentation of the financial statements. The auditors should strongly consider declining to provide the non-audit services on those grounds.

3. Accountancy services

Self-review and management threats nearly always arise when auditors provide accountancy services. There is a risk that FRS 102 will increase both of these threats

Self-review threat: the accounting in FRS 102 is more complex in areas such as intra-group loans at below market rates and hedge accounting. Remember, the self-review threat is that it is more difficult to check your own work because you will not be expecting errors. Where the accounting is complex, the threat increases.

Management threat: FRS 102 uses more fair value measurement techniques and determining fair values often requires professional judgement, which is the role of management.

On transition and going forward, auditors will need to carefully consider what safeguards are applied to address these threats. Different threats require different safeguards. Engagement quality control reviews or second partner reviews can be very effective in addressing management threats, and having separate teams preparing the financial statements, if at all possible, is always a good safeguard for self-review threats.

4. Taxation services

FRS 102 requires fair value re-measurement differences to pass through profit or loss and tax issues can therefore be more complex under new UK GAAP. It is likely that there will be more items to adjust for in the tax computation than before and not all of the re-measurement differences are taxable or deductible.

Auditors will have to ensure that self-review and management threats are appropriately addressed with safeguards as necessary. In practice, many audit firms have separate tax departments and if the tax team do the tax work then that can be a good safeguard. Even so, as with providing assistance with the transition, it is important to make it clear at the outset that the view taken by the tax team, or indeed any tax advice given, might not survive the audit, particularly in the first year. Audit firms will clearly want to avoid such situations but they might occur.

Auditors should also remember that tax still needs to be audited even if the tax department has helped with the work.

Where auditors provide tax planning services, special care needs to be taken if it involves the selection of accounting policies to achieve a desired tax effect. The threats to independence can be significant and this sort of service is not always compatible with the audit.

5. Valuation services

This is potentially the most troubling area for auditors. ES5 (Revised) *Non-audit services provided to audited entities*, states in paragraph 77 that audit firms may not provide valuations to an audited entity that is listed or a significant affiliate of a listed entity, where the valuation would be material to the listed company's financial statements, either separately or in aggregate with other valuations provided, Valuations may not be provided to other audited entities where the valuation would both involve a significant degree of subjective judgement **and** have a material effect on the financial statements, either separately or in aggregate with other valuations provided.

So for unlisted entities, auditors should not provide valuations that are both material and subjective. For listed entities they need only be material for the prohibition to apply.

FRS 102's tendency to measure at fair value could create problems. Here are some examples of assets requiring valuations under FRS 102:

- shares in an unlisted companies measured at fair value;
- share options valued using the Black Scholes model; and
- the fair value of a customer list as an intangible asset on acquisition.

There is the potential for a significant amount of subjectivity in all of these valuations and it is likely that auditors would not be able to provide them if they were material to the financial statements.

Where auditors provide valuations that are within the scope of what can be provided under paragraph 77, auditors will want to take care in documenting the nature of the service to demonstrate compliance with the Ethical Standard.

6. Audit vs non-audit services

It is important to distinguish between what is a non-audit service and what falls within the remit of the audit. It is **not** unusual for auditors to provide advice on the accounting policies currently in use, or on the application of current and proposed accounting standards, where such matters come to their attention during the course of the audit. The advice is a by-product of the audit service and is not an engagement to provide non-audit services. In others words auditors may advise management on how to correct errors in the financial statements, for example.

Example - Audits vs non-audit services (Carlisle Ltd)

The directors of Carlisle Ltd prepare their own financial statements without assistance from the auditors. They have selected a useful life for depreciating their freehold buildings of 50 years.

The auditors of Carlisle Ltd, identify that the buildings are mostly light industrial units clad with steel sheeting and that similar buildings tend to have a life of 20 to 25 years. The auditors ask the directors to reconsider their estimate and the directors of Carlisle reduce the useful life of the buildings to 20 years.

This was not the auditors' decision, they simply challenged management and presented objective evidence to support their view.

Example - Audits vs non-audit services (Maidstone Ltd)

The directors of Maidstone Ltd prepare their own financial statements without assistance from the auditors.

The company has a share option scheme and the directors have no experience valuing options but make a rough guess in drafting the accounts. The auditors of Maidstone Ltd use the Black Scholes model to develop their own estimate (which is significantly different to management's figure) and then supply this figure to management, who correct the financial statements.

The auditors of Maidstone claim not to have provided a valuation and they were simply requiring the adjustment of an unadjusted error. This 'work around' ES 5 paragraph 77 is fairly clearly a breach of the standard.

7. Informed management

When providing non-audit services to unlisted entities, a key element of the process is identifying whether there is 'informed management', and if there is, who they are.

'Informed management' is capable of making the necessary decisions which means that auditors do not have to make those decisions themselves, and consequently take on a management role.

In previous audits it might have been established that there was informed management. However, that was in relation to old UK GAAP. In other words, management would have understood how to make accounting policy decisions and appropriate accounting estimates under the old framework. This does not mean that they can do the same under new UK GAAP.

Example - Informed management (Bristol Ltd part 1)

The directors of Bristol Ltd are familiar with accounting for business acquisitions under FRS 102. They know how to fair value the assets and liabilities and determine the useful life of goodwill.

FRS 102 requires all intangible to be recognised at fair value on acquisition, including those that are not separable. Also, in terms of determining the useful economic life of goodwill, FRS 102 does not allow an indefinite life and if the useful life cannot be determined reliably, it limits the life to ten years.

The auditors will need to reconsider the issue of informed management in this new context. Remember that informed management is, in part, created by auditors when they provide the non-audit services, in that they can help educate management how FRS 102 is to be applied, ensuring that it is management who actually make the decisions.

8. Self-interest threat: fee dependence

Auditors may provide non-audit services of substantial value, particularly during the transition. Where the fees for non-audit services are larger than the audit fee, auditors need to give some thought as to the impact of the self-interest threat.

In extreme cases, smaller firms might find that the total fees, for a particular client, including non-audit services, approach the 10% threshold requiring an external review, or even the outright 15% threshold. Different thresholds apply for listed audits.

9. Intimidation threat

Of the six threats to independence, the one that seems to get forgotten is the intimidation threat. It is one of the less common threats that auditors encounter but when entities change their accounting framework, management will, in many cases, be abandoning accounting practices that they are familiar with and that work for them.

FRS 102 requires more complex and possibly unpopular policies in some cases and it is understandable that management might resist this change. This resistance might involve applying pressure on auditors to accept a less than ideal solution, or even non-compliance.

Example - Intimidation threat (Bristol Ltd part 2)

Bristol Ltd currently has an accounting policy not to amortise goodwill because, in the opinion of the directors, goodwill has an indefinite useful life.

The directors tell the auditors that they will retain this policy of non-amortisation on transition even though it is not compliant with FRS 102.

After a number of meetings the auditors convince the directors that this is not acceptable. The directors have now determined that goodwill will have a finite useful life of 499 years. Provided that the life can be estimated reliably, FRS 102 does not have a 20-year maximum life, unlike FRS 10 *Goodwill and intangible assets*.

The auditors tell the directors that this estimate cannot be supported, but the directors take a robust stance and claim that they have spoken to another audit firm that will accept the new finite life.

The intimidation threat is clear.

10. Audit documentation

Given all of the above, auditors might have a lot to think about regarding threats to independence and appropriate safeguards. It is critical that everything relevant is documented in the audit file.

The key elements of audit documentation include:

- the nature of the non-audit services;
- a description of the threats to independence: self-review, management, self-interest, intimidation, etc.;
- the amount of the non-audit fees compared to the audit fee, if relevant;
- those identified as ‘informed management’; and
- safeguards applied.

There might be situations in which *ES Provisions Available for Smaller Entities* is applicable, but given the nature of the threats to independence in this context, its use may be limited.

11. Communication with those charged with governance

Do not forget the requirements of the Ethical Standards, to communicate the identified threats to independence and relevant safeguards for listed entities.

ISA (UK AND IRELAND) 510 *INITIAL AUDIT ENGAGEMENTS* *(LECTURE A526 – 14.30 MINUTES)*

When an audit firm engages a new audit client it will need to apply the provisions in ISA (UK and Ireland) 510 *Initial audit engagements – opening balances*. The objective of this UK and Ireland ISA is to obtain sufficient appropriate audit evidence about whether:

(a) Opening balances contain misstatements that materially affect the current period's financial statements; and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Definitions used in the standard

Paragraph 4 of ISA (UK and Ireland) 510 states that the following terms are defined as follows:

(a) **Initial audit engagement** – an engagement in which either:

 (i) The financial statements for the prior period were not audited; or

 (ii) The financial statements for the prior period were audited by a predecessor auditor.

(b) **Opening balances** – Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

(c) **Predecessor auditor** – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

Audit procedures for opening balances

When a new audit client is engaged, the auditor must obtain a copy of the most recent financial statements, if any, together with the predecessor auditor's report on those financial statements. The auditor should then read these financial statements to obtain applicable information which is relevant to opening balances (including disclosures).

Audit procedures in relation to opening balances must enable the auditor to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements which might materially affect the current period's financial statements. Paragraphs 6(a) to (c) outlines specific procedures the auditor must carry out to obtain sufficient appropriate audit evidence by:

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

(i) Where the prior year financial statements were audited, reviewing the predecessor auditor's working papers to obtain evidence regarding the opening balances;

(ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

Where misstatements are noted by the auditor in the opening balances, the auditor must undertake additional audit procedures as they judge appropriate in the circumstances in order to determine the effect that the misstatements have on the current period's financial statements. Where the auditor concludes that misstatements do exist in the current period's financial statements, the auditor must communicate the misstatements with the appropriate level of management and those charged with governance to comply with the provisions in ISA (UK and Ireland) 450 *Evaluation of misstatements identified during the audit*.

Audit evidence on opening balances: fixed assets and long-term liabilities

The auditor can obtain some audit evidence in relation to fixed assets and liabilities by a review of the client's accounting records. For example, in relation to fixed assets invoices may be available to support the cost price of fixed assets and recalculation of the depreciation using techniques such as proof in total might provide audit evidence in respect of brought forward values.

Where liabilities are concerned, the auditor could obtain audit evidence through third party confirmations (bank confirmations and such like) to support the opening balances of long-term debt.

In addition, a review of the predecessor's working papers file will also provide some audit evidence concerning the opening balances of fixed assets and liabilities.

Audit evidence on opening balances: current assets and current liabilities

Some audit evidence in relation to opening balances of trade debtors and trade creditors can be obtained as part of the current period's audit procedures, such as cash collections from trade debtors and cash payments to suppliers. This should provide some audit evidence to satisfy the existence, rights and obligations, completeness and valuation assertions.

Stock and work in progress can prove trickier because audit procedures carried out on the closing stock/work in progress valuation will generally provide little audit evidence concerning opening stock and work in progress valuations. As a consequence, the auditor should perform additional audit procedures such as:

(a) Observing a current physical inventory count and reconciling it to the opening inventory quantities.

(b) Performing audit procedures on the valuation of the opening inventory items.

(c) Performing audit procedures on gross profit and cut-off.

Again, a review of the predecessor's working papers file may also serve to provide audit evidence in relation to opening balances on such items.

Accounting policies

The auditor must obtain sufficient appropriate audit evidence that the reporting entity's accounting policies reflected within the opening balances have been consistently applied in the current year's financial statements. Sufficient appropriate audit evidence must also be obtained by the auditor where the entity has changed any of its accounting policies to ensure that these have been appropriately accounted for and adequately disclosed.

Reporting issues

The scope for a qualified audit report is wider for initial engagements (although a qualified audit report is not always necessary where opening balances are concerned because the auditor can adopt various procedures to gather sufficient appropriate audit evidence concerning opening balances and the consistency of application of accounting policies). However, ISA (UK and Ireland) 705 *Modifications to the opinion in the independent auditor's report* provides guidance on circumstances which may result in a modification to the auditor's opinion.

When the auditor is unable to obtain sufficient appropriate audit evidence regarding opening balances, this will result in one of the following types of modifications to the opinion within the auditor's report:

(a) A qualified opinion or a disclaimer of opinion, as is appropriate in the circumstances; or

(b) Unless prohibited by law or regulation, an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations, and cash flows, where relevant, and unmodified regarding financial position.

Modifications to the predecessor auditor's report

The *Application and other explanatory material* at paragraph A9 to ISA (UK and Ireland) 510 says that in some situations, a modification to the predecessor auditor's opinion might not be relevant and material to the opinion on the current period's financial statements. The paragraph offers an example where there was a scope limitation in the prior period but this has now been resolved in the current period.

ISA (UK AND IRELAND) 501 *AUDIT EVIDENCE* *(LECTURE A527 – 11.02 MINUTES)*

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

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

The objective of ISA (UK and Ireland) 501 *Audit evidence – specific considerations for selected items* is for the auditor to obtain sufficient appropriate audit evidence in relation to:

(a) the existence and condition of inventory;

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

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

Inventory (stock and work in progress)

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

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

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

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

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

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

- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of the physical inventory counting.
- Whether the entity maintains a perpetual inventory system.

- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate. ISA (UK and Ireland) 600 *Special considerations – audits of group financial statements (including the work of component auditors)* deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regards to attendance of physical inventory counting at a remote location.
- Whether the assistance of an auditor's expert is needed. ISA (UK and Ireland) 620 *Using the work of an auditor's expert* deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

Observing management's instructions

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

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

Observing management's count procedures

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

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

Inspecting the inventory

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

Undertaking test counts of inventory

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

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

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

Inventory count conducted other than at the year-/period-end

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

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

If a perpetual inventory system is in place, management may perform physical counts or other tests to ascertain the reliability of the inventory quantity information contained in the stock valuation records. Where differences are noted between the perpetual inventory records and the actual physical count, care must be taken because this might indicate that controls over changes in inventory are not operating as effectively as they should. Factors which should be considered when designing audit procedures to obtain audit evidence concerning changes in inventory amounts between the date of the count and the balance sheet date include:

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

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

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

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

Paragraph 22 says that if substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:

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

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

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

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

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

Attendance at inventory count is impracticable

Where inventory is deemed material to the financial statements, then the auditor must make every attempt to attend the inventory count to observe the effectiveness of the count. There are occasions, however, when it is deemed impracticable for the auditor to attend the inventory count, for example because the location of the inventory may pose a threat to the auditor. Reasons of impracticability are quite rare and the UK and Ireland ISA does acknowledge that general inconvenience would not be a valid reason for the auditor not to attend the inventory count. In addition, factors such as difficulty, time or cost involved are also not considered to be valid reasons not to attend the inventory count.

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

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

Inventory under the custody and control of a third party

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

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

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

Litigation and claims

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

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

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

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

(c) Reviewing legal expense accounts.

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

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

Reviewing legal expense accounts

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

Communicating with the entity's external legal counsel

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

(a) A list of litigation and claims;

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

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

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

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

(b) The matter is complex.

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

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

The auditor is also required to date the auditor's report no earlier than the date on which they have obtained sufficient appropriate audit evidence on which to base their audit opinion. As a result, the auditor might need to obtain updated information from the entity's external legal counsel.

Segment information

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

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

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

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

ISA (UK AND IRELAND) 300 *PLANNING AN AUDIT OF FINANCIAL STATEMENTS*

Audit planning is frequently criticised by many professional regulators and the criticisms are usually based around the lack of quality of the planning that has been performed by the audit firm. Audit planning is one of the most crucial aspects of an audit because without undertaking a sufficient programme of planning, the auditor goes in 'blind' and this, in turn, increases audit risk (the risk that the auditor forms the incorrect audit opinion on the financial statements).

Planning aspects are found in the UK and Ireland ISAs in the 300 series, namely:

- ISA (UK and Ireland) 300 *Planning an audit of financial statements* (which is relevant to this part of the notes)
- ISA (UK and Ireland) 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment*
- ISA (UK and Ireland) 320 *Materiality in planning and performing an audit*
- ISA (UK and Ireland) 330 *The auditor's responses to assessed risks*

According to ISA (UK and Ireland) 300, the audit should be planned so that it will be performed in an effective manner. The UK and Ireland ISA says that planning involves establishing the overall audit strategy, which then feeds into development of the audit plan. ISA (UK and Ireland) 300 recognises that adequate planning will benefit the auditor in a number of ways and paragraph 2 sets out the benefits as follows:

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.
- Helping the auditor properly organise and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components and experts.

Preliminary engagement activities

ISA (UK and Ireland) 300 requires the auditor to perform 'preliminary engagement activities' at the commencement of an audit. These activities allow the auditor to identify and evaluate events or circumstances which undermine their ability to plan and perform the audit. At the start of an audit, paragraph 6 of ISA (UK and Ireland) 300 requires the auditor to:

(a) Perform procedures required by ISA (UK and Ireland) 220 *Quality control for an audit of financial statements* regarding the continuance of the client relationship and the specific audit engagement.

(b) Evaluate compliance with relevant ethical requirements, including independence, in accordance with ISA (UK and Ireland) 220.

(c) Establish an understanding of the engagement terms, as required under ISA (UK and Ireland) 210 *Agreeing the terms of audit engagement*.

The *Application and other explanatory material* at paragraph A6 in ISA (UK and Ireland) 300 gives examples of why these activities should be carried out:

- Ensuring the auditor maintains necessary independence and ability to perform the engagement.
- Ensuring there are no issues with management's integrity that may affect the auditor's willingness to continue the engagement.
- Ensuring there is clear understanding with the audit client as to the terms of the audit engagement.

Audit strategy and audit plan

Establishing the audit strategy will help the auditor to determine various issues that arise throughout the audit (subject to the auditor's risk assessment). The auditor needs to consider the resources that will be needed in certain high risk areas and the level of skill and experience that will need to be devoted to such areas, including the use of experts where necessary. The auditor will also need to consider the resources to assign to specific areas, when these resources are needed and how they will be managed. Paragraph 8 of ISA (UK and Ireland) 300 outlines the following requirements when developing the audit strategy:

(a) Identify the characteristics of the engagement that define its scope;

(b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

(c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

(d) Consider the results of the preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Once the auditor has addressed these issues, the detailed audit plan can then be developed. The audit plan should include the nature, timing and extent of procedures to be performed, which are all based on the auditor's assessment of risk. In view of this, it is important that the auditor undertakes their risk assessment procedures early on in the audit process and to plan the nature, timing and extent of specific further procedures depending on the outcome of their risk assessment. Paragraph 9 of ISA (UK and Ireland) 300 says that the auditor shall develop an audit plan which shall include a description of:

(a) The nature, timing and extent of planned risk assessment procedures, as determined under ISA (UK and Ireland) 315;

(b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA (UK and Ireland) 330; and

(c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs (UK and Ireland).

While audit planning naturally takes place at the start of the audit process, it is not finished and forgotten about once planning is complete. Indeed, paragraph A2 in the *Application and other explanatory material* to ISA (UK and Ireland) 300 recognises that planning is a 'continual and iterative process' and that changes to the original audit plan may well be needed as a result of unexpected events, changes in conditions, or as a result of evidence gathered during the detailed audit work. A typical example of this would be where audit evidence gathered reveals matters that differ significantly from the information which was available to the auditor during the original planning.

Direction, supervision and review

There is no one-size-fits-all when it comes to the extent of the direction and review of engagement team members. Issues which will influence the extent of the direction and review of engagement team members include:

- The size and complexity of the entity.
- The area of the audit.
- The assessed risks of material misstatement.
- The capabilities and competence of the individual team members performing the audit work.

Sole practitioner auditors will, having done all the work, be aware of all material issues. However, a practical problem will be forming an objective view on the appropriateness of the judgements made during the audit when the same individual has performed the entire audit. Where the audit involves contentious or complex issues, ISA (UK and Ireland) 300 suggests consulting with other suitably-experienced auditors or the auditor's professional body.

Documentation

Documenting the overall audit strategy is a record of the key decisions considered necessary so as to properly plan the audit and communicate significant matters to the audit team.

It is important that the audit plan is properly documented because this is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed levels of risk.

Where changes are made to the overall audit strategy and audit plan and hence changes are also made to the planned nature, timing and extent of audit procedures, a record of such changes must be documented so as to explain:

- the reasons for the change; and
- the overall strategy and audit plan finally adopted for the audit.

Initial audit engagements

It is usually the case that the auditor will need to adopt additional planning activities for an initial engagement as the auditor will not have experience of the entity that would otherwise be the case for recurring engagements. Additional matters which the auditor might consider in establishing an overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.

- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances.
- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

Additional considerations in establishing the overall audit strategy

ISA (UK and Ireland) 300 contains an Appendix *Considerations in establishing the overall audit strategy* which contains some useful examples of matters which the auditor should consider in establishing an overall audit strategy which, in turn, will influence the audit plan. The Appendix does acknowledge that other matters may also be relevant (as no two audits are generally the same) and hence the list is not comprehensive.

Characteristics of the engagement

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialised knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organisations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

Reporting objectives, timing of the audit, and nature of communications

- The entity's timetable for reporting, such as at interim and final stages.
- The organisation of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of the audit work throughout the engagement.
- Communications with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Significant factors, preliminary engagement activities, and knowledge gained on other engagements

- The determination of materiality in accordance with ISA (UK and Ireland) 320 and, where applicable:
    - The determination of materiality for components and communication thereof to component auditors in accordance with ISA (UK and Ireland) 600.
    - The preliminary identification of significant components and material classes of transactions, account balances and disclosures.
- Preliminary identification of areas where there may be a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- The manner in which the auditor emphasises to engagement team members the need to maintain a questioning mind and to exercise professional scepticism in gathering and evaluating audit evidence.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal control, including evidence of appropriate documentation of such internal control.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Significant industry developments such as changes in industry regulations and new reporting requirements.

- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

Nature, timing and extent of resources

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be a higher risk of material misstatement.

SUMMARY OF DEVELOPMENTS

The following are extracts from Press Releases issued by the FRC over the last three months.

FRC feedback statement on Joint Forum on Actuarial Regulation: A risk perspective

13 July 2015

The Financial Reporting Council (FRC) has today published a feedback statement on the discussion paper, '*Joint Forum on Actuarial Regulation: A risk perspective'*, which sought views on the Joint Forum on Actuarial Regulation's (JFAR) identification of risks to the public interest where actuarial work is relevant.

Common themes emerging from the feedback of over 300 respondents include risks arising from the fast changing pensions environment and the interconnectedness of many of the risks where actuarial work is relevant. As a result of the feedback, JFAR will focus on three areas in 2015/16 to help determine if the risks are being appropriately mitigated and if additional co-ordinated response is needed:

- Defined benefit (DB) to defined contribution (DC) pension scheme transfers: this review will look at the actuarial work being performed to support DB and DC transfers in the light of the new pension freedoms.
- General insurance provisions: this review will investigate the actuarial work supporting the setting of general insurance claims provisions in the light of the current economic environment and competitive insurance market.
- Group think: this review will consider the factors affecting actuarial group think including whether regulation itself can cause group think.

A new framework for Technical Actuarial Standards

16 July 2015

The FRC has today published *'Update on the consultation: A new framework for Technical Actuarial Standards'* following its consultation release in November 2014.

Most responses to this consultation suggested that we defer the introduction of TAS 100 (the general technical actuarial standard which is proposed to replace the existing Generic TASs) until changes to specific TASs are ready to be introduced to avoid two sets of changes in a short period of time.

The FRC agreed and TAS 100 will now be introduced with revisions to the FRC's Specific TASs, currently covering insurance, pensions, transformations and funeral plans. A review draft of TAS 100 and an analysis of reports to the consultation will be published when the FRC consults on the revised Specific TASs later this year.

New accounting standards offer simplification for micro-entities and small entities

16 July 2015

The Financial Reporting Council (FRC) has today issued a suite of changes that update and, in many cases simplify, UK and Ireland accounting standards. Key amongst the changes are new requirements for micro-entities, and the withdrawal of the *Financial Reporting Standard for Smaller Entities* (FRSSE).

The changes are largely in response to the implementation of the new EU Accounting Directive, and include:

- a new standard, FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*;
- new Section 1A *Small Entities* of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*; and
- other changes necessary for continued compliance with company law.

Melanie McLaren, Executive Director of Codes and Standards said:

'These new accounting standards support the implementation of the micro-entities regime, further simplifying accounting requirements for up to 1.5 million of the UK's smallest entities. They also respond to the new legal framework for disclosure in small company reporting, providing guidance for applying it and improving transparency relating to financial instruments, and they further improve the cost-effective reduced disclosure framework for listed groups by permitting IFRS-based presentation requirements in subsidiaries' financial statements.'

Changes made today also relate to the annual review of FRS 101 *Reduced Disclosure Framework* and address an implementation issue in relation to FRS 102.

The main changes are effective for accounting periods beginning on or after 1 January 2016, with early application permitted for accounting periods beginning on or after 1 January 2015.

UK responds to European Commission's Recommendation on the quality of corporate governance reporting ('comply or explain')

16 July 2015

The FRC's Director of Corporate Governance, David Styles, on behalf of the UK has responded to the European Commission's *Recommendation on the quality of corporate governance reporting* ('comply or explain').

'The "comply or explain" method of adherence has given companies flexibility and made it possible to set more demanding standards than can be done through hard rules. Experience has shown that the vast majority of companies attain these standards – in 2014 the Grant Thornton survey of compliance by FTSE 350 companies found that 94 per cent of companies complied with all, or all but one or two, of the 54 provisions in the Code. And by requiring companies to report to shareholders rather than regulators means that the decision on whether a company's governance is adequate is taken by those in whose interest the board is meant to act.

The FRC has commenced a communications exercise to raise standards and promote the flexibility of "comply or explain". Through this we will be reminding both companies and investors that simply complying without giving due consideration to what is appropriate and relevant reduces the flexibility that this approach aims to achieve. To this end, further work will be conducted during the rest of this year to monitor reporting by companies on explanations given when they are not compliant with the Code.'

The full letter can be viewed on the FRC's website (www.frc.org.uk).

FRC publishes draft Accounting Council advice on the IASB's Conceptual Framework for Financial Reporting

23 July 2015

The FRC's Accounting Council commenced its consideration of the IASB's Exposure Draft at its July meeting and reached tentative views. These may be amended in the course of developing the Accounting Council's advice to the FRC for its response to the Exposure Draft, which will be finalised in October.

Financial Reporting Council publishes Annual Report for 2014/15

28 July 2015

In its Annual Report for 2014/15 the Financial Reporting Council (FRC) outlines its achievements and the challenges it faced during the year. The Annual Report outlines progress against the FRC's 2013/16 strategic programme. As well as continuing to focus on key issues such as culture and behaviour, the FRC will be consulting stakeholders on its strategic priorities for 2016/19.

Sir Winfried Bischoff, Chairman of the FRC, said:

'Our primary mission is to maintain an effective regulatory framework for corporate governance and reporting in the public interests; one that supports the needs of investors and supports boards and the professions in meeting the necessary high standards. We measure success by the impact we make, not by our level of activity.

In my first year as Chairman I have listened to many of those the FRC regulates and with whom we work and seek to influence. Overall the feedback is positive with the FRC recognised as being consultative, willing to listen and influential within the EU and internationally. But there are areas where we need to make more progress, including promoting investor stewardship, clear and concise corporate reporting and the quality and value of audit. We also need to avoid imposing unnecessary burdens on those we regulate, developing non-regulatory solutions wherever possible, and being particularly mindful of the needs of small growing companies.

We are helping Government to shape the future of audit regulation. During 2014/15 the FRC has supported the Department for Business, Innovation and skills in their consultation on the implementation of the new Audit Regulation and Directive. The work of the FRC is likely to expand with a significant increase in the number of audit firms to be monitored and new arrangements for oversight of the audit profession. We have reviewed the impact of our work to monitor the quality of reporting and auditing and will take steps to further enhance its effectiveness.'

In 2015/16 the FRC will also complete the delivery of its three-year strategy by building on or embedding actions taken in the previous two years. Actions will include:

- Taking forward work on corporate governance and stewardship, in particular measures to enhance levels of engagement between investors and companies.

- A new project to focus on company culture and succession planning, including how to promote good practice in both areas.
- Promoting clear & concise reporting, including through the project to help smaller listed and AIM companies with the quality of their reporting.
- Continuing the programme of work to promote audit that is of a consistently high standard and which meets investors' needs.
- Finalising the project to identify and respond to public interest actuarial risks and update technical actuarial standards.

Department for Business, Innovation & Skills issues 'Update on the implementation of the EU Audit Directive and Regulation'

26 August 2015

The Department for Business, Innovation and Skills has published an update on the implementation of the EU Audit Directive and Regulation:

'Following Baroness Neville-Rolfe's Written Ministerial Statement of 20 July 2015, which named the Financial Reporting Council (FRC) as the intended UK Competent Authority for the regulation of auditors, the Department for Business, Innovation and Skills (BIS) is continuing to work with the FRC, Financial Conduct Authority (FCA), the Prudential Regulation Authority (PRA) and the Professional Bodies to implement the requirements of the Audit Directive and Regulation. The reforms take effect on 17 June 2016.

BIS consultation

BIS intends to publish a formal consultation in the next few weeks, focussing on the definition of a public interest entity (PIE), FRC powers and Professional Bodies' responsibilities, mandatory retendering and rotation of PIE auditor appointments and other issues.

FRC consultation

The EU reforms introduce changes to auditing and ethical standards. The FRC will, in September, report on the decisions it has reached in the light of responses to its preliminary consultation, and consult further on the detail of implementation. This will include in particular, types of entities in scope, prohibited non-audit services to audit clients, application of independence principles across firms' networks and, audit firm and key audit partner rotation.

At the same time, the FRC will amend existing auditing standards resulting from recent revisions to international auditing standards. The consultation will also include proposed changes to the UK Corporate Governance Code and its associated Guidance on Audit Committees. At a subsequent date, the FRC expects to consult on other issues, including possible changes to its disciplinary arrangements.

FCA and PRA consultations

The EU reforms introduce new Audit Committee requirements applying to all PIEs, i.e. to undertakings with securities admitted to trading on a regulated market, as well as to other banks, building societies and insurers.

The FCA will consult in early September on Audit Committee requirements applying to entities with securities admitted to trading on a regulated market, as an update to the Disclosure Rules and Transparency Rules (DTR) in the FCA handbook, which are supported by the FRC's Corporate Governance Code.

The PRA will be consulting in mid-September on Audit Committee requirements for banks, building societies and insurers regardless of whether or not they have issued transferrable

securities. If a firm falls within both the scope of the FCA and PRA Audit Committee rules, the PRA intends it should comply with both sets of rules.'

FRC's work to enhance justifiable confidence in audit through implementation of the EU Audit Regulation and Directive

29 September 2015

As part of its ongoing work to enhance justifiable confidence in audit, the Financial Reporting Council (FRC) has published a consultation on revisions to Ethical and Auditing Standards, the UK Corporate Governance Code and related Guidance on Audit Committees.

Audit underpins public confidence in corporate governance and reporting by UK companies. Since the financial crisis, the FRC has introduced measures to enhance confidence in the quality of audit and increase the value of auditor reporting to investors. The measures include retendering, enhanced and extended auditor and audit committee reporting, and increased transparency of the results of the FRC's audit quality inspections.

In April 2014, the FRC announced that to enhance confidence in the quality of audit, its work would include a focus on recommendations from the then Competition Committee's review of competition in the FTSE 350 audit market; the implementation of the new EU Regulation and Directive on statutory audit (ARD); developing best practice guidance for audit committees; and assessing whether ethical standards for audit remain fit for purpose.

The FRC is now consulting on proposals in connection with those elements which it considers should be introduced at the same time as the ARD is implemented into the UK. In developing its proposals, the FRC has sought to follow underlying principles and objectives:

- building a clear and sustainable framework and clear lines of accountability (so that companies and audit firms know the exact role of all UK regulatory bodies);
- maintaining market confidence in the independence of regulation (so that investors and potential investors remain confident in the quality of financial statements);
- applying the rule of proportionality, and delivering implementation that can be justified and defended; and
- serving the public interest.

The FRC's proposals reflect responses received to its earlier consultation *Auditing and ethical standards implementation of the EU Audit Directive and Regulation*, and include an impact assessment of the costs and benefits arising from decisions taken by the FRC.

Stephen Haddrill, FRC Chief Executive said:

'The Audit Regulation and Directive is large and complex. We are working closely with professional bodies to make sure the new regulatory regime works as effectively as possible. We must ensure that it builds on the progress made in the UK in recent years in terms of the quality of audit, that competition in the audit market is strengthened in a way that supports innovation and that the regulatory regime that emerges provides confidence to investors and to firms by being fair, understandable and independent.'

The FRC's consultation includes:

- A revised Ethical Standard for audit and other public interest assurance engagements incorporating changes required by the ARD. The FRC is a principles-based regulator and has developed an approach where principles are supported by more detailed requirements. This is intended to mitigate risk, which has been identified through FRC's audit quality inspection work, that auditors treat standards (and the Ethical Standard in particular) as a rule book where behaviour is driven by a series of prohibitions rather than assessment of what behaviours are appropriate. The standard covers matters such as how independence of the auditor might be judged, the role of the firm in ensuring ethical conduct; and prohibitions and limits on non-audit services in line with the ARD requirements. In line with feedback from the FRC's December consultation that investors' confidence is enhanced by existing, more stringent UK requirements and/or practices, the FRC proposes to retain those requirements where possible.

- Revised quality control and auditing standards incorporating where necessary, specific requirements of the ARD, and guidance to address UK and Irish legislation, and cultural and business issues. The International Audit and Assurance Standards Board (IAASB) has recently issued revised auditor reporting standards. As auditing standards in the UK and Ireland are based on international standards issued by the IAASB, the FRC is taking the opportunity to consult on revisions to the auditing standards. The FRC led the way with the introduction of extended auditor reporting and in revising the reporting standards it has sought to retain those requirements which drove innovation. Similarly, the FRC has led the way in respect of providing a longer term view of business viability and differentiating reporting for stewardship purposes from the reporting of accounting judgements. The FRC is of the view that auditor reporting related to going concern is in the public interest and is valuable to investors. The FRC therefore proposes, in addition to the enhancements made by the IAASB, to include additional UK requirements on the reporting of the going concern basis of accounting and related uncertainties.

- Changes to the UK Corporate Governance Code (the Code) which are being kept to the minimum required to align with the ARD and to limit the regulatory burden. The changes relate to the tenure of the auditor where the 2012 Code change introducing ten year retendering is now redundant; and to changes in the composition and role of the audit committee. The FRC is consulting on recommendations of the (now) Competition and Markets Authority (CMA) relating to increasing shareholder engagement on audit matters through changes to both the UK Corporate Governance and UK Stewardship Codes. The FRC considers that sufficient coverage is already given to this topic in both codes. The CMA also recommended that the Code introduces an advisory vote for shareholders to indicate their satisfaction with the audit committee's annual report. The CMA considered that its introduction would increase the audit committee's incentives to discharge their responsibilities in the interests of shareholders. The FRC considers that shareholders already have sufficient rights to express their opinion on the audit committee report.

- Rewritten 'Guidance on Audit Committees' to take account of amendments to the Code and regulatory framework, and recommendations put forward by the CMA, many of which coincide with amendments made by the ARD. There are changes to the composition of the audit committees covering sectoral competence; removal of references to audit retendering; changes covering new rules around the prohibition of non-audit services; and consequential changes, reflecting amendments to the Ethical and Auditing Standards for Auditors. Further, the FRC wishes to increase transparency of its audit quality inspection findings and corporate reporting review findings. The guidance includes reporting by audit committees of significant matters arising from FRC inspections and reviews. The guidance builds on the approach developed following the CMA recommendations in respect of audit quality inspection findings and announced by the FRC in November 2014.

- The proposed changes to the Code and the revised Ethical Standards and Auditing Standards will apply to financial periods beginning on or after 17 June 2016, the implementation date of the ARD.