

Accounting and Audit Quarterly Update – Quarter 4

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Business combinations and goodwill (Lecture A641 – 11.51 minutes)

Group issues are largely dealt with in Section 19 *Business Combinations and Goodwill* under FRS 102; although there is a close interaction with Section 9 *Consolidated and Separate Financial Statements*. Section 9 of FRS 102 applies to all parents which are required, or voluntarily choose, to prepare consolidated financial statements.

Groups which are medium-sized and large will invariably be required to prepare consolidated financial statements unless the provisions in paragraph 9.3 (exemption from preparing consolidated financial statements) or paragraph 9.9 (exclusions from consolidation) apply.

Small groups are exempt from the requirement to prepare consolidated financial statements (section 399(2A)) of the Companies Act 2006); although that is not to say that all small groups choose to take up this exemption. Indeed, some small groups do voluntarily prepare group accounts and where this is the case, FRS 102, Section 1A *Small Entities* provides guidance for small groups in paragraphs 1A.21 and 1A.22.

This section of the course will not look in detail at the preparation of group accounts, but will look at some of the changes to the preparation of such accounts under FRS 102 and will recap on some of the key concepts involved when preparing consolidated financial statements.

The concept of control

The term ‘business combination’ applies when a parent company acquires a subsidiary. In this situation, the parent company obtains **control** over the subsidiary. Control is usually evidenced by way of an ownership interest of more than 50%, but this is not absolute and other characteristics of the relationship can indicate that a parent has obtained control over a subsidiary even with an ownership interest of less than 51%, such as:

- the ability to appoint or remove the majority of the board of directors (or equivalent governing body);
- the power to cast the majority of votes at meetings of the board of directors/equivalent governing body where control of the entity is by that board or body;
- the power to govern the entity’s financial and operating policies under a statute or an agreement; or
- the power over more than 50% of the voting rights by virtue of an agreement with other investors.

It follows, therefore, that while control over a subsidiary is usually evidenced by an ownership interest of more than 50% of the voting rights/net assets of an entity, regard must be had to other conditions that may indicate control where the parent may not own more than 50% of the voting rights/net assets.

This is because control is based on substantive rights.

The purchase method

The purchase method of accounting is used when a parent acquires a subsidiary. FRS 102 (March 2018) contains five steps in applying the purchase method of accounting as follows:

- (a) identifying an acquirer;
- (b) determining the acquisition date;
- (c) measuring the cost of the business combination;
- (d) allocating, at the acquisition date, the cost of the business combination to the assets acquired and liabilities and **provisions for contingent liabilities** assumed and recognising and measuring any **non-controlling interest** in the acquiree; and
- (e) recognising and measuring **goodwill**.'

*FRS 102 (March 2018)
para 19.7*

Is it an acquisition or is it a group reconstruction?

Group reconstructions are also dealt with in Section 19 of FRS 102 and while this course cannot go into the detailed intricacies of group reconstructions, in some situations the first question to ask is whether the transaction is an acquisition of a subsidiary OR whether it is a group reconstruction.

When a group reconstruction takes place, the use of the merger method of accounting may be used instead of the purchase method. (Note that although the standard seems to make the merger method optional, in practice it will be required in order to give a true and fair view, if the transaction is a group reconstruction). The two concepts are fundamentally different. Merger accounting uses book values of assets and liabilities to combine the merging entities (fair values are not used, but some adjustments may be necessary to achieve uniformity of accounting policies). Under the purchase method of accounting, fair values are used to consolidate the subsidiary at the date of acquisition.

In addition, to qualify for the use of the merger method of accounting, it needs not to be prohibited by company law and the ultimate equity holders need to remain the same and their rights relative to each other unchanged. Also, no non-controlling interest in the net assets of the group is altered by the transfer. This is because if the rights are changed this indicates that it is not, in fact, group reconstruction as something else is happening to change the relationship with the group and outside parties.

In many cases, however, it will be clear whether a transaction is a business combination or a group reconstruction.

Overview of the principles of consolidation

As noted above, the course will not be going into the detailed mechanics of consolidation as it is expected that practitioners will already have a sound grasp of the basics and the mechanics have not changed through the FRC's triennial review (or indeed under FRS 102).

Accounting policies

Amounts included within the consolidated financial statements should be based on coterminous accounting policies. Where a subsidiary uses accounting policies that differ to the parent in its individual financial statements, consolidation adjustments will be necessary.

Accounting period-end dates

Subsidiaries should, wherever practicable, use the same accounting reference date and accounting period as the parent. Where a different accounting reference date is used, interim financial statements should be prepared to the parent's accounting reference date for use in the consolidation. Where this is not practicable, the subsidiary's financial statements for the previous financial year should be used provided that the year-end did not end more than three months before the parent's year-end. In these situations, any changes that have taken place in the intervening period that materially affect the view given by the group accounts should be taken into account by way of adjustment in the preparation of the consolidated financial statements.

Consolidated profit and loss account

Each individual entity within the group will prepare its own financial statements (referred to as the 'individual' financial statements). The parent will then consolidate the individual financial statements with those of its own (subject to consolidation adjustments) to arrive at the consolidated financial statements.

The consolidated profit and loss account is quite straightforward. It merely consolidates, line-by-line, up to the levels of profit after tax. After profit after tax, the amounts attributable to the parent and non-controlling interest are shown.

All intra-group sales, purchases and expenses are eliminated together with any unrealised profit (for example in stock).

Intra-group dividends are eliminated from the group's investment income and intra-group interest is eliminated from investment income and interest payable as appropriate.

Consolidated balance sheet

This is more complicated to prepare than the consolidated profit and loss account. The assets and liabilities section of the consolidated balance sheet reflect the net assets that

are under the control of the parent, whereas the capital and reserves section reflects the split of ownership interest between the parent and the non-controlling interest.

The table below outlines the preparation of the consolidated balance sheet:

Area	Method
Assets	Amalgamate on a line-by-line basis
Liabilities	Amalgamate on a line-by-line basis
Share capital	Parent company only
Reserves	Group reserves comprise: <ul style="list-style-type: none"> • Parent's reserves <i>plus (profit) or minus (loss)</i> • Share of subsidiary's post-acquisition profit/loss
Goodwill	Capitalise and amortise
Non-controlling interest	Their share of the subsidiary's net assets at the balance sheet date

Intra-group balances (debtors and creditors) should be eliminated. In practice agreeing intra-group balances can be problematic for some groups; particularly the larger groups. If they do not immediately contra, it is more than likely due to cash or in-transit items.

Intra-group dividends should be cancelled and the consolidated financial statements should only reflect dividends payable to the non-controlling interests.

Contingent liabilities in a business combination

Contingent liabilities are treated differently in a business combination than they are in the individual financial statements of an entity under Section 21 *Provisions and Contingencies*. In the separate financial statements of a reporting entity, contingent liabilities are not recognised but are instead disclosed because they fail to meet the recognition criteria for a liability due to not meeting the full criteria for a provision in paragraph 21.4(a) to (c).

Under paragraph 19.15(c) of FRS 102, contingent liabilities whose fair value can be measured reliably are recognised. This is because the transfer of economic benefit is reflected in the contingent liability's fair value rather than it being a criterion for recognition. The fair value of a contingent liability is the amount which a third party would charge to assume the contingent liability.

If the fair value of a contingent liability cannot be reliably measured, there is a resulting impact on the amount that is recognised as goodwill or, in the case of a bargain acquisition (ie where consideration is less than net assets acquired), negative goodwill.

When this situation applies,

the parent must disclose information relating to that contingent liability in accordance with Section 21 of FRS 102.

Example – Contingent liability in a business combination

On 1 March 2018, Topco Ltd acquired 100% of the net assets of Subco Ltd that is in the construction industry. On the date of acquisition, Subco was actively defending a lawsuit brought against the company by one of its contractors who is alleging a breach of contract. The value of the possible payment if breach of contract is proven is £100,000 but the lawyers have said that there is only a 10% chance that the courts would uphold the claim.

The contingent liability should be recognised by Topco on acquisition at its fair value of 10% of the potential payment (£10,000) that may arise if breach of contract is proven.

Measurement after initial recognition

Paragraph 19.21 of FRS 102 says that after initial recognition, the acquirer must measure contingent liabilities at the *higher* of:

- (a) the amount which would be recognised under Section 21 *Provisions and Contingencies*; and
- (b) the amount initially recognised *less* any amounts recognised as revenue under Section 23.

Applying these subsequent measurement principles, if the provision at the next balance sheet date turns out to be higher than the amount that was initially recognised, then the provision is increased as follows:

Dr Profit and loss account	X
Cr Provisions for liabilities	(X)

On the other hand, if the provision turns out to be *lower*, the liability is not reduced; instead it continues to be measured at fair value at the date of acquisition. The exception to this rule would be where the contingency ceases to exist or, where appropriate, reduced in respect of amortisation of the liability under the revenue recognition section (Section 23). The latter would only apply if the contingent liability relates to a revenue-generating activity.

Step acquisitions

Step acquisitions (often referred to as 'piecemeal' acquisitions) take place when a

parent acquires an additional ownership interest in a subsidiary, thus creating a reduction in non-controlling interest. Some investments can, in fact, turn into subsidiary status when additional acquisitions result in the parent owning more than 50% of the net assets of the investee because, unless there is clear evidence to suggest otherwise, the parent will have obtained control over the investee resulting in classification as a subsidiary.

Quite often a parent company, owning more than 50% of the net assets, will obtain further ownership interest in the subsidiary. It is this scenario that is significantly different than what was the case under old UK GAAP.

Under old UK GAAP, if a parent that already had control over a subsidiary, acquired a further ownership interest in the subsidiary's net assets, resulting in a diluted minority (non-controlling) interest, the net assets of the subsidiary would be revalued to fair value at the date control is increased and additional goodwill would also have been recognised. Under FRS 102 the net assets of the subsidiary are **not** revalued and **no** additional goodwill is recognised because paragraph 9.19D of FRS 102 would regard this transaction as one among equity holders in their capacity as equity holders.

Example – Acquisition of further ownership interest in a subsidiary

On 1 June 2017, Topco Ltd acquired 70% of the net assets in Subco Ltd for a purchase price of £500,000. On the date of acquisition, the fair value exercise revealed the net assets of Subco to be £380,000, which was also equivalent to book values. On 1 June 2018, Topco agreed to invest an additional £75,000 in Subco in exchange for a further 10% of the net assets and on this date Subco's net assets had a book value of £435,000 and a fair value of £485,000. The group's accounting reference date is 31 May.

Accounting for the subsidiary at the date of acquisition (1 June 2017)

At the date of acquisition, Topco has acquired control of Subco because it has acquired an ownership interest of 70% of the net assets. As a result, the identifiable assets and liabilities of Subco are consolidated at their fair value of £380,000. Positive goodwill is recognised in the consolidated financial statements of £234,000, calculated as follows:

	£
Cost of investment	500,000
Less net assets acquired:	
(70% x £380,000)	(266,000)
Positive goodwill (group accounts)	234,000

At the date of acquisition, the non-controlling interest (NCI) is £114,000 (or 30% x £380,000).

Year-end 31 May 2018

The increase in Subco's net assets amounts to £55,000 (£435,000 less £380,000) which has arisen due to the profit yielded by Subco during the year to 31 May 2018. This profit is split £38,500 to Topco (being 70% x £55,000) and £16,500 to the NCI. The NCI share is now £130,500 (£114,000 brought forward plus £16,500).

Further acquisition on 1 June 2018

On 1 June 2017, Topco acquired a further 10% of Subco which means that the NCI share of Subco's net assets drops from 30% to 20%.

NCI's share in Subco decreases by £43,500 ((30% - 20%) x £435,000) and their share will now equal £87,000 (£130,500 less £43,500) or 20% x £435,000.

This further acquisition is accounted for as a transaction among equity holders and the resulting change in NCI is accounted for under paragraph 22.19 of FRS 102. In this example, paragraph 22.19 would require the NCI to be adjusted to reflect the parent's additional ownership interest in the subsidiary. Any difference between the value of the NCI adjustment and the consideration paid to acquire the additional 10% interest is recognised in equity and attributed to the equity holders of the parent. Therefore, the accounting would be as follows:

	£
Dr Non-controlling interests	43,500
Dr Equity attributable to the parent	31,500
Cr Cash at bank	(75,000)

The key point to bear in mind where a parent company increases its shareholding in a subsidiary is that under FRS 102, the subsidiary's net assets are not revalued to fair value, nor is there any consequential increase to goodwill (as was the case under previous UK GAAP). FRS 102 requires the transaction to be accounted for as one among equity holders. Under FRS 102, the accounting treatment for such a transaction is inherently simpler.

Disposals

When a parent chooses to sell ownership interest in a subsidiary, there are two outcomes to the transaction: the parent either retains control of the subsidiary, or control is lost.

If control is lost, there are no differences in the accounting treatment under FRS 102 when compared to old UK GAAP. In such cases, the results of the subsidiary are included in the consolidated financial statements up to the date at which control is lost and a gain or loss (calculated as the difference between the fair value of the

consideration received and the identifiable net assets (including goodwill) of the subsidiary disposed of) recognised.

In some instances, however, a parent company may dispose of some, but not all, of its ownership interest in a subsidiary and still retain control of that subsidiary following the disposal (i.e. the parent will still own more than 50% of the net assets following the disposal).

When this happens, the change in the parent's controlling interest is accounted for as a transaction among equity holders in their capacity as equity holders. In other words, the carrying amount of the non-controlling interest is increased to reflect the parent's reduced ownership interest. Any difference between the consideration received by the parent and the amount of the adjustment to non-controlling interest is recognised directly in equity.

This treatment is notably different under FRS 102 as opposed to old UK GAAP. Under old UK GAAP, a gain or loss would be recognised on the disposal and a proportion of the associated goodwill would also be written off.

Example – Partial disposal where parent retains control

On 31 March 2017, Topco Ltd disposes of a 20% ownership interest in Subco Ltd for £300,000 which reduced Topco's holding from 80% to 60%. On 31 March 2017, the carrying amount of the identifiable net assets in Subco was £500,000 and the carrying amount of goodwill on acquisition at the date of the disposal was £30,000.

Under FRS 102, no gain or loss is recognised on the disposal as the transaction is treated as one between equity holders in their capacity as equity holders because Topco still retains control of Subco.

The NCI will increase from 20% to 40% and hence the NCI's share of Subco's net assets will increase from £100,000 (£500,000 x 20%) to £200,000 (£500,000 x 40%), i.e. by £100,000. No goodwill is attributable to the NCI.

As Topco has retained control following the partial disposal, paragraph 22.19 of FRS 102 will apply. The carrying amount of the NCI will be adjusted to reflect the change in Topco's ownership of Subco's net assets. The difference between the NCI adjustment and the fair value of the consideration received is recognised directly in equity and attributed to the equity holders of Top. The journals are:

	£
Dr Cash at bank	300,000
Cr Non-controlling interest	(100,000)
Cr Equity attributable to Topco	(200,000)

Illustrative statement of changes in equity showing change in ownership interest

Group	Called-up share capital £'000	Retained earnings £'000	shareholders' equity £'000	Total controlling interest £'000	Non Total equity £'000
At 01.04.2016	10	240	250	60	310
Profit for the year		120	120	30	150
Equity dividend		(50)	(50)		(50)
At 31.03.2017	10	310	320	90	410
Profit for the year		40	40	10	50
Equity dividend		(10)	(10)		(10)
Change in ownership		200	200	100	300
At 31.03.2018	10	540	550	200	750

Investments in associates (Lecture A642 – 15.39 minutes)

FRS 102 deals with investments in associates in Section 14 *Investments in Associates*. An ‘associate’ is defined in the Glossary to FRS 102 as:

*‘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**.’*

FRS 102 Glossary
associate

It is important to distinguish between an associate and a subsidiary because a parent-subsidiary relationship is created when the parent acquires **control** over the subsidiary. In such cases, group accounts may be required if any exceptions or exemptions from preparing group accounts cannot be claimed.

An investor has an investment in an associate when the investor has **significant influence** over the associate. The term ‘significant influence’ is defined as follows:

*‘Significant influence is the power to participate in the financial and operating policy decisions of the **associate** but is not **control** or **joint control**.’*

FRS 102 Glossary
significant influence

FRS 102, para 14.3 then goes on to provide additional guidance as follows:

- (a) If an investor holds, directly or indirectly (eg 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 (eg 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.’

FRS 102 para 14.3

Ownership interest of more than 20% but entity is not treated as an associate

Paragraph 14.3(a) of FRS 102 states an investor that holds, directly or indirectly, 20% or more of the voting power of the associate has significant influence, unless it can be clearly demonstrated that this is not the case.

The following are non-exhaustive examples of what may give rise to an ownership interest of 20% or more not being accounted for as an associate:

- Severe long-term restrictions prevent the investor from receiving funds from the investee.
- The investor rescinds all significant influence through an agreement with other investors.
- Law or regulation prevent significant influence from being exercised by the investor

(for example in a foreign country).

- It is probable (ie more likely than not) that the investee will issue additional shares to third parties which dilute the ownership interest of the investor.
- There are adverse political and economic conditions in the foreign country which the investee is situated.

The above points are not exhaustive and it is important to scrutinise the substance of the relationship between the investor and the investee carefully because significant influence may be achieved by other means.

Ownership interest is less than 20% but entity is treated as an associate

Paragraph 14.3(b) of FRS 102 states that where an investor holds, directly or indirectly, less than 20% of the voting rights of an entity, it is presumed that significant influence does not exist unless such influence can be clearly demonstrated.

Significant influence with a holding of less than 20% of the voting rights of an entity could arise, for example, where the investor's major shareholder or parent holds additional shares in the investee or the investee is a member of the executive or finance committee.

Ceasing to have significant influence

Significant influence over an investee is lost when the investor loses the power to participate in the financial and operating policy decisions of the investee. The loss of significant influence usually occurs due to disposal of the investee but it can also occur where the entity is taken over as a matter of law (eg by a court or official receiver).

Once significant influence is lost, the use of the equity method of accounting must cease.

Measurement – investor is not a parent

Paragraph 14.4 of FRS 102 states that an investor who is not a parent, but has an investment in one, or more, associates shall, in its individual financial statements, account for all of its investments in associates using either:

- the cost model;
- the fair value model per paragraphs 14.9 to 14.10A of FRS 102; or
- at fair value through profit or loss.

The above accounting policy choices only apply to investors that are not parents – ie they do not own any subsidiaries.

An investor which is not a parent and which chooses to adopt the cost model measures its investments in associates at cost less accumulated impairment losses.

Dividends and other distributions which are received from the investment are recognised as income regardless of whether the distributions are received from

accumulated profits of the associate arising before, or after, the date of acquisition.

Therefore, under the cost model:

- investments in associates are recognised at cost (including transaction costs such as legal fees);
- dividends and distributions are taken to the profit and loss account as income; and
- where there are indicators that the investment is impaired at the balance sheet date, it is written down to recoverable amount by way of an impairment loss. Impairment losses are recognised in profit and loss.

In practice, the cost model is the most common model used due to its simplicity.

Measurement – investor is a parent

Where the investor is a parent that prepares group accounts, they must, in their consolidated accounts, account for all of their investments in associates using the equity method of accounting (see 2.6 below). An exception to this rule would be where the associate is held as part of an investment portfolio as this would be measured at fair value through profit or loss in the group accounts.

The term ‘held as part of an investment portfolio’ is defined as follows:

*‘An interest is held as part of an investment portfolio if its value to the investor is through **fair value** as part of a directly or indirectly held basket of investments rather than as media through which the investor carries out **business**. A basket of investments is indirectly held if an investment fund holds a single investment in a second investment which, in turn, holds a basket of investments. In some circumstances, it may be appropriate for a single investment to be considered an investment portfolio, for example when an investment fund is first being established and is expected to acquire additional investments.’*

*FRS 102 Glossary **held as part of an investment portfolio***

Equity method of accounting

FRS 102, paragraph 14.8 states:

*‘Under the equity method of accounting, an equity investment is initially recognised at the transaction price (including **transaction costs**) and is subsequently adjusted to reflect the investor’s share of the profit or loss, **other comprehensive income** and **equity** of the associate.’*

FRS 102, para 14.8

Paragraph 14.8 refers to ‘equity investment’ but FRS 102 does not define this term. Equity instruments are usually investments in shares of another entity.

In the broadest terms, the equity method of accounting works as follows:

- initial recognition at cost; *plus* or (*minus*);

- share of profit (loss) from associate; *less*
- dividends and other distributions received from the associate.

Dividends and other distributions received from the associate are not taken to profit or loss under the equity accounting method; instead, they reduce the value of the investment in the consolidated balance sheet. A review of some financial statements has indicated that this accounting treatment has been incorrectly applied in the past, with some dividends and distributions being credited to the profit and loss account. This is incorrect under equity accounting as you are instead recognising a proportion of the profit of the associate. If you also recognised the dividends, you would be double-counting the associate's contribution to the group's profit.

Example – Equity accounting

On 1 January 2018, Smith Ltd acquires a 35% interest in Jones Ltd for £475,000. On this date, the book value of Jones' assets were £900,000. During the year to 31 December 2018, Jones makes a profit of £80,000 and pays a dividend of £120,000. The transactions are accounted for under the equity method of accounting as follows:

Acquisition of Jones Ltd

	£	£
Share of Jones net assets (£900,000 x 35%)	315,000	
Goodwill arising (£475,000 less £315,000) ¹	<u>160,000</u>	
		475,000
Share of profit (£80,000 x 35%)		28,000
Dividend received (£120,000 x 35%)		<u>(42,000)</u>
Carrying amount in group accounts at 31 December 2018		<u>461,000</u>

Reconciled as:

Share in book value of Jones net assets	301,000
(£315,000 + 35% (£80,000 - £120,000))	
Goodwill	<u>160,000</u>
Carrying value per group accounts at 31 December 2018	<u>461,000</u>

Additional considerations for the equity method

As noted above, distributions received from the associate reduce the carrying value of the investment; they are not taken to profit or loss. Adjustments to the carrying amount of the investment may also be required due to changes in the associate's equity arising from items of other comprehensive income.

When the interest in the associate is reduced to zero, any further losses are only recognised to the extent that the investor has a legal or constructive obligation, or has made payments on behalf of the associate.

¹ Goodwill 'arises' on the acquisition of Jones Ltd but is not shown separately in the group accounts, it is subsumed within the carrying amount of the investment in associate. The example shows it separately to show how it is calculated.

FRS 102 does not provide guidance as to what happens in the event that dividends are received to the extent that the investment is reduced to zero and further dividends or distributions are then received. In such situations, provided that the distributions are not refundable by the investor and the investor is not liable for the investor's liabilities, then any dividends or distributions received in excess of the carrying value of the investment should be recognised in income. It would not be appropriate to have a negative balance as an investment in associate in the group's balance sheet.

Potential voting rights

While potential voting rights are brought into consideration when establishing whether significant influence exists, the investor must measure its share of profit or loss and other comprehensive income (and its share of changes in the associate's equity) on the basis of the actual ownership interest at the reporting date and these measurements must not reflect the potential exercise, or conversion, of potential voting rights (eg where the investor has provided convertible debt).

Implicit goodwill and fair value adjustments

On acquisition of an associate, goodwill is the difference between the cost of the acquisition and the investor's share of the fair value of the net identifiable assets of the associate (see the example above). The investor must adjust its share of the associate's profit or losses after acquisition so as to account for the additional depreciation or amortisation of the depreciable or amortisable assets in the associates. This is because, at the date of acquisition, the associate's identifiable asset and liabilities will be fair valued and the fair values may be different than book values at the time the associate is acquired giving rise to a fair value adjustment to be incorporated in the consolidated financial statements.

Impairment

Where there is evidence that an associate is impaired, the investor must test the entire carrying amount of the investment for impairment using the provisions in Section 27 of FRS 102 as appropriate. The test for impairment is as a single asset. Goodwill arising on the acquisition of an associate is **not** tested separately, but is part of the test for impairment on the entire investment.

Investor's transactions with associates

It is not uncommon for an investor to trade with its associates and vice versa. Where such trading takes place, the investor must eliminate all unrealised profits and losses in a two-way direction (ie 'upstream' which refers to trading between the associate and the investor, and 'downstream' which refers to trading between the investor and the associate). Care must be taken here because this is not the same as eliminating intra-group trading where a subsidiary is concerned. This is because, in the case of an associate, the investor will only eliminate unrealised profits and losses to the extent of the investor's interest in the associate. In addition, it must be borne in mind that unrealised losses on such transactions may indicate that the asset transferred is

impaired.

As associates are not part of an investor's group, any inter-company balances between the group and the associates are not eliminated as they are when a subsidiary is consolidated.

Normal trading balances which are unsettled at the balance sheet date are recognised as current assets or current liabilities as appropriate. In addition, any long-term loans to the associate are disclosed as due after more than one year and this will require consideration as to whether such balances are shown as fixed assets or debtors due after more than one year in the consolidated balance sheet.

Coterminous period end

The equity method of accounting requires the associate to use the same accounting reference date as that of its investor, unless this is impracticable to do so. Such impracticalities are likely to be rare, but where it does prove to be impracticable the investor should use the most recent available financial statements of the associate and make adjustments for the effects of any significant transactions or events that have taken place between the two accounting periods.

Accounting policies

Where the associate uses accounting policies which differ from those used by the investor, the investor must adjust the associate's financial statements so that they reflect the accounting policies for the purposes of applying the equity method, unless it is impracticable to do so. Again, it is likely to be rare for such impracticalities to exist in practice.

Losses in excess of the investment

As noted above, when the investor's interest is zero, any additional losses are recognised as a provision but only to the extent that the investor has incurred a legal or constructive obligation which will necessitate the recognition of a provision under which the requirements of Section 21 *Provisions and Contingencies* of FRS 102 will be applied. In addition, the investor may also recognise a provision where it has made payments on behalf of the associate.

When the associate subsequently reports a profit, the investor can then resume recognising its share of those profits, but only where its share of the profits is equivalent to the share of losses not recognised.

Discontinuing the equity method

Generally, the equity method of accounting ceases from the date that the investor no longer has significant influence over the investment. The equity method will also no longer apply where the investor becomes a subsidiary (ie the investor increases its ownership interest in the associate such that a parent-subsidiary relationship is created, usually by way of an ownership interest of 51% or more). Where control is achieved, the investor applies the

provisions in Section 19 *Business Combinations and Goodwill*.

Conversely, if the associate becomes a joint venture, the investor will also cease to use the equity method (except in the case of a jointly controlled entity in the consolidated financial statements) and accounts for the joint venture in accordance with Section 15 of FRS 102.

Where the equity method of accounting is discontinued, the accounting for such is as follows:

- Where significant influence is lost as a result of a full or partial disposal, the associate is derecognised from the balance sheet and the difference between the disposal proceeds and the carrying amount of the investment at the date of disposal is recognised in profit or loss. Any interest which the investor continues to retain following the disposal is accounted for using Section 11 or Section 12 of FRS 102 as appropriate. The carrying amount of the associate on the date of disposal is then regarded as cost on initial measurement of the financial asset.
- If other reasons apply for the loss of significant influence, other than a partial disposal of the investment, the investor regards the carrying value of the investment as at that date as the new cost and the investment is accounted for under Section 11 or Section 12 of FRS 102 as appropriate.

The gain or loss recognised on disposal should also include all amounts that have been recognised in other comprehensive income which relate to the associate subject to the disposal and where such amounts have to be reclassified to profit or loss on disposal. Where amounts cannot be recycled through profit or loss, they are transferred directly to retained earnings.

In practice, the only items which may need to be reclassified on disposal of an associate under FRS 102 are those amounts relating to cash flow hedges that had been recognised in other comprehensive income.

Fair value models

Investors that are not parents but have an investment in one, or more, associates have an accounting policy option available to them which allows them to measure their investments in associates at fair value in the individual financial statements. Both the cost model, and the fair value model, are not alternatives for equity accounting in the group accounts as they are only relevant to the individual financial statements of the investor.

Initial recognition

On initial recognition, the investment in associate in the financial statements of an investor that is not a parent which chooses to adopt the fair value model shall measure it at transaction price. Any transaction costs which are incurred in acquiring the associate are immediately expensed; they are not recognised on the balance sheet as

part of the cost of the associate.

Subsequent measurement

At each balance sheet date, an investor that is not a parent which chooses to adopt the fair value model for its investments in associates shall measure its investments in associates at fair value. Changes in fair value from the previous reporting date are recognised in other comprehensive income.

Paragraph 14.10 of FRS 102 was amended as part of the triennial review. An investor measuring an investment in an associate at fair value is required to use the fair value guidance which is in paragraphs 11.27 to 11.32 of the September 2015 edition of FRS 102. This fair value guidance was moved as part of the triennial review's amendments into the Appendix to Section 2 *Concepts and Pervasive Principles* and paragraph 14.10 was amended in this respect. In addition, the undue cost or effort exemption was removed.

Dividends and distributions

Where the fair value model is being used to measure investments in associates, any dividends or distributions received from the associate are recognised as income in profit or loss regardless of whether the distributions are from accumulated profits of the associate which arose before or after the date of acquisition.

Fair value through profit or loss

As an accounting policy choice, paragraph 14.4 of FRS 102 allows an investor to account for its investments in associates at fair value through profit or loss.

Under this model, fluctuations in fair value are taken to profit or loss, as are dividends and other distributions from the associate. Fair value is determined by the investor having regard to the relevant fair value guidance (paragraphs 11.27 to 11.32 of FRS 102 (September 2015) or the Appendix to Section 2 in the March 2018 edition of FRS 102).

Disclosure requirements (Companies Act 2006)

Schedule 4 *Information on related undertakings required whether preparing Companies Act or IAS accounts* at paragraph 19 requires the following disclosures in respect of associated undertakings:

- '(1) The following information must be given where an undertaking included in the consolidation has an interest in an associated undertaking:
- (2) The name of the associated undertaking must be stated.
- (3) There must be stated—

Accounting Regulations, Sch 4, para 19

- (a) if the undertaking is incorporated outside the United Kingdom, the country in which it is incorporated,
 - (b) if it is unincorporated, the address of its principal place of business.
- (4) The following information must be given with respect to the shares of the undertaking held—
 - (a) by the parent company, and
 - (b) by the group,and the information under paragraphs (a) and (b) must be shown separately.
- (5) There must be stated—
 - (a) the identity of each class of shares held, and
 - (b) the proportion of the nominal value of the shares of that class represented by those shares.
- (6) In this paragraph “associated undertaking” has the meaning given by paragraph 19 of Schedule 6 to these Regulations; and the information required by this paragraph must be given notwithstanding that paragraph 21(3) of that Schedule (materiality) applies in relation to the accounts themselves.’

Disclosure requirements (FRS 102)

FRS 102, para 14.12 requires the following to be disclosed in the individual and group accounts:

- the accounting policy for investments in associates;
- the carrying amount of investments in associates; and
- the fair value of investments in associates accounted for using the equity method for which there are published price quotations.

Where the investor has received dividends or other distributions from the associate accounted for under the cost model, it must disclose the value of those dividends or distributions that have been recognised as income.

For equity accounted associates, disclose separately the investor’s share of the profit or loss of such associates and its share of any discontinued operations of such associates.

Where the fair value model has been used to measure investments in associates, disclose the information required by paragraphs 11.43 and 11.44 of FRS 102 (ie the basis for determining fair value, or if a reliable measure of fair value is no longer available for any financial instruments that would otherwise be required to be measured at fair value through profit or loss, disclose that fact).

In respect of the individual financial statements of an investor that is not a parent, disclose summarised financial information concerning 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 which would be exempt if they had subsidiaries, are exempt from this disclosure requirement.

Provisions and contingencies (Lecture A643 – 23.31 minutes)

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

The requirements for provisions and contingencies are outlined in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 21 *Provisions and Contingencies*.

Provisions for liabilities

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

In respect of provisions for liabilities, FRS 102 says that a provision is a liability whose timing or amount is uncertain. The fact that there is uncertainty in respect of the timing and amount is why it is important to ensure that any provisions made in the financial statements would be able to stand up to scrutiny in the event, for example, of a HMRC enquiry into the entity’s corporation tax return.

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

1. The entity must have a present obligation that has arisen because of something that has occurred in the past.
2. It is more likely than not that the entity will have to transfer some economic benefit (eg cash or another form of asset) in order to settle the obligation.
3. The amount of the obligation can be measured with some degree of reliability (ie a reliable estimate can be made).

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

All three criteria have to be met (it is not one or two out of the three). This is to stop companies from deliberately recognising provisions that are unlikely to crystallise. Prior to the introduction of accounting standards in this area, it was not uncommon for companies to deliberately manipulate the profit (or loss) of a business by creating or releasing provisions that effectively would not crystallise. This act of manipulation was coined ‘big bath accounting’ or ‘big bath provisioning’ and worked by focussing on the

profit or loss of the business first and then working upwards through the profit and loss account until a desired profit or loss figure was arrived at. The requirement to meet all three criteria was designed to outlaw the act of big bath provisions.

Creation of an 'obligation'

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

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

Legal obligation

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

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

Example – No obligating event

In 2016, legislation was passed which requires an entity operating in the chemical industry to reduce its effluent levels by 40% by 31 October 2018 which means investing in additional denitrification processes (the process by which nitrogen is removed from water).

At 31 December 2018, which is the company's year-end, the entity had not done anything to reduce its effluent levels. The financial controller has included a provision for the costs that she estimates will be needed to complete the work.

The provision should not be included in the accounts to 31 December 2018. This is because there is no obligating event (the investment in the additional denitrification processes).

At 31 December 2019 the company had still not made any attempts to reduce its effluent levels. The financial controller has made a provision again on the grounds that the date has now passed for the company to have completed this work.

There is still no obligating event at the year-end 31 December 2019 because the company has still not done anything to invest in additional denitrification costs. The company may need to make a provision for fines and penalties for non-compliance with the legislation but this would only be the case if it were to be probable that such fines and penalties will be imposed and a reliable estimate could be made of the penalties. There is an obligating event in respect of the fines and penalties which is the non-compliance with the legislation.

Constructive obligation

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

Example – Constructive obligation

A retailer of office equipment has a sign above its cash desk informing customers that it will give refunds on goods purchased provided the item is returned within 14 days from the date of purchase. This applies regardless of whether the goods are faulty or not.

In this example, the published policy of the retailer goes over and above any legal obligation but a constructive obligation arises from the retailer's established published practice. Conversely, any ad-hoc refunds would be less clear in establishing any obligation.

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

Recognition of a provision in the financial statements

FRS 102 says that where a provision meets the recognition criteria, it should be recognised at the best estimate of the amount that will be required to settle the obligation. When a provision involves a large population of items, the estimate must reflect the weighting of all

possible outcomes by their associated probabilities.

Example – Provision for defective goods

A well-established company sells electrical products such as dishwashers, washing machines, TV and audio equipment. It sells goods to the general public with a warranty which covers customers for the costs of repair that occur during the first six months from the date of purchase. The company is preparing its financial statements for the year-ended 31 December 2018 and calculations carried out by the financial controller suggest that if all the products sold contained minor defects, the costs of repair would be £1 million. If major defects occurred in all the products, the costs of repair would be £4 million.

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

The provision for the year is calculated as follows:

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

Contingent liabilities

Contingent liabilities are not recognised in the financial statements because they fail to meet the recognition criteria for a provision. There is, however, one exception to this rule which applies to contingent liabilities which have been assumed by the acquirer of an acquiree in a business combination and for which paragraphs 19.20 and 19.21 of FRS 102 apply (Section 19 deals with business combinations and goodwill). These are examined in Section 1 of these course notes.

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

Example – Contingent liability

A company has made a provision for damages amounting to £10,000 in its financial statements for the year-ended 31 December 2018 in respect of a legal claim brought against the company by one of its customers. The legal advisers have advised the company that at the reporting date, they are uncertain as to the potential outcome of the case. The case is considered to be material to the company.

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

Contingent assets

A contingent asset is directly the opposite of a contingent liability and, again, is not reflected in the financial statements of the reporting entity. Contingent assets will only be recognised in the financial statements if it is 'virtually certain' that an entity will realise the contingent asset (for example, an insurance company agreeing to pay out a claim to the company). The recognition criterion is stricter because of the underpinning principle in financial reporting that assets cannot be stated in an entity's balance sheet at any more than recoverable amount.

Offsetting provisions

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

In these cases, it is important that the entity recognises the asset and the liability separately; they must **not** be offset in the balance sheet because this would mean assets and liabilities are both understated; thus presenting a misleading financial position. Section 21 does, however, allow the expense relating to the provision in the profit and loss account to be offset, thus presenting the expense net of the reimbursement in the profit and loss account.

Disclosures for provisions

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

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

- (a) a reconciliation showing:
 - (i) the carrying value at the beginning and end of the period;
 - (ii) additions to the provision during the period, including any adjustments that have arisen due to changes in measuring the discounted amount;

- (iii) amounts charged against the provision during the period; and
- (iv) unused amounts which have been reversed during the period;
- (b) a brief description of the nature of the obligation together with the expected amount and timing of any resulting payments;
- (c) an indication of the uncertainties about the amount or timing of those outflows; and
- (d) the value of any expected reimbursement – this should also state the amount of any asset that has been recognised for the reimbursement.

Comparative information for previous periods is not required.

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

Disclosures for contingent liabilities

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

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

- (a) an estimate of the contingent liability's financial effect;
- (b) an indication of the uncertainties relating to the amount or timing of any outflow; and
- (c) the possibility of any reimbursement.

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

Disclosures for contingent assets

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

Prejudicial disclosures

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

contingent asset.

Paragraph 21.17 is heavily restrictive in that it says ‘In extremely rare cases ...’. The term ‘extremely rare cases’ is not defined in FRS 102 and in real life, there are a wide range of circumstances where entities may be in negotiation with third parties in respect of a provision, contingent liability or contingent asset. The key point to emphasise is that paragraph 21.17 concerns **disclosure requirements only**. It follows, therefore, that paragraph 21.17 does not exempt a reporting entity from making, say, a provision for a liability. It might also be the case that a provision for liability is reimbursed from a third party (such as an insurance company) and where this is the case and a reimbursement asset has been recognised on the grounds that its receipt is virtually certain, the prejudicial disclosure exemption may extend to the reimbursement asset (although a reporting entity would disclose which asset balance is affected).

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

Prejudicial disclosures: provisions

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

- ‘(a) a table showing the reconciliation required by paragraph 21.14(a) in aggregate, including the source and application of any amounts transferred to or from provisions during the reporting period;*
 - (b) particulars of each provision in any case where the amount of each provision is material; and*
 - (c) the fact that, and reason why, the information required by paragraph 21.14 has not been disclosed.’*
- FRS 102, para 21.17*

Prejudicial disclosures: contingent liabilities

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

- ‘(a) particulars and total amount of any contingent liabilities (excluding those which arise out of insurance contracts) that are not included in the statement of financial position;*
 - (b) the total amount of contingent liabilities which are undertaken on behalf of or for the benefit of:*
 - (i) any **parent** or fellow **subsidiary** of the entity;*
 - (ii) any subsidiary of the entity; or*
 - (iii) any entity in which the reporting entity has a participating interest,*
- FRS 102, para 21.17*

shall each be stated separately; and

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

Prejudicial disclosures: contingent assets

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

Borrowing costs (Lecture A644 – 4.38 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with borrowing costs in Section 25 *Borrowing Costs*. The term ‘borrowing costs’ is defined in the Glossary as:

‘Interest and other costs incurred by an entity in connection with the borrowing of funds.’

FRS 102 Glossary
borrowing costs

Recognition

Section 25 of FRS 102 allows an accounting policy choice where borrowing costs are concerned – they can either be capitalised as part of the cost of a qualifying asset or they are expensed as incurred. The term ‘qualifying asset’ is defined as:

*‘An **asset** that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the circumstances any of the following may be qualifying assets:*

FRS 102 Glossary
qualifying asset

- (a) **inventories;**
- (b) *manufacturing plants;*
- (c) *power generation facilities;*
- (d) **intangible assets; and**
- (e) **investment properties.**

***Financial assets**, and inventories that are produced over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.’*

The definition of a qualifying asset refers to an asset which ‘... takes a substantial period of time to get ready for its intended use or sale.’ The term ‘substantial period of time’ is not a defined term in FRS 102 and will involve the exercise of judgement, but in practice it would not be a period shorter than 12 months. It would be unusual for an entity to capitalise borrowing costs where the period of construction is less than 12 months because of the work involved and the overall immaterial effect this may have on the financial statements.

It is important to emphasise that where the entity is a micro-entity that has chosen to apply FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* as its financial reporting framework, there is no accounting policy choice available. Borrowing costs must be written off to profit and loss as incurred – they must not be capitalised.

Companies applying FRS 102 which choose to capitalise borrowing costs must do so consistently for a class of qualifying assets. It follows, therefore, that if an entity decides to change its accounting policy from expensing to capitalising or vice versa, this will

represent a change in accounting policy. Voluntary changes in accounting policy are permissible under FRS 102 at Section 10 *Accounting Policies, Estimates and Errors*. However, paragraph 10.8 says that a change in accounting policy should only be effected if that change:

- ‘(a) is required by an FRS; or
- (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity’s financial position, financial performance or cash flows.’

FRS 102, para 10.8

It would not be considered appropriate (or cost-effective) if an entity were to change between capitalising and expensing from one period to the next and this would also bring into question the overall intention of management and what it is they are trying to achieve by consistently changing their policy in the area of borrowing costs (for example manipulation of the financial statements to achieve a desired outcome).

If an entity changes an accounting policy because the change will result in the financial statements providing reliable and more relevant information, the change is applied retrospectively.

Specific borrowings used in constructing an asset

Paragraph 25.2A of FRS 102 says that borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset are those costs which the entity would have avoided if the expenditure on the qualifying asset had not been made. In practice, where an entity is self-constructing an asset it is common to take out specific finance to undertake the project if the business has not got access to the finance in the form of disposable income. Where specific borrowing costs are incurred on a project, management must determine the amount of borrowing costs which are eligible for capitalisation. This will be the actual borrowing costs incurred less any investment income (ie bank interest) received on the temporary investment of those borrowings.

Investment income would arise if the entity were to deposit undrawn funds in an interest-bearing bank account, such as a deposit account.

General borrowings used in constructing an asset

It may be the case that an entity which is constructing a qualifying asset will use general borrowings to fund the project rather than incur specific borrowings. Paragraph 25.2C of FRS 102 says that to the extent that funds applied to obtain a qualifying asset form part of the entity’s general borrowings, the amount of borrowing costs eligible for capitalisation are determined by applying a capitalisation rate to the expenditure on that asset.

Clearly, when an entity uses general borrowings to fund a qualifying asset, the amount of the borrowing costs which are eligible for capitalisation is not as clear-cut as it would be had specific borrowings been incurred. The use of general borrowings where an entity has a policy of capitalisation of borrowing costs will create inherent complexities

in determining the amounts eligible for capitalisation.

Capitalisation rate

The capitalisation rate used during an accounting period is the weighted average of rates applicable to the entity's general borrowings which are outstanding during the period. The amount of borrowing costs which an entity capitalises during the reporting period cannot exceed the amount of borrowing costs incurred during that same period.

Example – Calculation and use of a capitalisation rate

During the year to 31 October 2018, Pastures Ltd commenced a property development, incurring the following expenses:

	£
July 2018	16,000
August 2018	20,000
September 2018	25,000

The company has a range of borrowings on which interest has been paid as follows:

	Balance outstanding	Interest paid
	£	£
7-year loan at 9%	18,000	1,620
8-year loan at 8%	32,000	2,560
1-year loan	11,000	1,000
Bank overdraft (average)	<u>9,000</u>	<u>950</u>
	70,000	6,130

The capitalisation rate to be applied on the qualifying expenditure is calculated as:

$$£6,130 / £70,000 \times 100 = 8.76\%$$

The interest capitalised during the year is as follows:

	£
£16,000 x 5/12 x 8.76%	584
£20,000 x 3/12 x 8.76%	438
£25,000 x 2/12 x 8.76%	<u>365</u>
Interest to capitalise	<u>1,387</u>

The total interest paid in the year is £6,130 and the borrowing costs eligible for capitalisation are £1,387 and so the rule in FRS 102, para 25.2C which prohibits the amount of capitalised interest exceeding the amount of borrowing costs incurred during the period is not breached. If the amount eligible for capitalisation were higher than the amount of borrowing costs incurred, the amount capitalised in the period would be capped at the total amount of borrowing costs incurred in the period.

The rule in paragraph 25.2C which restricts the amount of borrowing costs capitalised if they exceed the amount of borrowing costs incurred may not pose a problem in an individual entity's financial statements. Problems may, however, arise in a group context where individual subsidiaries correctly capitalise borrowing costs, but at group level the total amount of borrowing costs capitalised may exceed the borrowing costs incurred for the group as a whole. This will necessitate a consolidation adjustment to reduce the

amount of borrowing costs capitalised at group level.

Period of capitalisation

The period of capitalisation is outlined in paragraphs 25.2D(a) to (c) of FRS 102.

Paragraph 25.2D of FRS 102 requires an entity that chooses to capitalise borrowing costs to:

- capitalise borrowing costs from the point it first incurs expenditure on the qualifying asset and undertakes activities to prepare the asset for its intended use or sale;
- suspend capitalisation during periods where active development is paused; and
- cease capitalisation when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Example – Construction is suspended

Winter Enterprises Ltd is constructing a new building for use in its operations. It has taken out a bank loan to fund the project and incurs interest on a monthly basis. The company has adopted a policy of capitalising the interest incurred on the borrowings as part of the cost of the building.

In April, construction was stopped because of an accident on the site. The period of suspension was four months and during that time the finance director has continued to post the interest incurred on the borrowings to the cost of the new building.

The finance director is incorrect to continue capitalising the borrowing costs during the period of suspension. Paragraph 25.2D(b) is specific that capitalisation must be suspended during extended periods where active development of the asset has paused.

Paragraph 25.2D(b) refers to ‘extended periods’ but this is not a defined term. Professional judgement will therefore be needed when determining whether any pause in the construction is an extended period and hence suspend capitalisation.

Capitalisation must cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. Cessation of capitalisation is necessary because the asset will effectively be ready for use or sale regardless of the fact that additional administrative procedures may still need to be completed. However, where there are unavoidable issues which prevent the asset from being used as intended or sold, continued capitalisation of borrowing costs may be appropriate as illustrated in the following example.

Example – Legislative clearance required

On 10 June 2018, Galway Ltd completed the building of a new warehouse which it had funded by specific borrowings through a four-year bank loan. The company has a policy of capitalising the interest on this loan as part of the cost of the new warehouse.

The company has to have clearance from the Health and Safety directorate before it can be used due to the nature of the products being stored in the warehouse. This clearance cannot be obtained until September 2018 due to a backlog of cases being handled by the Health and Safety directorate. The finance director is unsure whether to continue capitalising the borrowing costs which the company will incur in the months of June 2018 to September 2018.

Ordinarily, capitalisation will cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are complete. However, when it is not possible to avoid a delay between physical completion and any consents required to use the asset, capitalisation of borrowing costs will continue to be appropriate. This is because until the Health and Safety clearance is received, the asset cannot be regarded as ready for intended use.

In the example above, the delay between the physical completion of the asset and the point at which it is ready for intended use was due to formalities beyond the control of the company. Continued capitalisation was therefore appropriate between the date of physical completion and clearance being received. However, if the delay in physical completion is intentional rather than unavoidable, capitalisation of borrowing costs must cease.

Disclosure requirements

When an entity reporting under FRS 102 does not adopt a policy of capitalising borrowing costs, there are no additional disclosure requirements prescribed by Section 25 of FRS 102.

Interest payable and similar expenses will be shown as a separate line item in a Format 1 profit and loss account and paragraph 11.48(b) of FRS 102 requires an entity to disclose total interest expense calculated using the effective interest method for financial liabilities which are not at fair value through profit or loss.

If an entity adopts a policy of capitalising borrowing costs, it must disclose:

FRS 102, para
25.3A(a) and (b)

- ‘(a) the amount of borrowing costs capitalised in the period; and*
- (b) the capitalisation rate used.’*

Disclosures in respect of capitalised borrowing costs are also needed under the Accounting Regulations (Schedule 1 paragraph 27(3)). These require the amount of interest included in the cost of an asset to be disclosed in a note to the accounts. This is different than the requirements of FRS 102 which require disclosure of the amount of borrowing costs capitalised in the period; the Companies Act 2006 requires the cumulative amount of interest included in the cost of the asset to be disclosed.

Amendments to IFRSs effective from 1 January 2018

(Lecture A645 – 11.42 minutes)

IFRS frequently changes as a result of the IASB's work plan. The following standards were amended as part of the IASB's work plan and the amendments take effect for annual periods commencing on or after 1 January 2018:

- IFRS 9 *Financial Instruments*
- IFRS 15 *Revenue from Contracts with Customers*
- IFRS 2 *Share-based Payment*
- IFRS 1 *First-time Adoption of International Financial Reporting Standards*
- IAS 28 *Investments in Associates and Joint Ventures*
- IAS 40 *Investment Property*
- IFRIC 22 *Foreign Currency Transactions and Advance Consideration*

IFRS 9 Financial Instruments

IFRS 9 was issued in July 2014 and is effective for annual periods commencing on or after 1 January 2018. In addition, on 12 September 2016, the IASB published '*Applying IFRS 9 "Financial Instruments" with IFRS 4 "Insurance Contracts"*' which provides a deferral option. This provides two options for entities which issue insurance contracts that are within the scope of IFRS 4. An entity choosing to apply the IFRS 9 deferral approach does so for annual periods beginning on or after 1 January 2018.

IFRS 15 Revenue from Contracts with Customers

This standard is effective for annual periods beginning on or after 1 January 2018. On 12 April 2016, the IASB issued '*Clarifications to IFRS 15 "Revenue from Contracts with Customers"*' and applies to an entity's first annual IFRS financial statements for a period beginning on or after 1 January 2018.

IFRS 2 Share-based Payment

On 20 June 2016, the IASB published final amendments to IFRS 2 which clarify the classification and measurement of share-based payment transactions. The amendments are effective for annual periods beginning on or after 1 January 2018, with earlier adoption permissible.

Prior to the amendments, IFRS 2 contained no guidance on how vesting conditions affect the fair value of liabilities for cash-settled share-based payments. The revised IFRS 2 now includes guidance that introduces accounting requirements for cash-settled share-based payments and follows the same approach as used for equity-settled share-based payments.

There is an exception in the revised IFRS 2 so that a share-based payment where the entity settles the share-based payment arrangement net is classified as equity-settled in its entirety provided the share-based payment would have been classified as equity-settled had it not included the net settlement feature.

Prior to the revisions, IFRS 2 did not address the situation when a cash-settled share-based payment changes to an equity-settled share-based payment due to modifications of the terms and conditions. The revised IFRS 2 now clarifies that:

- on such modifications, the original liability recognised in respect of the cash-settled share-based payment is derecognised and the equity-settled share-based payment is recognised at the modification date fair value to the extent that services have been rendered up to the modification date;
- any difference between the carrying amount of the liability as at the modification date and the amount recognised in equity at the same date would be recognised in profit and loss immediately.

IFRS 1 First-time adoption of International Financial Reporting Standards

On 8 December 2016, the IASB issued '*Annual Improvements to IFRS Standards 2014-2016 Cycle*'. The amendments to IFRS 1 are effective for annual periods beginning on or after 1 January 2018.

The amendments delete the short-term exemptions in paragraphs E3 to E7 of IFRS 1 because they have served their intended purpose.

IAS 28 Investments in Associates and Joint Ventures

As with IFRS 1, IAS 28 contains amendments as part of the '*Annual Improvements to IFRS Standards 2014-2016 Cycle*' which are effective for annual periods beginning on or after 1 January 2018.

The amendments to IAS 28 clarify that the election to measure at fair value through profit or loss an investment in an associate or joint venture that is held by an entity which is a venture capital organisation (or other qualifying entity) is available for each investment in an associate or joint venture on an investment-by-investment basis upon initial recognition.

IAS 40 Investment Property

On 8 December 2016, the IASB issued '*Transfers of Investment Property (Amendments to IAS 40)*'. These amendments are effective for periods beginning on or after 1 January 2018 with earlier application permissible.

Paragraph 57 has been amended to state that an entity shall transfer property to, or from, investment property when, and only when, there is evidence of a change in use. A change of use occurs if property meets, or ceases to meet, the definition of investment property. A change in management's intentions for the use of a property by itself does

not constitute evidence of a change in use.

In addition, the list of evidence in paragraph 57(a) to (d) was designated as ‘non-exhaustive’ rather than the previous ‘exhaustive’ list.

IFRIC 22 Foreign Currency Transactions and Advance Consideration

IFRIC 22 was issued on 8 December 2016. This interpretation becomes effective for annual reporting periods beginning on or after 1 January 2018 with earlier application permissible.

IFRIC 22 clarifies the accounting for transactions which include the receipt or payment of advance consideration in a foreign currency. It covers foreign currency transactions when an entity recognises a non-monetary asset or non-monetary liability arising from the payment, or receipt, of advance consideration before the entity recognises the related asset, expense or income. The IFRIC does not apply when an entity measures the related asset, expense or income on initial recognition at fair value or at the fair value of the consideration received or paid at a date other than the date of initial recognition of the non-monetary asset or non-monetary liability. In addition, IFRIC 22 need not be applied to income taxes, insurance contracts or reinsurance contracts.

The ‘date of the transaction’ for the purpose of determining the exchange rate is the date of initial recognition of the non-monetary prepayment asset or deferred income liability.

Where there are multiple payments or receipts in advance, a date of transaction is established for each payment or receipt.

On initial application of IFRIC 22, the entity has a choice of application, either:

- retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or
- prospectively to all foreign currency assets, expenses and income in the scope of the interpretation initially recognised on or after the beginning of the reporting period an entity first applies the interpretation or the beginning of a prior reporting period presented as comparative information.

Accounting and audit in a no-deal Brexit (Lecture A646 – 5.52 minutes)

The last ‘major’ regulatory change was by virtue of The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980) which made changes to the Companies Act 2006 for the transposition of the EU Accounting Directive into company law. Since then, the most frequently asked question is what will happen in the world of accounting and auditing when Britain leaves the EU in March 2019?

At the time of writing, there is still uncertainty as to how the accounting and auditing professions will be affected following Brexit. There are lots of ‘suspicions’ as to what may happen, but it is not worth speculating on such matters as there are likely to be further announcements in the coming months about how the profession will work after Britain leaves the EU.

On 12 October 2018, the Department for Business, Energy and Industrial Strategy published some guidance on what would happen to accounting and audit if there is no Brexit deal. The idea of the guidance is to set out information which allows businesses and citizens to understand what they would need to do in a no deal situation to make informed plans and preparations.

Currently, the UK follows the EU rules and regulations in the areas of accounting, corporate reporting and audit. This regime is mainly reflected in the Companies Act 2006 and the Regulations made under that Act. There are, however, some entities which have their own specific legislation and the guidance acknowledges that this will be of relevance to such entities also.

No Brexit deal

If, after March 2019, there is no deal, the government has stated that they will continue to have a functioning regulatory framework for companies and that the same laws and rules which are currently in place will continue to apply (by virtue of powers in the EU Withdrawal Act 2018 to correct deficiencies in law arising from Brexit). This will be done in conjunction with the governments in Scotland, Wales and Northern Ireland.

Accounting and corporate reporting

The guidance confirms that UK incorporated subsidiaries and parents of EU businesses will continue to be subject to the UK’s corporate reporting regime. There are, however, certain exemptions in the Companies Act 2006 in respect of the individual accounts which will no longer be extended to companies with parents or subsidiaries incorporated in the EU. The guidance cites an example of a UK company which is exempt from the requirement to prepare individual accounts where it is dormant, and part of a group of companies with an EU parent company that prepares group accounts. This exemption will only continue to be available after Britain’s departure from the EU if the parent company is established in the UK.

If a UK business has a branch operating in the EU, then it will become a third country

business and will be required to comply with specific accounting and reporting requirements for such businesses in the Member State in which they operate. Member States may no longer regard compliance with the accounting and reporting requirements of the Companies Act 2006 as sufficient.

A UK company which is listed on an EU market may need to provide additional assurance to the relevant listing authority that their financial statements comply with IFRS as issued by the IASB, which will need to be done in accordance with EU third country requirements. The guidance confirms that in the short term, this could lead to changes to the compliance statements within the financial statements that are submitted to the listing authorities.

There will be changes to reporting requirements which will impact on how UK accounting and company secretarial service providers interact with their clients. In this respect, systems may need to be changed to capture additional information for reporting purposes and obtaining additional agreements and assurances from the relevant listing authorities prior to their reporting date.

Audit

The guidance confirms that the UK will provide individual auditors with EU qualifications with a transitional period, from the date of exit until the end of December 2020. During this transitional period, the auditor can apply to be recognised in the UK provided they pass an aptitude test. After the end of December 2020, EU auditors will cease to benefit from automatic recognition of their qualifications in the UK and may not be offered an aptitude test. This will not affect auditors with Irish qualifications as the Republic of Ireland uses audit qualifications granted by UK qualifying bodies.

Currently, those with EU qualifications count towards the required majority of appropriately qualified owners or managers of a UK audit firm. This will only apply during the transitional period. Post-transition, only owners or managers with qualifications recognised in the UK will count towards the majority of appropriately qualified owners or managers of a UK audit firm. EU qualified individuals that were recognised as part of the management body prior to exit will continue to be recognised.

Audits of an EU business which is seeking to issue shares or debt securities on a UK-regulated market must be carried out by an auditor registered with the Financial Reporting Council (FRC). Such audits will be included within inspections carried out by the FRC who will visit the registered auditor in the EU Member State where the business is incorporated until that Member State is recognised in the UK as having an equivalent audit regulatory framework. Conversely, where a UK business is seeking to issue shares or debt securities on a regulated market in the EU, the audit will need to be undertaken by an auditor registered as a ‘third country auditor’ within the EU Member State in which the market operates.

That audit will then fall under the remit of inspections by the recognised authority for that market.

Where there is no deal, a UK audit qualification may not be recognised in an EU Member State (with the exception of Ireland). A UK audit firm that wishes to own part of, or be part of the management body of, an EU firm will no longer be recognised among the required majority of EU qualified owners or managers.

Conclusion

As the departure date from the EU moves ever closer, understandably more people are asking questions about what will happen. The guidance does state that a no deal scenario is unlikely given the mutual interests of the UK and the EU in securing a negotiated outcome and the guidance aims to prepare companies for a no deal scenario.

ISA (UK) 320 Materiality in Planning and Performing an Audit (Lecture A647 – 10.08 minutes)

ISA (UK) 320 *Materiality in Planning and Performing an Audit* deals with the auditor's responsibility in applying materiality and performance materiality in an audit of financial statements. ISA (UK) 320, paragraph 2 states that:

'... Although financial reporting frameworks may discuss materiality in different terms, they generally explain that misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.'

ISA (UK) 320, para 2

If the financial statements contain material misstatement, they cannot be deemed to show a true and fair view.

The focus of the audit is to identify the significant risks of material misstatements within the financial statements and then apply appropriate audit procedures which are aimed at identifying and quantifying material misstatement.

There is no 'one-size-fits-all' in ISA (UK) 320 as to how materiality should be calculated – the auditor's determination of materiality is a matter of professional judgement. It will be affected by the auditor's perception of the financial information needs of users.

Arriving at a materiality level

As noted above, materiality is based on professional judgement and factors which the auditor must consider when determining a materiality level usually include (among other things):

- whether the misstatement would affect the economic decision-making of the users;
- the size and nature of misstatements; and
- the information needs of the users as a group.

It is not practicable to design audit procedures which aim to detect all misstatements, but the auditor must consider the nature of potential misstatements and design relevant audit procedures to address the risks of material misstatement. In addition, the auditor must not only consider the size of uncorrected misstatements, but must consider the nature of them together with the particular circumstances of their occurrence.

Material by size

The use of an 'averaging' method is common among audit firms. The following benchmarks may be used as a starting point:

½ - 1% of turnover

5 – 10% of pre-tax profit

1 – 2% of gross assets

Under the averaging method, an average is then struck and this is used as the financial statement materiality level. However, keep in mind that this method is not the only method that can be used and also may not be appropriate. Indeed, different benchmarks or different thresholds may be used depending on the client.

Also, keep in mind that it may not necessarily be appropriate to base materiality on, say, turnover. For example, where the client has inappropriately capitalised research expenditure, judging the materiality of the issue against revenue is unlikely to be useful; it would be appropriate to use gross assets and pre-tax profit to measure the materiality of the inappropriately capitalised expense.

Example – Materiality levels

Financial statement extracts:		
	2018	2017
	£'000	£'000
Turnover	21,350	19,770
Gross assets	9,124	7,359
Pre-tax profit	1,022	349
		<u>Materiality</u>
Turnover	<u>½%</u>	<u>1%</u>
	107	198
Pre-tax profit	<u>5%</u>	<u>10%</u>
	51	35
Gross assets	<u>1%</u>	<u>2%</u>
	91	147
As an average (preliminary materiality)	<u>83</u>	<u>127</u>

However, a suitable materiality level is most likely to be one that lies within the overlap of the ranges calculated for profit and total assts. £91,000 (1% of gross assets) represents 9% of pre-tax profit. As this is at the lower end of the asset range, this may be a prudent measure of materiality resulting in a higher level of audit work. In addition, where draft financial statements are concerned, there is a higher risk of errors and consequently sample sizes for audit testing should be increased (ie preliminary materiality should be set at a relatively lower level) and hence the average of £83,000 may be used.

Material by nature

Materiality is not just concerned with the numbers in the accounts. Some items within the financial statements may be material by nature (ie the impact they have on the financial statements), such as:

- misstatements which, when adjusted, would turn a reported profit into a loss;
- misstatements which, when adjusted, would turn reported net assets into a net liability position (or net current assets to net current liabilities);
- directors' transactions such as remuneration and advances, credit and guarantees during the year;
- contingent liability disclosures; and
- related party disclosures.

Performance materiality

Auditors cannot design procedures which aim to find every misstatement in the financial statements – indeed this would be impracticable. It is more likely that misstatements are material in aggregate and for this reason, ISA (UK) 320 includes a further concept of performance materiality.

ISA (UK) 320, paragraph 9 states:

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

ISA (UK) 320, para 9

Therefore, the auditor sets performance materiality at a level lower than overall financial statement materiality and uses this lower threshold when designing and

performing audit procedures. So, for example, if performance materiality is £20,000 then any trade debtors in an after-date cash sampling test at or over £20,000 would be included in the sample.

Example – Performance materiality

The audit senior is planning an audit of Sycamore Ltd for the year-ended 31 October 2018. She has determined a materiality level for the financial statements as a whole of £95,000. Work in progress has been identified as containing a higher risk of material misstatement and hence performance materiality needs to be applied to this area.

As with financial statement materiality, there is no pre-determined calculation for performance materiality. The audit senior will determine performance materiality as a percentage of financial statement materiality (say 75%) and hence performance materiality will be (£95,000 x 75%) £71,250. The audit senior could, however, use a higher or lower percentage depending on her professional judgement.

The aim of performance materiality is to reduce the risk that the aggregate of immaterial misstatements exceeds materiality for the financial statements as a whole.

Using the above example, where a misstatement was identified of, say, £80,000 without performance materiality, the audit senior would have concluded that work in progress does not contain material misstatement. However, the audit may not have detected further misstatements which, when added to the £80,000, would result in a material misstatement. The use of performance materiality means that the audit senior would conclude that a misstatement of £80,000 is material and hence would require the directors to amend the financial statements to correct this misstatement, which in turn reduces audit risk (the risk that the auditor expresses an inappropriate opinion).

Revisions to materiality

Materiality levels are not just calculated at the planning stage of the audit and then forgotten about. ISA (UK) 320 requires the auditor to revise materiality for the financial statements as a whole (and, where applicable, the materiality level(s) for particular classes of transactions, account balances or disclosures) when the auditor becomes aware of information which would have caused them to have determined a different amount(s) initially.

When the auditor concludes that a lower materiality level for the financial statements as a whole (and, where applicable, materiality level(s) for particular classes of transactions, account balances or disclosures) is necessary, the auditor must also determine whether it is necessary to revise performance materiality also. In addition, the auditor must also determine whether the nature, timing and extent of further audit procedures remains appropriate.

Documentation

ISA (UK) 320 requires the auditor to include the following amounts and factors considered in their determination of materiality in the audit documentation:

- materiality for the financial statements as a whole;
- if applicable, the materiality level(s) for particular classes of transactions, account balances or disclosures;
- performance materiality; and
- any revisions to materiality levels as the audit progressed.

ISA (UK) 402 Audit Considerations Relating to an Entity Using a Service Organisation (Lecture A648 – 11.27 minutes)

ISA (UK) 402 outlines the auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations.

The standard acknowledges that many entities outsource aspects of their business to organisations which provide a range of services, for example payroll. A lot of these services will be integral to the entity's business operations, but not all such outsourced services will be relevant to the audit. Services provided by the service organisation are relevant to the audit when those services (and the controls over them) are part of the user-entity's information system, including related business processes, which are relevant to financial reporting.

ISA (UK) 402 defines a 'user auditor' and a 'user entity' as follows:

- *User auditor – An auditor who audits and reports on the financial statements of the user entity*
- *User entity – An entity that uses a service organization and whose financial statements are being audited*

Obtaining an understanding of the services provided by the service organisation

ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* requires the user auditor to obtain an understanding of the user entity using the services of a service organisation in the user entity's operations. This includes:

- The nature of the services that are provided by the service organisation and the significance of those services to the user entity, together with the effect those services have on the user entity's internal control;
- The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
- The degree of interaction between the activities of the service organisation and those of the user entity;
- The nature of the relationship between the user entity and the service organisation which also includes the relevant contractual terms for the activities undertaken by the service organisation; and
- If the service organisation maintains all, or part, of the user entity's accounting records, whether those arrangements impact the work which the auditor will perform to fulfil reporting responsibilities in relation to accounting records that

are established in law or regulation.

The reason for the auditor having to understand these matters is so that any risk of material misstatement created by the use of a service organisation can be identified and an appropriate response planned.

The user auditor is required to obtain an understanding of the controls in place at the service organisation and must also evaluate the design and implementation of relevant controls at the user entity which relate to the services provided by the service organisation. Information should be available from the user entity to enable the understanding outlined above to be obtained, for example, via reports received from the service organisation, technical manuals and the contract between the service organisation and the user entity.

In situations where the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor must obtain that understanding by other means, which include the following:

- obtaining a type 1 or type 2 report if available (see below);
- contacting the service organisation, through the user entity, to obtain specific information;
- visiting the service organisation and performing audit procedures that will provide the necessary information about the relevant controls at the service organisation; or
- using another auditor to carry out procedures that will provide the information about the relevant controls at the service organisation.

Type 1 or type 2 reports

A type 1 report focuses on the description and design of controls, whereas a type 2 report also covers the operating effectiveness of the controls. These types of reports can provide some assurance over the controls which should have operated at the service organisation.

A 'service auditor' is defined in ISA (UK) 402 as:

'An auditor who, at the request of the service organization, provides an assurance report on the controls of a service organization.'

To determine whether a type 1 or type 2 report is required, the auditor must be satisfied as to:

- the service auditor's professional competence and independence from the service organisation; and
- the adequacy of the standards under which the type 1 or type 2 report was issued. For example, the service auditor may be practising in a country where different standards are followed in respect of reports on controls at a service organisation and the user auditor may obtain information about the standards

used by the service auditor from the standard-setting organisation.

Where the user auditor plans to use a type 1 or type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, the user auditor must:

- evaluate whether the description and design of controls at the service organisation is at a date, or for a period, that is appropriate for the user auditor's purposes;
- evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and
- determine whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Auditor's response to assessed risks of material misstatement

ISA (UK) 330 *The Auditor's Responses to Assessed Risks* requires the auditor to design appropriate responses to assessed levels of risk. In responding to risks where the use of service organisation is concerned, the auditor must:

- determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions (e.g. completeness, accuracy etc) is available from the records held at the user entity; and, if not
- perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform procedures at the service organisation on the user auditor's behalf.

Test of controls

If the user auditor expects that the controls at the service organisation are operating effectively, the user auditor obtains audit evidence concerning the operating effectiveness of those controls from one, or more, of the following procedures:

- obtaining a type 2 report, if available;
- performing tests of controls at the service organisation; or
- using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.

Where the user auditor plans to use a type 2 report as audit evidence which states that controls at the service organisation are operating effectively, the user auditor must determine whether the service auditor's report provides sufficient appropriate audit evidence concerning the effectiveness of the controls by:

- evaluating whether the description, design and operating effectiveness of controls at the service organisation is at a date, or for a period, that is appropriate for the user auditor's purposes;
- determining whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, performing tests over their operating effectiveness;
- evaluating the adequacy of the period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and
- evaluating whether the tests of controls performed by the service auditor and the results, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate evidence to support the auditor's risk assessment.

Fraud, non-compliance with laws and regulations and uncorrected misstatements in respect of activities at the service organisation

The user auditor must inquire of management of the user entity as to whether the service organisation has reported to the user entity (or whether the user entity is otherwise aware of) any fraud, non-compliance with laws and regulations or uncorrected misstatements which affect the financial statements of the user entity. The user auditor must then evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report.

Reporting

If the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation, the auditor must modify their opinion as a limitation on the scope of the audit will exist. This could arise when:

- the auditor is unable to obtain a sufficient understanding of the services provided by the service organisation and does not have a basis for the identification and assessment of the risks of material misstatement;
- an auditor's risk assessment includes an expectation that controls are operating effectively, but the auditor is unable to obtain sufficient appropriate audit evidence about the operating effectiveness of the controls; or
- sufficient appropriate audit evidence is only available from records held at the service organisation and the user auditor is unable to obtain direct access to these records.

The effect on the auditor's report (ie a qualified or disclaimer of opinion) will all depend on the auditor's conclusion as to whether the possible effects on the financial

statements are material and pervasive.

If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report must indicate that such reference does not diminish the user auditor's responsibility for that opinion.

Statutory Auditors Regulations: LLPs (Lecture A649 – 10.23

minutes)

In November 2017, *Auditors, Insurance, Limited Liability Partnerships The Statutory Auditors Regulations 2017* was laid before Parliament. This statutory instrument (SI) changed the rules concerning auditor resignation statements for LLPs in order to align them with the same requirements for companies.

Revised requirements and 'exempt reasons'

Under the revised rules, the LLP will no longer need to notify the relevant audit authority (eg ICAEW or ACCA or other accountancy body with which the auditor is registered) where the LLP believes that the auditor's reasons for leaving prior to the end of their term of office are all 'exempt reasons'.

'Exempt reasons' are:

- The auditor is ceasing to practise as an auditor.
- The LLP has become small and hence is claiming audit exemption under section 477, 479A or 480 and will include in its balance sheet a statement of the type of audit exemption claimed.
- The LLP is being wound up under an insolvency procedure.
- The LLP is a subsidiary undertaking of a UK parent and its new auditor is auditing the group accounts and the individual accounts of other UK subsidiary undertakings included in the consolidation. Note, however, this reason is only an exempt reason if the auditor who is conducting, or is to conduct, an audit of the group accounts is also conducting, or is able to conduct, the audit (if any) of the accounts of each of the subsidiaries that is incorporated in the UK and included in the consolidation.

Hence, where an LLP is acquired by another LLP, it will no longer need to notify the relevant audit authority if it asks its existing auditors to resign and appoints the acquiring LLPs auditors instead.

Where the outgoing auditor is required to send a statement to the LLP, they must also send a copy to the relevant audit authority, but need not send a copy to Companies House. However, the statement would be required to be sent to Companies House if the statement indicates matters that the auditor thinks should be brought to the attention of the members of the LLP or creditors.

Audit authority is to be notified

Where the relevant audit authority is to be notified, the LLP will have 28 days from the auditor ceasing to hold office in which to notify the relevant audit authority.

Documenting second partner review (Lecture A650– 14.45 minutes)

Second partner review v Engagement Quality Control Reviews (EQCR)

EQCR is a very specific type of second partner review that is required by the International Standard on Quality Control (UK) 1 (Revised June 2016) (ISQC 1) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements*.

A second partner review, is a more general term for a review by a second independent partner.

EQCR	Second partner reviews other than EQCRs
Required by ISQC 1 for all listed audits.	Often used as a safeguard to address threats to independence.
Firms should have policies and procedures when EQCRs are required where certain criteria are met.	Can be used where the audit is higher risk, there are specific problems or where modified or other non-standard reports are to be issued.
The nature of the review is set out in ISQC 1.	A second partner review other than an EQCR can be carried out in any way that the firm thinks necessary.
ISQCs are currently being revised which will almost certainly result in more specific requirements relating to the content and nature of the review.	

In light of the impending changes to ISQCs, some firms are revising their policies away from requiring EQCRs (unless they are required by an ISA or ISQC) towards more tailored reviews.

This section does not consider EQCRs in any detail. Instead it looks at how firms could refine their second partner review procedures to better serve their specific needs.

Second partner review as a safeguard addressing threats to independence

Second partner review can be a very effective safeguard addressing certain threats to independence. It is particularly effective in addressing familiarity and self-interest threats as it provides a fresh pair of eyes.

It can also work with self-review, intimidation, advocacy and management threats. However, whatever the threat, it is only effective if the review is tailored to address that particular threat.

Example – Threats arising from the provision of non-audit services

The auditor of A Ltd assists with the preparation of the financial statements and provides Corporation Tax compliance services to the company as non-audit services. The safeguard used to address these threats is second partner review. What should the second partner review include?

There is little point in doing a full file review as the purpose of the review is very specific.

The review should consider how the auditor's independence might have been affected by providing the non-audit services. The review should look at any issues that might arise from self review threats, which would include looking at the financial statements and the tax computations.

The reviewer should also consider whether there were any management decisions required in these areas that the auditor might have advised on, in order to identify the effect of management threats. This would involve looking through the completion section of the audit file and carefully considering accounting policies and accounting estimates.

Example – Threats arising from long association

The audit engagement partner of B Ltd has been doing the audit of the company for 15 years. A second partner review is being used as a safeguard against the threats to independence arising from long association. What should the second partner review include?

The reviewer will need to carefully tailor their review to focus on the areas where audit quality might suffer due to long association.

The reviewer will start with a review of the financial statements, using their professional judgment to identify any interesting transactions, balances, accounting policies and disclosures. The reviewer might look into the audit file in more detail in these specific areas and may have discussions with the audit partner to confirm how the issues were addressed.

Note: the scope of these second partner reviews will be very specific to that audit and will change as the review progresses. The use of the reviewer's professional judgment is critical in ensuring an effective review.

Second partner review for other reasons

Firms should have policies and procedures that set out criteria for when second partner reviews (including EQCRs) are required. This criteria might include when:

- the auditor's report has a modified opinion, emphasis of matter or material uncertainty relating to going concern paragraph;

- there are particular risks on the audit; or
- the firm considers there to be a public interest in the audit. This may be different to a Public Interest Entity (PIE) audit, which is very tightly defined.

The second partner review needs to be tailored to address the relevant issues that drove the need for the review.

Documentation

A checklist might be needed for an EQCR on a listed audit but for other second partner reviews it is of limited use.

The documentation of the review should cover:

- the scope of the review;
- the key issues considered; and
- how any questions were resolved.

Reviewers often raise written notes/questions, and the engagement partner of the audit team record a response. Some firms have a policy of destroying such documents for legal reasons, but it is important that any useful documentation created as part of the second partner review process is retained.

Example – essential documentation of the results of a second partner review

Extract from audit file:

Second partner review note

Why is annual subscription income recognised on a cash basis rather than on an accruals basis? The file does mention this unusual accounting policy.

Response from engagement partner

This was considered when we first did the audit. It is an odd situation that members are under no legal obligation to pay the annual fees, so the company can only recognise the income when it is paid.

Note: If this query is destroyed an important bit of evidence on this year's file will be omitted. The note could be destroyed provided that the evidence is properly recorded elsewhere.

Note2: The auditors also should not forget to obtain corroborating evidence of this unusual situation. Verbal (or even written) representations from management are never sufficient on their own.

Example documentation

Second partner review

Why was a second partner review needed?

As a safeguard addressing long association of the audit partner. (18 years – see PAF ref xxx)

Scope of the second partner review

A review of the financial statements and the auditors' approach to key audit areas to provide a fresh, independent view of the audit.

Issues arising

Goodwill – this is being amortised over 20 years. Is there enough evidence to support that?

Investment property – directors' valuations have been used and accepted for a number of years. Are the directors sufficiently knowledgeable and independent to produce these valuations? Is it possible to better corroborate the valuations?

Conclusions

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Second partner

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Date