

Audit and Accounting Quarterly Update – Quarter 4

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1 FRS 102: Property, plant and equipment

Property, plant and equipment is dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 17 *Property, Plant and Equipment*.

The term 'property, plant and equipment' is defined as:

Tangible assets that:

- (a) *are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and*
- (b) *are expected to be used during more than one period.*

FRS 102 Glossary
**property, plant
and equipment**

Under the Accounting Regulations, fixed assets are defined slightly differently as assets which are '... intended for use on a continuing basis'.

Example – Classification of assets in a holiday park

A holiday park operator owns a number of static caravans which are rented out to visitors during the holiday season. The company has an accounting reference date of 31 December and on 30 November 2019 it decides to invest in five new caravans to replace five older ones. The older caravans will be put up for sale but will continue to be used in the business. The finance director has reclassified the older caravans as inventory on the basis that they can be sold at any time.

The new caravans held for rental are capitalised in the balance sheet as tangible fixed assets because they meet the definition of property, plant and equipment. Those held for sale should remain as tangible fixed assets until such time that they are sold because they continue to be used in the business (i.e. they will still generate an income stream for the entity).

Even if the old caravans were surplus to requirements, that in itself does not change the nature of the asset, hence they should not be reclassified as inventory.

In order to qualify for recognition on the balance sheet, FRS 102 contains two strict criteria which must be met. An entity can only recognise an asset on the balance sheet if, and only if:

- (a) *it is **probable** that future economic benefits associated with the item will flow to the entity; and*
- (b) *the cost of the item can be measured reliably.*

FRS 102, para 17.4
(a) and (b)

1.1 Spare parts and servicing equipment

FRS 102 deals with the accounting for spare parts and servicing equipment at paragraph 17.5. Paragraph 17.5 recognises that such items are usually carried as inventory in the reporting entity's accounting records and are included in profit or loss as they are consumed. Consideration must, however, be given to major spare parts and stand-by equipment because such items are considered to be fixed assets under FRS 102 when the entity expects to use them for more than one accounting period (otherwise they are classified as inventory and accounted for under FRS 102, Section 13 *Inventories*). A similar principle also applies if the spare parts and servicing equipment can only be used in connection with an item of fixed asset.

1.2 Component accounting

FRS 102 places more emphasis on component accounting. Component accounting would be appropriate when certain parts (i.e. components) of an item of property, plant and equipment might require replacement at regular intervals (the standard cites an example of a roof on a building). The standard requires that the cost of replacing such a component is added to the carrying amount of the asset when the cost is incurred and only if the replacement part is expected to provide incremental future benefits to the company. The carrying value of the part(s) that have been replaced are derecognised from the accounts in the usual way.

Component depreciation is also a feature of FRS 102. Component depreciation is appropriate when the major components of an item of fixed asset have a significantly different useful economic life than the rest of the asset. Examples frequently cited include the linings of blast furnaces and the engines of aircraft. When the major components of a fixed asset have significantly shorter lives than the main asset itself, FRS 102 would require the entity to depreciate each such component separately over its useful life.

Example – Component depreciation

A company manufactures chemicals for use in domestic cleaning products. It purchases a new machine on 1 January 2019 for £60,000 that is expected to have a useful economic life of ten years with a nil residual value at the end of this useful economic life. The company identifies the following major components:

Component A:	Cost £8,500 with a useful life of four years
Component B:	Cost £7,200 with a useful life of three years
Component C:	Cost £6,500 with a useful life of five years

In this example, the cost attributable to the remainder of the asset is £37,800. The company will depreciate components A, B and C over their useful lives of four, three and five years respectively. The remainder of the machine is treated as a single asset and is depreciated over ten years. The depreciation charges in year 1 if component accounting is not used and if component accounting is used can be compared as follows:

<u>No component accounting</u>	<u>Component accounting</u>
£60,000 ÷ 10 years = <u>£6,000</u>	Component A: £8,500 ÷ 4 years
£2,125	Component B: £7,200 ÷ 3 years
£2,400	Component C: £6,500 ÷ 5 years
£1,300	Remaining asset: £37,800 ÷ 10 years
<u>£3,780</u>	Total depreciation <u>£9,605</u>

In the above example, while the depreciation charge is essentially higher under component accounting, this is representative of the fact that various major components of the asset have significantly shorter lives than the main asset itself and therefore gives a more representative depreciation charge than if the asset were written off over ten years as a single asset.

1.3 Initial recognition

Fixed assets are always initially recognised at cost. Cost can be made up of several components, including:

- the initial purchase price;
- irrecoverable taxes;
- duties;
- legal fees;
- brokerage fees;

- other costs directly attributable¹ to bringing the asset to its location and condition intended by management; and
- borrowing costs capitalised in accordance with paragraph 25.2.

However, paragraph 17.11 specifically disallows certain types of expenditure from forming part of the cost of an asset and include:

- the costs of opening a new facility;
- the costs of introducing a new product or service, including advertising costs and promotional activities;
- costs of conducting business in a new location or with a new class of customer and this includes staff training; and
- administration and other general overhead costs.

Ordinarily the cost of an item of fixed asset is the cash price equivalent at the date of recognition and this will usually be found on the supplier's invoice. If, however, payment is deferred beyond normal credit terms, then the cost price is the present value of all future payments.

Example – Identification of costs to be capitalised

Barley Co Ltd acquired a machine from a supplier based in the USA and incurred expenditure relating to the following:

1. Costs of purchase including import duties.
2. Costs of transporting the equipment to its site in a factory in Birmingham.
3. Labour and material costs incurred in modifying the equipment to meet the specific needs of the entity's potential customers.
4. Training costs relating to staff who will be directly involved in operating the machinery.
5. Operating losses incurred between the time the equipment was ready for use and when it was operating at full capacity (when customer order levels were on target).

Items 1, 2 and 3 are capitalised as they satisfy the test of being necessary in bringing the item of equipment to its intended location and operating condition.

Items 4 and 5 do not satisfy the capitalisation criteria and must be recognised as expenses in the period in which they are incurred. Training costs are not part of the directly attributable costs of bringing the machine to the location and condition necessary for it to be capable of operating as intended by management because this would be the case regardless of the fact that the staff need training to use it.

¹ The term 'directly attributable' means any costs which the entity would have avoided had it not entered into the transaction in the first place.

Operating losses do not qualify to be included in the cost of the new machine because these are not costs directly attributable to bringing the machine to the location and condition necessary for it to be capable of operating as intended by management. Such losses are an inherent business risk.

1.4 Subsequent measurement

FRS 102 allows two subsequent measurement bases for property, plant and equipment (PPE):

- the cost model; and
- the revaluation model

Cost model

Under the cost model, items of PPE are measured at cost less depreciation less impairment losses.

In practice, the cost model is the most popular model and applies to most assets. Generally, all assets are depreciable assets and hence will be subject to depreciation except in the case of land which does not usually depreciate.

A point worthy of note, however, is that if the entity is a micro-entity and is reporting under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, it is **only** permitted to use the cost model – the revaluation model is not allowed because a micro-entity cannot use the alternative accounting rules in company law.

Revaluation model

FRS 102 allows an entity to subsequently measure items of PPE using the revaluation model. Under the revaluation model, fixed assets are carried at their latest revaluation amount less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

Revaluation gains are taken to a revaluation reserve within equity and reported as other comprehensive income. The exception to this would be where the revaluation gain reverses a previous revaluation loss that has been reported in profit or loss in respect **of the same asset**. A revaluation loss is taken to the revaluation reserve to the extent of a surplus on the revaluation reserve in respect **of the same asset** with any excess being taken to the profit and loss account (there cannot be a debit balance on the revaluation reserve). In addition, care must be taken not to offset gains and losses of one revalued asset against gains and losses of another revalued asset.

Revaluation gains for assets accounted for under Section 17 are NOT taken to the profit and loss account. Some accountants have confused the accounting for a revaluation gain under FRS 102, Section 17 with a fair value gain on an investment property accounted for under Section 16 *Investment Property*. Fair value gains on investment property are taken to the profit and loss account instead of a revaluation reserve account because Section 16 uses the fair value accounting rules in company law.

Example – Revaluation loss with a subsequent revaluation gain

On 31 March 2017, Bradley Co Ltd revalued an asset which had a carrying value of £100,000 down to £70,000. The revaluation reserve in respect of this asset stood at £20,000. Deferred tax has been ignored for the purposes of this example.

The revaluation loss on 31 March 2017 is recorded as follows:

Dr Revaluation reserve	£20,000
Dr Fair value adjustment (P&L)	£10,000
Cr Property, plant and equipment	£30,000

Being revaluation loss as at 31 March 2017

On 31 March 2019, the fair value of the asset had increased to £110,000 and the finance director wishes to incorporate this fair value gain into the financial statements. The entries are:

Dr Property, plant and equipment	£40,000
Cr Fair value adjustment (P&L)	£10,000
Cr Revaluation reserve	£30,000

Being revaluation gain as at 31 March 2019

The revaluation gain is not taken wholly to the revaluation reserve as £10,000 of it reverses the previously recognised revaluation loss.

Relevant deferred tax adjustments would also be made as this is a non-monetary asset subject to revaluation.

Determining fair value

FRS 102, paras 17.15C and 17.15D make reference to the determination of fair value for the purpose of applying the revaluation model. FRS 102, para 17.15C states that the fair value of land and buildings is derived from market-based evidence which is usually obtained by appraisal by professionally-qualified valuers. Such professionally-qualified valuers would include chartered surveyors. Fair value in respect of plant and equipment is usually derived from their market value determined by appraisal. This could be obtained from a dealer in such plant and equipment.

Where there is no market-based evidence of fair value due to the asset being specialised in nature (e.g. a school building), and the item is rarely sold, except as part of a continuing business, the entity may need to estimate fair value using an income or depreciated replacement cost approach.

Deferred tax

Where an entity adopts the revaluation model, deferred tax must be brought into account in accordance with the requirements of FRS 102, para 29.8. Deferred tax is measured at the tax rates and allowances which will apply when the timing differences reverse (currently the rate is generally 17% but this may change in the future subject to the Budget on 6 November 2019). Deferred tax recognised in respect of revalued items of PPE is taken to the revaluation reserve.

Revaluation frequency

FRS 102 does not prescribe a set time limit for revaluations. Paragraph 17.15B says that revaluations shall be made with **sufficient regularity** to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period. Therefore, some types of fixed assets may go several years without a revaluation being undertaken, but these would tend to be assets whose fair value remains relatively static over a long period of time. Conversely, some assets (such as properties) may require revaluations on a much more regular basis. The judgement call that is required here is to consider whether the carrying value of the revalued assets is materially higher or lower than its fair value; if it is, then a revaluation is needed.

1.5 Depreciation

All tangible fixed assets must be depreciated; although in the majority of cases, land will not depreciate as this is considered to have an indefinite useful life. FRS 102 does not stipulate which assets must be subjected to which depreciation

methods; however, in practice the straight-line and reducing balance (sometimes referred to as the 'diminishing balance method') are used. In a manufacturing company, it may be appropriate to use the 'usage method' of depreciation for certain types of machinery. Under the usage method, depreciation is only charged when an asset is being used; hence under this method the depreciation charge can be nil while there is no production.

If an entity changes its depreciation method (for example, depreciating an asset at 33% on a straight-line basis instead of 25% on a reducing balance basis), then this represents a change in estimation technique. The change is not applied retrospectively because changes in estimation are accounted for prospectively; only changes in accounting policy are applied retrospectively and a change in depreciation method is not a change in accounting policy.

FRS 102, para 17.21 provides factors which the entity must consider when determining the useful life of an asset as follows:

- (a) *The expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.*
- (b) *Expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.*
- (c) *Technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.*
- (d) *Legal or similar limits on the use of the asset, such as the expiry dates of related **leases**.*

FRS 102, para 17.21 (a) to (d)

1.6 Depreciable amount

The term 'depreciable amount' is defined as:

*The cost of an **asset**, or other amount substituted for cost (in the **financial statements**), less its **residual value**.*

The depreciable amount of an asset is calculated as cost less residual value. The balance is then depreciated over the asset's useful economic life.

Under FRS 102, residual values are based on the price which an entity would **currently** obtain if it were to dispose of the asset less the estimated costs of disposal if the asset were already of the age and in the condition expected at the end of its useful life. This means that depreciation charges could fluctuate from one period to the next because the depreciable amount could go up or down depending on what happens with the residual value.

1.7 Impairment

It is important to remember a fundamental principle that underpins financial reporting which is that assets must not be stated in the balance sheet at any more than recoverable amount. If assets are overstated this clearly results in the accounts becoming misleading.

To achieve this, management must review the entity's assets at each balance sheet date to identify if there are indicators that any asset is impaired. If an asset is impaired, the requirements of FRS 102, Section 27 *Impairment of Assets* will apply and this involves calculating recoverable amount, comparing recoverable amount to the carrying amount; and if carrying amount is higher than recoverable amount, recognising the difference as an impairment loss in profit or loss.

If the entity is going to be reimbursed for an asset that is impaired; for example, if an insurance company is going to reimburse the entity for a vehicle that has been damaged in an accident, then that compensation can only be recognised as a debtor when its receipt is **virtually certain**. Note the term 'virtually certain' is not the same as 'probable'. The term 'probable' is defined as 'more likely than not'; virtually certain is not defined in FRS 102 and in practice there would have to be official confirmation from the third party that they do intend to reimburse the entity.

Impairments can be reversed when the circumstances giving rise to the impairment cease to apply. Impairments can only be reversed to bring the carrying amount of the asset up to the value which would have been stated – net of depreciation/amortisation – had no impairment been recognised. It must also be emphasised that impairment losses in respect of goodwill must never be reversed.

2 Intangible assets and goodwill (Lecture A684 – 18.24 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with the issue of intangible assets (but not goodwill) at Section 18 *Intangible Assets other than Goodwill*. Unlike old UK GAAP, goodwill is not dealt with in the intangible assets section, instead it is dealt with in Section 19 *Business Combinations and Goodwill*.

Intangible assets tend to cause some complexities because sometimes they can be extremely subjective items to account for and over the last couple of years some questions have begun to emerge concerning the accounting treatment of certain items under FRS 102. In addition, we will also consider some of the changes that have been made to the accounting for intangible assets other than goodwill as part of the Financial Reporting Council's triennial review of UK GAAP which completed in December 2017.

2.1 Definition of an intangible asset

FRS 102 defines an 'intangible asset' as:

*An identifiable non-monetary asset without physical substance. Such an **asset** is identifiable when:*

*FRS 102 Glossary
intangible asset*

- (a) *it is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or **liability**; or*
- (b) *it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.*

It follows, therefore, that all assets which are separable are identifiable. Separability is not, however, the only indication of identifiability. An asset which arises from contractual or legal rights can also be identifiable.

Example – Separable asset

Peter runs his own taxi company in the UK and needs a taxi licence in order to operate his taxi.

The taxi licence would be regarded as an identifiable asset because it is needed to operate the vehicle, hence is a critical aspect of his business and it also arises from legal rights despite the fact that the licence would not usually be separable from the underlying business as it would only be transferable to other taxi operators.

2.2 Scope of Section 18

FRS 102, Section 18 does not apply to:

- (a) **financial assets** (see Section 11 Basic Financial Instruments and Section 12 Other Financial Instruments Issues);
- (b) **heritage assets** (see Section 34 Specialised Activities);
- (c) exploration for and evaluation of mineral resources, such as oil, natural gas and similar non-regenerative resources (see Section 34) and expenditure on the development and extraction of such resources; or
- (d) **deferred acquisition costs** and intangible assets arising from contracts in the scope of **FRS 103**, except for the disclosure requirements in this section which apply to intangible assets arising from contracts within the scope of FRS 103.

FRS 102 para 18.3

2.3 Recognition and measurement

Care needs to be taken not to inappropriately recognise intangible assets on a company's balance sheet. For example, internally generated goodwill is strictly prohibited under FRS 102, paragraph 18.8C(f) (as was the case in FRS 10 *Goodwill and intangible assets* and the FRSSE). Over the years some entities have recognised internally generated goodwill on the balance sheet in contravention of accounting standards which invariably presents a misleading position. If a company purchases goodwill, then that purchased goodwill can be recognised on the balance sheet at cost.

Paragraph 18.4 of FRS 102 says that an entity shall recognise an intangible asset if, and only if:

- (a) it is **probable** that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- (b) the cost or value of the asset can be measured reliably.

FRS 102 para 18.4 (a) and (b)

Internally generated goodwill fails test (b) because there is no reliable measure of cost, generally because there is no 'active market' from which to derive a reliable measure of cost. The term 'active market' is defined in the Glossary to FRS 102 as:

A market in which all the following conditions exist:

FRS 102 Glossary
active market

- (a) the items traded in the market are homogeneous;
- (b) willing buyers and sellers can normally be found at any time; and
- (c) prices are available to the public.

Simply obtaining a valuation of goodwill from an accountancy firm does not mean it can be recognised on the balance sheet as there is still no active market.

Ordinarily, goodwill will only arise in a business combination under FRS 102, hence it being placed in Section 19 *Business Combinations and Goodwill*.

2.4 Software and website development costs

An issue which is generating debate is the classification of software and website development costs. FRS 102 does not address the classification of software and website development costs and therefore in the absence of specific guidance, reporting entities are required to develop and apply a suitable accounting policy to classify such costs as either tangible or intangible fixed assets. FRS 102, para 10.5 provides a hierarchy of sources which are to be referred to (in descending order) in developing this policy.

Software and website costs which are being developed internally are dealt with under Section 18 of FRS 102 as research and development costs (para 18.8H). All research expenditure (pure and applied) must be written off to profit or loss as expenditure; there is no option at all to capitalise research expenditure. This is because in the research phase of a project, an entity will be unable to demonstrate that an intangible asset exists which will generate probable future economic benefits.

Once the research phase has completed and the project has been moved into the development phase, the entity may recognise software and website development costs if, and only if, an entity can demonstrate all of the following:

- (a) *The technical feasibility of completing the intangible asset so that it will be available for use or sale.*
- (b) *Its intention to complete the intangible asset and use or sell it.*
- (c) *Its ability to use or sell the intangible asset.*
- (d) *How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.*
- (e) *The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.*
- (f) *Its ability to measure reliably the expenditure attributable to the intangible asset during its development.*

FRS 102 para 18.8H
(a) to (f)

Micro-entities reporting under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* cannot capitalise any development costs; all such costs are written off to the profit and loss account as incurred. This is because the capitalisation of development costs is an accounting policy choice

under UK GAAP and micro-entities reporting under FRS 105 have no accounting policy choices available to them.

Accounting treatment: website development costs

Website development costs should only be capitalised if they meet the recognition criteria of an asset; one of those criteria being that *'it is probable that the expected future economic that are attributable to the asset will flow to the entity'*.

To assess whether costs qualify for recognition on the balance sheet, the entity must look at the overall functionality of the website. If the website will allow third parties to place orders for goods or services, then this creates a revenue stream for the business (i.e. economic benefit). Provided the cost can be measured reliably and none of the expenditure relates to research costs, then the website may be capitalised on the balance sheet as an intangible asset and amortised over its useful economic life. **Please note that under FRS 102, intangible assets cannot have indefinite useful lives** (see 'Amortisation of intangible assets' below).

If the website does not generate income for the business, then it will fail to meet the asset recognition criteria and the costs of the website must be written off to profit or loss.

Care must be taken with the accounting treatment for website development costs because mistakes can be costly (especially if the incorrect tax treatment is applied).

Accounting treatment: software costs

When software costs meet the recognition criteria for an asset, again consideration must be given as to the type of software being capitalised. If the software is not critical for the hardware to operate then the software should be capitalised as an intangible fixed asset. However, if the software is a critical aspect of enabling the hardware to work (for example, an operating system), then the software costs are capitalised as part of the hardware, i.e. as a tangible fixed asset.

Regardless of whether the software is capitalised as an intangible asset or a tangible asset, the software must be amortised or depreciated over its useful economic life.

2.5 Initial measurement (separately acquired intangible assets)

FRS 102, para 18.9 requires an entity to measure an intangible asset initially at cost. Para 18.10 confirms that the cost of a separately acquired intangible asset comprises:

- (a) *its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and*

FRS 102 para 18.10 (a) and (b)

- (b) *any directly attributable cost of preparing the asset for its intended use.*

Examples of 'directly attributable costs' include:

- legal and professional fees;
- costs of testing whether the intangible asset is functioning correctly; and payroll costs of individuals employed by the entity who are directly engaged in bringing the intangible asset to its working condition. Internally generated intangible assets

In practice, it is often difficult to justify recognising internally generated assets and those that are recognised will usually be restricted to specific situations relating to development expenditure where the entity has a policy of capitalising development costs.

FRS 102, para 18.10A states that the cost of an internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria in FRS 102, paras 18.4 and 18.8H.

FRS 102, para 18.10B then goes on to state that the cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce and prepare the intangible asset to be capable of operating in the manner intended by management. Paragraph 18.10B provides the following examples of directly attributable costs:

- (a) *costs of materials and services used or consumed in generating the intangible asset;*
- (b) *costs of **employee benefits** (as defined in Section 28 Employee Benefits) arising from the generation of the intangible asset;*
- (c) *fees to register a legal right; and*
- (d) ***amortisation** of patents and licences that are used to generate the intangible asset.*

FRS 102 para
18.10B (a) to (d)

It must be emphasised that FRS 102, para 18.17 states that expenditure on an intangible item which was initially recognised as an expense must not be recognised at a later date as part of the cost of an asset.

Example – Distinguishing between the research phase and development phase of an internal project

An entity is developing a new accounts production system for accountants in poorer overseas countries to help them become more efficient in the way that they prepare financial statements and undertake other assignments for their clients.

The project team have structured the project as follows:

1. Identify the need for a new accounts production system.
2. Commission research for any existing equivalent accounts production system in that part of the world.
3. Commission research for any existing equivalent accounts production systems that may have features which the entity believe are currently only unique to themselves.
4. Undertake research for any other competitors which may be involved in producing equivalent accounts production systems in the timescale which the project team have devised.
5. Commission the design of the new accounts production system.
6. Prepare a shortlist from step 5 above.
7. Obtain a budget from the finance department for the new system and then compare this budget to the shortlist prepared in step 6.
8. Prepare a further shortlist of two possible alternatives based on feedback from the project management team.
9. Send the final two shortlisted candidates to the board of directors for their approval.
10. Develop the new accounts production system.
11. Undertake testing.
12. Roll out the new system.

The recognition criteria at each stage should be considered in order to establish when capitalisation of development costs can commence and hence when the recognition criteria has been met. At stage 5 of the project, the technical feasibility of completing the project has been confirmed. At the end of stage 7 it has been established how the project will generate future economic benefits. At the beginning of stage 10 all of the recognition criteria have been met and the board of directors have approved the project which, in turn, provides evidence of the company's intention to complete the project. The budgeted information will also provide evidence of the entity's ability to measure the expenditure.

2.6 Subsequent measurement

FRS 102, Section 18 allows for two subsequent measurement bases:

- the cost model; and
- the revaluation model.

Cost model

After initial recognition, the entity measures the intangible asset at cost less accumulated amortisation (see 2.7 below) and accumulated impairment losses.

Revaluation model

Under the revaluation model, an intangible asset whose fair value can be measured reliably is carried at a revalued amount, less subsequent amortisation and impairment. Fair value will need to be obtained by reference to an active market.

While Section 18 does allow the revaluation model for intangible assets, in practice the model is rarely used. This is because it is rare for an active market to exist for intangible assets other than for items such as taxi licences and production quotas.

There are some important points to note where the revaluation model for intangible assets is concerned:

- the revaluation model can only be applied that have previously been recognised as intangible assets; it cannot be applied to intangible assets that have previously been expensed; and
- the revaluation model can only be applied to those intangible assets which have been initially recognised at cost. Hence, for an intangible asset acquired as part of a business combination, 'cost' means fair value at the date of acquisition. The revaluation model cannot be applied to intangible assets which have been initially recognised at amounts other than cost.

The revaluation model in Section 18 works in the same way as the revaluation model in Section 17 (see 1.4 above).

2.7 Amortisation

Under FRS 102, all intangible assets have finite useful lives. It is no longer permissible to carry intangible assets with indefinite useful lives as it was under previous FRS 10 and the FRSSE.

FRS 102, para 18.19 says that the useful life of an intangible asset which has arisen from contractual or other legal rights must not exceed the period of the contractual or other legal rights. However, it may be shorter depending on how long the entity expects to use the intangible asset.

FRS 102, para 18.20 places a cap of 10 years on amortisation **in exceptional cases only**. This 10-year rule has caused an element of confusion because some accountants believe this to be a maximum period for **all** intangible assets, which is not the case.

Paragraph 18.21 of FRS 102 says that intangible assets are amortised on a systematic basis over their useful lives. It would not be unreasonable for certain intangible assets to have a longer life than 10 years and as long as management can provide evidence to support their assessment of that useful life, it would be acceptable to amortise the intangible assets over that said period. The 10-year rule in FRS 102 is triggered when management are unable to make a reliable estimate of the useful life of an intangible asset. The 10-year cap is a maximum, not a minimum – therefore management may determine a five-year amortisation period to be appropriate or even less.

Residual values

FRS 102, para 18.23 states that an entity must assume that the residual value of an intangible asset is zero unless:

- (a) *there is a commitment by a third party to purchase the asset at the end of its useful life; or*
- (b) *there is an active market for the asset and:*
 - (i) *residual value can be determined by reference to that market; and*
 - (ii) *it is probable that such a market will exist at the end of the asset's useful life.*

*FRS 102 para 18.23
(a) and (b)*

2.8 Review of amortisation period and amortisation method

FRS 102, para 18.24 recognises that factors such as a change in how an intangible asset is used, technological advancements and changes in market prices may influence residual values and useful lives of intangible assets. If such indicators are present, FRS 102, para 18.24 requires management to review its previous estimates and, if current expectations differ, amend the residual value, amortisation method or useful life as appropriate. Such amendments are changes in estimation and hence are accounted for prospectively in accordance with FRS 102, Section 10 *Accounting Policies, Estimates and Errors*. No retrospective restatement is needed.

2.9 Impairment of intangible assets

As noted earlier, assets cannot be carried in the balance sheet in excess of recoverable amount and this principle applies to fixed assets (i.e. tangible and intangible) also. This does not mean, in practice, that an impairment calculation has to be carried out at each balance sheet date; FRS 102 only requires an *assessment* of whether there are any indicators of impairment. If there are indicators of impairment, then recoverable amount of the asset must be calculated and compared to carrying values. Where the carrying amount of a

fixed asset exceeds recoverable amount, the fixed asset is impaired and is written down to recoverable amount.

2.10 Changes to Section 18 arising from the FRC's triennial review

The definition of an intangible asset in FRS 102 is different than under previous UK GAAP and gave rise to the need to recognise additional intangible assets that were acquired in a business combination (i.e. where a parent acquires a subsidiary). This increased costs of compliance in some instances, which the FRC have recognised goes against the principles of standard-setting.

The FRC decided to amend Section 18 *Intangible Assets other than Goodwill* as part of the triennial review so as to provide entities with an accounting policy choice of either separately recognising intangible assets acquired in a business combination or including them within goodwill. If the entity chooses to separately recognise intangible assets, they must apply this policy to all intangible assets in the same class and on a consistent basis.

Note – as the changes to Section 18 arose from the triennial review, they are effective for accounting periods commencing on or after 1 January 2019. Early adoption is permissible provided all of the triennial review amendments are applied at the same time. The exception to this early adoption rule is in respect of the directors' loan simplification (for small entities) and the tax effects of gift aid payments amendment.

FRS 102, para 18.8 in the March 2018 edition of the standard states:

*Intangible assets acquired in a **business combination** shall be recognised separately from goodwill when all the following three conditions are satisfied:*

FRS 102 para 18.8

- (a) *the recognition criteria set out in paragraph 18.4 are met;*
- (b) *the intangible asset arises from contractual or other legal rights; and*
- (c) *the intangible asset is separable (ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, asset or **liability**).*

An entity may additionally choose to recognise intangible assets separately from goodwill for which condition (a) and only one of (b) or (c) above is met. When an entity chooses to recognise such additional intangible assets, this policy shall be applied to all intangible assets in the same class (ie having a similar nature, function or use in the business), and must be applied consistently to all business combinations. Licences are an example of a category of intangible asset that may be treated as a separate class, however, further subdivision may be appropriate, for example, where different types of licences have different functions within the business.

The effect of the above is to reduce the costs of compliance of having to separately recognise intangible assets acquired as part of a business

combination. Reporting entities can continue to separately recognise such intangible assets if they wish, provided this accounting policy is applied consistently to all intangible assets in the same asset class.

It must also be noted that where the entity does adopt a policy of recognising intangible assets separately from goodwill, paragraph 18.28A requires the acquirer to disclose the nature of those intangible assets and the reason why they have been separated from goodwill.

3 Government grants (Lecture A685 – 10.04 minutes)

Government grants are dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 24 *Government Grants* and in Section 19 *Government Grants* in FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Issues relating to micro-entities that receive government grants are dealt with later.

3.1 Scope of section 24

Section 24 of FRS 102 deals with the accounting requirements for all government grants. The term 'government grants' is defined in the Glossary to FRS 102 as:

*Assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the **operating activities** of the entity.*

FRS 102 Glossary
government grant

Government refers to government, government agencies and similar bodies whether local, national or international.

Government grants do not include forms of government assistance which cannot reasonably have a value placed on them, nor does Section 24 include transactions with government which cannot be distinguished from the normal trading transactions of the entity.

FRS 102, para 24.3 confirms that Section 24 does not deal with government assistance which is provided to an entity in the form of benefits which are available in determining the entity's taxable profit (or loss). The section itself cites examples of such government assistance which include:

- income tax holidays;
- investment tax credits;
- accelerated depreciation allowances; and
- reduced income tax rates.

3.2 Recognition and measurement

A reporting entity cannot recognise a government grant until the recognition criteria has been met. In order to meet the recognition criteria, there must be reasonable assurance that:

- the entity will comply with the conditions attaching to the grant; and
- the grants will be received.

The term 'reasonable assurance' is used in FRS 102, para 24.3A but the standard does not define it and this raises the question as to whether it should be taken to have the same meaning as 'probable' (which is defined in the standard as 'more likely than not'). In the context of government grants, it would not be

unreasonable to assume that 'reasonable assurance' has the same meaning attributed to it as 'probable'.

Example – Recognition criteria not met

Summer Limited has a year end of 31 December 2019 and on 30 November 2019 it applied for a government grant towards the cost of expenses incurred in training seven apprentices. The application confirms that the government will only agree to reimbursement of these expenses at its discretion. At the balance sheet date the company had not been given confirmation as to whether its application had been successful or not.

The financial controller has nonetheless included a debtor in respect of the grant due from the government and has taken the corresponding entry to profit and loss. She has done this on the basis that a customer has confirmed that they were successful in obtaining a similar grant.

The financial controller is incorrect to recognise a debtor in the financial statements for the year ended 31 December 2019 because at the reporting date the company was unsure whether, or not, the grant would be received from the government (confirmation was not received from the government). Therefore, the debtor should be reversed and accounted for in the financial statements for the year ended 31 December 2020 if it is received.

Where the recognition criteria are met by the reporting date, then the grant is measured at the fair value of the asset received or receivable. If any of the grant is repayable (or becomes repayable) by the year-end, then a liability is recognised when the repayment meets the definition of a liability.

3.3 Accrual and performance models

An entity receiving (or expecting to receive) a government grant that meets the recognition criteria laid down in FRS 102, para 24.5D is required to recognise the grant based on the accrual model or the performance model. This is an accounting policy choice and must be applied on a class-by-class basis.

It must be noted that micro-entities choosing to report under FRS 105 cannot apply the performance model. They must only use the accrual model.

Accrual model

The accrual model of grant recognition will be the most familiar to accountants. This model requires the grant to be classified as either a revenue-based grant or a capital-based grant.

According to FRS 102, para 24.5D, grants which relate to revenue shall be recognised in income on a systematic basis over the periods in which the entity recognises the related costs for which the grant is intended to compensate.

Example – Grant received for costs already incurred

Spring Ltd has applied for a grant towards the cost of employing 100 members of a community where unemployment is very high. The terms of the grant application have been met and the grant has been agreed by the government. The grant was received after the year end date had passed but confirmation that it was receivable was received prior to the year end.

A grant which becomes receivable as compensation for expenses (or losses) which have already been incurred is recognised within income in the period in which it becomes receivable. Therefore, the entity recognises the grant as income when the government confirms its agreement to providing the grant – i.e. in the current year, not in the succeeding year when the company physically receives the grant.

Grants which relate to assets (i.e. capital-based grants) are recognised in income on a systematic basis over the expected useful life of the asset.

Example – Capital-based grant

Autumn Ltd (Autumn) has purchased a new item of machinery for £100,000 outright in cash which has an estimated residual value of £nil at the end of its useful economic life. The machine is being depreciated in accordance with the company's accounting policy for such equipment, being 10 years on a straight-line basis with a full year's depreciation charge in the year of acquisition, but none in the year of disposal.

Autumn applied for a government grant towards the cost of this asset and the government have confirmed that they will meet 20% of the cost of the equipment in the form of a grant (i.e. a grant of £20,000). This has been received by the company two weeks after the purchase of the machine.

The entries in the books of the company in respect of the new machine and the grant are as follows:

Purchase of the machine

Dr Property, plant and equipment additions	£100,000
Cr Cash at bank	£100,000

Being purchase of new machine

Dr Depreciation expense (profit and loss)	£10,000
Cr Accumulated depreciation (balance sheet)	£10,000

*Being depreciation of new machine in year 1*Government grant

Dr Cash at bank	£20,000
Cr Deferred income	£20,000

Being initial receipt of the government grant

Dr Deferred income	£2,000
Cr Profit and loss account (other income)	£2,000
<i>Being 1/10th of the grant released to profit or loss</i>	

It should be noted that FRS 102, paragraph 24.5G specifically prohibits the value of the capital-based grant from being deducted from the cost of the asset (i.e. Dr Bank, Cr PPE additions) and hence recognising the grant in profit and loss by way of reduced depreciation charges. This is because such an accounting treatment is incompatible with company law because the statutory definitions of ‘purchase price’ and ‘production cost’ make no provisions for deductions from such amounts.

Performance model

The performance model is dealt with in FRS 102 at paragraph 24.5B.

Where the entity has an accounting policy of applying the performance model, a grant is recognised in the financial statements as follows:

- (a) *A grant that does not impose specified future **performance-related conditions** on the recipient is recognised in income when the grant proceeds are received or receivable.*
- (b) *A grant that imposes specified future performance-related conditions on the recipient is recognised in income only when the performance-related conditions are met.*
- (c) *Grants received before the **revenue recognition** criteria are satisfied are recognised as a liability.*

FRS 102 para 24.5B

Example – Performance-related conditions met

Winter Ltd has set up a new branch in a deprived area of the country and has an accounting reference date of 31 March each year. In order to entice businesses to set up operations, the government have introduced a scheme whereby it will provide a grant to the company once certain conditions have been met. The conditions are as follows:

- The company must be trading to full capacity by 31 December 2019.
- The company must have successfully employed at least 150 people on a full-time basis by 31 January 2020.
- The company must take on at least 25 people under the age of 25 on an apprenticeship scheme.

The company successfully achieved all the conditions imposed on them by the government and the grant was duly received on 26 March 2019. The financial controller is unsure whether to recognise the whole grant in profit or loss or defer it in the balance sheet.

The company has complied with all its performance-related conditions imposed on it by the government where the grant is concerned. Provided none

of the grant is, or may become, repayable in the future, the entire grant can be recognised in income for the year ended 31 March 2019.

3.4 Micro-entities

FRS 105, Section 19 *Government Grants* outlines the accounting requirements for government grants. Micro-entities choosing to report under FRS 105 cannot use the performance model for grants and instead must only use the accrual model. Micro-entities must still classify government grants as either revenue-based or capital-based and account for them in the same way as entities reporting under FRS 102. Any grants which are, or become, repayable must be recognised as a liability when the repayment meets the definition of a liability.

3.5 Disclosures

The disclosure requirements in respect of grants are as follows:

- (a) the **accounting policy** adopted for grants in accordance with paragraph 24.4;
- (b) the nature and amounts of grants recognised in the **financial statements**;
- (c) unfulfilled conditions and other contingencies attaching to grants that have been recognised in income; and
- (d) an indication of other forms of government assistance from which the entity has directly benefited.

FRS 102 para
24.6(a) to (d)

For the purpose of the disclosure required by paragraph 24.6(d), government assistance is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under specified criteria. Examples include free technical or marketing advice and the provision of guarantees.

FRS 102 para 24.7

4 Events after the end of the reporting period (Lecture A686 – 13.39 minutes)

Events after the reporting period (or 'post balance sheet events' as many accountants are familiar with) are dealt with in FRS 102 at Section 32 *Events after the end of the Reporting Period*. Such events can have a significant impact on a company's financial statements because of the need to reflect certain transactions which take place after the year end but occur after the year end in the financial statements; and to disclose other material issues whose conditions did not exist at the year end.

Section 32 refers to two types of event under its scope:

- adjusting events; and
- non-adjusting events.

4.1 Adjusting events

An adjusting event is one which is reflected within the financial statements and is an event where the conditions existed at the year/period end but which crystallises after the year/period end. The key to identifying whether the event is adjusting is to ensure that it is clear that the conditions giving rise to the event existed at the balance sheet date. FRS 102, paragraph 32.5 contains some examples of adjusting events as follows:

- The settlement of a court case after the balance sheet date which confirms that an entity had present obligation at the balance sheet date. Any previously recognised provision related to this court case is adjusted in accordance with FRS 102, Section 21 *Provisions and Contingencies* or the entity recognises a new provision.
- Receipt of information after the balance sheet date which confirms that an asset has suffered impairment such as:
 - the classic scenario of the bankruptcy of a customer after the balance sheet date which confirms the trade debtor is irrecoverable (ie impaired); and
 - sale of stock after the balance sheet date which may give evidence relating to their estimated selling price less costs to complete and sell (i.e. selling price is less than cost).
- The cost of assets purchased after the balance sheet date, or proceeds received from the sale of assets sold prior to the balance sheet date.
- Determination of profit-sharing bonus payments made after the balance sheet date if the entity had a legal or constructive obligation at the balance sheet date to make such payments as a result of events before that date (see Section 28 *Employee Benefits*).

- Discovery of fraud/error which show that the financial statements are incorrect.

If the conditions relating to the above existed at the balance sheet date, they would be reflected within the financial statements.

Example – Bonus payments

Bury Co Ltd has always paid bonuses to its two directors based on 5% of profit before tax. The draft management accounts as at 30 November 2019 include a gross bonus, plus employer's NIC amounting to £31,500 each following the resolution to pay a bonus based on the draft figures on 20 November 2019. This bonus is not paid until such time that the financial statements are approved because of various adjustments that are often incorporated into the finalised financial statements. The financial statements are approved four months after the year end and because of a large stock write-down, the profits have reduced to such an extent that the gross bonus, plus the employer's NIC should only be £14,500 each.

This is an example of an adjusting event because the decision to pay the bonuses was made prior to the year end and therefore bonuses will need to be reduced.

4.2 Non-adjusting events

Non-adjusting events are those that are indicative of conditions that arose after the end of the reporting period but before the financial statements are approved. In other words, their conditions did not exist at the balance sheet date.

By their definition, non-adjusting events are not adjusted for in the financial statements. Instead, additional disclosures may be required in the financial statements. Some practitioners have fallen foul to non-compliance with standards regarding post-balance sheet events in the belief that if an event occurs after the year end, then that is all there is to it and the event will be dealt with accordingly in the subsequent accounting period. FRS 102, Section 32 requires disclosure of a non-adjusting event if non-disclosure would influence the decisions that users make on the basis of the financial statements. In other words, if the non-adjusting event is material.

Section 32 offers some (non-exhaustive) examples of non-adjusting events at paragraph 32.7 and 32.11 as follows:

- A decline in the market value of investments between the end of the reporting period and the date when the financial statements are authorised for issue. The decline in market value does not normally relate to the condition of the investments at the end of the reporting period, but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognised in its financial statements for the

investments. Similarly, the entity does not update the amounts disclosed for the investments as at the end of the reporting period, although it may need to give additional disclosure in accordance with paragraph 32.10.

- An amount that becomes receivable as a result of a favourable judgement or settlement of a court case after the reporting date but before the financial statements are authorised for issue. This would be a contingent asset at the reporting date and disclosure may be required by paragraph 21.16. However, agreement on the amount of damages for a judgement that was reached before the reporting date, but was not previously recognised because the amount could not be measured reliably, may constitute an adjusting event.
- A major business combination or disposal of a major subsidiary.
- Announcement of a plan to discontinue an operation.
- Major purchases of assets, disposals or plans to dispose of assets, or expropriation of major assets by government.
- The destruction of a major production plant by a fire.
- Announcement, or commencement of the implementation, of a major restructuring.
- Issues or repurchases of an entity's debt or equity instruments.
- Abnormally large changes in asset prices or foreign exchange rates.
- Changes in tax rates or tax laws enacted or announced that have a significant effect on current and deferred tax assets and liabilities.
- Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees.
- Commencement of major litigation arising solely out of events that occurred after the end of the reporting period.

Example – Discontinuation of a division

Brightmall Ltd is a supermarket which operates four different classes of business division: groceries, mobile telephone providers, internet service providers and domestic appliances. Each division is considered material to the financial statements of the company. The financial statements for the year ended 31 August 2019 have not yet been approved. On 30 September 2019, the company directors decided that because of extremely difficult trading conditions, and a heavy loss, it would discontinue the domestic appliances division. This announcement was made on 1 October 2019.

This is a non-adjusting event because the decision to discontinue the division took place after the balance sheet date. However, because the division is considered to be material to the financial statements, it would need to make disclosure concerning the closure of the appliances division.

Example – Share issue post year end

Hardacre Co Limited has a year end of 31 July 2019. On 4 August 2019, it issues a further 1,000 shares in an attempt to raise finance as the company has recently been experiencing cash flow difficulties and the bank have requested shareholders make further investment to demonstrate their commitment to the company before the bank will agree to further lending.

FRS 102, paragraph 32.11 recognises issues or repurchases of an entity's debt or equity instruments as a non-adjusting event and therefore this transaction should be disclosed as such within the financial statements as a non-adjusting event.

4.3 Going concern

The issue of going concern is a material one in all companies – large and small. When preparing financial statements, the company usually does so on the going concern basis. However, a company will not be able to use the going concern basis of preparing the financial statements if management determines *after* the reporting date that it either intends to cease trading or liquidate the business, or has no realistic alternative but to cease trade or liquidate (FRS 102, para 32.7A).

In situations when the directors conclude that the financial statements are not to be prepared on the going concern basis, the effect is so pervasive that there has to be a change in the basis of preparation (i.e. a basis other than the going concern basis). This alternative basis should not merely be an adjustment to the amounts recognised in the financial statements, but should be a complete change to the basis of accounting. In such a situation a basis other than the going concern basis must be used.

The 'break up' basis of accounting or 'liquidation basis' is inconsistent with FRS 102 because these bases recognise the future costs of closing the business whereas FRS 102 only permits the entity to recognise costs which it has incurred up to and including the balance sheet date. Therefore, the break up or liquidation basis would not be used if the financial statements are prepared under FRS 102, except in very rare circumstances.

If the going concern basis is not appropriate, the entity must disclose the basis on which the financial statements have been prepared together with the reason(s) why the entity is no longer a going concern.

Example – Going concern basis is not appropriate

Cordley Co Ltd is preparing financial statements to 31 October 2019. On 4 December 2019, following negotiations, the bank have 'called in' the overdraft of £500,000 immediately to the company's ongoing trading difficulties. This has had a catastrophic effect on the company as they have failed to secure borrowing facilities with other financiers and the directors have decided that they have no realistic alternative but to cease trading with immediate effect and liquidate the company.

The going concern basis is not appropriate in this company's circumstances, and therefore the directors may make disclosures as follows (**please note the following disclosures are illustrative disclosures only and may not be appropriate in every situation**).

In the directors' report:

Statement of directors' responsibilities

The last bullet point regarding the responsibility of the directors to prepare the financial statements on a going concern basis should be amended to make it clear that, despite their responsibilities still remaining the same, the going concern basis is no longer appropriate. Such a disclosure may be as follows:

As explained in Note X to the financial statements, the directors do not consider the going concern basis to be appropriate and these financial statements have therefore not been prepared on that basis.

Basis of preparation of the financial statements

The basis of preparation paragraph should explain the reasons why the going concern basis is no longer appropriate in the circumstances and the effect of this approach. Such a disclosure could be as follows:

The company has failed to reach agreement with its bankers concerning the renewal of the company's borrowing facilities. The company has ceased trading with immediate effect and therefore the financial statements have been prepared on a basis other than the going concern basis. This basis includes, where applicable, writing the company's assets down to net realisable value. Provisions have also been made in respect of contracts which have become onerous at the balance sheet date. No provision has been made for the future costs of terminating the business unless such costs were committed to at the reporting date.

Event after the reporting period (note to the financial statements)

This would be relevant in this scenario because the event causing the going concern presumption to be departed from occurred after the year end. A disclosure example is as follows:

As disclosed in the accounting policies note at Note X, the company ceased to trade on 4 December 2019 on the grounds that the directors have been unable to source additional finance to enable the business to continue as a going concern. The going concern basis is not appropriate and the directors have therefore not prepared the financial statements on that basis.

4.4 Dividends

Dividends which are proposed after the balance sheet date cannot be recognised in the financial statements at the balance sheet date. This requirement also applies where the financial statements have not yet been authorised for issue. This is because at the balance sheet date, no obligation to pay the dividend exists. However, the dividends proposed may be disclosed within the financial statements and could be shown as a separate component of retained earnings at the end of the reporting period.

4.5 Date of authorisation of the financial statements

Under Section 32, the entity must disclose the date on which the financial statements were authorised for issue and who gave that authorisation. This disclosure is usually generated automatically by the accounts production software system and may look something as follows:

The financial statements were approved by the Board of Directors on [insert date of approval] and were signed by:

.....

J Smith – Director

.....

B Jones – Director

4.6 Disclosure requirements – non-adjusting events

As non-adjusting events require disclosure within the financial statements, an entity must disclose the following for each category of non-adjusting event(s) after the end of the reporting period:

- (a) *the nature of the event; and*
- (b) *an estimate of its financial effect or a statement that such an estimate cannot be made.*

*FRS 102 para 32.10
(a) and (b)*

5 Employee benefits

Employee benefits are dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 28 *Employee Benefits*. Micro-entities reporting under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* are required to follow the provisions in Section 23 *Employee Benefits*.

Section 28 of FRS 102 outlines the accounting treatment for all forms of consideration provided to an employee with the exception of share-based payments, which are dealt with in Section 26 of FRS 102 *Share-based Payment*.

The term ‘employee benefits’ is defined in the Glossary to FRS 102 as:

All forms of consideration given by an entity in exchange for service rendered by employees.

FRS 102 Glossary
employee benefits

There have been few changes made to Section 28 as a result of the recent triennial review. The triennial review amendments come into mandatory effect for accounting periods commencing on or after 1 January 2019 with early adoption permissible. If the entity early adopts the changes made to Section 28, it must early adopt all of the triennial review amendments. The changes made to Section 28 are summarised as follows:

Paragraph number	Amendment made
28.1	Removal of the definition of ‘employee benefits’ as this is contained in the Glossary.
28.15(b)	Reference to the fair value guidance in the Appendix to Section 2 <i>Concepts and Pervasive Principles</i> rather than paragraphs 11.27 to 11.32.
28.21A	Reference to current <u>reporting</u> period rather than just ‘current period’.
28.28	Clarification that the cost of a defined benefit plan recognised in accordance with paragraph 28.23 may be presented net of the amounts relating to changes in the carrying amount of the right to reimbursement.
28.30	Clarification that the entity recognises the <u>net</u> change in the liability <u>during the period</u> unless FRS 102 requires or permits the change to be included in the cost of an asset. It then provides examples as to which types of assets (inventory or property, plant and equipment).
28.38	Clarification that it is the ‘sponsoring employer’s’ financial statements which takes the cost of a defined benefit plan where there is no agreement or policy stating how the cost is

	to be allocated in a group.
	There is also additional clarification that the recognition of the defined benefit cost requires the recognition of a corresponding net defined benefit asset or liability in the individual financial statements of any group entity recognising a net defined benefit cost.
28.41	Changes to the wording. Rather than refer to ‘defined multi-employer benefit plans’, they are now referred to as ‘multi-employer defined benefit plans.’

5.1 Scope of Section 28

Paragraph 28.1 of FRS 102 outlines the scope of the section. Section 28 applies to all employee benefits, except share-based payment arrangements (see Section 26).

Employee benefits include:

- (a) short-term employee benefits (other than termination benefits) which are expected to be settled by the entity in full before 12 months after the balance sheet date in which the employee renders the service;
- (b) post-employment benefits (retirement benefits) which are employee benefits, other than termination and short-term employee benefits, which are payable after the completion of employment;
- (c) other long-term employee benefits, which are all employee benefits, other than short-term employee benefits, post-employment benefits and termination benefits; or
- (d) termination benefits, which are employee benefits provided in exchange for an employee terminating their employment as a result of either:
 - (i) the entity’s decision to terminate the employee’s employment before the normal retirement date; or
 - (ii) the employee decides to accept voluntary redundancy in exchange for those benefits.

Paragraph 28.2 of FRS 102 is shown as ‘[Deleted]’. The equivalent paragraph 28.2 in the *IFRS for SMEs* clarifies that employee benefits do not include share-based payment arrangements. FRS 102 (March 2018) includes this in the opening paragraph 28.1 hence it would be meaningless to include it again in paragraph 28.2.

5.2 Recognition principle for all employee benefits

The general recognition principle for all employee benefits is that an entity recognises:

- (a) a liability, after deduction of all amounts which have been paid to the employees, or as a contribution to the pension fund. A prepayment is recognised if the amounts paid exceed the liability, provided the excess will lead to a reduction in future payments, or a refund; and
- (b) an expense, unless another part of FRS 102 requires the cost to be recognised elsewhere, e.g. within inventory or property, plant and equipment.

In practice, it is relatively uncommon to recognise the expense within another section of the balance sheet, although this could arise, for example, in development costs where an employee is directly engaged in the production of an intangible asset arising from the development phase where the recognition criteria are met.

5.3 Short-term employee benefits

Paragraph 28.4 of FRS 102 provides four examples of what it considers to be short-term employee benefits as follows:

- (a) wages, salaries and social security contributions;
- (b) paid annual leave and paid sick leave;
- (c) profit-sharing and bonuses; and
- (d) non-monetary benefits (e.g. company cars, medical care and free or subsidised goods or services) for current employees.

It is important not to consider the above examples to be conclusive and regard must be had to paragraph 28.1(a) which states that short-term employee benefits are those benefits which are ‘... expected to be settled wholly before twelve months after the end of the **reporting period** in which the employees render the related service.’ Hence, the scope could be wider than the four examples provided by paragraph 28.4.

Reference to ‘short-term’ in financial reporting usually implies a period of 12 months or less after the balance sheet date in which the related service is rendered. FRS 102 does not provide specific guidance on the unit of account which should be used to evaluate the period over which the benefit is expected to be settled; for example, whether it should be per individual employee or all employees. It would therefore be acceptable for the entity to assess whether any employees are expected to receive settlement after 12 months from the balance sheet date. Where this is the case, such benefits would be regarded as long-term rather than short-term.

5.4 Measurement of short-term employee benefits

Paragraph 28.5 of FRS 102 (March 2018) states:

When an employee has rendered service to an entity during the reporting period, the entity shall measure the amounts recognised in accordance with

FRS 102 para 28.5

paragraph 28.3 at the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service.

The cost of the above is measured at the cost **to the employer** of providing the benefit.

5.5 Short-term compensated absences

One of the most notable differences between Section 28 of FRS 102 and previous UK GAAP is the need to make an accrual for short-term compensated absences accrued by the employee, but not paid until after the balance sheet date. The most common type of short-term compensated absence is holiday pay (although paragraph 28.6 of FRS 102 also cites sick leave as well).

Paragraph 28.6 of FRS 102 states that an entity must recognise the expected cost of accumulating compensated absences when the employees render service that increases their entitlement to future compensated absences. The term 'accumulating compensated absences' is defined in the Glossary to FRS 102 as:

Compensated absences that are carried forward and can be used in future periods if the current period's entitlement is not used in full.

*FRS 102 Glossary
accumulating
compensated
absences*

In respect of such compensated absences, the entity measures these at the undiscounted additional amount which the entity expects to pay and will recognise these as current liabilities.

Generally, companies will recognise items such as unpaid holiday pay when the holiday year is not coterminous with the financial year; or when employees can carry forward a certain number of days holiday to the next holiday year.

Example – Holiday year coterminous with the financial year

Smallco Ltd has an accounting reference date and holiday year of 30 June. An employee is entitled to 30 days holiday per year and can carry forward up to five days holiday into the next holiday year. At the year end 30 June 2019, an employee has taken 27 days holiday.

An accrual is made for three days holiday entitlement which will be taken in the next accounting period.

Example – Holiday year not coterminous with the financial year

Smallco Ltd has a year end of 30 June 2019 and a holiday year which ends on 31 December 2019. An employee is entitled to 30 days holiday per year and at the financial year-end had taken 20 days of their entitlement.

A prepayment of five days holiday will be made in the financial statements for the year ended 30 June 2019 ((30 days x 6/12) – 20 days).

Paragraph 28.7 of FRS 102 states that an entity must recognise the cost of other **non-accumulating** compensated absences when the absences occur. The cost of such absences is measured at the undiscounted amount of salaries and wages paid or payable for the period of the absence.

In some cases, absences such as sick leave, may not be carried forward if they are unused (this applies to most entities). Where the balance cannot be carried forward to the next financial year/accounting period, no obligation is recorded in the financial statements.

5.6 Profit-sharing and bonus plans

Many entities provide profit-sharing and bonus plans to their employees and it is important that such arrangements are correctly accounted for in the financial statements. Paragraph 28.8 of FRS 102 outlines the recognition criteria for such arrangements and the expected cost of profit-sharing and bonus payments can only be recognised in the financial statements when:

- (a) *the entity has a present legal or **constructive obligation** to make such payments as a result of past events (this means that the entity has no realistic alternative but to make the payments); and*
- (b) *a reliable estimate of the obligation can be made.*

FRS 102 para
28.8(a) and (b)

The above recognition criteria may be familiar because they are consistent with the recognition criteria for a provision in the financial statements per Section 21 *Provisions and Contingencies*. For clarity, the term 'constructive obligation' is defined in the Glossary to FRS 102 as:

An obligation that derives from an entity's actions where:

- (a) *by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and*
- (b) *as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.*

FRS 102 Glossary
**constructive
obligation**

Example – Profit-sharing arrangement containing a vesting condition

Mediumco Ltd has a profit-sharing arrangement in place for its employees. The conditions stipulate that the entity will pay out a share of its profit to employees who serve throughout the year. Should no employees leave the entity during the year, the profit-sharing payment will be 2.5% of profit. The directors have assessed that, based on past experience, the number of staff which will leave the entity during the reporting period will reduce the profit-share to 2% of profit.

In this situation, Mediumco Ltd recognises a liability and an expense equivalent to 2% of profit.

5.7 Defined contribution pension plans

Defined contribution pension plans are dealt with in FRS 102 (March 2018) at paragraphs 28.13 to 28.13A. Defined contribution plans are easier to account for than defined benefit pension plans which are discussed in the next section.

Paragraph 28.13 of FRS 102 states:

An entity shall recognise the contributions payable for a period:

FRS 102 para 28.13

- (a) *As a liability, after deducting any amount already paid. If contribution payments exceed the contribution due for service before the reporting date, an entity shall recognise that excess as an asset to the extent that the prepayment will lead to a reduction in future payments or a cash refund.*
- (b) *As an expense, unless another section of this FRS requires the cost to be recognised as part of the cost of an asset such as inventories or property, plant and equipment.*

Paragraph 28.13A of FRS 102 then goes on to deal with contributions to a defined contribution plan which are not expected to be settled wholly within 12 months after the balance sheet date in which the employees render the related service. Paragraph 28.13A requires the liability to be measured at the present value of the contributions payable using the methodology for selecting a discount rate specified in paragraph 28.17 (i.e. having regard to market yields on high quality corporate bonds). The unwinding of the discount is recognised as a finance cost in profit and loss in the period in which it arises.

In practice, it is unlikely that the provisions in paragraph 28.13A will apply to companies in the UK because legislation governing pension schemes requires contributions to be paid on a prompt basis.

5.8 Defined benefit pension plans

Defined benefit pension plans are dealt with in FRS 102 (March 2018) in paragraphs 28.14 to 28.28. Such plans are complex to account for and they require actuarial information in order that the accounting input and associated disclosures can be made in the financial statements. This part of the course will not look in detail at defined benefit plan accounting, but will aim to flag up those key areas where there are difficulties under FRS 102.

FRS 102 is more relaxed in its requirements than previous UK GAAP at FRS 17 *Retirement benefits*. FRS 102 does not require the use of an independent actuary to perform the comprehensive actuarial valuation; nor does it require comprehensive annual valuations to be carried out. In practice, however, it is usually the case that an independent actuary is used and the valuation is obtained annually because the resulting surplus or deficit in the defined benefit pension plan can be significantly different year on year.

The key steps in dealing with a defined benefit pension plan are as follows:

Primary statement	Recognise
Balance sheet	A defined benefit liability, being the net of: <ul style="list-style-type: none"> the defined benefit obligation; less plan assets.
Profit and loss	Cost of the plan, including: <ul style="list-style-type: none"> current cost; past service cost; and interest cost.
Other comprehensive income	Remeasurements, including: <ul style="list-style-type: none"> actuarial gains and losses; return on plan assets (excluding amounts included in net interest on the net defined liability); and change in a surplus which is irrecoverable, excluding amounts included in net interest on the net defined liability.

A notable difference between FRS 102 and FRS 17 is the calculation of the interest taken to profit and loss. Under FRS 102, the calculation of the net interest charge is consistent with the requirements in IAS 19 and is essentially the interest cost on the defined benefit obligation less interest income on the plan assets. This excludes the effect of any surplus which is irrecoverable.

Under previous UK GAAP, FRS 17 took into account the expected return on plan assets when calculating the finance cost/credit. The rates used for the expected return on plan assets are generally higher than those on high quality corporate bonds which will usually mean the total pension charge in profit and loss will increase due to the change. As plan assets continue to be measured at fair value, any volatility in profit and loss will usually be compensated for in other comprehensive income.

Surpluses

In many cases, a defined benefit liability will be recognised on the balance sheet. However, some defined benefit plans are in a surplus position and care needs to be taken where the surplus is concerned.

A surplus can only be recognised on the balance sheet if that surplus is recoverable (this is to prevent an asset being recognised which is not recoverable). A surplus will be recoverable either through reduced contributions into the plan going forward; or by way of a refund from the plan.

Paragraph 28.22 of FRS 102 (March 2018) states that a surplus can only be recognised to the extent that the entity is able to recover the surplus. If the surplus is irrecoverable, it cannot be recognised. Any change in the amount of a defined benefit plan surplus which is not recoverable is recognised in other comprehensive income.

Careful scrutiny of the plan's agreement or Trust Deed will be needed where a plan surplus arises to check on the recoverability (or otherwise) of the surplus.

Group plans

At least one member in the group has to apply defined benefit accounting under FRS 102. Where there is a contractual agreement or stated policy for charging the net defined benefit cost, the individual financial statements of the group member recognises the cost so charged. If there is no such policy or agreement, the net defined benefit cost is recognised in the individual financial statements of the group entity which is the sponsoring employer for the plan.

The other group entities then recognise a cost equal to their contribution payable for the period.

Presentation (deferred tax)

Under previous FRS 17, defined benefit plans were presented in the balance sheet net of deferred tax consequences. There were specific rules which said that deferred tax attributable to the defined benefit pension plan were not to be aggregated and presented with other deferred tax assets and liabilities.

Paragraph 29.23 of FRS 102 states that an entity presents deferred tax liabilities within provisions for liabilities and deferred tax assets within debtors, unless it has chosen to present an adapted balance sheet.

FRS 102 is unclear as to whether an entity should present the gross asset or liability at the foot of the balance sheet. In practice, a net defined benefit liability is included at the foot of the balance sheet in much the same way as it was under previous FRS 17. Where deferred tax is concerned, it seems that most practitioners are defaulting to the actual wording in FRS 102 and including these within other deferred tax balances.

Summary of the accounting treatment for a defined benefit plan

	P&L	OCI	Plan assets	Plan liabilities	Plan deficit
Bal b/f 01.01.19			X	(X)	(X)
Contributions			X		X
Current service cost	X			(X)	(X)
Past service cost	X			(X)	(X)
Net interest on defined benefit liability	X		X	(X)	(X)
Actuarial gain or loss		X		(X)	(X)
Return on plan assets		(X)	X		X
Benefits paid			(X)	X	-
Bal c/f 31.12.19			<u>X</u>	<u>(X)</u>	<u>(X)</u>

5.9 Multi-employer defined benefit plans

In May 2019, the FRC issued amendments to FRS 102 because some multi-employer defined benefit plans (which were accounted for as defined contribution plans) had carried out exercises which enabled, for the first time, sufficient information to participating employers which allowed the use of defined benefit accounting. As a result participating employers are changing their accounting for these defined benefit plans (i.e. transitioning from defined contribution accounting to defined benefit accounting).

Prior to the amendments, FRS 102 did not specify clear requirements to address the transition from defined contribution accounting to defined benefit accounting in respect of a multi-employer defined benefit plan. The issue is that an entity which previously applied defined contribution accounting to such a plan and had entered into an agreement to fund a deficit would have recognised a liability in respect of that deficit. The question arose as to what to do with that liability on transition because a liability for an agreement to fund a deficit is not recognised when defined benefit accounting is applied (FRS 102, para 28.15A).

The amendments to FRS 102 now require the difference between any liability for the contributions payable arising from an agreement to fund a deficit and the net defined benefit liability recognised when applying defined benefit accounting to be recognised in other comprehensive income.

5.10 Other long-term employee benefits

Paragraph 28.29 of FRS 102 (March 2018) provides examples of long-term employee benefits which are not expected to be settled wholly before 12 months after the balance sheet date in which the employees render the related service as follows:

- (a) *long-term paid absences such as long-service or sabbatical leave;*
- (b) *other long-service benefits;*
- (c) *long-term disability benefits;*
- (d) *profit-sharing and bonuses; and*
- (e) *deferred remuneration.*

FRS 102 para 28.29
(a) to (e)

An entity will usually present other long-term employee benefits as creditors: amounts falling due after more than one year. It should be emphasised that where the employee benefit is presented (i.e. as either current or long-term) is based upon whether the entity has an **unconditional right** to defer settlement for at least 12 months from the balance sheet date so careful scrutiny of the transaction will be necessary to ascertain if this unconditional right to defer settlement for at least 12 months from the balance sheet date exists.

Paragraph 28.30 provides the accounting treatment for the liability, which is measured at the net total of the following amounts:

- (a) the present value of the benefit's obligation at the balance sheet date (calculated using the methodology for selecting a discount rate in paragraph 28.17 – i.e. on high quality corporate bonds); *less*
- (b) the fair value at the balance sheet date of the plan assets (if any) out of which the obligations are to be settled directly.

Changes in the liability are recognised in profit and loss, except to the extent that FRS 102 requires, or permits, the change to be included in the cost of an asset.

A notable difference between the accounting for a defined benefit plan and the accounting for long-term employee benefits is that all changes are recognised in profit and loss (unless the change is taken to the balance sheet to an asset such as inventory or property, plant and equipment). Remeasurement components in a defined benefit plan are taken to other comprehensive income, which is not the case for long-term employee benefits.

5.11 Termination benefits

Termination benefits are always recognised in profit and loss. They are not included in the cost of any assets because they do not provide the entity with any future economic benefits.

A commitment to pay termination benefits by the entity may arise because of legislation or other contractual terms. Usually, when an employee's employment is terminated prior to retirement, the employee will be entitled to

some form of termination payment (eg pay for services rendered up to the date of termination, unpaid holiday pay and a curtailment of retirement benefits/other employee benefits). They arise due to the entity terminating the employee's service rather than arising from the employee's rendering of services.

Paragraph 28.34 of FRS 102 says that an entity recognises termination benefits as a liability and as an expense only when the entity is demonstrably committed:

- (a) *to terminate the employment of an employee or group of employees before the normal retirement date; or*
- (b) *to provide termination benefits as a result of an offer made in order to encourage voluntary redundancy.'*

FRS 102 para 28.34
(a) and (b)

Paragraph 28.35 of FRS 102 then confirms that an entity is demonstrably committed to a termination only when the entity has a detailed formal plan for the termination and is without realistic possibility of withdrawal from the plan.

Measurement of termination benefits

An entity measures termination benefits at the best estimate of the expenditure which would be required to settle the obligation at the balance sheet date. Where offers are made to encourage voluntary redundancy, the obligation is measured based on the number of employees expected to accept the offer.

In cases where termination benefits are due more than 12 months after the balance sheet date, they are discounted to present value using the methodology for selecting a discount rate specified in paragraph 28.17 (i.e. having regard to market yields at the balance sheet date on high quality corporate bonds).

6 Small company exemption thresholds – examples (Lecture A687 – 20.50 minutes)

It is surprisingly common to see financial statements where small company exemptions have been used despite the company not being eligible to take them! Where a qualified accountant was involved in the preparation of the accounts this creates a major risk for them because their professional body expects them to check that a company is eligible for the small company exemptions that it applies.

Consequently, it is not unusual to see professional accountants being disciplined by ACCA or ICAEW for failings in this area.

This section is intended to remind accountants of the rules and how easy it is to get an assessment of eligibility wrong.

6.1 Small company exemption thresholds

The qualifying conditions to be small are met by a company (or group) in a year if it satisfies two or more of the following requirements:

- **Turnover** Not more than £10.2 million
- **Balance sheet total** Not more than £5.1 million
- **Average number of employees** Not more than 50

In order to qualify as small in any financial year (other than its first) the entity must:

- a) meet the qualifying conditions in the current year and the previous year; or
- b) meet the conditions in the current year and qualify as small in the previous year; or
- c) meet the conditions in the previous year and qualify as small in the previous year.

Note that, in the case of c), it does not have to satisfy the requirements in the current period.

Example 1

X Ltd incorporates on 1 July 2017. These are its results for its five periods ending on 31 December:

	2017	2018	2019	2020	2021
Turnover	£6.5m	£11.2m	£9.2m	£8.0m	£8.5M
Balance sheet total	£6.1m	£7.5m	£5.5m	£4.5M	£5.5M
Number of employees	40	45	51	45	45

Is the entity eligible to apply the small company accounting exemptions?

Is the entity eligible for small company audit exemption?

Example 2

The following data applies to the H Group for the year ended 31 December 2019. The group consists of H Ltd (parent) and three wholly owned subsidiaries – A Ltd, B Ltd and C Ltd.

	H Ltd	A Ltd	B Ltd	C Ltd
Turnover	£1m	£11m	£1m	£1m
Balance sheet total	£2m	£4m	£1m	£1m
Number of employees	10	55	10	10

The figures for the years 31 December 2018 and 31 December 2017 were the same as those shown above. There is no trading within the group and no balances with other members of the group.

Which of the companies qualify as a small company in 2019 and which of them qualify for audit exemption?

Example 3

My firm is the auditor of a UK subsidiary of Spanish holding company. The UK company has turnover and gross assets below the audit exemption thresholds and the directors wish to take advantage of audit exemption in order to reduce costs. The holding company has not requested an audit and has stated that they will be satisfied with a compilation report from my firm. The holding company auditor has also not requested that the subsidiary is audited.

Can the UK company directors take advantage of audit exemption when the company is part of a group?

Example 4

Currently, my firm is considering whether to accept appointment as advisors for a UK company who takes advantage of audit exemption. The company is a subsidiary of a holding company incorporated in an offshore jurisdiction where financial statements are not publicly available. The UK directors say that they do not have access to financial information for the holding company or other group companies.

Is this company eligible for audit exemption?

The solutions to these examples are in the Appendix to these notes.

7 IFRS 9 Financial Instruments (Lecture A688 – 9.54 minutes)

7.1 Application date

Reporting periods commencing on or after 1 January 2018. Early adoption was permitted subject to local endorsement requirements.

7.2 Overview

In July 2014, the IASB published the final version of IFRS 9 *Financial Instruments*, bringing together the classification and measurement, impairment and hedge accounting phases of its long-running project to replace IAS 39 *Financial Instruments: Recognition and Measurement*.

The package of improvements introduced by the new standard includes:

- adopting a principles-based approach to the classification and measurement of financial assets – driven by the business model in which the asset is held and its cash flow characteristics;
- adopting a more forward-looking ‘expected credit loss’ model to account for the impairment of financial assets;
- removing the counter-intuitive requirement that meant in certain instances an entity would recognise gains in the fair value of a financial liability in profit or loss when its own credit risk deteriorated and losses when it improved; and
- introducing a substantially-reformed approach to hedge accounting that better aligns the accounting treatment with an entity’s risk management activities.

All entities would have needed to carefully assess the extent to which their financial reporting would be affected by the new standard. While many of the changes will have the biggest impact on financial sector businesses (this area is not specifically considered in these notes), other corporates were advised not to underestimate the potential impact of the standard.

7.3 Key changes

The following table summarises the key changes made by IFRS 9:

Changes in IFRS 9	
Scope	<p>IFRS 9 applies to all types of financial instrument except those that fall under the requirements of other standards.</p> <p>The scope is very similar to IAS 39. However, the scope of IFRS 9’s impairment requirements is broader than that of its predecessor and includes items such as financial</p>

Changes in IFRS 9	
Recognition and initial measurement	<p>guarantee contracts that were previously measured under IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i> and contract assets under IFRS 15 <i>Revenue from Contracts with Customers</i> that are not otherwise within the scope of IFRS 9.</p> <p>Financial assets and financial liabilities are recognised when, and only when, the entity becomes party to the contractual provisions of the instrument.</p> <p>Generally, financial instruments are recognised initially at fair value plus or minus transaction costs. However, for financial instruments classified as measured at fair value through profit or loss, transaction costs are immediately expensed to profit or loss.</p>
Classification and measurement of financial assets	<p>These requirements are unchanged from IAS 39.</p> <p>Financial assets are classified and measured according to the business model in which they are held and their contractual cash flow characteristics. Accordingly, financial assets are classified and measured at amortised cost, fair value through other comprehensive income (FVTOCI) or fair value through profit or loss (FVTPL).</p>
Classification and measurement of financial liabilities	<p>The IAS 39 categories of held-to-maturity, loans and receivables, and available-for-sale are removed.</p> <p>Financial liabilities are classified and measured either at amortised cost or at FVTPL.</p> <p>This is unchanged from IAS 39. However, if an entity elects to take the fair value option, IFRS 9 requires – except in certain limited cases – gains or losses that are attributable to changes in the credit risk of the entity to be presented in other comprehensive income. Under IAS 39, all such gains and losses would have been recognised in profit or loss.</p>
Reclassification	<p>Under IFRS 9 it is clear that a gain or loss should be recognised at the time of a non-substantial modification whereas, under IAS 39, the required treatment was ambiguous and it was common practice to spread the difference over the remaining term of the liability.</p> <p>Except in the case of financial assets classified by irrevocable election, financial assets are reclassified if, and only if, the objective of the business model in which they are held changes significantly. Such changes are</p>

Changes in IFRS 9	
Impairment of financial assets	<p>expected to be infrequent. Reclassifications of financial liabilities are not allowed.</p> <p>IFRS 9 introduces a forward-looking 'expected loss' model, replacing IAS 39's 'incurred loss' model. Under IFRS 9, it is no longer necessary for a loss event to have occurred before credit losses are recognised. Instead, the standard requires an entity to recognise a loss allowance for financial assets (except those classified as FVTPL and equity investments designated as FVTOCI) based on expected credit losses. This means that there is generally a loss recognised in profit or loss at the first reporting date after initial recognition of the financial asset.</p>
Derecognition	<p>Financial assets are derecognised when, and only when, the contractual rights to the cash flows from the asset expire, or the asset is transferred and the transfer qualifies for derecognition.</p> <p>Financial liabilities are derecognised when, and only when, the obligation within the contract is discharged, cancelled or expires. Certain exchanges and modifications of financial liabilities may also result in derecognition. These requirements are largely unchanged from IAS 39, although there is clarification relating to the recognition of gains and losses following a non- substantial modification of a financial liability.</p>
Disclosures	<p>Disclosure requirements for financial instruments are detailed in IFRS 7 <i>Financial Instruments: Disclosures</i>, including numerous requirements for the reporting period that includes the date of initial application of IFRS 9.</p>

8 Ethical issues for auditors – common problems (Lecture A689 – 23.52 minutes)

This section examines some of the more common ethical issues for auditors, but it does not consider the requirements for either listed audits or Public Interest Entities (PIEs).

8.1 Non-audit services – prohibited services

When auditing entities that are not (PIEs) or listed there are many non-audit services that auditors can provide which are not prohibited (although appropriate safeguards are often required).

When the FRC's *Ethical Standard* (ES) was introduced in 2016 it created two problem prohibitions which relate to providing tax advocacy services and certain tax services where contingency fees are charged.

Additionally, auditors providing valuation services has been problematic for a while. The ES makes the point that the auditor cannot undertake a valuation that is both material and involves significant subjective judgement.

8.2 Non-audit services – applying safeguards

Auditors, particularly of smaller entities, often provide non-audit services such as accountancy and corporation tax compliance. In addition VAT, PAYE and other similar services are also common.

These services tend not to be prohibited when provided to unlisted companies and non-PIEs, but there are certain conditions that must be met:

- The auditor has to identify and document the name(s) of informed management.
- The nature of the services provided need to be documented – note that some non-audit services will be prohibited such as accountancy services which involve creating originating documentation or that forms part of the entity's internal control environment.
- Threats to independence must be identified and documented – sometimes the threats might be so great that they cannot be managed with safeguards and either the service should not be provided or the auditor should withdraw from the engagement.
- Appropriate safeguards need to be applied – for certain non-audit services, safeguards are always required.

Question 1 – Ask the audience

Company A Ltd maintains good accounting records and prepares accurate and complete management accounts. It adjusts for accruals, prepayments, depreciation, stock, warranty provisions, bad debts, tax, deferred tax etc. Everything balances!

However, Company A does not have the expertise to put its financial statements in Companies Act format and draft the relevant disclosures and they ask the auditors to do this. Few adjustments are needed to the reported results in the management accounts.

What are the independence considerations that the auditor must consider?

Question 2 – Ask the audience

Company B Ltd needs significant assistance with the preparation of the financial statements, corporation tax returns, VAT and PAYE. Nothing balances!

What are the independence considerations that the auditor must consider?

Note: Neither of the above questions have a written answer, because different audit firms approach these issues in different ways and have different policies. A written answer might confuse people if it suggested a different approach to that adopted by a particular firm.

However, what these examples should illustrate is the need to document the nature of the non-audit services and identify the threats and appropriate safeguards on a case-by-case basis.

8.3 Long association and the 10-year rule

For listed audit clients there is a requirement for mandatory audit partner rotation. However, there is no equivalent requirement for unlisted audit engagements.

For unlisted clients, once an audit engagement partner has held this role for a continuous period of ten years, careful consideration must be given as to whether a reasonable and informed third party would consider the audit firm's objectivity and independence to be impaired. The ES does not demand rotation of the partner at this point but, in the absence of rotation, it requires either safeguards to be applied or, in the absence of safeguards, the audit firm must document the reasons why the partner continues to participate in the audit engagement without safeguards and these facts are communicated to those charged with governance of the client.

For example, the following documentation might be seen on an audit file.

Dover Transport Ltd – extract from audit file - example

The audit partner, Mr Georghegan, has been the audit engagement partner for 22 years for Dover Transport Ltd (DTL). DTL is a large client and the partner spends approximately 20 hours a year working on the audit, accounts, tax and other services for this client.

Long association has led to a familiarity threat and the safeguard applied is a second partner review by Mrs Coleman the compliance partner.

Rainbow Ltd – extract from audit file - example

Rainbow Ltd is a small charity and Mrs Ramillies has been the audit engagement partner for 10 years. It is a pure audit with a fee of £3,000 per annum and the partner's involvement is only three hours a year. The audit senior who does most of the audit work has only been doing the audit for the past two years

There is no significant threat to independence arising from long association, partly because long association has not caused any particular over-familiarity on the part of Mrs Ramillies and partly because the audit senior has only been doing this audit for two years. The client has been informed of this issue.

Note: In this example the new audit senior is seen as reducing the partner's long association threat. In practice the effect of this can sometimes be overstated and perhaps a second partner review is needed as a safeguard

8.4 Gifts and hospitality

The ES deals with the issue of gifts and hospitality in paragraphs 4.61D to 4.65. Paragraph 4.61D of the ES states:

A firm, its partners and any covered person, and persons closely associated with them, shall not solicit or accept pecuniary and non-pecuniary gifts or favours, including hospitality, from an entity relevant to the engagement, or any other entity related to that entity, unless an objective, reasonable and informed third party would consider the value thereof as trivial or inconsequential.

FRC Ethical
Standard
paragraph 4.61D

Paragraph 4.62 of the ES then goes on to confirm that when gifts, favours or hospitality are accepted from an audit client, or from others related to the audit client, a self-interest and familiarity threat to integrity, objectivity and independence are created. In addition, familiarity threats are also created where gifts, favours or hospitality are offered to an audit client, its partners or any other covered person.

What do you think about the following scenarios?

Scenario 1

The financial statements of North Co Ltd for the year ended 31 August 2019 have just been approved and the auditor's report thereon signed by the audit engagement partner. The chief executive officer of North Co has offered to take the audit engagement partner out for a business lunch at North Co's expense.

Scenario 2

An audit client has a staff canteen or a dining room, and the audit staff are invited to use these facilities at lunchtime, free of charge.

Scenario 3

The audit manager is invited to their audit client's staff Christmas party.

Paragraph 4.63 of the ES states:

The firm shall establish policies on the nature and value of gifts, favours and hospitality that may be accepted from and offered to an entity relevant to an engagement, or any other entity related to that entity, their directors, officers and employees, and shall issue guidance to assist partners and staff to comply with such policies.

*FRC Ethical
Standard
paragraph 4.63*

Where gifts and hospitality are accepted by the audit firm, or are offered more than once, the view of an objective, reasonable and informed third party of the **cumulative** effect is considered. Therefore, to comply with this requirement, a record of such gifts and hospitality (and offers thereof) should be retained by the audit firm.

When there is any doubt as to the acceptability of gifts, favours or hospitality by the audit team, the team must discuss the situation with the engagement partner. Where the audit engagement partner has any doubts as to the acceptability of gifts, favours or hospitality, he/she must refer the issue to the firm's ethics partner/ethics function. Whenever there are doubts in such cases, it would always be advisable to decline the offer as, in such cases, if there are doubts in the minds of the audit engagement team, it is usually the case that the view of an objective, reasonable and informed third party would be that an ethical threat has been created.

9 Audit exemption for subsidiary companies (Lecture A690 – 12.46 minutes)

9.1 Background

For accounting periods ending on or after 1 October 2012, companies that are subsidiaries of EEA parents will, irrespective of size, be entitled to audit exemption subject to fulfilment of a number of detailed conditions. The most onerous of these conditions is that the parent undertaking must give a guarantee under section 479C in respect of the liabilities of the subsidiary.

9.2 Brexit

At the time of writing the future of this exemption for holding companies outside the UK is in doubt. A no-deal Brexit would remove the exemption for all companies except those with a UK holding company who gives the guarantee.

9.3 Refresher Q&As

The legislation has given rise to a number of practical questions and some of these are included below.

Q1. My client is a subsidiary of a parent company based in Guernsey. Can they take advantage of audit exemption as a subsidiary company of an EEA parent?

No. See quote below from www.gov.gg:

'Guernsey is neither a separate Member State nor an Associate Member of the European Union. The terms relating exclusively to the Channel Islands and the Isle of Man were subsequently embodied in Protocol No. 3 of the Treaty of Accession of the United Kingdom to the EEC, signed on 22 January 1972.'

Further extracts from that website are:

Protocol No. 3 placed the Channel Islands and the Isle of Man within the Common Customs territory of the Community and the Common External Tariff of the European Economic Community. Broadly speaking this means that no customs duties are applied to goods exported to members of the customs union but a common customs tariff applies to goods imported into the customs union from non-member countries.

Protocol 3 also provides that Guernsey is 'within' the EU for most of the purposes of the free movement of goods but outside the EU for other purposes, in particular non-customs related fiscal matters and the free movement of persons and services. The Island is not eligible for assistance from the Union's structural funds or under the support measures for agricultural markets.

Ratification of the EEA Agreement by the United Kingdom had the effect of extending the Agreement to the Crown Dependencies from 1 January 1995, by

virtue of the Community Treaties enshrined in the UK Treaty of Accession. However, the EEA Agreement applies to the Crown Dependencies only to the extent that is consistent with Protocol 3.

Q2: If one subsidiary in a group wishes to take advantage of audit exemption, is it necessary for all subsidiaries in the group to take advantage of audit exemption?

No.

Q3: X Ltd is a subsidiary of a parent company in Germany. The ultimate parent company is based in the USA. Can X Ltd take advantage of audit exemption under S479A and, if so, which parent needs to provide the guarantee?

X Ltd is entitled to audit exemption under S479A. The German parent will provide the guarantee.

One possible sticking point is that X Ltd must be included in accounts drawn up by the German parent and these must be filed in the UK with a translation into English or Welsh. It may be that the German company enjoys an exemption from preparing group accounts (similar to our exemption in S401 of CA 2006) and are not willing to prepare them for this purpose.

In passing, what would the situation be if the immediate parent was the US company and the ultimate parent was the company in Germany? In this case, X Ltd could still claim exemption. The German parent will provide the guarantee and include X Ltd in the group accounts.

The reason why this is the case can be found in s1162, CA 2006. Subsection 2 gives the general definition of a parent, holding a majority of the shares etc. Subsection 3 then goes on to say: *'For the purposes of subsection (2) an undertaking shall be treated as a member of another undertaking if any of its subsidiary undertakings is a member of that undertaking.'*

So where you have Company A which owns Company B which owns Company C, then Company A is the parent of C for the purposes of claiming exemption under s479A. A parent company can therefore be the ultimate parent or any intermediate parent in the chain.

Q4: My client is a UK company which is the parent of a UK group. It is keen to adopt audit exemption for all of its subsidiaries. They have asked whether the guarantee required under S479C can follow a standard form or whether they need to take their own legal advice.

Companies are required to confirm the guarantee for each year to Companies House. The guarantee statement should be prepared by a solicitor. Apparently, there are legal difficulties in having a standard guarantee that all companies could use.

This cost was envisaged by the government when BIS (as it was previously known) published the government's response to its consultation in September 2012. This included the following comments:

'The Impact Assessment anticipates there may be a one-off cost for external legal and accounting advice in the range of £2,000–£5,000 per group holding company when the guarantee is first made and valued, and a subsequent ongoing annual cost for internal legal advice regarding the continued provision of the guarantee.'

'However, in accordance with responses from consultees for more clarity as to the guarantee, the legislation implementing the policy provides that the parent guarantee is given under statute. This should make it more straightforward for parents and creditors, and reduce the legal advice necessary.'

'In terms of ongoing costs, the Impact Assessment estimates that each group will require 4-10 hours of internal legal advice.'

We wait to see developments in this area but, at the moment, the only advice you could give to a client is that they need to take legal advice.

Q5. What debts are covered by the guarantee? Is it just the debts in the subsidiary's balance sheet or does it go further than that?

S479C(3) of the CA 2006 states:

'A guarantee given under this section has the effect that:

- (a) the parent guarantees all outstanding liabilities to which the subsidiary is subject at the end of the financial year to which the guarantee relates, until they are satisfied in full, and*
- (b) the guarantee is enforceable against the parent undertaking by any person to whom the subsidiary company is liable in respect of those liabilities.'*

The guarantee is in force for all liabilities that exist at the balance sheet date until they are satisfied. Notice that the above quote does not refer to liabilities recognised in the balance sheet therefore we need to consider other possible amounts as well.

The article *'Every rose has its thorn'* published in *Audit and Beyond* addresses this question somewhat. It says that, although the Regulations fail to define *'all outstanding liabilities'*, the Consultation Report indicates that the wording of the guarantee is deemed to cover liabilities in tort and contingent liabilities.

Contingent liabilities will not be recognised in the balance sheet (if they were we would call them provisions) and may not even be disclosed (if they are remote). The contingent liability arising in 2012 could come back to haunt the parent company many years in the future.

What about obligations under operating leases as disclosed in the notes to the accounts? We know that they do not need to be recognised as liabilities in the balance sheet but are they *'liabilities to which the subsidiary is subject at the end of the financial year'*? If so, they are caught within the guarantee.

Liabilities with respect to finance leases are included in the balance sheet net of interest costs which are not yet due but are these future interest costs *'liabilities to which the subsidiary is subject at the end of the financial year'*?

Observe also that the guarantee could relate to liabilities arising in previous years since the guarantee covers all outstanding liabilities to which the subsidiary is subject at the end of the financial year not just the ones that arose during the financial year.

So, to quote the article again: *'the liabilities guaranteed can stretch endlessly into the past and the parent remains potentially liable for these liabilities infinitely into the future'*.

And this indefinite future survives even the sale of the subsidiary – although presumably the sale agreement could arrange for the new owners to take over the guarantee from the previous owners.

This uncertainty over the scope of the guarantee is another reason why the parent should seek legal advice before going ahead.

10 Going concern requirements strengthened (Lecture A691 – 7.04 minutes)

In September 2019, the Financial Reporting Council (FRC) issued a revised version of ISA (UK) 570 *Going Concern* which becomes effective for audits of financial statements for periods commencing on or after 15 December 2019. Early adoption is permitted.

This revised ISA (UK) has been extensively amended in light of the well-publicised criticisms of the auditing profession. ISA (UK) 570 (Revised September 2019) increases the work which auditors are required to do when auditing the going concern status of an entity.

10.1 Responsibilities of the auditor

The previous version of ISA (UK) 570 stated at paragraph 6 that the auditor's responsibilities are to '... obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting ... and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.' This responsibility still applies under the revised ISA (UK) 570 but paragraph 6 has been restructured so it is clearer to understand.

10.2 Definitions

ISA (UK) 570 (Revised September 2019) contains defined terms in paragraph 9-2 which defines 'management bias' and a 'material uncertainty related to going concern' as follows:

Management bias – A lack of neutrality by management in the preparation of information.

ISA 570 (Revised
September 2019)
para 9-2

Material uncertainty related to going concern – An uncertainty related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern, where the magnitude of its potential impact and likelihood of occurrence is such that appropriate disclosure of the nature and implications of the uncertainty is necessary for:

- (i) in the case of a fair presentation financial reporting framework, the fair presentation of the financial statements; or*
- (ii) in the case of a compliance framework, the financial statements not to be misleading.*

10.3 Extended auditor's responsibilities

The risk assessment procedures and related activities section of ISA (UK) 570 (Revised September 2019) has been significantly increased. ISA (UK) 570 (Revised September 2019) requires the auditor to obtain an understanding of:

- the entity and its environment;

- the applicable financial reporting framework; and
- the entity's system of internal control.

In addition, if the auditor identifies events or conditions which may cast significant doubt on the entity's ability to continue as a going concern which management has not previously identified or disclosed to the auditor, ISA (UK) 570 (Revised September 2019) requires the auditor to:

- a) request management to perform additional procedures to understand the effect of the events or conditions on management's going concern assessment;
- b) inquire as to why management's going concern assessment failed to identify or disclose the events or conditions; and
- c) perform additional audit procedures relating to the newly identified events or conditions.

10.4 Evaluating management's assessment of going concern

The auditor is still required to obtain sufficient appropriate audit evidence to identify whether events or conditions exist which may cast significant doubt on the entity's ability to continue as a going concern and identify whether, or not, a material uncertainty exists. In addition, the auditor is also still required to obtain sufficient appropriate audit evidence concerning the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

The auditor's responsibilities are extended further as ISA (UK) 570 (Revised September 2019) also requires the auditor to:

- evaluate the method used by management in assessing the entity's ability to continue as a going concern, including determining if:
 - the method selected is appropriate in the context of both the financial reporting framework and the auditor's understanding of the entity;
 - changes from the method used in prior periods are appropriate; and
 - whether the calculations are applied in accordance with the method and are mathematically accurate;
- evaluate the relevance and reliability of the underlying data used to make the assessment;
- evaluate the assumptions on which management's assessment is based which requires the auditor to determine whether there is adequate support for the assumptions underlying management's assessment which includes determining:

- whether the assumptions are appropriate in the context of the applicable financial reporting framework and, where applicable, changes from the prior period are appropriate; and
 - whether the assumptions are consistent with each other and with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit;
- evaluating management's plans for future actions in respect of going concern, including evaluating whether the outcome of these plans is likely to improve the situation and whether they are feasible;
- considering whether any additional facts or information have become available since the date on which management made its assessment; and
- requesting written representations from management and, where appropriate, those charged with governance, concerning their plans for future actions and the feasibility of those plans.

The auditor is also required to make greater use of the entity's viability statement where one is produced.

10.5 Reporting

ISA (UK) 570 (Revised September 2019) uses the words 'appropriate' and 'appropriateness' in terms of the disclosures made in the financial statements relating to going concern rather than 'adequate' and 'adequacy'.

Use of the going concern basis is inappropriate

As is currently the case, if the financial statements have been prepared on a going concern basis, but, in the auditor's judgement, this basis is inappropriate, the auditor expresses an adverse opinion.

It is worth noting that where the entity does conclude that the going concern basis is inappropriate and is preparing its financial statements under FRS 102, it would not be appropriate to use the 'break up' basis to prepare the financial statements as this basis is inconsistent with FRS 102. A basis other than the going concern basis would be required and the basis on which the financial statements have been prepared will be disclosed in the financial statements.

Use of the going concern basis is appropriate

Where the auditor concludes that the going concern basis is appropriate, the auditor must include a section in the auditor's report headed up 'Conclusions related to going concern' or other appropriate heading and include:

- where there is no material uncertainty related to going concern (see below), a statement that the auditor has not identified a material uncertainty related to events or conditions which, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern for a period of at

least 12 months from the date on which the financial statements are authorised for issue (not 12 months from the balance sheet date);

- a conclusion that management's use of the going concern basis is appropriate;
- where the entity is required to, or voluntarily chooses to, report under the UK Corporate Governance Code, or to explain why they have not, the auditor is required to state that they have nothing material to add or draw attention to in respect of the directors' statement in the financial statements about whether the directors considered it appropriate to adopt the going concern basis of accounting in preparing the financial statements; and
- for public interest entities, other listed entities, entities that are required, and those that voluntarily choose to report on how they have applied the UK Corporate Governance Code, and other entities which are subject to the governance requirements of The Companies (Miscellaneous Reporting) Regulations 2018 (SI 2018/800), an explanation as to how the auditor evaluated management's assessment of the entity's ability to continue as a going concern and, where relevant, key observations arising with respect to that evaluation.

Use of the going concern basis is appropriate but a material uncertainty exists

Where management have made appropriate disclosures in the financial statements, the auditor expresses an unmodified (unqualified) opinion. The auditor's report must include a section headed up 'Material Uncertainty Related to Going Concern' (which is currently the case under ISA (UK) 570 (Revised June 2016)) which:

- draws attention to the relevant note in the financial statements that discloses the material uncertainties;
- states that these events or conditions indicates a material uncertainty exists and that it may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's report is not modified in respect of this matter; and
- for entities which are required, or voluntarily choose to, report on how they have applied the UK Corporate Governance Code, or to explain why they have a not, a statement that the auditor has nothing material to add or draw attention to in respect of the directors' identification in the financial statements of any material uncertainties to the entity's ability to continue to do so over a period of at least 12 months from the date of approval of the financial statements.

Auditors must keep in mind that it is not correct to use an emphasis of matter paragraph where material uncertainties related to going concern have been appropriately/adequately disclosed in the financial statements. Such issues must be included under a Material Uncertainty Related to Going Concern paragraph which acts in a similar way to an emphasis of matter paragraph but is not an emphasis of matter paragraph. The paragraph must cross-reference to the relevant disclosure note in the financial statements and must confirm that the auditor's opinion is not modified (qualified) in respect of this matter.

It should also be noted that the use of a Material Uncertainty Related to Going Concern paragraph is only used when **adequate** or **appropriate** disclosure has been made in the financial statements. If inadequate/inappropriate disclosure has been made, the auditor's report will be modified (qualified) accordingly.

Appropriate disclosure has not been made in the financial statements

Where the entity has not made appropriate disclosures in the financial statements about a material uncertainty related to going concern, the auditor expresses a qualified opinion or adverse opinion in accordance with ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report* as appropriate.

11 Attendance at stocktakes (Lecture A692 – 4.49 minutes)

The December 2019 reporting season is almost upon us and auditors will be considering the planning for their December year end audits, particularly attendance at the client's stock count.

Auditors are required to attend stock counts when the value of stock and work in progress is material to the financial statements. Attendance at stock counts is dealt with in ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items*. It should be noted that the previous Practice Note 25 which dealt with attendance at stocktaking was withdrawn in December 2018 because much of this guidance is now dealt with in ISA (UK) 501.

The overarching objective to attending the stock count is for the auditor to gather evidence to cover the following assertions:

- existence;
- valuation;
- completeness; and
- rights and obligations.

11.1 Objective of ISA (UK) 501

ISA (UK) 501 requires the auditor to:

- attend the physical stock count (unless impracticable), if inventory is material to the financial statements; and
- perform procedures on the final inventory records to determine whether they accurately reflect the count results.

It is not the responsibility of the auditor to carry out the stock count. The auditor's responsibility is to evaluate management's instructions and procedures for the count; observe the performance of the count; inspect the inventory and perform test counts.

11.2 Prior to the stock count

Before the auditor attends the stock count, they must undertake an element of planning which would normally include:

- performing analytical procedures and discussing any significant variances with management;
- discussing stocktaking arrangements and procedures with management;
- familiarising themselves with the nature of the inventory, volume, identification of high value items and the general accounting method of stock valuation;
- considering the location of the stock;

- considering the quantity and nature of work in progress, quantity of stocks held by third parties and whether an auditor's expert may be required;
- considering the internal controls relating to stocks to identify problems areas (e.g. problems in relation to cut-offs);
- considering whether any internal audit function exists and deciphering the extent to which reliance can be placed on internal audit;
- reviewing the results of previous stock counts; and
- reviewing the prior year audit working papers.

Paragraph 4 of ISA (UK) 501 requires the auditor to attend the stock count if the value of the stock at the balance sheet date is (likely to be) material to the financial statements. Primarily the attendance at stock count is that of an observation test, i.e. to observe whether the procedures adopted by management would reduce the risk of material misstatement in the final stock valuation.

The auditor is required to obtain sufficient and appropriate audit evidence regarding the existence and condition of the inventory, in addition to other procedures, unless physical attendance at the stock count is impracticable.

11.3 During the inventory count

Auditors should attend the inventory count whilst the count is underway as one of the objectives is to ensure that management's instructions are being carried out correctly. Auditors must also ensure that:

- inventory 'teams' are in place so that one person counts whilst another person records the quantities on the 'rough' stock sheets;
- no movements of inventory take place during the count;
- sequentially numbered count sheets and a sequence check is performed of these stock sheets once the count is complete;
- count sheets show the description of the goods but do not show the quantities expected to be counted; and
- damaged and/or obsolete items are separately identified so they can be valued appropriately.

The auditor will usually use an audit programme to undertake the work; however, the auditor should carry out some substantive procedures during the audit which often include:

- selecting a sample of items from the inventory count sheets and physically inspecting the items in the warehouse (this verifies **existence**);
- selecting a sample of physical items from the warehouse and tracing to the inventory count sheets to ensure that they are recorded accurately (this verifies **completeness**);
- enquiring of management whether goods held on behalf of third parties are segregated and recorded separately (this verifies **rights and obligations**);

- inspecting the inventory being counted for evidence of damage or obsolescence that may affect estimated selling price (this verifies **valuation**);
- recording details of the last deliveries prior to the year end. This information will be used in final audit procedures to ensure that no further amendments have been made thereby overstating or understating inventory (this verifies **completeness and existence**);
- obtaining copies of inventory count sheets at the end of the inventory count, ready for checking against the final inventory listing after the inventory count (this verifies **completeness and existence**); and
- attending the inventory count (if one is to be performed) at the third party warehouses (this verifies **completeness and existence**).

The timing of the stock count is a critical factor to consider. For example, the client may have an accounting reference date of 31 December, but the year end inventory count may not be undertaken on this particular day (it may be carried out before or after 31 December) and therefore additional procedures may need to be carried out by the auditor, such as roll-back or roll-forward procedures.

The auditor must consider the controls in place over the count. For example, whether the teams carrying out the inventory count are objective and have the necessary experience; what controls the client has over the stock and the susceptibility of stock to theft or deterioration; the degree of fluctuation in stock levels and whether there are any inherent difficulties when it comes to estimates included in the stock valuation.

Sources of evidence relating to the existence of stocks are:

- evidence from audit procedures relating to the reliability of accounting records upon which the stock valuation in the financial statements is based;
- evidence from tests of controls over stock, including the counting procedures; and
- substantive evidence from physical inspections at the stock count.

Where the entity does not maintain detailed stock records, the quantification of stock is likely to be based on a full, physical stock count at the balance sheet date, or very close to the balance sheet date. Evidence to satisfy the existence assertion is therefore greater when the stock count is carried out at the year end, or at a date very close to the year end. This could well provide sufficient and appropriate audit evidence; however the auditor must also be satisfied that the records of stock movement are also reliable in the intervening periods.

11.4 After the inventory count

The auditor is required to carry out certain procedures after the inventory count, which are normally carried out during the detailed audit fieldwork on the financial statements. Such procedures include:

- tracing the items counted during the inventory count to the final inventory list to ensure it is the same as the one used at the year end and to ensure

that any errors identified during counting procedures have been rectified (this verifies **completeness**);

- casting the list to ensure arithmetical accuracy and agree the total valuation to the financial statements and relevant disclosures (this verifies **completeness** and **classification**);
- inspecting purchase invoices for a sample of inventory items to agree their cost (this verifies **valuation**);
- inspecting purchase invoices to ensure the goods are in the name of the client (this verifies **rights**);
- inspecting post year end sales invoices for a sample of inventory items to determine if estimated selling price is reasonable. This will also assist in determining if inventory is held at the lower of cost and estimated selling price less costs to complete and sell (this verifies **valuation**);
- inspecting the ageing of the inventory items to identify old and/or slow-moving amounts that may require an allowance and discussing these with management (this verifies **valuation**);
- recalculating work in progress and finished goods valuations using payroll records for labour costs and utility bills for overhead absorption (this verifies **valuation**);
- tracing the goods received immediately prior to the year end to year end creditors and inventory balances (this verifies **completeness** and **existence**);
- tracing goods despatched immediately prior to the year end to the nominal ledger to ensure the items are not included in stock and sales (and debtors where relevant) have been recorded (this verifies **completeness** and **existence**);
- calculating inventory turnover/days ratio and comparing this to the prior year to assess whether inventory is being held longer and therefore requires a provision to bring the value down to the lower of cost and estimated selling price less costs to complete (this verifies **valuation** and is an analytical procedure); and
- calculating gross profit margins and comparing this to the prior year. The auditor should investigate any significant differences which may highlight an error in cost of sales and closing stock (this verifies **valuation** and is an analytical procedure).

11.5 Stock held at third parties

Where a third party holds stock on behalf of the client the auditor should obtain external confirmation from the third party of the quantity and condition of the goods to confirm **rights** and **obligations**.

If the goods held by the third party are material, the auditor should attend the inventory count to verify **existence** of the inventory.

The auditor may also obtain a report from the third party's auditors confirming the reliability of the internal controls at the third party.

12 Auditors' unmodified opinion

Auditor reporting is dealt with in the ISAs (UK) in the 700 series as follows:

- ISA (UK) 700 (Revised June 2016) *Forming an Opinion and Reporting on Financial Statements*
- ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's report*
- ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report*
- ISA (UK) 706 (Revised June 2016) *Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report*
- ISA (UK) 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements*
- ISA (UK) 720 (Revised June 2016) *The Auditor's Responsibilities Relating to Other Information*

12.1 Objective of the auditor

According to ISA (UK) 700, para 6, the objectives of the auditor are:

- (a) *To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and*
- (b) *To express clearly that opinion through a written report.*

ISA (UK) 700, para 6

Notwithstanding the recent criticism of the auditing profession, the importance of the independence of the auditor cannot be overstated as it is fundamental to the level of confidence that the auditor's report is appropriate. The auditor's report is usually included in the 'front end' of the annual report in order that it is given prominence.

12.2 Reasonable assurance

The auditor cannot express absolute assurance that the financial statements are completely correct. This is because of the inherent limitations of an audit, examples of which are as follows:

- the financial statements include subjective estimates and other judgemental matters;
- the auditor may rely on the entity's internal controls which have their own inherent limitations;
- representations from management may have to be relied upon as the only source of evidence in some areas;
- audit evidence is persuasive not conclusive; and
- the auditor does not test all transactions and balances – they carry out substantive testing on a sampling basis.

Part of the 'expectations gap' is that the general public believe that the auditors test all transactions as well as believing that auditors must detect fraud. Some members of the public also believe that the responsibility for preparing the financial statements rests with the auditors when, in reality, this responsibility is management's.

To that end, auditors only ever express **reasonable** assurance in their report. This is a high level of assurance but is not a 100% guarantee that the financial statements are completely correct.

12.3 Forming an opinion on the financial statements

The auditor must evaluate whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework (e.g. FRS 102 or IFRS). This evaluation must also include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

ISA (UK) 700, para 13 states that the auditor must evaluate whether:

- (a) *The financial statements appropriately disclose the significant accounting policies selected and applied. In making this evaluation, the auditor shall consider the relevance of the accounting policies to the entity, and whether they have been presented in an understandable manner;*
- (b) *the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;*
- (c) *the accounting estimates made by management are reasonable;*
- (d) *the information presented in the financial statements is relevant, reliable, comparable, and understandable. In making this evaluation, the auditor shall consider whether:*
 - *The information that should have been included has been included, and whether such information is appropriately classified, aggregated or disaggregated, and characterized.*
 - *The overall presentation of the financial statements has been undermined by including information that is not relevant or that obscures a proper understanding of the matters disclosed.*
- (e) *The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and*
- (f) *The terminology used in the financial statements, including the title of each financial statement, is appropriate.*

ISA (UK) 700, para 13

An auditor is required to form an opinion as to whether the financial statements give a true and fair view (unmodified opinion) or whether they contain material misstatement (modified opinion). The types of opinion are:

- **Unmodified (unqualified) opinion** which states that the financial statements give a true and fair view and have been prepared in compliance with relevant legislative requirements and UK GAAP.
- **Modified opinion** which can be qualified 'except for', adverse or disclaimer of opinion depending on the severity of the issue giving rise to the modified opinion.

This section of the course concentrates on the unmodified auditor's opinion.

12.4 Content of an unmodified auditor's report

The auditor's report must be in writing and contain the following elements:

- **Title** – the auditor's report must have a title that clearly indicates that it is the report of an independent auditor.
- **Addressee** – the auditor's report must be addressed, as appropriate, based on the circumstances of the engagement (e.g. to the shareholders or members of the entity).
- **Auditor's opinion** – this section contains the auditor's opinion on the financial statements and must also:
 - identify the entity whose financial statements have been audited;
 - state that the financial statements have been audited;
 - identify the title of each statement comprising the financial statements;
 - refer to the notes, including the summary of significant accounting policies; and
 - specify the date of, or period covered by each financial statement comprising the financial statements.
- **Basis for opinion** – the basis for opinion paragraph must state that the audit was conducted in accordance with the ISAs (UK) and applicable law and refer to the section of the auditor's report which describes the auditor's responsibilities under the ISAs (UK). It must also include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements and has fulfilled the auditor's other responsibilities in accordance with these requirements. The section must also state whether the auditor believes that the audit evidence is sufficient and appropriate to provide a basis for the auditor's opinion.
- **Going concern** – the auditor must report in accordance with ISA (UK) 570 (Revised June 2016 or Revised September 2019) *Going Concern*.
- **Key audit matters** – for audits of listed entities, the auditor must communicate key audit matters in the auditor's report in accordance with ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report*.

- **Other information** – where applicable, the auditor must report in accordance with ISA (UK) 720 (Revised June 2016) *The Auditor's Responsibilities Relating to Other Information*.
- **Responsibilities for the financial statements** – the auditor's report must include a section headed up 'Responsibilities of Management for the Financial Statements' (or equivalent according to the particular legal framework) which describes management's responsibility for:
 - preparing the financial statements in accordance with the applicable financial reporting framework and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, where appropriate, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.
- **Auditor's responsibilities for the audit of the financial statements** – this section of the report clarifies that the auditor is responsible for expressing reasonable assurance as to whether the financial statements give a true and fair view and express that opinion in the auditor's report. The section also describes the auditor's responsibilities in respect of risk assessment, internal controls, going concern and accounting policies.

Note – in the UK, the auditor is permitted to cross-refer to the applicable version of a 'Description of the Auditor's Responsibilities for the Audit of the Financial Statements' that is maintained on the website of an appropriate authority (e.g. the FRC).

- **Other reporting responsibilities** – this section of the report highlights additional reporting responsibilities, if applicable. This usually includes reporting on the adequacy of the accounting records, internal controls or other information published in the financial statements. Where the auditor is required to report by exception on certain matters, the auditor must describe the auditor's responsibilities for such matters and incorporate a suitable conclusion in respect of such matters.
- **Name of the engagement partner** – the name of the audit engagement partner must be included in the auditor's report of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat. In circumstances which the auditor intends not to include the name of the audit engagement partner in the

auditor's report, the auditor must discuss this intention with those charged with governance to inform them of the auditor's assessment of the likelihood and severity of a significant personal security threat.

- **Signature of the auditor** – the auditor's report must be signed.
- **Auditor's address** – the auditor's report must include the location in the jurisdiction where the auditor practises.
- **Date** – the auditor's report must be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base their opinion. Any information which comes to light after this date will not have been considered by the auditor when forming their opinion.

An unmodified (unqualified) auditor's opinion can also include additional paragraphs which do not affect the opinion including:

- An emphasis of matter paragraph
- A Material Uncertainty Related to Going Concern paragraph
- An Other Matters paragraph

12.5 Emphasis of matter paragraphs

Emphasis of matter paragraphs are dealt with in ISA (UK) 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. An emphasis of matter paragraph is used by the auditor to refer to a matter (other than going concern) which has been adequately presented or disclosed in the financial statements by the directors. The auditor's judgement is that such matters are of such fundamental importance to the users' understanding of the financial statements that the auditor should emphasise the disclosure.

The auditor's report is usually contained at the 'front end' of the financial statements. Some users of the financial statements may not read the detailed notes to the financial statements and it may be the case that the matter being emphasised in the auditor's report is disclosed at the back end of the annual report. The use of an emphasis of matter paragraph in the auditor's report means that the user will stand more of a chance of reading the relevant disclosure note than if it was not referred to in the auditor's report.

It is important to emphasise that an emphasis of matter paragraph can **only** be used when a matter has been **adequately disclosed** in the financial statements because the auditor can only emphasise something which is already included in the financial statements. If the matter has not been adequately disclosed, it is likely to give rise to a modified opinion and an emphasis of matter paragraph must not be used in respect of that matter.

An emphasis of matter paragraph does not modify the auditor's in any way and the paragraph itself must:

- cross-refer to the relevant disclosure note in the financial statements to which the emphasis of matter paragraph relates; and
- confirm that the auditor's opinion is not modified in respect of the matter.

Examples of 'fundamental matters' which may be referred to in an emphasis of matter paragraph include:

- the financial statements have been prepared on a basis other than the going concern basis;
- there is uncertainty relating to the future outcome of exceptional litigation or regulatory action;
- there has been a significant subsequent event between the date of the financial statements and the date of the auditor's report;
- the entity has early applied an accounting standard;
- there has been a major catastrophe after the balance sheet date but before the financial statements have been authorised for issue;
- corresponding figures have been restated;
- the financial statements have been recalled and reissued or when the auditor provides an amended auditor's report; or
- there has been a significant restructuring during the year that has had a major impact on the declared results of the entity (i.e. an exceptional item).

Example – Emphasis of matter paragraph

We draw your attention to Note 30 in the financial statements which describes the effects of a major restructuring carried out by the entity during the year. Our opinion is not modified in respect of this matter.

Key Audit Matters (KAM) section included in the auditor's report

If there is a KAM section in the auditor's report (i.e. for a listed entity), an emphasis of matter paragraph must not be used to highlight an issue already included within the KAM section of the auditor's report.

12.6 Material Uncertainty Related to Going Concern

Where there is a material uncertainty related to going concern which the directors have adequately disclosed in the financial statements, the auditor uses a Material Uncertainty Related to Going Concern (MURGC) paragraph to highlight the issue. An emphasis of matter paragraph is **not** used to flag this up to the user.

As with an emphasis of matter paragraph, a MURGC paragraph cross-references to the relevant disclosure note which describes the material uncertainty and the MURGC paragraph also confirms that the auditor's opinion is not modified in respect of this matter.

A MURGC paragraph can only be used to highlight a material uncertainty related to going concern that has been **adequately** disclosed by management in the financial statements. If adequate disclosure has not been made (referred to as 'inappropriate' disclosure as per ISA (UK) 570 (Revised September 2019)) then the auditor's opinion is modified accordingly (qualified 'except for' or adverse).

The location of the MURGC paragraph is not specified in ISA (UK) 570, but it is usually included directly after the Basis for Opinion paragraph.

12.7 Other matter paragraph

An 'other matter' paragraph is included in the auditor's report to deal with any other matters which are relevant to the users' understanding of the audit. This paragraph will usually highlight matters which the auditor deems necessary which may not be presented or disclosed in the financial statements which, in the auditor's judgement, are relevant to understanding the audit, the auditor's responsibilities or the auditor's report.

Examples include:

- communication of matters relating to audit planning and scoping matters where law or regulation require;
- an explanation of the reasons why the auditor has not resigned where a pervasive inability to obtain sufficient appropriate audit evidence is imposed by management (e.g. denying access to accounting records by management) and the auditor is unable to withdraw from the engagement due to legal restrictions;
- if law, regulation or UK GAAP requires, or permits, the auditor to provide further explanations of the auditor's responsibilities; or
- to communicate that the auditor's report is intended solely for the intended users and should not be distributed to, or used by, other parties.

13 Modified auditors' reports (Lecture A693 – 12.54 minutes)

An auditor will usually only express a modified (qualified) audit opinion as a last resort as they will give the client ample opportunity to resolve the issue(s) giving rise to the modified opinion, provided that it is in the control of the client.

However, in some situations, the auditor may conclude that:

- based upon the evidence obtained, the financial statements as a whole are not free from material misstatement whether caused by fraud or error. In such cases, the entity will not have complied with the applicable financial reporting framework; or
- the auditor has been unable to obtain sufficient appropriate audit evidence to enable them to conclude that the financial statements as a whole are free from material misstatement whether caused by fraud or error.

The nature of the opinion expressed in the auditor's report will depend on whether the issue is material or material and pervasive.

13.1 Material but not pervasive

A matter is considered material, but not pervasive, when the issue only affects an isolated area of the financial statements. Examples include:

- capitalisation of research expenditure in contravention of FRS 102, para 18.8C;
- failing to disclose a material related party transaction;
- not attending the inventory count (where the inventory balance is material) because the auditor was appointed after the year end date had passed; and
- failing to make a provision for material unpaid holiday pay at the year end.

Where the client refuses to correct a material but not pervasive misstatement, the auditor expresses a qualified 'except for' opinion which states that 'except for' the effects of the material misstatement, the financial statements otherwise give a true and fair view. The Basis for Modified Opinion paragraph will then describe the nature of the modification in more detail and quantify the effects where applicable or possible.

13.2 Material and pervasive

A matter is considered 'pervasive' if, in the auditor's judgement:

- the effects are not confined to specific elements, accounts or items of the financial statements;
- if so confined, represent or could represent a substantial proportion of the financial statements; or
- in relation to disclosures, are fundamental to users' understanding of the financial statements.

Hence, a pervasive matter must be fundamental to the financial statements therefore rendering them unreliable as a whole.

Example

A large private company operates a defined benefit pension plan for its employees and has a year end of 31 December 2019. Due to a dispute with the actuarial firm, the company has refused to commission a valuation for financial reporting purposes of the pension scheme. The pension scheme is significantly material to the financial statements and the directors are insistent that they will not obtain a valuation.

As the accounting input and disclosures are expected to be material and affect multiple areas of the accounts, i.e. the balance sheet for the resulting surplus/deficit, profit and loss account for the interest charge and current/past service cost and other comprehensive income for actuarial gains and losses and expected return on plan assets, together with the disclosure notes required under Section 28 of FRS 102, it can be said that the misstatements would be both material and pervasive.

13.3 Qualified 'except for' for opinion

A qualified 'except for' opinion is expressed by the auditor when the issue giving rise to the modification is material but not pervasive. The auditor's opinion states that 'except for' the matter the matter, the financial statements give a true and fair view – in other words the matter is material to the area of the financial statements affected, but does not affect the remainder of the financial statements.

The Basis for Qualified Opinion paragraph will describe the effects of the issue, together with quantification where appropriate.

Example

A company operates in the pharmaceutical industry and has a significant amount of capitalised development expenditure on its balance sheet. The company reports under full FRS 102 and has a year end of 30 September 2019. During the year the company capitalised an amount of £450,000 worth of development expenditure which is considered significantly material to the financial statements. No amortisation has been charged on the additional development expenditure as the project was still nearing completion at the year end.

During the audit fieldwork, the auditor discovered that of the £450,000 worth of additions to intangible fixed assets, £220,000 was, in fact, research expenditure which should have been written off to the profit and loss account per paragraph 18.8E of FRS 102. The auditor concludes that this amount is

material to the financial statements. Management have refused to correct this misstatement on the basis that they disagree with the auditor's conclusion and the auditor disagrees with management that it should be capitalised. All other misstatements identified during the audit have been corrected.

In this example, the auditor disagrees with management's accounting treatment of the research expenditure. Assets and profit are overstated but the misstatement, despite being material, is not pervasive. The auditor concludes that the requirements of FRS 102 have not been complied with and hence will express a qualified opinion as follows:

Qualified opinion

We have audited the financial statements of ...

In our opinion, except for the matter described in the Basis for qualified opinion section of our report, the accompanying financial statements:

- give a true and fair view of the state of the company's affairs as at 30 September 2019 and of its profit for the year the ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Basis for qualified opinion

The company has recognised an amount of £220,000 of research expenditure as capitalised development expenditure on the balance sheet as at 30 September 2019 which, in our opinion, is not in accordance with the requirements of FRS 102. The company should have recognised the research expenditure in profit and loss for the year ended 30 September 2019 to comply with paragraph 18.8E of FRS 102. Accordingly, the company's intangible fixed assets should be reduced by an amount of £220,000 with a corresponding reduction in profit.

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

13.4 Adverse opinion

An adverse opinion is expressed when a misstatement is considered to be material and pervasive. This will mean that the financial statements do not give a true and fair view. Examples of such issues include:

- preparing the financial statements on a going concern basis when the going concern basis of accounting is inappropriate;
- non-consolidation of a subsidiary; or
- material misstatement of a balance which represents a substantial proportion of the assets or profits and would, perhaps, turn a profit into a loss.

Example

Purley Enterprises Ltd has prepared its financial statements for the year ended 31 October 2019 on a going concern basis. On 14 November 2019, the bank confirmed that they would no longer be willing to support the company as it had defaulted on its loan terms, breached its overdraft facility on a number of occasions during the year and had failed to supply the bank with management accounts as requested. In addition, the company had entered into an arrangement with HMRC to pay an accelerated payment notice in respect of a tax avoidance scheme over a period of six months, but the company was already in arrears and HMRC have threatened to issue winding up proceedings.

The director has approached a number of other banks who have refused to help the company but is confident that eventually the company will find a bank to support it. The auditor has concluded that the going concern basis of accounting is inappropriate. The director has refused to have the financial statements prepared on a basis other than the going concern basis of accounting as he feels this may influence the decision of any potential lender.

Paragraph 21 of ISA (UK) 570 *Going Concern* says that if the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgement, this basis is inappropriate, the auditor must express an adverse opinion. This is because the effects of the inappropriate use of the going concern basis of accounting are both material and pervasive. The adverse opinion will be expressed as follows:

Adverse opinion

We have audited the financial statements of ...

In our opinion, because of the significance of the matter discussed in the Basis for adverse opinion section of our report, the financial statements:

- do not give a true and fair view of the state of the company's affairs as at 31 October 2019 and of its loss for the year then ended;
- have not been properly prepared in accordance with United Kingdom

General Accepted Accounting Practice; and

- have not been prepared in accordance with the requirements of the Companies Act 2006.

Basis for adverse opinion

As explained in note 3 of the financial statements, the financial statements have been prepared on the going concern basis. However, in our opinion, due to the number and significance of the material uncertainties, the company is not a going concern in accordance with paragraph 3.8 of FRS 102 and therefore the financial statements should not be prepared on the going concern basis. Following a breach of the company's loan terms and overdraft facility, the company's bank has expressed their unwillingness to support the company and the directors have so far been unable to source financiers to continue to support the business. In addition, the terms of an arrangement to pay with HMRC in respect of a tax avoidance scheme has also not been complied with.

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

13.5 Disclaimer of opinion

A disclaimer of opinion is issued when the auditor is unable to form an opinion on the financial statements and the effects of any possible misstatements could be pervasive. Examples of situations giving rise to a disclaimer of opinion include:

- a failure by the client to keep adequate accounting records;
- refusal by the directors to provide written representations; or
- a failure by the client to provide evidence over a single account balance which represents a substantial proportion of the assets or profits or over multiple balances in the financial statements.

Disclaimer of opinions are rare in practice, but they do arise. Where a disclaimer of opinion is issued:

- the statement that sufficient appropriate audit evidence to provide a basis for the auditor's opinion is not included;
- the statements regarding the audit being conducted in accordance with ISAs (UK) and independence and other ethical responsibilities are positioned

within the auditor's responsibilities section and not the Basis for Disclaimer of Opinion paragraph; and

- the key audit matters section (where applicable) is not included in the auditor's report as to do so would suggest the financial statements are more credible in respect of those matters which would be inconsistent with the disclaimer of opinion on the financial statements as a whole.

Keep in mind that a disclaimer of opinion is **not** an audit opinion – it confirms that the auditor cannot form an opinion on the financial statements.

Example

A wholly-owned subsidiary has prepared its financial statements using the going concern basis of accounting for the year ended 31 July 2019. Management of the subsidiary have prepared the financial statements on the going concern basis of accounting on the grounds that the parent of the group itself will support the business. The auditor of the subsidiary has discussed the issue with the group auditor who has confirmed that the group has a significant level of overdue debt owed to it and, in the group auditor's opinion, the group nor the parent, has been able to produce any detailed projections, in the form of budgets or forecasts, which demonstrate the group's ability to continue as a going concern. The subsidiary is reliant on additional finance/investment which has not yet been secured.

Based on these facts, the auditor has concluded that they are unable to form an opinion as to whether the going concern basis of accounting is appropriate and has expressed a disclaimer of opinion which is expressed as follows:

Disclaimer of opinion

We have audited the financial statements of ...

We do not express an opinion on the accompanying financial statements. Because of the significance of the matter described in the Basis for disclaimer opinion section of our report, we have not been able to obtain sufficient appropriate evidence to provide a basis for an audit opinion on these financial statements.

Basis for disclaimer of opinion

The audit evidence available to us to confirm the appropriateness of management's use of the going concern basis of accounting was limited because the company is reliant on support from the Group. The Group has not been able to provide any corroboratory evidence that it is able to continue to trade for the foreseeable future as a going concern. The Group has significant levels of indebtedness and has not provided any financial projections which would indicate that it has the ability to continue to trade as a going concern for the foreseeable future.

As a result, we were unable to determine whether the going concern basis of

accounting is appropriate in the company's circumstances.

Auditor's responsibilities for the audit of the financial statements

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. However, because of the matter described in the Basis for disclaimer of opinion section of our report, we were not able to obtain sufficient appropriate evidence to provide a basis for an audit opinion on these financial statements.

13.6 Summary of opinions

The table below provides a high level overview of the auditor's opinion on the financial statements when a modified opinion is to be expressed:

	Material but not pervasive	Material and pervasive
Financial statements contain material misstatement	<ul style="list-style-type: none"> • Qualified opinion • Except for ... • Basis for qualified opinion paragraph 	<ul style="list-style-type: none"> • Adverse opinion • Financial statements do not give a true and fair view • Basis for adverse opinion paragraph
Auditor unable to obtain sufficient appropriate audit evidence	<ul style="list-style-type: none"> • Qualified opinion • Except for ... • Basis for qualified opinion paragraph 	<ul style="list-style-type: none"> • Disclaimer of opinion • Do not express an opinion • Basis for disclaimer of opinion paragraph

14 Appendix: Small company exemption thresholds – solutions to examples

Example 1 - Solution

X Ltd incorporates on 1 July 2017. These are its results for its five periods ending on 31 December:

	2017	2018	2019	2020	2021
Turnover	£6.5m	£11.2m	£9.2m	£8.0m	£8.5M
Balance sheet total	£6.1m	£7.5m	£5.5m	£4.5M	£5.5M
Number of employees		40	45	51	45
	45				

Is the company eligible to apply small company accounting exemptions?

- 2017:** No – remember to pro-rate turnover for the six-month accounting period
2018: No
2019: No
2020: No – it has to be small for two consecutive years
2021: Yes – this is the second year it is small

Is the company eligible for small company audit exemption:

- 2017:** No
2018: No
2019: No
2020: No
2021: Yes

Note: Ignoring groups, if a company is small then it is also able to claim audit exemption. Small company audit exemption is not available to members of medium sized or large groups.

Example 2

The following data applies to the H Group for the year ended 31 December 2019. The group consists of H Ltd (parent) and three wholly owned subsidiaries – A Ltd, B Ltd and C Ltd.

	H Ltd	A Ltd	B Ltd	C Ltd
Turnover	£1m	£11m	£1m	£1m
Balance sheet total	£2m	£4m	£1m	£1m
Number of employees	10	55	10	10

The figures for the years 31 December 2018 and 31 December 2017 were the same as those shown above. There is no trading within the group and no balances with other members of the group.

Which of the companies qualify as a small company in 2019 and which of them qualify for audit exemption?

H Ltd – Parent of a medium-sized group. Therefore, it cannot be small, it must be medium-sized. No audit exemption can be claimed unless it were a member of a larger group where the s479A group audit exemption might apply (if the conditions are met).

A Ltd – Clearly medium-sized – small company audit exemption is not available but s479A might be.

B Ltd & C Ltd – Small for accounting purposes. Small company audit exemption is not available because it is a member of a medium-sized group. s479A audit exemption might be available.

Example 3

My firm is the auditor of a UK subsidiary of Spanish holding company. The UK company has turnover and gross assets below the audit exemption thresholds and the directors wish to take advantage of audit exemption, in order to reduce costs. The holding company has not requested an audit and has stated that they will be satisfied with a compilation report from my firm. The holding company auditor has also not requested that the subsidiary is audited.

Can the UK company directors take advantage of audit exemption when the company is part of a group?

Small company audit exemption is not available because the group is not small. The fact that the group includes overseas companies makes no difference; the overseas entities are included when considering the size of the group. Note s479A audit exemption could be available

Example 4

Currently, my firm is considering whether to accept appointment as advisors for a UK company who take advantage of audit exemption. The company is a subsidiary of a holding company incorporated in an offshore jurisdiction where financial statements are not publicly available. The UK directors say that they do not have access to financial information for the holding company or other group companies.

Is this company eligible for audit exemption?

Small company audit exemption is only available if the directors are satisfied that the conditions for the exemption are met. Ignorance is not an excuse for getting this wrong. s479A is probably not available because of the nature of the holding company.