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1. FRS 105 REMINDER (LECTURE A630 – 8.27 MINUTES)

Where a micro-entity client in the UK has opted to prepare its financial statements for an accounting period commencing on or after 1 January 2017 (i.e. a 31 December 2017 year-end onwards) under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, it is worth emphasising to check that the additional disclosure requirements have been made at the foot of the balance sheet.

FRS 105 was amended as part of the FRC's triennial review. For micro-entities in the UK, two additional disclosure requirements in respect of off-balance sheet arrangements and employee numbers are now required. These additional disclosures should have been made for accounting periods starting on or after 1 January 2016, but were omitted from FRS 105 (July 2015).

Therefore, for 31 December 2017 year-ends onwards, please ensure that your micro-entity clients reporting under FRS 105 disclose:

- (a) off-balance sheet arrangements as required by section 410A of the Companies Act 2006;
- (b) employee numbers as required by section 411 of the Companies Act 2006;
- (c) advances, credit and guarantees granted to directors as required by section 413 of the Companies Act 2006; and
- (d) financial commitments, guarantees and contingencies as required by regulation 5A of, and paragraph 57 of Part 3 of Schedule 1 to, the Small Companies Regulations.

The consequence of failing to make the required disclosures is that the presumption that the micro-entity's financial statements give a true and fair view because they have been prepared in accordance with the legally required minimum will not be achieved.

In addition, don't forget the section 396(A1) information which is required as follows:

- (a) the part of the UK in which the micro-entity is registered;
- (b) the micro-entity's registered number;

- (c) whether the micro-entity is a public or private company and whether it is limited by shares or by guarantee (note as micro-entities cannot be public companies, all micro-entities will refer to themselves as being private);
- (d) the address of the micro-entity's registered office; and
- (e) where appropriate, the fact that the micro-entity is being wound up.

While accounts production software systems will often generate the disclosures as a matter of course, it is always worthwhile taking some time to check that the disclosures are in accordance with company law.

2. EMPLOYEE BENEFITS (LECTURE A631 – 10.03 MINUTES)

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 and 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 change in the liability 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	<p>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.</p> <p>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.</p>
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.'

2.1 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 them terminating their employment as a result of:
 - (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.

2.2 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.

2.3 *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.

2.4 *Measurement of short-term employee benefits*

Paragraph 28.5 of FRS 102 (March 2018) states:

FRS 102 para 28.5

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

2.5 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:

FRS 102 Glossary
**accumulating
compensated
absences**

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

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 2018, 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 2018 and a holiday year which ends on 31 December 2018. 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 2018 $((30 \text{ days} \times 6/12) - 20 \text{ days})$.

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.

2.6 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:

*FRS 102 para 28.8(a)
and (b)*

- '(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.'*

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*.

Paragraph 22 of IAS 19 *Employee Benefits* provides more detailed guidance as to when an entity can make a reliable estimate of its legal or constructive obligation. IAS 19.22 states such a reliable estimate can be made when, and only when:

- '(a) *the formal terms of the plan contain a formula for determining the amount of the benefit;*
- (b) *the entity determines the amounts to be paid before the financial statements are authorised for issue; and*
- (c) *past practice gives clear evidence of the amount of the entity's constructive obligation.'*

IAS 19 para 22(a) to (c)

In addition, IAS 19 also provides some useful guidance where the receipt of a profit share is conditional upon the employee remaining in the employment of the entity. In these cases, the plan creates a constructive obligation as the employee renders his/her service which increases the amount that they will receive if they remain in the company's employment until the end of that specified period.

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.

2.7 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:

- (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.

2.8 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 change has arisen as a result of 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	<p>A defined benefit liability, being the net of:</p> <ul style="list-style-type: none"> the defined benefit obligation; less plan assets.
Profit and loss	<p>Cost of the plan, including:</p> <ul style="list-style-type: none"> current cost; past service cost; and interest cost.
Other comprehensive income	<p>Remeasurements, including:</p> <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.

A summary of the accounting treatment for a defined benefit pension plan is shown overleaf.

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 01.01.18			X	(X)	(X)
Contributions			X		X
Current service cost	X			(X)	(X)
Past service cost	X			(X)	(X)
Net interest on defined benefit	X		X	(X)	(X)

liability				
Actuarial gain or loss	X		(X)	(X)
Return on plan assets	(X)	X		X
Benefits paid		(X)	X	-
Bal c/f 31.12.18		<u>X</u>	<u>(X)</u>	<u>(X)</u>

2.9 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.

2.10 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).

3. FOREIGN CURRENCY TRANSACTIONS (LECTURE A632 – 18.30 MINUTES)

Many companies enter into foreign currency transactions. Whether they buy or sell goods denoted in foreign currencies or have an overseas branch or group member, transactions in foreign currencies will need to be translated into the currency of the reporting entity in the financial statements.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with foreign currency translation in Section 30 *Foreign Currency Translation* and there are some notable differences between FRS 102 and previous UK GAAP which are outlined in the table below:

Issue	FRS 102	Previous UK GAAP
Functional currency	Functional currency is dealt with in FRS 102 and is the currency of the primary economic environment in which it operates.	No concept of separate functional v presentation currency but instead SSAP 20 had a concept of local currency.
Presentation currency	An entity is free to choose which currency it reports its financial information under.	Previous UK GAAP did not permit the use of a presentation currency which was not the local currency.
Derivative instruments	Forex derivative instruments are brought onto the balance sheet at fair value through profit or loss, although hedge accounting is available subject to meeting certain criteria. If hedge accounting is used, fair value gains/losses are taken to other comprehensive income.	Initial measurement of derivatives was not specified but were usually the same (i.e. at transaction price).

3.1 Scope of FRS 102

Section 30 of FRS 102 (March 2018) applies to:

- (a) foreign currency transactions;
- (b) foreign operations; and
- (c) the translation of an entity's financial statements into a presentation currency.

The term 'presentation currency' is defined in the Glossary to FRS 102 as:

*'The currency in which the **financial statements** are presented.'*

3.2 Functional currency

FRS 102 requires each entity to identify its 'functional currency', which is defined in the Glossary to FRS 102 as:

*FRS 102 Glossary
functional currency*

'The currency of the primary economic environment in which the entity operates.'

An entity's functional currency is a matter of fact – not a choice. Hence, where there has been a change in functional currency, it follows that there has been a change in the primary economic environment in which the entity operates. The 'primary economic environment' is the environment in which the entity operates and is usually the one in which it primarily generates and spends cash.

As noted later in this section of the notes, it is imperative that an entity correctly identifies its functional currency and there are three primary factors which an entity must consider in determining its functional currency:

- '(a) the currency:*
- FRS 102 para 30.3*
- (i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for goods and services are denominated and settled); and*
 - (ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services; and*
- (b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).'*

The factors above are those which FRS 102 says are the 'most important factors' which an entity must take into account when determining its functional currency. In other words, these are the 'primary' factors.

FRS 102 then goes on to provide some secondary factors which are taken into account when the primary indicators of functional currency (see above) do not provide clear evidence as to the entity's functional currency:

- '(a) the currency in which funds from **financing activities** (issuing debt and equity instruments) are generated; and*
- FRS 102 para 30.4*
- (b) the currency in which receipts from **operating activities** are usually retained.'*

In practice, the primary indicators will often be sufficient enough and management must ensure that they give priority to the primary indicators.

When the functional currency of a foreign operation is unclear, paragraph 30.5 of FRS 102 provides additional factors which should be considered. The objective of these additional factors is to establish whether the foreign operation's functional currency is the same as that of the reporting entity. The reporting entity, in this context, is the entity that has the foreign operation as its subsidiary, branch, associate or joint venture:

- '(a) Whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the*
- FRS 102 para 30.5 (a) to (d)*

*foreign operation only sells goods imported from the reporting entity and remits the proceeds to it. An example of the latter is when the operation accumulates cash and other **monetary items**, incurs **expenses**, generates **income** and arranges borrowings, all substantially in its local currency.*

- (b) *Whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.*
- (c) *Whether **cash flows** from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.*
- (d) *Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.'*

Example – Functional currency

Topco Ltd is a company based in the UK whose functional currency is GBP. It has a subsidiary located in Spain (Subco). Subco obtains product from Topco and sells them to its local customers. Invoices are generated from Topco in respect of these sales and the Spanish customers pay Topco directly. Proceeds from any cash sales are also remitted to the company's bank account which Topco's central finance department manages and controls.

The functional currency of Subco is GBP because it is merely operating as an extension (ie a branch) of Topco.

3.3 *Ball Holdings v HMRC*

In *Ball Holdings v HMRC*, the functional currency used to prepare Ball Holdings' statutory financial statements was changed from Sterling to US Dollars. The change resulted in Ball Holdings recognising a large foreign exchange loss which the company claimed against its corporation tax as an allowable expense. HMRC enquired into the tax return and subsequently rejected the claim, stating the entity's functional currency should be Sterling and not US Dollars.

Ball Holdings argued that they had entered into a derivative contract, which subsequently triggered the requirements of previous FRS 23 *The effects of changes in foreign exchange rates*. The First-Tier Tribunal (FTT) had to decide whether the requirements of FRS 23 had been correctly applied when the entity changed its functional currency from Sterling to US Dollars.

The key test in FRS 23 (as is the case in FRS 102, paragraph 30.5(a)) was whether the activities of the foreign operation were being carried out as an extension of the reporting entity, rather than being carried out with a significant degree of **autonomy** (see above).

The fundamentals of the case hinged on the ‘autonomy’ of Ball Holdings. If Ball Holdings did not have autonomy, its functional currency would have been US Dollars; if it did have autonomy, its functional currency would have been Sterling and no translation loss would have arisen.

The FTT concluded that Ball Holdings had not correctly interpreted FRS 23 and had taken the word ‘autonomy’ out of context. In the context of FRS 23, ‘autonomy’ is wide as it is a search for a primary economic environment, whereas Ball Holdings had taken it to be confined to the decision-making powers.

HMRC dismissed the taxpayer’s appeal as it concluded the entity had incorrectly interpreted the standard stating that the financial statements must be prepared under UK GAAP. The judge subsequently went on to state that any interpretation of accounting standards does not necessarily mean that the financial statements have been prepared under UK GAAP; particularly where that interpretation is incorrect.

This case highlighted the importance of not only determining functional currency correctly, but also **correctly** interpreting accounting standards. A misinterpretation means that the entity has not applied GAAP and HMRC require financial statements to be prepared under GAAP principles.

3.4 Reporting foreign currency transactions

Broadly, the means by which an entity translates foreign currency transactions is no different than in previous UK GAAP (other than where contracted or forward rates are involved). A summary of the method is as follows:

- Translate foreign currency monetary items using the closing rate.
- Translate non-monetary items which are measured in terms of historical cost in a foreign currency using the exchange rate at the date of the transaction.

- Translate non-monetary items which are measured at fair value in a foreign currency using the exchange rates at the date when the fair value was determined.

Examples of monetary and non-monetary items are shown in the table below:

Monetary	Non-monetary
Cash and bank balances	Intangible assets
Bank loans and overdrafts	Property, plant and equipment
Trade debtors/trade creditors	Goodwill
Specific bad debt provisions	Inventory
Holiday pay accruals	Provisions to be settled by way of a non-monetary asset
Deferred tax assets/liabilities	Shareholders' equity
Finance lease obligations	Deferred income (the cash flow has already taken place hence non-monetary)

Exchange differences

Exchange differences on translation are usually recognised in profit and loss. There is no specific guidance in FRS 102 as to where exchange differences should be recognised within the profit and loss account; some entities choose to recognise them in cost of sales (assuming a Format 1 profit and loss account), whereas others choose to recognise them in administrative expenses. Where an entity decides to present exchange differences in cost of sales rather than administrative expenses, or vice versa, this would constitute a change in accounting policy per Section 10 of FRS 102 *Accounting Policies, Estimates and Errors* and hence the change must be applied retrospectively.

3.5 Foreign exchange derivatives

Under FRS 102, an entity (including a small entity) may have to bring derivative financial instruments onto the balance sheet which arise through forward foreign exchange contracts. A 'derivative' financial instrument is an instrument which 'derives' its value from a change in the value of an underlying asset. Therefore, a foreign exchange derivative will derive a value from changes in the foreign exchange rate.

When a company enters into a forward foreign currency contract, say, one month prior to its year-end to sell foreign currency one month after its year-end, then on the date the contract is entered into the fair value of the contract will usually be nil. Over the next two months, foreign exchange rates are likely to fluctuate and these fluctuations will generate a value for the forward foreign currency contract and it is this value that will be reported on the balance sheet and any changes in that value from one reporting period to the next will be recognised in profit or loss; unless cash flow hedge accounting is being applied in which case gains and losses are reported in other comprehensive income.

Example – Foreign exchange derivative

A company has a year-end of 31 March 2018 and reports under FRS 102. On 1 February 2018, the company sells goods to a customer based in America for \$120,000 and payment is to be received in three months' time (i.e. on 30 April 2018). VAT is ignored for the purposes of this example.

The company enters into a forward foreign currency contract to sell \$120,000 on 30 April 2018 at a contracted rate of \$1.65:£1. Details of the foreign exchange rates are as follows:

Date	Forward rate	
	Spot	to 30.04.18
	\$1:£1	\$1:£1
01.02.2018	1.63	1.65
31.03.2018	1.60	1.62
30.04.2018	1.58	-

Under previous UK GAAP, the company would have normally accounted for this transaction using the contracted rate (i.e. 1.65); although the company could have also chosen not to and used the spot rate at the transaction date.

Step 1 – recognise the debtor at the date of sale (1 February 2018)

The company would have accounted for this transaction using the rate in the contract (1.65) under previous UK GAAP as paragraph 4 of SSAP 20 *Foreign currency translation* allowed this and hence under old UK GAAP, the company would have recognised a debtor of £72,727 (being \$120,000 ÷ 1.65).

FRS 102, paragraph 30.7 requires the foreign currency transaction to be recorded at the spot rate at the date of the transaction, hence under FRS 102 the company will translate the sale at 1.63, hence:

Dr Trade debtors £73,620
Cr Sales £73,620
Being translation of sale at spot rate (\$120,000 ÷ 1.63)

Step 2 – calculate the derivative instrument at 31 March 2018

As the contracted rate cannot be used under FRS 102, a derivative instrument is recognised on the balance sheet, calculated as follows:

£

\$120,000 at contracted rate of 1.65	72,727
\$120,000 at year-end forward rate of 1.62	74,074
Loss on derivative instrument	<u>1,347</u>

The loss has arisen because of what has happened with the exchange rates. If the company were to sell at the year-end forward rate of 1.62 they would receive £74,074, but as they are selling at a contract rate of 1.65 they would only receive £72,727 and hence a loss has been generated on the contract at the year-end which has to be recognised in the financial statements as follows:

Dr Loss on derivative – profit and loss £1,347

Cr Derivative liability – balance sheet £1,347

Being loss on derivative at year-end

Under SSAP 20 no entries would have been needed had the company accounted for the transaction at the contracted rate.

Step 3 – calculate the foreign exchange gain/loss at the year-end 31 March 2018

The company will have to work out the foreign exchange gain or loss as follows:

	£
\$120,000 at the year-end spot rate (1.60)	75,000
Less original debtor recognised	(73,620)
Foreign exchange gain	<u>1,380</u>

This gain is taken to the profit and loss account as a credit (i.e. Dr Debtors, Cr Profit and loss account).

Step 4 – settlement takes place on 30 April 2018

Calculate the derivative instrument at the settlement date

Calculate the fair value of the derivative instrument at the date of settlement as follows:

	£
\$120,000 at settlement date spot rate 1.58	75,949
\$120,000 at year-end forward rate 1.62	<u>74,074</u>

Loss on derivative at settlement date	1,875
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The entries at 30 April 2018 in respect of the derivative instrument are:

Dr Loss on derivative (P&L)	£1,875
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Cr Derivative liability – balance sheet	£1,875
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Being loss on derivative at fair value

Clear the derivative and the debtor

The company's customer will pay them £72,727 (\$120,000 @ 1.65). The derivative instrument is recognised as a liability of £3,222 (£1,347 + £1,875) and hence the journals are:

Dr Cash at bank	£72,727
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Dr Derivative liability – balance sheet	£3,222
---	--------

Cr Trade debtors	£75,949
------------------	---------

Being removal of derivative instrument and settlement of debtor

The derivative liability sitting on the balance sheet prior to clearing after receipt of the payment can be reconciled as follows:

	£
\$120,000 @ settlement date spot rate 1.58	75,949
\$120,000 @ contract rate of 1.65	72,727
Loss on forex contract at 30 April 2018	<u>3,222</u>

The £3,222 loss on the derivative represents the loss that the company has made by taking out the forward foreign currency contract. In other words, the company would have received £3,222 more had they undertaken the transaction using spot rates.

A balance of £949 will be left on the customer's account on the sales ledger which is made up of the £75,000 year-end debtor (see Step 3) less £75,949 (£120,000 ÷ 1.58 – see Step 4). This represents the foreign exchange gain.

A comparison of the above example can be seen as follows:

SSAP 20 FRS 102

£ £

Profit and loss account – 31 March 2018

Turnover	72,727	73,620
Foreign exchange gain	-	1,380
Loss on derivative instrument	-	(1,347)
	<hr/>	
	<u>72,727</u>	<u>73,653</u>

Balance sheet – 31 March 2018

Asset - trade debtor	72,727	75,000
Liability - derivative financial instrument	-	(1,347)
	<hr/>	
	<u>72,727</u>	<u>73,653</u>

Profit and loss account – 30 April 2018

Turnover	-	-
Foreign exchange gain	-	949
Loss on derivative	-	(1,875)
	<hr/>	
	-	(926)

Balance sheet - 30 April 2018

Profit and loss reserves b/f 31.03.18	72,727	73,653
Profit and loss reserves c/f 30.04.18	72,727	72,727

3.6 Presentation currency

Some groups may have several entities, some with a different presentation currency and these entities will need to be translated into a common currency in the group accounts.

Where an entity's functional currency is not the currency of a hyperinflationary economy (hyperinflation is inflation which is out of control), the following procedures are applied in order to translate the entity's results and financial position into a different presentation currency:

- (a) Assets and liabilities for each balance sheet (including comparatives) are translated at the closing rate at the balance sheet date.
- (b) Income and expense for each profit and loss account/statement of comprehensive income is translated at exchange rates at the date of the transactions. For practical reasons, an entity may use an average rate for the period. However, if exchange rates fluctuate significantly, the use of the average rate will be inappropriate.
- (c) All resulting exchange differences are recognised in other comprehensive income.

FRS 102 does not prohibit the retranslation of amounts in respect of share capital and equity reserves. However, in practice, the translation of such equity amounts would be meaningless, because any differences would not be reclassified to profit or loss. A difference in equity pre-translation to equity post-translation would simply mean the difference is merely recognised in another component of equity. Hence, share capital and other components of equity should be translated using historical rates (i.e. the rate

at the date each amount of share capital was issued or the date of the transaction for equity reserves, such as the revaluation reserve).

The effect of this is that if share capital has been issued on multiple dates, more than one historical rate will apply in translating share capital into the presentation currency. This would also apply to other components of reserves, such as the revaluation reserve; i.e. if more than one revaluation an asset (or number of assets) has been done, the rate used will be the rate at the date of each separate revaluation.

When this approach is applied, the balance on retained earnings (profit and loss account reserves) will be a balancing figure due to the retranslation of assets and liabilities at closing rate and other equity items at historical rate. FRS 102 does not contain any requirement to take such differences to a foreign currency reserve to allow for subsequent recycling, unlike IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

Example – Retranslation

The financial statements of US Co are prepared using US Dollars as the functional currency. The parent company is located in the UK and prepares consolidated financial statements using Sterling as its presentation currency. Summary financial statements for Forex Co as at 31 March 2018 (when the exchange rate was £1:\$1.50) are as follows:

	\$'000	Historical rate
Net assets	300	
Equity and reserves		
Share capital issued 1.7.17	20	1.60
Share capital issued 1.10.17	50	1.65
Share capital issued 1.12.17	30	1.70
	100	
Revaluation reserve 1.8.17	40	1.62

Revaluation reserve 31.3.18	20	1.50
	<hr/>	
	60	
Retained earnings	140	
	<hr/>	
Equity and reserves	300	
	<hr/> <hr/>	

The financial statements are translated into the presentation currency as follows:

	\$'000	£'000	
	<hr/>		
Net assets	300	200	
	<hr/> <hr/>		
Equity and reserves			
Share capital issued 1.7.17	20	12.5	
Share capital issued 1.10.17	50	30.3	
Share capital issued 1.12.17	30	17.6	
	<hr/>		
	100	60.4	
Revaluation reserve 1.8.17	40	24.7	
Revaluation reserve 31.3.18	20	13.3	
	<hr/>		
	60	38.0	
Retained earnings	140	101.6	(balancing figure)
	<hr/>		
Equity and reserves	300	200.0	
	<hr/> <hr/>		

Assume for the purposes of the above example that opening net assets had been translated into Sterling at a value of £100,000 and profit for the year was \$200,000,

translated at an average rate of 1.65 (giving £121,200). The difference of £21,200 is a foreign exchange adjustment which, together with the adjustments above, would go to other comprehensive income.

4. IMPAIRMENT OF ASSETS (LECTURE A633 – 11.28 MINUTES)

One of the implicit rules in financial reporting is that assets should not be carried in the balance sheet in excess of recoverable amount. The term 'recoverable amount' is defined in the Glossary to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* as:

FRS 102 Glossary
recoverable amount

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

FRS 102 (March 2018) deals with impairment of assets in Section 27 *Impairment of Assets*. The scope paragraph of Section 27 was condensed during the FRC's triennial review essentially to remove the definition of an impairment loss. Paragraph 27.1 of the March 2018 edition of FRS 102 now confirms that Section 27 applies to the impairment of assets and the recognition of impairment losses. Section 27 does not apply to:

- (a) **assets** arising from **construction contracts** (see Section 23 Revenue);
- (b) **deferred tax assets** (see Section 29 Income Tax);
- (c) assets arising from **employee benefits** (see Section 28 Employee Benefits);
- (d) **financial assets** within the scope of Section 11 Basic Financial Instruments or Section 12 Other Financial Instruments Issues;
- (e) **investment property** measured at **fair value** (see Section 16 Investment Property);
- (f) **biological assets** related to **agricultural activity** measured at fair value less estimated costs to sell (see Section 34 Specialised Activities); and
- (g) **deferred acquisition costs** and **intangible assets** arising from contracts within the scope of **FRS 103**.'

FRS 102 paragraph
27.1(a) to (g)

Applying the scope of Section 27, the following types of assets would be included:

- intangible assets including goodwill;
- tangible fixed assets;
- stock and work in progress;

- investments in subsidiaries measured at cost in the separate financial statements;
- investments in associates and joint ventures carried at cost;
- assets obtained by a lessee under a finance lease, or a lessor under an operating lease.

4.1 Stock and work in progress

Stock and work in progress (referred to as 'inventories' in FRS 102) must be assessed for impairment at each reporting date. This is done by comparing the carrying amount of each item of inventory (or groups of similar items) with its selling price less costs to complete and sell (which used to be called 'net realisable value' under previous UK GAAP). Inventory is impaired when its estimated selling price less costs to complete and sell is lower than cost and a write-down to estimated selling price would be needed to comply with FRS 102 principles.

Paragraph 27.3 of FRS 102 states that where it is impracticable to determine the selling price less costs to complete and sell for inventories on an item by item basis, the entity may group items of inventory relating to the same product line which have similar purposes or end uses and are produced and marketed in the same geographical area for the purpose of assessing impairment.

The term 'impracticable' is defined in the Glossary to FRS 102 as follows:

'Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.'

FRS 102 Glossary
impracticable

Example – Sale after the balance sheet date (1)

Computers R Us Ltd has a batch of computer components with a cost price of £5,000 in inventory as at 31 July 2018 (the company's year-end). These components were used in a model of laptop computer which the company has discontinued manufacturing. A competitor has said that they will buy the components from the company at a price of £3,500 because they can use them. Computers R Us have agreed to the sale which took place on 20 August 2018.

A sale after the balance sheet date which is at a lower price than cost would generally indicate that there is evidence that fair value less costs to sell and complete is lower and hence a write-down of this inventory of £1,500 (£5,000 - £3,500) would be required.

Example – Sale after the balance sheet date (2)

Computers R Us Ltd has a batch of computer components with a cost price of £5,000 in inventory as at 31 July 2018 (the company's year-end). On 16 August 2018, damage was caused to these components by an employee meaning that they could not be used in the manufacturing process. A competitor has said that they will buy the components from the company at a price of £3,500 because they can use them. Computers R Us have agreed to the sale which took place on 20 August 2018.

Selling price became lower than cost on 16 August 2018 when the damage to the components happened. This happened after the year-end of 31 July 2018, hence the conditions giving rise to the impairment did not exist at the year-end and the loss in value should not be accounted for until the next accounting period. If the directors assess that the components could be sold (undamaged) for an amount at, or in excess of, the cost of £5,000 plus any costs to complete the sale, then no write-down would be required as at 31 July 2018.

Impairment reversals for inventory

At each balance sheet date, management are to make a new assessment of selling price less costs to complete and sell. When the circumstances which gave rise to the original impairment loss no longer exist, or there is clear evidence of an increase in selling price less costs to complete and sell, the entity must reverse the amount of the impairment. The reversal is **limited to the amount of the original impairment loss** so that the new carrying amount is at the lower of cost and the revised selling price less costs to complete and sell.

4.2 Impairment of assets other than inventories

Paragraph 27.5 of FRS 102 (March 2018) states:

FRS 102 para 27.5

*'If, and only if, the **recoverable amount** of an asset is less than its carrying amount, the entity shall reduce the carrying amount of the asset to its recoverable amount. That reduction is an impairment loss. Paragraphs 27.11 to 27.20A provide guidance on measuring recoverable amount.'*

The impairment loss referred to in paragraph 27.5 of FRS 102 is recognised immediately in profit and loss. Where the asset is measured at revaluation, the impairment loss is

taken to the revaluation reserve (to the extent of a surplus on the revaluation reserve in respect of that asset), with any excess being taken to profit and loss.

In respect of revalued assets, the impairment requirements are somewhat different than under previous UK GAAP. FRS 11 *Impairment of fixed assets and goodwill* required an impairment loss on a revalued fixed asset to be recognised directly in profit and loss where it was caused by a clear consumption of economic benefits (i.e. through use). FRS 102 does not contain such a requirement and hence it may not be the case that where the asset is measured under the revaluation model, that the entire impairment loss is recognised immediately in profit and loss. It should, instead, be recognised in the revaluation reserve unless (or until) the impairment loss(es) exceed the surplus on the revaluation reserve for that asset.

4.3 Indicators of impairment

FRS 102 does not mandate an entity to determine recoverable amounts for assets and compare this to respective carrying values each year. Instead, it requires an entity to assess, at each balance sheet date, whether there is any indication that an asset may be impaired. Where such indicators exist, the entity then estimates recoverable amount. Where there is no indicator that an asset is impaired, it is not necessary to estimate recoverable amount.

Paragraph 27.8 of FRS 102 then goes on to state that where it is not possible to estimate the recoverable amount of an individual asset, the entity estimates the recoverable amount of the cash-generating unit to which the asset belongs. The paragraph then goes on to clarify that an asset's 'cash-generating unit' is the smallest identifiable group of assets that includes the asset and generates cash inflows which are largely independent of the cash inflows from other assets or groups of assets.

There are two sources of information which FRS 102 requires an entity to consider when assessing if there is any indication that an asset may be impaired:

- external sources of information; and
- internal sources of information.

External sources of information

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

FRS 102 para 27.9(a)

This could be caused by a general decrease in market values of similar types of assets (for example where property prices decline).

FRS 102 para 27.9(b)

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

This could arise due to an introduction in new legislation which bans the use of certain products which the entity may manufacture or where a product becomes obsolete due to competitors' introducing better products in the marketplace.

FRS 102 para 27.9(c)

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

It may be appropriate to revisit the calculation used previously where an asset has been subjected to an impairment test where an interest rate has increased and could materially affect the discount rate which was used in that calculation. It should be noted that the review itself should only be carried out if the change in interest rates would affect the recoverable amount **materially**.

FRS 102 para 27.9(d)

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

A businesses' share price may have fallen due to varying degrees of factors and while this, in itself, may not necessarily give rise to an impairment loss being recognised, a formal review for impairment should be carried out by management. Care should also

be taken to ensure that the discount rate used to calculate value in use is consistent with current market assessments.

Internal sources of information

FRS 102 para 27.9(e)

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

When an asset becomes obsolete or there is physical damage to the asset, this is an indicator that the asset is showing signs of impairment. For example, a motor vehicle which has been damaged in a car accident or damage to an item of machinery in the production department.

FRS 102 para 27.9(f)

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

Such significant changes may result in the asset becoming idle due to a restructuring exercise carried out by the entity (such as discontinuing a manufacturing line) and this may trigger the entity to try and dispose of the asset before they originally planned, due to it becoming 'out of service'. This will provide evidence that the asset is impaired and may need writing down to recoverable amount.

FRS 102 para 27.9(g)

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

This could arise where maintenance costs for an asset are budgeted to be higher than originally planned.

4.4 Fair value less costs to sell and value in use

The recoverable amount of an asset (or cash-generating unit) is the **higher** of its fair value less costs to sell and its value in use. When it is not possible to estimate the recoverable amount of an individual asset, the asset's cash-generating unit is used instead.

FRS 102 acknowledges that it is not always necessary to determine *both* an asset's fair value less costs to sell and its value in use. If either of these amounts are in excess of the asset's carrying amount, the asset is not impaired and hence it is not necessary to determine the other amount.

The recoverable amount of an asset is essentially its contribution to future cash flows for the entity. This can either arise from selling the asset at current market price or at 'fair value less costs to sell' or through continuing use of the asset.

Paragraph 27.14 of FRS 102 provides the following sources of evidence (in descending order) of fair value less costs to sell:

- a price in a binding sale agreement in an arm's length transactions which is adjusted for directly attributable costs of disposal;
- the bid price in an active market less the costs of disposal. If current bid prices are not available, the price of the most recent transaction may provide a basis on which to estimate fair value less costs to sell (where there has been no significant change in economic circumstances between the date of the transaction and the estimation date); and
- the best information available to reflect the amount which the entity could obtain (at the end of the reporting period) for the disposal of the asset in an arm's length transaction after deducting the disposal costs.

The entity must also consider any restrictions which are imposed on the asset according to paragraph 27.14A of FRS 102. Costs to sell (see below) must include the cost of obtaining relaxation of a restriction, where necessary, in order to enable the asset to be sold. If a restriction would also apply to any potential purchaser of an asset, the fair value of the asset may be lower than that of an asset whose use is not restricted.

Costs to sell

Costs to sell would usually include:

- legal costs;
- stamp duty and similar transaction taxes;
- removal costs; and
- other directly attributable (incremental) costs associated with bringing the asset into the condition expected for the sale to complete.

Value in use

Value in use calculations are inherently complex and, in practice, fair value less costs to sell is often the simpler value to use for the purposes of impairment testing.

The term ‘value in use’ refers to the present value of the future cash flows which are expected to be derived from an asset.

Paragraph 27.15 of FRS 102 requires the following steps to be used in the present value calculation:

- estimate the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and
- apply the appropriate discount rate to those future cash flows.

Calculating an asset’s value in use requires the following elements to be reflected:

FRS 102 para 27.16(a) to (e)

- an estimate of future cash flows the entity expects to derive from the asset;*
- expectations about possible variations in the amount or timing of those future cash flows;*
- the time value of money, represented by the current market risk-free rate of interest;*
- the price for bearing the uncertainty inherent in the asset; and*
- other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.’*

Estimates of future cash flows in (a) above would include:

- projections of cash inflows by the entity continuing to use the asset;
- projections of cash outflows necessary to generate the cash inflows from continuing use; and
- net cash flows (if any) which are expected to be received (or paid) for the disposal of the asset at the end of its useful life in an arm's length transaction between knowledgeable and willing parties.

Such future cash flows could be derived from budgets or forecasts. However, they should not include cash inflows or outflows from financing activities (e.g. interest) or income tax receipts or payments.

The future cash flows are to be estimated for the asset in its **current** condition and must not include cash inflows or outflows which are expected to arise from:

- a future restructuring which has not yet been carried out; or
- improving or enhancing the asset's performance.

The discount rate above should be:

- a pre-tax rate(s) which reflect current market assessments of:
 - the time value of money; and
 - the risks specific to the asset for which future cash flow estimates have not been estimated.

This information is unlikely to be available for individual assets due to the unique nature of different transactions as well as the fact that few listed entities offer a readily usable comparison.

The discount rate(s) used to measure an asset's value in use must not reflect risks for which the future cash flow estimates have been adjusted so as to avoid double-counting.

Where an asset is being held for its service potential, FRS 102 clarifies that a cash-flow driven valuation (e.g. value in use) may be inappropriate. Value in use for such assets is determined by the present value of the asset's remaining service potential plus the *net* amount the entity would receive from its disposal. In some cases, this may be taken to be costs avoided by possession of the asset and so the standard suggests that depreciated replacement cost may be a suitable measurement model.

4.5 Recognition of an impairment loss

An impairment loss is to be allocated in the following order:

- first, reduce the carrying amount of any goodwill allocated to the cash-generating unit; then
- allocate the balance to the remaining assets of the unit on a pro-rata basis of the carrying amount of each asset in the cash-generating unit.

Paragraph 27.22 of FRS 102 restricts the amount by which an asset in a cash-generating unit can be reduced by. This paragraph states that an entity must not reduce the carrying amount of any asset in the cash-generating unit below the highest of:

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

Any excess amount which cannot be allocated to an asset because of the above restriction is allocated to the other assets of the unit pro-rata on the basis of the carrying amount of those other assets.

This allocation is different than previous UK GAAP. Previous FRS 11 allocated an impairment loss first to any goodwill, then any intangible assets and then to tangible fixed assets.

4.6 Goodwill impairment

There are specific rules in FRS 102 relating to goodwill at paragraphs 27.24 to 27.27.

The first point to emphasise is what where goodwill has been written down by way of an impairment loss, the write-down must not be reversed in a subsequent period. This is to reflect the provisions of the EU Accounting Directive and also makes FRS 102 consistent with IAS 36 *Impairment of Assets*.

For non-wholly-owned subsidiaries, part of the recoverable amount of a cash-generating unit will be attributable to the non-controlling interests (NCI). During the impairment test, paragraph 27.26 of FRS 102 requires the carrying amount of that unit to be notionally adjusted before being compared with its recoverable amount. This is done by grossing up the carrying amount of goodwill which is allocated to the cash-generating unit to include goodwill attributable to the NCI. This notionally adjusted amount is then compared to recoverable amount to determine whether the CGU is impaired.

Example – Notional adjustment for goodwill

Holdco Ltd acquires an 80% ownership interest in Subco for £100,000. At the date of acquisition, Subco's net assets had a fair value of £75,000 and hence goodwill was recognised of £40,000 ($£100,000 - (£75,000 \times 80\%)$).

For the purpose of impairment testing the goodwill on acquisition of Subco, the goodwill of £40,000 is grossed-up to £50,000 ($£40,000 \times 100/80$). This grossed-up amount is then aggregated with the other net assets and compared with the CGU's recoverable amount to ascertain any impairment amount.

4.7 Reversals

As noted in 4.6 above, impairment losses in respect of goodwill must not be subsequently written back. Once an impairment loss has been recognised for goodwill, it stays as a loss.

In respect of all other assets, previously recognised impairment losses can be recognised if, and only if, the reasons for the impairment loss cease to apply.

It will be necessary to determine whether the previously recognised impairment loss was based on:

- (a) the recoverable amount of an individual asset; or
- (b) the recoverable amount of the cash-generating unit to which the asset belongs.

Recoverable amount based on the amount of an individual asset

Where recoverable amount was based on the amount of an individual asset, the following requirements will apply:

- (a) *The entity shall estimate the recoverable amount of the asset at the current reporting date.* *FRS 102 para 27.30(a) to (d)*
- (b) *If the estimated recoverable amount of the asset exceeds its carrying amount, the entity shall increase the carrying amount to recoverable amount, subject to the limitation described in (c) below. That increase is a reversal of an impairment loss. The entity shall recognise the reversal immediately in profit or loss unless the asset is carried at revalued amount in accordance with another section of this FRS (for example, the revaluation model in Section 17 Property, Plant and Equipment). Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with the relevant section of this FRS.*
- (c) *The reversal of an impairment loss shall not increase the carrying amount of the asset above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment been recognised for the asset in prior years.*
- (d) *After a reversal of an impairment loss is recognised, the entity shall adjust the depreciation (amortisation) charge for the asset in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.'*

Example – Reversal of an impairment loss

An intangible asset is purchased for £50,000 and is being amortised on a straight-line basis over 20 years. Three years after it has been purchased, it becomes impaired and is written down from its carrying amount of £45,000 to £30,000. Two years after the

impairment loss, carrying amount is £26,250 ($(£30,000 / 16 \text{ years}) \times 2 - £30,000$), the recoverable amount of the intangible asset is estimated to be £40,000 as the circumstances giving rise to the original impairment loss have ceased to apply.

As the circumstances giving rise to the original impairment loss have ceased to apply, the impairment loss is reversed. However, the impairment loss can only be reversed to the extent that it does not increase the carrying amount of the intangible asset to what it would have been had no impairment previously been recognised. Had the impairment never occurred, the carrying amount would be £37,500 ($£50,000 - (£2,500 \times 5)$). Therefore, not all of the original £15,000 impairment loss can be reversed (only £13,750 can be reversed being £37,500 carrying value to date pre impairment loss, less £26,250 carrying value post impairment loss). The difference is the amount of amortisation that would have been charged had the impairment loss not been recognised. The effect of the above is shown below:

	No	
	Impairment	Impairment
	£	£
Cost at 1 January 2018	50,000	50,000
Year 1	(2,500)	(2,500)
Year 2	(2,500)	(2,500)
End of year 2	45,000	45,000
Year 3	(2,500)	(15,000)
Carrying value	42,500	30,000
Year 4	(2,500)	(1,875)*
Year 5	(2,500)	(1,875)
	37,500	26,250
Recoverable amount	40,000	40,000
Difference	2,500	13,750
Original impairment		15,000
Amount of reversal		13,750
Difference		1,250

* $(£30,000/16 \text{ years})$

The difference above of £1,250 is the difference between the amortisation charge which would have been recognised had no impairment loss been recorded, i.e. £5,000 (£2,500 x 2) and the amortisation charge that has been recognised following the impairment loss of £3,750 (£1,875 x 2).

Recoverable amount estimated for a cash-generating unit

When the original impairment loss was based on the recoverable amount of the cash-generating unit to which the asset, including goodwill belongs, the following requirements apply according to paragraph 27.31 of FRS 102:

- (a) *The entity shall estimate the recoverable amount of that cash-generating unit at the current reporting date.* *FRS 102 para 27.31(a) to (e)*
- (b) *If the estimated recoverable amount of the cash-generating unit exceeds its carrying amount, that excess is a reversal of an impairment loss. The entity shall allocate the amount of that reversal to the assets of the unit, except for goodwill, pro rata with the carrying amounts of those assets, subject to the limitation described in (c) below. Those increases in carrying amounts shall be treated as reversals of impairment losses and recognised immediately in profit or loss unless an asset is carried at revalued amount in accordance with another section of this FRS (for example Section 17 Property, Plant and Equipment). Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with the relevant section of this FRS.*
- (c) *In allocating a reversal of an impairment loss for a cash-generating unit, the reversal shall not increase the carrying amount of any asset above the lower of:*
- (i) *its recoverable amount; and*
 - (ii) *the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.*
- (d) *Any excess amount of the reversal of the impairment loss that cannot be allocated to an asset because of the restriction in (c) above shall be allocated pro rata to the other assets of the cash-generating unit, except for goodwill.*
- (e) *After a reversal of an impairment loss is recognised, if applicable, the entity shall adjust the depreciation (amortisation) charge for each asset in the cash-generating unit in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.'*

Applying the above paragraphs mean that the reversal of any impairment loss will be allocated only between those assets to which the original impairment loss was allocated (although not necessarily in the same proportions as the loss was originally allocated). Where this results in a reversal being allocated to an asset which is less than its pro-rata share of the reversal, the amount of the impairment reversal which would otherwise have been allocated to the asset should be allocated to other assets of the unit (but not goodwill), on a pro-rata basis.

4.8 Disclosure requirements

The disclosure requirements in respect of asset impairment are outlined in paragraphs 27.32 to 27.33A of FRS 102 and are as follows:

FRS 102 para 27.32

*'An entity shall disclose the following for each **class of assets** indicated in paragraph 27.33:*

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

FRS 102 para 27.33

An entity shall disclose the information required by paragraph 27.32 for each of the following classes of asset:

- (a) inventories;*
- (b) **property, plant and equipment** (including investment property accounted for by the cost method);*
- (c) goodwill;*
- (d) intangible assets other than goodwill;*
- (e) investments in **associates**; and*

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

FRS 102 para 27.33A

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

5. GOVERNMENT GRANTS (LECTURE A634 – 8.55 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.

5.1 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:

FRS 102 Glossary
government grant

*'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.'*

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.

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.

5.2 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.

Example – Recognition criteria not met

Summer Limited has a year-end of 31 December 2017 and on 30 November 2017 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 year-end the company had not heard whether its application had been successful or not.

The financial controller has 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 2017 because at the year-end the company was unsure whether, or not, the grant would be received from the government (confirmation was not received from the government). Therefore, the receivable should be reversed and accounted for in the financial statements for the year-ended 31 December 2018 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.

5.3 *Accrual and performance models*

An entity receiving (or expecting to receive) a government grant that meets the recognition criteria laid down in paragraph 24.3A of FRS 102 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.

5.4 *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.

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 was 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 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 should be recognised within income in the period in which it becomes receivable. Therefore, the entity should recognise 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) should be 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 ten 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.

Summer 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
<i>Being depreciation of new machine in year 1</i>	
<u>Government grant</u>	
Dr Cash at bank	£20,000
Cr Deferred income	£20,000
<i>Being initial receipt of the government grant</i>	
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 paragraph 24.5G of FRS 102 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.

5.5 Performance model

The performance model was a new model not found under previous UK GAAP and is based on the performance model in the *IFRS for SMEs*. The performance model works by allowing a company to recognise a grant immediately in profit or loss; however, there are certain criteria that have to be considered as follows:

- A grant which does not impose specified future performance-related conditions on the recipient can be recognised in income when the grant proceeds are received or receivable.
- A grant which imposes specified future performance-related conditions on the recipient is recognised in income only when the performance-related conditions are met.

- Grants which are received before the revenue recognition criteria are satisfied are recognised as a liability.

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 they 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 2018.
- The company must have successfully employed at least 150 people on a full-time basis by 31 January 2018.
- 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 2018. 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 2018.

5.6 *Micro-entities*

Section 19 *Government Grants* in FRS 105 outlines the accounting requirements for government grants. Micro-entities 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.

5.7 *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)

FRS 102 para 24.7

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.'

6. RECENT SORP ANNOUNCEMENTS (LECTURE A635 – 3.35 MINUTES)

6.1 Pension SORP

The Pensions Research Accountants Group (PRAG) have published their revised SORP 2018 which must be applied mandatorily for periods commencing on or after 1 January 2019 (early adoption is permissible).

The revised SORP reflects the amendments made by the FRC to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (March 2018), specifically:

- Clarifying that the disclosure requirements in FRS 102 (March 2018) in respect of the identification of financial statements are applicable to pension schemes and the SORP provides guidance on how these requirements are to be applied.
- Clarifying that the financial statements of pension schemes should comply with FRS 102 in its entirety.
- Clarification that IAS 26 *Accounting and Reporting by Retirement Benefit Plans* has not been adopted by the EU, hence a UK private sector pension plan would not report under EU-adopted IFRS. FRS 100 *Application of Financial Reporting Requirements* at paragraph 4(b) states that financial statements can be prepared either in accordance with FRS 102 or EU-adopted IFRS (IAS 26 has not been adopted by the EU). The previous version of the SORP appeared to confirm that IAS 26 was a standard that had been adopted in the EU.

Copies of the revised SORP can be [obtained from this link](#) (although a user-subscription is required).

6.2 LLP SORP

On 1 August 2018, the Consultative Committee of Accountancy Bodies (CCAB) published an updated draft of its LLP SORP for comment. The draft LLP SORP reflects the amendments issued by the FRC following the triennial review of FRS 102 in December 2017.

CCAB have included updates in the draft LLP SORP as follows:

- The guidance on the cash flow statement presentation which reflects the new requirements to disclose changes in net debt between the start of the reporting period and the end of the reporting period.
- The guidance on accounting by small LLPs to reflect the simpler recognition and measurement requirements available to small entities when accounting for certain loans.
- Provision of additional guidance on the revised recognition rules for intangible assets acquired in a business combination.
- Guidance on merger accounting to reflect the extended definition of a group reconstruction.

There have also been other minor clarifications proposed to the LLP SORP in order to maintain consistency with FRS 102 (March 2018).

CCAB propose to make the revised LLP SORP mandatory for periods commencing on or after 1 January 2019 (i.e. consistent with the mandatory effective from date for FRS 102 (March 2018)), although there are some limited exceptions to this rule.

Copies of the draft LLP SORP can be [obtained from this link](#) and the consultation will close on 17 October 2018.

Comments should be submitted by email to admin@ccab.org.uk.

7. USE OF BANNERMAN PARAGRAPHS (LECTURE A636 – 8.20 MINUTES)

(reproduced from an article published on AccountingWEB by Steve Collings)

The use of disclaimers which limit the duty of care to third parties by auditors in their auditor's report has increased significantly over the years. The use of 'Bannerman' paragraphs are common in both auditors' reports and other reports issued by accountancy firms which aim to limit the professional firm's duty of care to third parties.

The use of disclaimers in an auditor's report was highlighted more recently in the case of *Barclays Bank plc v Grant Thornton*. Grant Thornton prepared non-statutory audit reports on Von Essen Hotels Limited Group (VEH) and expressed unqualified opinions for both 2006 and 2007. Barclays Bank alleged that the financial statements had been manipulated to show that VEH was capable of meeting bank covenants on its loan facility when, in fact, it could not. As a result, Barclays Bank suffered losses of some £45million when VEH went into administration in April 2011. The bank also stated that it relied on the unqualified opinions when making the loans to VEH.

Barclays claimed that Grant Thornton owed a duty of care to them and that this duty of care was breached because the auditors failed to uncover the alleged fraud. Barclays also said that Grant Thornton would have been aware that they would be placing reliance on the auditor's report. Grant Thornton's auditor's report contained the Bannerman wording which set out that they did not accept or assume responsibility in respect of the reports to anyone other than the company and its directors.

The judge accepted Grant Thornton's argument and struck out the claim. The judge stated that Barclays should have been aware of the Bannerman paragraph in the report – particularly as it was included in the first two paragraphs of the report and, therefore, if Barclays Bank had not read it, then they should have.

The judge concluded that the Bannerman paragraph was reasonable having regard to the 1977 Unfair Contract Terms Act.

7.1 *Placement of the Bannerman paragraph in the auditor's report*

The use of Bannerman continues to feature in auditors' reports – although care needs to be taken if you are regulated by ACCA (see later). As auditors will be aware, the structure of the auditor's report has now changed in ISA (UK) 700 (Revised June 2016) *Forming an Opinion and Reporting on Financial Statements* which apply to audits of financial statements for periods commencing on or after 17 June 2016.

The changes brought about by ISA (UK) 700 are in the form of the structure of the auditor's report itself – for example the 'Opinion' paragraph is the first paragraph of the report and there are additional requirements in respect of going concern and other information.

In May 2018, the ICAEW updated their guidance in the form of Technical Release 01/03AAF (Revised) *The Audit Report and Auditors' Duty of Care to Third Parties*. Appendix 1 to the Technical Release positions the Bannerman paragraph at the end of the report, above the signature section of the auditor's report and is worded as follows:

'Use of our report

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.'

7.2 Firms regulated by ACCA

Firms regulated by ACCA are required to have an understanding of [Technical Factsheet 84](#) *The use of Disclaimers in Audit Reports*. In particular, paragraph 19 of Technical Factsheet 84 which discourages the use of disclaimers in the auditor's report. ACCA's view is that standard disclaimers are not seen as an appropriate or proportionate response to Bannerman and could devalue the auditor's report. Indeed, ACCA state that where the audit is carried in accordance with the ISAs (UK), there would be no need to include a standard disclaimer in the auditor's report.

ACCA's view is that audit firms that conduct their work in accordance with the ISAs (UK), they reduce the risk of a negligence claim being brought against them. Hence, ACCA's

view is that they do not encourage the use of disclaimers such as the Bannerman paragraph. Therefore, they should only be included in justifiable situations and should not be used on a regular basis.

7.3 Conclusion

The use of disclaimers is common, both in audit and non-audit reports generated by professional firms. ICAEW do encourage their use so as to manage the risk of liability to third parties, but this view is not shared by ACCA who continue to suggest that work done in accordance with the required standards would not need a blanket disclaimer.

8. ISA (UK) 500 AUDIT EVIDENCE (LECTURE A637 – 11.47 MINUTES)

The most crucial aspect to any audit is audit evidence. Audit evidence is the basis on which the audit engagement partner (the senior statutory auditor) forms their opinion as to whether the financial statements give a true and fair view. It is also fair to say that a lack of audit evidence is one of the most frequently criticised areas of audit files during file reviews (see also Section 11 of these course notes which discuss the ICAEW's findings during their review of audit files in 2017).

ISA (UK) 500 *Audit Evidence* deals with the auditor's responsibilities in obtaining audit evidence on which they will form their opinion. ISA (UK) 500 clearly outlines its objective at paragraph 4 which says:

ISA (UK) 500 para 4

'The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.'

The key phrase used in this objective is *'... sufficient appropriate audit evidence'*. 'Sufficiency' is the measure of the quantity of audit evidence, whereas 'appropriateness' is the measure of the quality of audit evidence; that is its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Audit evidence is cumulative in nature and is generated primarily through audit procedures undertaken during the audit (for example substantive procedures and tests of control). Audit evidence can be obtained from prior year audits, but when considering the appropriateness of this evidence, the auditor must determine whether changes have occurred since the previous audit which may affect its relevance to the current audit.

8.1 Procedures for obtaining audit evidence

Two of the UK planning ISAs directly link into audit evidence; ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* and ISA (UK) 330 *The Auditor's Responses to Assessed Risks*. These two UK ISAs say that audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

- (a) risk assessment procedures; and
- (b) further audit procedures, which comprise:
 - (i) tests of controls, when required by the ISAs (UK) or when the auditor has chosen to do so; and
 - (ii) substantive procedures, including tests of details and substantive analytical procedures.

Audit evidence corroborates management's assertions made in the financial statements; however, some audit evidence obtained by the auditor during the course of the audit fieldwork can also contradict management's assertions. Audit evidence from external sources is the most reliable form of evidence – however such evidence is also the most time-consuming and costly to obtain and therefore the auditor will apply other procedures to generate audit evidence, including:

- Inspection
- Observation
- Confirmation
- Recalculation
- Reperformance
- Analytical procedures

'Inquiry' is also another audit procedure which can be used (and is often used) in obtaining audit evidence. However, the problem with this source of evidence is that it is the weakest form of evidence and the UK ISA acknowledges that inquiry alone does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. As a result, inquiry should complement other forms of audit evidence.

Inspection

Inspection involves the examination of records or documents which can be both internal and external. In addition, inspection can also involve physically inspecting an asset for existence and any evidence of impairment.

Inspection tends to be the most commonly used procedure and involves substantiating amounts in the accounting records by reference to documentation. Revenue, for example, will be audited in part by agreement to related contracts and invoices, together with any proof of delivery of goods or services.

Example - Inspection

The financial statements of a company show the addition of a large number of computers during the year amounting to £90,000 which is material to the financial statements. The audit senior has emailed the purchase ledger clerk and asked for a copy of the invoice to be scanned and sent to the audit firm so that they can verify the rights and obligations assertion relating to this equipment.

The invoice from the supplier could have been altered by the purchase ledger clerk. The audit senior should have inspected the original document whilst carrying out the detailed audit work at the company's premises as ISA (UK) 500 considers that original documents are more reliable than photocopies, scanned copies or copies transmitted by facsimile

Observation

Observation involves looking at a process or procedure being performed by others. The most common observation test is the attendance at the year-end stock count. This type of procedure provides audit evidence concerning the performance of a process or procedure but it does have inherent limitations. For example, observation tests are of limited application because they are only valid at a point in time and in some situations there are no alternative procedures which can be carried out.

Example - Observation

The audit senior has attended the year-end stock count of a company and is observing a team of counters checking the quantities and pricing of stock. The counters are organised into teams of two, with one person counting and another person recording the quantities on the stock sheets.

While errors or omissions may not be made whilst the audit senior is in attendance at the stock count, the procedures adopted by management may not be followed in their entirety once the auditor has left the premises.

External confirmation

External confirmation (see also Section 10 of these notes) represents audit evidence because it will ordinarily be a direct written response to the auditor from a third party. The most common type of external confirmation is a bank audit letter (or bank certificate). While in practice it is more common to obtain external confirmations which relate to certain account balances and their elements, external confirmations can also be obtained for non-account balances, such as confirming the terms of agreements or transactions which an entity has with third parties.

Example – Confirmation letter

As part of the normal audit process, the audit senior has undertaken a trade debtors circularisation to confirm the amounts owed by customers.

Trade debtors circularisations are a common type of audit procedure. However, they are limited in their reliability because while they may satisfy the existence assertion, they do not satisfy the valuation assertion (confirming a debt exists does not confirm that the debt will be recoverable) and hence other procedures will need to be adopted to confirm valuation, such as after-date cash testing.

Recalculation

Recalculation consists of checking the mathematical accuracy of documents or records and this sort of procedure can be carried out manually or electronically.

Example - Recalculation

The accounting policy for the depreciation of assets of East Ltd (East) is to depreciate on a pro-rata basis only in the year of acquisition. East has a year-end of 31 March 2018 and on 1 July 2017 an item of machinery was purchased.

Recalculation will involve checking that the accounting policy in respect of depreciation has been correctly calculated by recalculating the depreciation charge on this asset based on 9/12 of a full year's depreciation charge. This type of test is also known as a 'proof in total' test or a 'reasonableness' test

Reperformance

Reperformance involves the auditor independently undertaking a procedure which has previously been carried out by the client.

Example - Reperformance

The audit senior wants to confirm that the PAYE and NIC liabilities of a client have been correctly paid over during the year and that the year-end liability is fairly stated. She decides to undertake a PAYE/NIC control account reperformance for the year-ended 31 July 2018.

Reperforming the PAYE/NIC control account for the year will help to identify any potential over- or under-payments of taxes during the year or at the year-end. It will also offer comfort to the auditor if her reperformance of the PAYE/NIC control account agrees to the year-end financial statements

Analytical procedures

Analytical procedures involve the analysis of the relationships between amounts included within the financial statements, either within the same period, or between comparable amounts from different periods, or in some circumstances through available industry statistics. In carrying out substantive analytical procedures, the auditors will develop their own estimate of the figures they expect to see, compare this estimate with the actual outcome, obtain an explanation for any differences and then corroborate this explanation by reference to other audit evidence or other information available from the entity. It should be noted that there is a separate ISA, namely ISA (UK) 520 *Analytical Procedures* which provides the requirements to auditors where such procedures are concerned and must be applied on all audits.

Example – Analytical procedures

The audit senior has undertaken an analytical review of West's profit and loss account. He has noticed that gross profit margins in 2018 were 40% and in 2017 were 55%.

The fluctuation in gross margins would need to be investigated by the audit senior to ensure they are, in fact, correct and no errors (such as cut-off errors) have been made. Ordinarily gross margins remain static from one period to the next and the variation in gross margins could indicate inappropriate revenue recognition policies or errors in stock valuations.

8.2 Concluding comments

Audit evidence tends to be weak in certain areas of the audit. For example, when testing revenue for income completeness, often the starting point is the sales invoice. Such tests should start from outside of the accounting system, hence the 'source' transaction is often the customer order. Also, keep in mind that while inquiry is a valid audit procedure under ISA (UK) 500, it should not be used as sole audit evidence as it is a weak form of evidence.

9. ISA (UK) 501 AUDIT EVIDENCE – SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS (LECTURE A638 – 13.14 MINUTES)

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

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

The objective of ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items* is for the auditor to obtain sufficient appropriate audit evidence in relation to:

- (a) the existence and condition of inventory;
- (b) completeness of litigation and claims involving the entity; and
- (c) presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

9.1 *Inventory (stock and work in progress)*

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

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

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

- inspect the inventory; and
- perform test counts.

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

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

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

- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of the physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate. ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regards to attendance of physical inventory counting at a remote location.
- Whether the assistance of an auditor's expert is needed. ISA (UK) 620 *Using the Work of an Auditor's Expert* deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

Observing management's instructions

The primary aim where the observation of management's instructions is concerned is to evaluate whether these instructions will reduce the risk of material misstatement.

Paragraph A4 of ISA (UK) 501 outlines various factors which the auditor must also consider and whether management's instructions address:

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

Observing management's count procedures

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

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

Inspecting the inventory

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

Undertaking test counts of inventory

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

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

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

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

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

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

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

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

- (b) The reliability of the entity's perpetual inventory records.
- (c) The reasons for any significant differences between the information obtained during the physical count and the perpetual inventory records.

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

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

- (a) substantive procedures, combined with tests of controls for the intervening period; or
- (b) if the auditor determines that it is sufficient, further substantive procedures only,

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

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

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

Attendance at inventory count is impracticable

Where inventory is deemed material to the financial statements, then the auditor must make every attempt to attend the inventory count to observe the effectiveness of the count. There are occasions, however, when it is deemed impracticable for the auditor

to attend the inventory count, for example because the location of the inventory may pose a threat to the auditor. Reasons of impracticability are quite rare and the UK ISA does acknowledge that general inconvenience would not be a valid reason for the auditor not to attend the inventory count. In addition, factors such as difficulty, time or cost involved are also not considered to be valid reasons not to attend the inventory count.

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

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

Inventory under the custody and control of a third party

Where inventory is under the custody and control of a third party, the provisions in ISA (UK) 505 *External Confirmations* will be triggered where external confirmations are considered necessary (see Section 10 of these notes).

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

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

9.2 *Litigation and claims*

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

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

- (a) inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) reviewing legal expense accounts.

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

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

Reviewing legal expense accounts

The auditor must consider whether it is appropriate to review legal expense accounts which might provide evidence concerning litigation and legal claims. Many 'off-the-shelf' audit programmes often include a test to review the nominal ledger accounts for

such expense accounts during the audit of provisions and contingencies and hence in many cases this test will be carried out as a matter of routine.

Communicating with the entity's external legal counsel

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

- (a) a list of litigation and claims;
- (b) where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- (c) a request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

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

- (a) The auditor determines that the matter is a significant risk.
- (b) The matter is complex.
- (c) There is disagreement between management and the entity's external legal counsel.

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

The auditor is also required to date the auditor's report no earlier than the date on which they have obtained sufficient appropriate audit evidence on which to base their

audit opinion. As a result, the auditor might need to obtain updated information from the entity's external legal counsel.

9.3 Segment information

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

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

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

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

10. EXTERNAL CONFIRMATIONS (LECTURE A639 – 7.33 MINUTES)

External confirms are dealt with in ISA (UK) 505 *External Confirmations*. ISA (UK) 505 cross-refers to ISA (UK) 500 *Audit Evidence* by noting that the following generalisations apply to audit evidence:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

ISA (UK) 505 para 2

Depending on the circumstances, external confirmations may prove to be more reliable than evidence generated internally by the entity.

The objective of ISA (UK) 505 is for the auditor to design and perform such procedures to obtain relevant and reliable audit evidence when using external confirmations.

10.1 Requirements

The auditor is required to maintain control over all external confirmation requests. This includes:

- Determining the information to be confirmed or requested.
- Selecting the appropriate party to make the confirmation.
- Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor.
- Sending the requests, including follow-up requests when applicable, to the confirming party.

The most common types of external confirmations requested by audit firms include bank audit letters (although the mandatory requirement to obtain a bank audit letter

has been relaxed and such letters are determined on a risk basis by the auditor) and debtors circularisation letters.

10.2 Management refuses to allow a confirmation request

Although quite rare in practice, in situations when management refuses to allow the auditor to send a confirmation request, the auditor must:

- Determine why management has refused the request and obtain audit evidence to support their validity and reasonableness.
- Consider the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including fraud risk as well as on the nature, timing and extent of other audit procedures.
- Perform alternative audit procedures which are designed to obtain relevant and reliable audit evidence.

Where the auditor concludes that management's refusal is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from other procedures, the auditor must enter into communication with those charged with governance in accordance with ISA (UK) 260 *Communication with Those Charged with Governance*. In addition, the auditor must also determine the implications for the auditor's opinion in accordance with ISA (UK) 705 *Modifications to the Opinion in the Independent Auditor's Report*.

10.3 Evaluating the results

Where an external confirmation is received by the auditor, but the auditor has doubts concerning the reliability of the response to a confirmation request, the auditor must obtain further audit evidence to resolve those doubts. This could arise, for example, where the auditor does not believe the response is authentic or the auditor does not believe the response is portraying accurate information.

Where the auditor concludes that a response is unreliable, the auditor must evaluate the implications on the assessment of the relevant risks of material misstatement

(including fraud risks) as well as on the related nature, timing and extent of other audit procedures.

In all cases, the auditor must evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary. In cases such as trade debtors circularisations, further audit procedures will always be necessary to address the valuation assertion (e.g. after-date cash receipts testing).

Non-responses

Response rates for certain types of external confirmations can be quite low; particularly for debtors circularisations. Where non-responses are concerned, the auditor must carry out alternative audit procedures to obtain relevant and reliable audit evidence. For example, with the client's permission, contacting the client's customer and asking for confirmation of their purchase ledger balance by telephone or confirmation by other forms, such as in an email.

In rare situations, the auditor may conclude that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence where alternative audit procedures will not provide such evidence. In these situations, where the auditor does not obtain such confirmation, they determine the implications for the audit and the auditor's opinion (which may be qualified due to a limitation in scope/insufficient evidence).

Exceptions

In some cases, a response may be received that indicates exceptions – for example a debtor's circularisation may request positive confirmation of a £2,000 balance at the year-end, but the customer states the amount on their purchase ledger is only £1,700. In such situations, the auditor must investigate such exceptions to establish whether, or not, they are indicative of misstatements.

10.4 Negative confirmations

Circularisations to customers and suppliers can be both positive and negative. However, ISA (UK) 505 recognises that negative confirmations provide less persuasive audit evidence than positive ones. To that end, the standard does not allow the auditor to

use negative confirmation requests as sole substantive procedures to address an assessed risk of material misstatement at the assertion level, unless **all** of the following are present:

- (a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;*
- (b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;*
- (c) A very low exception rate is expected; and*
- (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.'*

ISA (UK) 505 para 15(a) to (d)

11. ICAEW AUDIT MONITORING 2018 (LECTURE A640 – 22.07 MINUTES)

The ICAEW have released their findings of their 2017 audit monitoring visits. During 2017, the ICAEW conducted 619 audit monitoring visits, 611 as a UK Recognised Supervisory Body and 8 under the Crown Dependencies' recognised auditor oversight regime.

The ICAEW have stated that:

2018 Audit
Monitoring

'Although audit quality has remained relatively consistent overall, there is still room for improvement.'

In addition, ICAEW also reviewed 1,019 audits including 26 AIM and Nex companies, five market-traded entities (under the Crown Dependencies regime), 199 charities and 44 pension schemes. 473 audits were of entities which would have applied FRS 102 for the first time (excluding early adoption).

Of these reviews:

- 76% were either satisfactory or generally acceptable;
- 16% required improvement; and
- 8% required significant improvement.

ICAEW also reviewed limited aspects of a further 161 audits and 238 engagements completed under the Solicitors' Regulation Authority's Accounts Rules which require registered auditor status.

ICAEW are required to make a report to the Audit Registration Committee (ARC) where there are significant concerns about a firm's compliance with the Audit Regulations. In 2017, one in ten audit monitoring reviews resulted in a report to the ARC.

Poor audit quality has been cited as a key issue by ICAEW in 36 out of 60 reports to the ARC in 2017. Some, but not all, cases, also contained significant financial reporting issues.

Insufficient audit evidence is the most common significant weakness on audit files according to ICAEW and they have identified the top three ISAs which cause audit quality weaknesses:

- *ISA 500 Audit Evidence*
- *ISA 230 Audit Documentation*
- *ISA 315 Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and Its Environment*

The next three most common ISAs where non-compliance was noted are:

- *ISA 530 Audit Sampling*
- *ISA 580 Written Representations*
- *ISA 570 Going Concern*

11.1 ISA 500 Audit Evidence

ICAEW cite insufficient audit evidence as the main weakness on audit files. Most issues surround revenue testing, fixed assets, stock and work in progress, and other areas where professional judgement is needed such as goodwill and intangible assets.

Problems frequently encountered include the sufficiency of audit evidence for:

- completeness of revenue;
- ownership;
- rights and obligations relating to fixed assets; and
- the valuation of stock and work in progress.

11.2 ISA 230 Audit Documentation

ICAEW have said that there are 'significant issues' where audit documentation is concerned. Common problems include firms failing to record material aspects of their audit work, or the link between the audit evidence and the final conclusion of the audit.

In some (limited) instances, ICAEW have found significant parts of audit files which 'go missing' or the file has not been assembled and archived within 60 days of signing the auditor's report (as required by ISQC (UK) 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*).

11.3 ISA 315 Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and Its Environment

ICAEW confirm that where the auditor does not adequately assess risk through lack of understanding of the client's activities and internal controls, this can lead to an inappropriate audit plan and, consequently, audit evidence which fails to address the risks of material misstatement of the financial statements.

ICAEW have found a number of cases where inspectors are unable to see how well the auditor understands the business and the risks. In addition, inspectors have also found cases where there are apparently significant risks which the auditor does not appear to have addressed.

11.4 ISA 530 Audit Sampling

Audit sampling must reflect the materiality and audit risk of the relevant balance or class of transaction. ICAEW audit inspectors often find that a sample has been taken from a restricted population (e.g. overdue trade debtors) with no testing of the material trade debtors within credit terms at the year-end. Focussing on overdue debts will identify whether a client's general or specific bad debt provision is adequate, but regard must be had to other trade debtors who may be within credit terms to verify the valuation and existence assertions.

11.5 ISA 580 Written Representations

ISA 580 (note the 2018 audit monitoring report cites ISA 570 under the 'Other Common Issues' section of the report (which is going concern) rather than ISA 580) requires certain management representations to be obtained on all audits, which often go beyond standard clauses. ICAEW have found that in areas requiring significant judgement, an auditor has not requested specific management representations to supplement their detailed audit work, where appropriate. Conversely, ICAEW have also found that the auditor has over-relied on representations rather than doing supporting detailed audit work. Over-reliance on written representations must be avoided as they are designed to complement other audit evidence and can also increase audit risk (the risk that the auditor expresses an incorrect opinion on the financial statements). On their own, written representations are insufficient as audit evidence because they are internally generated.

11.6 ISA 570 Going Concern

Going concern has to be addressed on all audits and the standard requires the auditor to assess the work done, and conclusions reached, by those charged with governance. In a lot of audits, this assessment can be relatively straightforward (particularly for smaller audits). However, in other audits it is less straightforward and the report cites businesses which operate on small margins with little headroom over loan covenants and these types of audits will involve difficult judgements.

ICAEW clarify that it is important that the auditor can demonstrate how it has challenged management's forecast (hence demonstrating professional scepticism also) when the assumptions contradict recent trading results or other available evidence.

11.7 Financial reporting issues (case study)

ICAEW visited a small firm with five audit clients. Two of these files highlighted financial reporting issues.

On the first file, a material liability had been recognised on the balance sheet. Questions asked by the inspector revealed that this was more likely to be a contingent liability, which is disclosed rather than recognised.

On the second file, ICAEW queried a large intra-group debtor which the firm had identified as doubtful and a review of the file also indicated that the doubtful debt was a legitimate concern of the auditor. However, the auditor had not proposed any adjustments to the client and had expressed an unqualified audit opinion.

ICAEW confirm that these issues indicate an ineffective review process of the audit work at the firm. The firm in question agreed to discuss these points with the clients at the next audit and ICAEW were satisfied that this was an appropriate response in the circumstances.

While ICAEW were satisfied with the firm's response, it was a significant concern and they subsequently made a report to the ARC to recommend imposing external hot file reviews of all audits (to include a review of the draft financial statements) until ICAEW is satisfied that the quality of the financial statements is of an appropriate standard.

11.8 Compliance with the Ethical Standard (case study)

All auditors are required to comply with the Ethical Standard issued by the Financial Reporting Council. In addition, independence and objectivity are fundamental aspects which auditors must comply with and the ICAEW/ARC take breaches of the Ethical Standard very seriously.

While the report confirms that breaches of the Ethical Standard are not as prevalent as issues with audit quality and financial reporting, the ICAEW do come across instances where breaches of the Ethical Standard have arisen.

The ICAEW have included a Case Study in their report where a previous auditor resigned due to a threat to independence. The threat arose because the firm's sole equity partner became a director of the audit client. The new auditor agreed to use two of the former auditor's staff as sub-contractors on the audit.

ICAEW state that while this arrangement may make practical sense to help the new auditor, in this particular instance these sub-contractors would not be independent as they were employed by a director of the audit client.

Notwithstanding the fact that ICAEW's review of the audit work performed was of a good standard, there were clearly independence issues. ICAEW recommended that the ARC impose an external hot file review of the next audit of this client to provide evidence that all threats to independence have been resolved.

Other aspects of breaches of the Ethical Standard include a partner of the audit firm being a trustee of a trust which owns a material interest in an audit client. ICAEW recommends audit firms review the helpsheet *Covered person* which sets out who is included in the definition of 'covered person' because a failure to understand these issues may result in a breach of the Ethical Standard which could result in a report to the ARC.

11.9 Eligibility

The final point which the ICAEW raise in their report concerns eligibility to practise as a registered (statutory) auditor. In order to be a statutory auditor, all firms must continue to meet the criteria for eligibility set out in the Audit Regulations.

The report acknowledges that structural changes within a firm may result in short periods where a registered auditor is unable to fulfil the eligibility requirements. Where the firm consults with ICAEW on a swift basis, they can usually help to resolve the issue and arrange for a dispensation to allow it to continue signing auditor's reports for an interim period of three months while the firm resolves the matter. Where firms fail to notify ICAEW about these changes, there is a risk that independence and objectivity is impeded and, in some cases, may result in the firm underpaying audit registration fees.

When firms have been ineligible for audit registration for a significant period and have saved registration fees as a result, ICAEW notify ARC. The report cites an example of when a firm appoints a new principle who is not an ICAEW, ICAS, CAI or ACCA member or a registered auditor, but does not apply for audit affiliate status for the new principal. In order to continue audit registration, the ARC will ensure that the firm makes the appropriate changes to become eligible for audit registration and may impose a regulatory penalty. The ARC's starting point for calculating this penalty is likely to be the amount of underpaid registration fees so that all firms pay their appropriate share of the costs of ICAEW regulation.

In 2017, ICAEW made eight reports to the ARC in respect of eligibility issues.

