Accounting and Audit Quarterly Update – Quarter 1

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1. FRC issue Staff Factsheets

On 13 December 2018, the FRC issued seven Staff Factsheets on various aspects of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and reflect the changes that arose due to the triennial review. The aim of the Factsheets is to assist stakeholders by highlighting certain requirements of FRS 102. They are not designed to be a replacement of any of the provisions of FRS 102 and the Factsheets should not be relied upon as definitive statements on the application of FRS 102 or as a substitute for reading the detailed provisions of the standard.

Prior to the Factsheets, the FRC had issued 16 Staff Education Notes. The Staff Education Notes provided useful commentary on the differences between previous UK GAAP and FRS 102. However, the Staff Education Notes had served their purpose and hence the FRC felt these should be replaced by some useful guidance on certain areas of FRC which may need additional clarification.

The Factsheets are available free of charge from the FRC's website (www.frc.org.uk) and there are seven in total as follows:

- Factsheet 1 – FRS 102: Triennial Review 2017 Amendments
- Factsheet 2 – FRS 102: Triennial Review 2017 Transition
- Factsheet 3 – FRS 102: Illustrative Statement of Cash Flows
- Factsheet 4 – FRS 102: Financial Instruments
- Factsheet 5 – FRS 102: Property: Fair Value Measurement
- Factsheet 6 – FRS 102: Business Combinations
- Factsheet 7 – FRS 102: Transition to FRS 102

2. LP SORP is revised (Lecture A651 – 11.48 minutes)

On 14 December 2018, the Consultative Committee of Accountancy Bodies (CCAB) issued a revised Statement of Recommended Practice – Accounting by Limited Liability Partnerships (LLPs SORP). The SORP has been amended to reflect the changes made to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland as a result of the FRC's triennial review. A link to the revised LLP SORP can be found here.

The revised SORP is effective for periods commencing on or after 1 January 2019 (in line with FRS 102 (March 2018) which incorporates the amendments arising from the triennial review). Early adoption is permissible, provided all amendments are applied from the same date, with some limited exceptions.

The notable changes to the LLP SORP include the following:

a.1 Cash flow statement

FRS 102 (March 2018) Section 7 Statement of Cash Flows contains a requirement (at paragraph 7.22) for an entity producing a cash flow statement to present a reconciliation of net debt. Additional guidance has been included in the revised SORP at paragraph 74C which clarifies that although 'loans and other debts due to members' are considered to be borrowings for the purposes of the definition of net debt, they are not external financing. The revised SORP recommends that LLPs present in the notes to the financial statements an analysis of the movements in net debt for the period, with appropriate subtotals to show the changes in net debt before members' debt separately from debt relating to members. There is a presentation example for the net debt reconciliation on page 30 of the revised SORP.

2.2 Loans to small LLPs

When members' capital has been classified as a financial liability, there may be a need to discount that liability to present value using a market rate of interest for a similar loan (i.e. if it constitutes a financing arrangement). FRS 102 (March 2018) contains an exception to this requirement in paragraph 11.13A for small entities (including LLPs), stating:

'As an exception to paragraph 11.13, the following financing transactions may be measured initially at transaction price:

*(a) a basic financial liability of a **small entity** that is a loan from a person who is within a director's group of close family members[1], when that group contains at least one shareholder[2] in the entity; and*

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[1] In this context, a director's group of close family members shall be the director and the close members of the family of that director (see glossary definition of **close members of the family of a person**). This includes a person who is the sole director-shareholder of an entity.

[2] For small LLPs this shall be read as a member who is a person.

(b) a public benefit entity concessionary loan (see paragraph PBE11.1A).'

Paragraph 57A of the revised LLP SORP confirms that discounting will not be required where the members' capital is repayable on demand or at short notice (e.g. on termination of membership).

The exemption from discounting loans to a small entity in FRS 102 (March 2018), paragraph 11.13A also applies to small LLPs ('small' being as defined in the Companies Act 2006). However, paragraph 57A of the revised LLP SORP confirms that the meaning of 'director' has not been defined in FRS 102 for an LLP. Accordingly, the SORP recommends that for the purposes of applying the exemption in FRS 102 (March 2018), paragraph 11.13A, a director is taken to mean a member, who is a person, with an equivalent role in the LLP. For some LLPs that may be all the members; whereas for others it may be a member who is part of a governing body or management board.

2.3 Business combinations and group accounts

The revised LLP SORP includes an additional paragraph 108A to reflect the new recognition requirements for intangible assets acquired as part of a business combination in FRS 102 (March 2018).

FRS 102 (March 2018), paragraph 18.8 states that intangible assets must be recognised separately from goodwill if they are separable and arise from contractual or other legal rights subject to the recognition criteria in FRS 102 (March 2018), paragraph 18.4 being met.

Some entities wishing to recognise more intangible assets separately from goodwill can do so through the accounting policy choice contained in FRS 102 (March 2018), paragraph 18.8. To qualify for separate recognition, the intangible asset must still meet the recognition criteria in FRS 102 (March 2018), paragraph 18.4 but the intangible asset need only be separable OR arise from contractual or legal rights.

This particular issue could be relevant for certain business combinations involving LLPs when two LLPs come together, but no cash is paid and no additional amounts of purchase consideration are identified. The Basis for Conclusions in the revised LLP SORP acknowledges that where this is the case, and substantial intangible assets are recognised on acquisition, it can give rise to negative goodwill. Negative goodwill arises when the cost of a business combination is less than the fair value of the net assets recognised at the date of acquisition. As a consequence, paragraph 108B of the revised LLP SORP suggests that an LLP may conclude that it is preferable to have a policy of NOT recognising such additional intangible assets.

2.3 Definition of a group reconstruction

The definition of a group reconstruction was extended in FRS 102 (March 2018) to include the transfer of the business of one group entity to another; and the transfer of the business of one group entity to a new entity which is not a group

entity but whose equity holders are the same as those of the parent. This extended definition does not change the accounting treatment set out in paragraph 5 of Appendix 4 of the LLP SORP but the appendix has been updated to reflect the revised definition.

3. SRA Accounts Rules 2018 (Lecture A652 – 5.19 minutes)

On 14 June 2018, the Solicitors Regulation Authority (SRA) announced that the SRA Accounts Rules (2018) were approved by the SRA Board and will, subject to the approval of the Legal Services Board, be introduced in April 2019.

The final version of the SRA Accounts Rules has not changed significantly from the draft version which was published in June 2017.

3.1 Definition of 'client money'

The majority of the consultation responses were supportive of the SRA's aim of simplifying the SRA Accounts Rules. However, at the consultation stage there was widespread criticism concerning the proposal to amend the definition of 'client money' so as to exclude payments on account of costs and certain disbursements as having to be treated as client money.

The revised definition of client money includes money held or received by a firm in respect of fees and any unpaid disbursements if held or received prior to the delivery of a fee note for the same.

Rule 4 Client money must be kept separate states:

'Where you are holding client money and some or all of that money will be used to pay your costs:

(a) you must give a bill of costs, or other written notification, to the client or the paying party;

(b) this must be done before you transfer any client money from a client account to make the payment; and

(c) any such payment must be for the specific sum identified in the bill of costs or other written notification, and covered by the amount held for the particular client or third party.'

Rule 17.2 in the SRA Accounts Rules 2011 states:

'If you properly require payment of your fees from money held for a client or trust in a client account, you must first give or send a bill of costs, or other written notification of costs incurred, to the client or the paying party.'

The words 'properly require' are no longer used in the revised Rule 4. The impact of this is quite significant because the presence of the words 'properly require' prevent a firm from transferring funds from the client account to the office account where a bill has been sent to the client, but the work covered by the bill has not yet been completed.

On the face of it, the SRA Accounts Rules 2018 would therefore seem to allow a solicitor to transfer monies from the client account to the office account if a bill

has been rendered to the client for work not yet completed (i.e. a payment on account of costs).

In addition, the SRA Accounts Rules 2018 refer to the firm's 'costs' as opposed to the firm's 'fees' as is referred to in Rule 17.2 of the SRA Accounts Rules 2011.

The definition of 'costs' comprises the firm's profit costs and disbursements; whereas the definition of 'fees' is purely the profit cost element of the bill. Seemingly, the impact of this is that a firm will be unable to transfer funds held in the client account to cover disbursements paid out of office monies on behalf of the client prior to sending the client a bill.

3.2 Legal Aid Agency receipts

Under the SRA Accounts Rules 2018, monies received from the Legal Aid Agency can, as is currently the case under the SRA Accounts Rules 2011, be paid into the firm's office account. A notable change, however, is the fact that the obligation to either pay any unpaid disbursements, or transfer the corresponding funds from the office account to the client account has been removed.

The SRA's view is that the removal of the provision for disbursements to be retained in a client account if they are not paid within either 14 days (where a funding certificate is in force) or 28 days (payments received under a civil or criminal contract) does not mean that the firm will be able to hold payments from the Legal Aid Agency in their business account indefinitely.

3.3 Further developments

The SRA have simplified and shortened the SRA Accounts Rules 2018 (indeed the SRA Accounts Rules 2018 only span seven pages). However, this is not the end of the project as the SRA have indicated that they intend to publish additional guidance on the correct interpretation and application of the proposed new SRA Accounts Rules 2018 which is to be read in conjunction with the new rules.

At the time of writing, it is currently unclear as to the form or volume of the additional guidance which the SRA is proposing to publish but it is expected to be quite detailed given the following list of areas which the SRA have identified may need additional guidance:

- Acting as a trustee and client money
- What is client money
- Name of client account
- Withdrawals to make payments to Charity
- Who can make withdrawals from client account?
- Residual balances due to a client
- Requirements to pay interest
- Accounting records and systems

- Accountant's Reports
- Record keeping around operation of joint accounts
- Operation of a client's own account
- Treatment of legal aid money/monies received relating to formal appointments (insolvency)
- Use of Third Party Managed Accounts
- Client account as a banking facility
- Waiver provisions
- Out of scope monies in an MDP

Given the above list of areas, it is inevitable that the additional guidance to be published by the SRA will more than likely be treated as if they form part of the rules as opposed to be being treated as guidance.

4. Taxation under UK GAAP (Lecture A653 – 18.05 minutes)

Issues relating to taxation are dealt with in FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland in Section 29 Income Tax and in FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime in Section 24 Income Tax.

4.1 Defined terms

'Current tax' is defined as:

'The amount of **income tax** payable (refundable) in respect of the **taxable profit** (tax loss) for the current period or past **reporting periods**.'

'Deferred tax' is defined as:

'**Income tax** payable (recoverable) in respect of the **taxable profit (tax loss)** for future **reporting periods** as a result of past transactions or events.'

'Income tax' is defined as:

'All domestic and foreign taxes that are based on **taxable profits**. Income tax also includes taxes, such as withholding taxes, that are payable by a **subsidiary**, **associate** or **joint venture** on distributions to the reporting entity.'

The definition of 'income tax' refers to 'taxable profit'. Taxable profit is often not the same as accounting profit due to tax legislation which differs from financial reporting standards. For example, depreciation is often disallowed for the purposes of the tax computation but is required to be brought into account by FRS 102, Section 17 *Property, Plant and Equipment* and FRS 105, Section 12 *Property, Plant and Equipment and Investment Property*. Company law also requires tangible fixed assets to be depreciated – although investment property measured at fair value through profit or loss applies the Fair Value Accounting rules in the Companies Act 2006 and hence is not depreciated as the investment property is remeasured to fair value through profit or loss at each reporting date.

In addition, it should also be noted that the definitions of 'current tax' and 'deferred tax' refer to 'income tax'. This is not the same type of tax which an employee suffers through the PAYE system. A company pays corporation tax on its profits and must submit a corporation tax return to HM Revenue and Customs (a form CT600).

4.2 Current tax

FRS 102, paragraph 29.3 requires an entity to recognise a current tax liability for tax payable on taxable profit. The term 'taxable profit (tax loss)' is defined as:

'The profit (loss) for a **reporting period** upon which **income taxes** are payable or recoverable, determined in accordance with the rules established by the taxation authorities. Taxable profit equals taxable income less amounts deductible from taxable income.'

A current tax asset must be recognised for the benefit of a tax loss that can be carried back to recover tax paid in a previous period (provided it is virtually certain that HMRC will refund the tax asset).

To the extent that current tax for the current and prior periods is unpaid, a liability is recognised. Where the amount already paid exceeds the amount due for those periods, the excess is recognised as an asset to the extent that the asset is recoverable.

FRS 102, paragraph 29.5 requires an entity to measure a current tax liability (asset) at the amount of tax which it expects to pay (recover) using the tax rates and laws that have been enacted or substantively enacted by the reporting date. The term 'substantively enacted' is defined in the Glossary to FRS 102 as follows:

'Tax rates shall be regarded as substantively enacted when the remaining stages of the enactment process historically have not affected the outcome and are unlikely to do so.

A UK tax rate shall be regarded as having been substantively enacted if it is included in either:

(a) a Bill that has been passed by the House of Commons and is awaiting only passage through the House of Lords and Royal Assent; or

(b) a resolution having statutory effect that has been passed under the Provisional Collection of Taxes Act 1968. (Such a resolution could be used to collect taxes at a new rate before that rate has been enacted. In practice, corporation tax rates are now set a year ahead to avoid having to invoke the Provisional Collection of Taxes Act for the quarterly payment system.)

A Republic of Ireland tax rate can be regarded as having been substantively enacted if it is included in a Bill that has been passed by the Dail.'

4.3 Accounting for current tax

Ordinarily, current tax is recognised in profit or loss on the grounds that it relates to the ongoing operations of the business. This, however, is not absolute in all cases because where current tax relates to items which are recognised in other comprehensive income, the current tax is also recognised in other comprehensive income. Similarly, where the current tax relates to items which are recognised directly in equity, the tax is also recognised in equity (although this is rare).

4.4 Accelerated Payment Notices (APNs)

APNs were introduced into the Finance Act 2014 and this course does not examine the relevant tax legislation associated with APNs. Essentially, APNs are issued where the entity enters into a tax avoidance scheme. The APN requires the business to pay HMRC the disputed amount of tax upfront while the dispute is resolved.

If a business receives an APN, it does not automatically trigger the recognition of a liability in the financial statements because this will be a judgement call on the part of the directors. The APN provides additional evidence that a liability exists. Once the directors are satisfied that a liability exists, the APN is recognised in the financial statements. The key issue to bear in mind is that a liability can only be recognised if there is a legal obligation as a result of past events and the value of the liability can be reliably measured (i.e. the recognition criteria for a liability are met).

4.5 Deferred tax

At the outset it is worth noting that micro-entities choosing to report under FRS 105 are prohibited from accounting for deferred tax. This is because the minimal information which a micro-entity is required to disclose in the financial statements mean that it would not be possible to distinguish between current tax and deferred tax, hence the FRC took the decision to prohibit micro-entities from accounting for deferred tax.

For small entities upwards, deferred tax is required to be brought into account if material.

FRS 102, paragraph 29.6 requires deferred tax to be recognised in respect of all timing differences at the balance sheet date (with certain exceptions). The term 'timing differences' is defined as:

'Differences between **taxable profits** and **total comprehensive income** as stated in the **financial statements** that arise from the inclusion of **income** and **expenses** in tax assessments in periods different from those in which they are recognised in financial statements.'

Deferred tax is not provided for in respect of permanent timing differences. The term 'permanent differences' is defined as:

'Differences between an entity's taxable profits and its total comprehensive income as stated in the financial statements, other than timing differences.'

FRS 102, paragraph 29.10 confirms that permanent differences arise because certain types of income and expense are non-taxable or disallowable, or because certain tax charges or allowances are greater or smaller than the corresponding income or expense in the financial statements. Deferred tax is not recognised on permanent differences except for the circumstances set out in FRS 102, paragraph 29.11 which relates to business combinations.

Timing differences are said to arise in one accounting period and then reverse in subsequent accounting periods, hence the tax charge in the later periods will be affected by transactions or events that have arisen in a previous accounting period. This has a direct impact on the reporting entity because future tax assessments will be higher or lower than they would have been if those timing differences had not occurred. The overarching objective of deferred tax is, therefore, to smooth out the effects of future tax consequences by recognising

the tax effects of all income and expenditure, gains and losses, assets and liabilities in the same period in which they are recognised rather than in the period in which they form part of the company's taxable profit.

4.6 Timing difference 'plus'

Accountants will, by now, be familiar with the timing difference 'plus' approach used in FRS 102. The original idea behind the timing difference plus approach was to enable a calculation of deferred tax by an entity reporting under UK GAAP which would be similar if the entity had prepared its financial statements using IFRS. However, the notable difference between FRS 102 and IAS 12 *Income Taxes* is the fact that IAS 12 uses a temporary difference approach to deferred tax, whereas FRS 102 uses a timing difference approach. IAS 12 is focussed on the balance sheet and the values at which assets and liabilities are crystallised rather than the timing difference approach which is focussed on the inclusion of income and expenditure in profit and loss – hence the focus of the timing difference approach is on the profit and loss account.

The 'plus' part of the timing difference plus approach brings in three additional situations which trigger deferred tax consequences.

Entities reporting under FRS 102 are now required to bring deferred tax into account in respect of:

- non-monetary assets that have been subjected to the revaluation model (or carried at fair value at each balance sheet date, such as investment property);
- business combinations; and
- unremitted earnings in overseas subsidiaries, associates, branches or interest in joint ventures.

4.7 Rate of tax used in the calculation of deferred tax

FRS 102, paragraph 29.12 requires an entity to measure a deferred tax liability (asset) using the tax rates and laws that have been enacted or substantively enacted by the reporting date that are expected to apply to the reversal of the timing difference.

A common error is to use the rate of tax in force at the balance sheet date. Paragraph 29.12 is clear that the rate of tax to be used is the tax rate which is **expected to apply to the reversal of the timing difference**.

The rate of corporation tax for the corporation tax year starting 1 April 2019 is 19%. This will reduce to 17% for the corporation tax year starting on 1 April 2020.

4.8 Revaluations of non-monetary assets

FRS 102 requires deferred tax to be brought into account in respect of a non-monetary asset subject to revaluation. This was not the case under previous UK GAAP.

The most common type of asset to be revalued is a building. In addition, FRS 102 (March 2018) Section 16 *Investment Property* requires all investment property to be remeasured to fair value through profit and loss at each balance sheet date. There are no 'undue cost or effort' exemptions in the March 2018 edition of FRS 102. Intra-group investment property can be measured using the cost model (cost less depreciation less impairment) but this accounting policy choice only applies to investment property rented out to another group entity.

Example – Deferred tax on a revaluation of a property

Argyll Ltd has a portfolio of investment properties that it uses to generate rental income. On 1 January 2018, Argyll Ltd acquired an investment property which is accounted for under FRS 102, Section 16. The cost of the property was £100,000.

The company is preparing its financial statements for the year-ended 31 December 2018 and on this date commissioned an external valuer to value the properties.

Due to an increase in housing prices during 2018, the Chartered Surveyor has confirmed that the property has benefitted from a £10,000 increase in fair value. The company currently pays tax at 19% but the corporation tax rate is expected to reduce to 17% on 1 April 2020. The company has no plans to dispose of the property in the foreseeable future.

FRS 102, paragraph 29.12 requires the company to measure deferred tax using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Hence, the accounting entries for the £10,000 gain are:

Dr Investment property £10,000

Cr Fair value gains (profit and loss) £10,000

Being fair value gain of investment property at 31 December 2018

The company must also make provision for deferred tax to comply with FRS 102, paragraph 29.16. Paragraph 29.16 states that deferred tax relating to investment property that is measured at fair value is to be measured using the tax rates and allowances that apply to the sale of the asset. The deferred tax is calculated using the rate of 17% as the company is not expecting to dispose of the property in the foreseeable future. The entries are:

Dr Tax expense (profit and loss) £1,700

Cr Deferred tax provision £1,700

Being provision for deferred tax on investment property at 17%

4.9 Business combinations

A 'business combination' is defined in the Glossary to FRS 102 as:

'The bringing together of separate entities or **businesses** into one reporting entity.'

FRS 102, paragraph 29.11 states:

'When the amount that can be deducted for tax for an asset (other than goodwill) that is recognised in a business combination accounted for by applying the purchase method is less (more) than the value at which it is recognised, a deferred tax liability (asset) shall be recognised for the additional tax that will be paid (avoided) in respect of that difference.

Similarly, a deferred tax asset (liability) shall be recognised for the additional tax that will be avoided (paid) because of a difference between the value at which a liability is recognised in a business combination accounted for by applying the purchase method and the amount that will be assessed for tax. The amount attributed to goodwill (or negative goodwill) shall be adjusted by the amount of deferred tax recognised.'

Example – deferred tax in a business combination

On 1 January 2018, Topco Ltd acquired 100% of the share capital of Subco Ltd for £900,000. Extracts from Subco's financial statements at the date of acquisition are as follows:

	Book value	Fair value	Tax deductions
	£'000	£'000	£'000
Property	300	400	210
Plant and machinery	200	250	75
Other current assets	100	100	100
Liabilities	(40)	(40)	(40)
	560	710	345

Subco has unutilised corporation tax losses amounting to £35,000 and Topco intends to utilise these losses among other group members in its portfolio by way of group relief. Subco has not previously recognised any deferred tax asset in respect of these tax losses as the directors were unsure as to whether they were capable of recovery. The Group calculates deferred tax at 17%.

Goodwill arising on the acquisition of Subco Ltd is calculated as follows:

	Book value £'000	Fair value £'000	Tax deduction £'000	Timing difference £'000	Tax rate	Deferred tax (rounded) £'000
Property	300	400	210	190	17%	32
Plant	200	250	75	175	17%	30
Other CA	100	100	100	-	-	-
Liabilities	(40)	(40)	(40)	-	-	-
Tax loss c/f	-	N/A	N/A	(35)	17%	(6)
	560	710	345	330		56

Goodwill calculation:

	£'000
Cost of investment	900
Net assets acquired	(710)
Deferred tax liability	(56)
Goodwill on acquisition	134

4.10 Unremitted earnings

Under previous UK GAAP, unremitted earnings of subsidiaries, associates and joint ventures only gave rise to deferred tax liabilities to the extent that dividends had been accrued in the financial statements, or if there was a binding agreement to distribute previous earnings.

FRS 102, paragraph 29.9 states:

'Deferred tax shall be recognised when income or expenses from a **subsidiary**, **associate**, branch, or interest in **joint venture** have been recognised in the financial statements, and will be assessed to or allowed for tax in a future period, except where:

(a) *the reporting entity is able to control the reversal of the timing difference; and*

(b) *it is probable that the timing difference will not reverse in the foreseeable future.*

Such timing differences may arise, for example, where there are undistributed profits in a subsidiary, associate, branch or interest in a joint venture.'

When an entity has investments in subsidiaries, associates or jointly controlled entities, the investor will be entitled to a share of the earnings from these investments. In the consolidated financial statements, the investor will consolidate the results of subsidiaries and equity account associates/jointly controlled entities. Timing differences will generally arise in the group accounts because the profits of the investee have been recognised but have not been assessed to corporation tax which would arise if those profits had been distributed to the investor.

For investments in subsidiaries, associates and jointly controlled entities, a deferred tax liability is recognised unless both of the requirements in FRS 102, paragraph 29.9 are met.

4.11 Deferred tax assets

Deferred tax assets must only be recognised in the balance sheet if they are capable of recovery. FRS 102, paragraph 29.7 takes a pessimistic approach to the recognition of deferred tax assets. The paragraph states that unrelieved tax losses and deferred tax assets must only be recognised to the extent that it is probable (i.e. more likely than not) that they will be recovered against the reversal of deferred tax liabilities or other future taxable profits. The paragraph then confirms that the very existence of unrelieved tax losses is strong evidence that there may not be other future taxable profits against which the losses will be relieved.

Therefore, be careful with deferred tax assets and be sure that such assets are capable of recovery. Just because a transaction or event may give rise to a deferred tax asset, it does not mean that it is automatically recognised. The underpinning principle in financial reporting is that assets must not be stated in the balance sheet in excess of their recoverable amount.

Example – Recognition of a deferred tax asset

Innsbruck Co Ltd has been established for many years. However, due to difficult trading conditions the company has sustained a loss (both for financial reporting and tax purposes) of £65,000. The company's year-end is 31 October 2018 and the financial statements have been completed to draft stage. The financial statements are expected to be authorised for issue on 10 January 2019.

On 1 November 2018, the company was awarded a contract with a well-known builder to fit conservatories on each of its sites for a period of five years. The company is expected to make a healthy profit from this contract which commences in the summer of 2019.

In this instance a deferred tax asset could be recognised in the financial statements for the year-ended 31 October 2018 because there is evidence that the company *will* generate suitable taxable profits in the future for which the deferred tax asset can be utilised.

4.12 Reconciliation of tax expense (non-small companies)

FRS 102, paragraph 29.27(b) requires a reconciliation between:

(a) the tax expense (income) included in profit or loss; and

(b) the profit or loss on ordinary activities before tax multiplied by the applicable tax rate.

It should be noted that the statutory formats of the profit and loss account do not refer to the phrase '… on ordinary activities' even though FRS 102, paragraph 29.27(b) still refers to the term.

The relationship between the two can be affected by various items, such as tax-free income, disallowable expenditure, differing tax rates, adjustments to prior year tax values, changes in corporation tax rates and utilisation of tax losses.

The starting point for the tax reconciliation note is to determine the applicable tax rate. FRS 102, paragraph 29.27(d) also requires an explanation of changes in the applicable tax rate(s) compared with the previous accounting period.

Example – tax reconciliation note

8. Tax on profit

	2018	2017
	£	£
Current tax:		
UK corporation tax	158,791	190,585
Deferred tax	(4,602)	(6,637)
Tax on profit	154,189	183,948

	2018	2017
	£	£
Profit before tax	328,398	862,838
Profit multiplied by the standard rate of corporation tax		
in the UK of 19% (2017: 19%)	62,396	163,939
Expenses not deductible for tax purposes	86,020	25,191
Depreciation in excess of capital allowances	4,042	1,455
Adjustment to tax charge in respect of prior years	1,800	-
Effect of balancing charge	4,533	-

Movement in deferred tax	(4,602)	(6,637)
Total tax charge	154,189	183,948

The difference between the requirements of FRS 102 (as reflected in the example above) and previous UK GAAP is that FRS 102 requires a reconciliation to the tax **expense** shown in the profit and loss account. Old UK GAAP only required the entity to reconcile to the tax **charge** (i.e. the current tax charge shown in the trial balance). Some software providers make provision for this requirement whereas others do not, so be sure to understand that you are reconciling to the tax charge per profit and loss and not to the tax expense and hence you should expect to see deferred tax movements in the reconciliation where there have been such movements via profit and loss.

5. IFRS 16 Leases (Lecture A654 – 28.01 minutes)

5.1 Overview of IFRS 16

The final version of IFRS 16 was issued in January 2016 and becomes mandatory for accounting periods commencing on or after 1 January 2019.

IFRS 16 is significantly different from IAS 17 *Leases* for lessees, effectively requiring all leases to be accounted for as finance leases.

It removes the distinction between operating and finance leases. All leases (including those previously regarded as operating leases under IAS 17) will be brought onto the statement of financial position (balance sheet) as **right-of-use assets**, with a corresponding leasing obligation.

Importantly, the new requirements will extend to all leases of land and buildings! This means that IFRS 16 will have a big impact on a large number of entities, who will be moving significant debts onto their balance sheet and the relevant expenses will be differently presented in the income statement.

All contracts will need to be analysed carefully to determine whether they are lease contracts or contracts which contain both lease and non-lease components.

There are limited exemptions for short-term leases with a lease term of 12 months or less, and leases for which the underlying asset is of low value.

The transition requirements give a choice between full retrospective application, and retrospective application from the date of initial application (i.e. the cumulative catch up method first seen in IFRS 15 *Revenue from Contracts with Customers*).

For lessors, the dual accounting model in IAS 17 is carried over into IFRS 16. Thus for lessor accounting, the distinction between operating and finance leases remain. These notes only look at lessee accounting where there are significant changes.

5.2 The 'right of use' model

The 'right-of-use model' used in IFRS 16, reflects that at the start of the lease, a lessee obtains a right to use the underlying asset for a period of time, and the lessor has provided or delivered that right.

IFRS 16 states that a customer has the right to direct the use of an identified asset if either:

(a) the customer has the right to direct how and for what purpose the asset is used throughout its period of use; or

(b) the relevant decisions about use are pre-determined and the customer has the right to operate the asset throughout the period of use without the supplier having the right to change these operating instructions.

5.3 Identifying a lease

Leases are different from services because, at the start of a lease, the customer obtains control of a resource (the right to use an item). The definition and accompanying guidance focuses on whether a customer controls the use of an item.

A customer controls the use of an item when the customer has exclusive use of the item for a period of time and can decide how to use it.

5.4 Non-lease (service) components

It is common for contracts to contain both lease and service components. Two common examples of contracts containing both a lease and services are:

- a lease of a van with maintenance services; and

- a lease of a building with security and cleaning services.

Because leases and services are often combined in a contract and the accounting for these components will be different, IFRS 16 addresses the separation of lease and service components of contracts. The new requirements apply only to leases or lease components of contracts.

When accounting for contracts with lease and service components, a lessee would separate the amounts for the lease and the services using available information (including estimates). A lessee would then recognise only the amounts that relate to the lease on the balance sheet.

For simplicity, IFRS 16 allows a lessee to choose not to separate services from a lease and, instead, account for the entire contract as a lease. Given the accounting consequences of this choice (that services would also be recognised on the balance sheet), entities are expected to make this election only when the service components of contracts are small.

5.5 Lease term

In practice this can be difficult, particularly for land and property leases where break clauses and the rights to extend occupation are common. It is also important because the lease liability is the sum of the fair value of the payments over **the term of the lease.**

The term of the lease comprises:

- the non-cancellable period of the lease;
- periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
- periods covered by an option to terminate the lease if the lessee is reasonably certain *not* to exercise that option.

Note that this definition is important in establishing whether or not a lease falls within the definition of a short-term lease.

5.6 Exemptions

Exemptions within IFRS 16 are very limited and relate to short-term leases and leases of low value items.

Short-term leases - A lessee may elect not to apply the general requirements of IFRS 16 to a short-term lease - defined as a lease that at commencement date has a lease term (as defined above) of 12 months or less.

To satisfy the definition, the lease must not contain a purchase option. The election to apply the exemption should be made on a class-by-class basis.

The accounting treatment is simple – lease payments should be expensed over the lease term on a straight-line or other systematic basis (in much the same way as previous operating leases were treated).

Low value items - A lessee may elect not to apply the general requirements of IFRS 16 to leases for which the underlying asset is of low value, in which case the items are simply expensed in the period in which they are incurred.

The value of an underlying asset should be based on its value when new (IFRS 16.5(b)), and the assessment is performed on an absolute basis regardless of materiality to lessee (IFRS 16.B4).

The election may be made on a lease-by-lease basis (IFRS 16.8).

Possible examples include leases of tablets and personal computers and small items of furniture and telephones.

5.7 Initial measurement of a right of use asset

Measurement applies from the commencement date, defined as the date on which a lessor makes an underlying asset available for use by a lessee.

Initial measurement comprises:

- the amount of the initial measurement of the lease liability;
- any lease payments made at or before commencement date less any lease incentives received;
- any initial direct costs incurred by the lessee; and
- an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset and restoring the site or the asset.

5.8 Lease liability

The lease liability is initially measured at the present value of the lease payments that are not paid at commencement date.

The discount rate is the interest rate implicit in the lease but if this cannot be readily determined, the lessee should use the lessee's incremental borrowing rate. This is defined as the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value in a similar economic environment.

The lease payments to be included comprise:

- fixed payments less any lease incentives received;
- variable lease payments;
- amounts expected to be paid under residual value guarantees;
- the exercise price of a purchase option that the lessee is reasonably certain to assess; and
- payments of penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease.

Subsequent measurement is covered by IFRS 16, paragraph 40 and requires a lessee to remeasure the lease liability by discounting the revised lease payments using a revised discount rate in either of the two following situations:

- there is a change in the lease term, in which case the revised lease payments should be determined on the basis of the revised lease term (see IFRS 16 Illustrative Example 13 for a comprehensive numerical example); or
- a change in the option to purchase the underlying asset.

5.9 Right-of-use asset

Assuming the right-of-use asset is measured using the cost model, it should subsequently:

- be measured at cost;
- less any accumulated depreciation and any accumulated impairment losses; and
- adjusted for any remeasurement of the liability (as per IFRS 16, para 36(c)).

Note IFRS 16, para 39 which refers to reassessment of the lease liability and which requires that a lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset.

IFRS 16, paras 34 and 35 refer to other measurement models:

- the fair value model in IAS 40 *Investment Property* (Appendix D to IFRS 16 contains a revised text of IAS 40); and
- the revaluation model in IAS 16 *Property, Plant and Equipment*.

Example - Initial recognition and subsequent measurement of a lease asset and liability

Details of the lease are as follows:

- Payments: £2,250 paid at end of each year
- Interest rate implicit in the lease: 6.13%
- Fair value of asset: £6,000
- Useful economic life: three years with zero residual value

Leased asset:

End of Year	Asset b/f	Depreciation (charged to P&L)	Asset c/f
1	£6,000	£2,000	£4,000
2	£4,000	£2,000	£2,000
3	£2,000	£2,000	£0

Lease obligation:

End of Year	Liability b/f	Interest at 6.13% (charged to P&L)	Payment received at y/e	Liability c/f
1	£6,000	£368	(£2,250)	£4,118
2	£4,118	£252	(£2,250)	£2,120
3	£2,120	£130	(£2,250)	£0

5.10 Transitional arrangements

Assessment of leases in existence at date of initial application

Unless the practical expedient in IFRS 16, Appendix C, paragraph C2 is selected, an entity is required to reassess contracts in place at the date of initial application in accordance with the revised definition and application Guidance in IFRS 16.

The date of initial application is defined as the start of the reporting period in which the entity first applies IFRS 16. Hence, this will effectively be 1 January 2019 for a 31 December 2019 year-end **(note the 'date of initial application' of a standard is not the same as the 'date of transition')**. The transitional arrangement options in paragraph C5 would then be applied (below).

However, paragraph C3 offers what is referred to as a ‘practical expedient’. Under this option, contracts in place at the date of initial application of IFRS 16 are not required to be re-assessed, but those previously identified as leases under IAS 17/ IFRIC 4 *Determining Whether an Arrangement Contains a Lease* must be accounted for as above in accordance with IFRS 16, either by full retrospective application, or by retrospective application from the date of initial application (see below) – paragraphs C5-C18 will be applicable.

IFRS 16 need not be applied to those contracts that were *not* previously identified under IAS 17/ IFRIC 4 as containing a lease.

Transitional arrangements options

Appendix C, *Effective date and transition*, is very detailed (almost five pages) and merits careful consideration.

For lessees there is a choice between applying:

- full retrospective application (requiring restatement of each comparative period); or
- retrospective application from date of initial application (the start of the reporting period in which the entity first applies the IFRS) – this is sometimes referred to as the ‘cumulative catch-up’ transition method.

Full retrospective application is the usual method required when an entity applies a new accounting policy for the first time, for example as a result of the issue of a new IFRS.

5.11 Practical expedients

These practical expedients are only available if the ‘cumulative catch-up’ transition method is selected. They may be applied on a lease-by-lease basis.

The practical expedients are:

- application of single discount rate to portfolio of leases;
- application of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as alternative to impairment assessment at date of initial application;
- accounting for leases whose term ends within 12 months of date of initial application as short term leases;
- exclusion of initial direct costs from measurement of right of use asset at date of initial application; and
- use of hindsight in determining lease term where contract includes options to extend or terminate the lease.

6. Full, filleted or abridged accounts? (Lecture A655 – 15.02 minutes)

The preparation and filing requirements of financial statements has been a confusing subject for a lot of accountants since the abolition of abbreviated accounts for accounting periods commencing on or after 1 January 2016.

So what are the options for small companies and who gets what?

6.1 Full accounts

The term 'full accounts' means the directors' report, profit and loss account, statement of changes in equity and balance sheet together with the full notes based on FRS 102, Section 1A *Small Entities*. In other words, the accounts are 'unabridged'.

When full accounts are prepared, the shareholders (sometimes referred to as 'members') get these together with HM Revenue and Customs (HMRC).

The filing obligations for small companies are contained in s444 of the Companies Act 2006. Section 444(1) states that:

'The directors of a company subject to the small companies regime—

(a) must deliver to the registrar for each financial year a copy of the balance sheet drawn up as at the last day of that year, and

(b) may also deliver to the registrar—

(i) a copy of the company's profit and loss account for that year, and

(ii) a copy of the directors' report for that year.'

Hence, where full accounts are prepared for the members and HMRC, the company has a choice of what to file at Companies House. It can either file the bare minimum which is the balance sheet (the same one as prepared for the shareholders) plus the balance sheet related notes (which are referred to as 'filleted accounts' in that the directors' report and the profit and loss account have been 'filleted out' of the full accounts). Alternatively, the company can file the full accounts (i.e. directors' report, profit and loss account, balance sheet and the notes).

Most small companies prefer not to file the full accounts at Companies House for obvious reasons; most going for the filleted accounts option.

6.2 Abridged accounts

At the outset it must be emphasised that 'abridged accounts' are **NOT** the replacement for the now defunct 'abbreviated accounts' regime. Abridged accounts are a further option available to the members provided company law protocol has been followed.

The Companies Act 2006 allows a small entity to prepare abridged financial statements which comprise an abridged profit and loss account **and/OR** an abridged balance sheet.

Hence, the small company can prepare, for example, an unabridged profit and loss account and an abridged balance sheet (or vice versa); or it can prepare both an abridged profit and loss account and an abridged balance sheet.

Whichever type of abridgement is opted for both the shareholders and HMRC will receive the abridged financial statements. Some accountants believe that abridged financial statements only relate to the copy filed at Companies House – this is not the case. HMRC will accept the abridged accounts because this is what has been prepared for the shareholders.

When abridged accounts are prepared, any items preceded by Arabic numerals in the statutory formats are not disclosed (such as a breakdown of debtors and creditors due within one year). Hence, management and the shareholders will not see the detail in their copy of the financial statements that they would otherwise see if the entity did not prepare abridged accounts.

In order for the entity to prepare abridged accounts, all the shareholders have to unanimously agree to the abridgement taking place. This approval must be received **before** the accounts are approved. In addition, the approval protocol is an annual process because the shareholders can only agree to the entity preparing abridged financial statements for the preceding financial year.

For Companies House filing purposes, the small entity can file 'filleted abridged' accounts. Again, the filleting regime means the directors' report, (abridged) profit and loss account and any notes relating to the (abridged) profit and loss account are removed. Hence, the Registrar only receives the abridged balance sheet and the notes to the abridged balance sheet. In practice, the notes to the abridged balance sheet will contain less information than unabridged financial statements (and hence less information will be available on the public record) because items preceded with an Arabic numeral are not included in the notes. The face of the abridged balance sheet will effectively look no different than an unabridged balance sheet.

Many small companies are preparing an unabridged profit and loss account and an abridged balance sheet. What this does is it shows the value of turnover, other income and cost of sales (which would otherwise be combined in an abridged profit and loss account) but reduces the information disclosed in the notes to the financial statements. The profit and loss account is removed anyway for filing purposes and hence this is proving to be a very popular option.

Note

Do keep in mind the protocol which must be followed **each year**. The unanimous consent of all the shareholders must be obtained before the accounts are

prepared where abridged financial statements are prepared – even if it is only the balance sheet that is abridged.

6.3 Employee numbers when filing accounts at Companies House

Section 411 of the Companies Act 2006 contains the requirement for all companies to disclose the average number of employees employed by the business during the accounting period for which the financial statements are prepared.

The disclosure of the average number of employees discloses how many employees, on average, the business has employed during the year. It is not a payroll disclosure. Therefore, all accounts submitted to Companies House must show the average number of employees; hence this information must not be 'filleted' out even if the small entity prepares abridged financial statements.

6.4 Micro-entities

Micro-entities are required, as a minimum, to file the balance sheet and notes at the foot of the balance sheet. For accounting periods commencing on or after 1 January 2017, the notes must comprise:

- Off-balance sheet arrangements.
- Employee numbers.
- Advances, credit and guarantees granted to directors.
- Financial commitments, guarantees and contingencies.

Micro-entity LLPs are required to disclose all of the above with the exception of advances, credit and guarantees as an LLP does not have directors.

The profit and loss account for a micro-entity does not need to be filed at Companies House. There is no requirement for a directors' report for a micro-entity.

7. Key issues from the triennial review: reminder (Lecture A656 – 26.58 minutes)

In March 2018, the Financial Reporting Council (FRC) issued new editions of UK GAAP which incorporate the amendments arising the from the triennial review. The amendments from the triennial review are mandatory for accounting periods commencing on or after 1 January 2019. Early adoption is permissible provided the March 2018 edition of the relevant FRS (e.g. FRS 102) is applied at the same time. There are two amendments arising from the triennial review which can be early adopted separately without having to early adopt the March 2018 edition of FRS 102 which are the amendments arising in respect of:

- Directors' loans (see 7.1 below); and
- The tax effects of gift aid payments (see 7.3 below).

7.1 Directors' loans

There is no longer a requirement for a **small entity** ('small' as defined in the Companies Act 2006) to discount loans from a director-shareholder, or from a person who is within a director's group of close family members when that group contains at least one shareholder in the entity, to present value using a market rate of interest.

Key points where this exception is concerned are:

- The company or LLP receiving the loan must small (turnover not more than £10.2m, gross assets not more than £5.1m and not more than an average of 50 employees – two out of three for two consecutive years to be met).
- The loan must be from (not to) a director who is also a shareholder or from a member of the group of close family members of the director when that group contains a shareholder.

The glossary to FRS 102 defines 'close members of the family of a person' as follows:

'Those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including:

(a) that person's children and spouse or domestic partner;
(b) children of that person's spouse or domestic partner; and
(c) dependants of that person or that person's spouse or domestic partner.'

A point to note is that where the entity receives, for example, an interest-free loan from a director which is material, the related party disclosure provisions in FRS 102, paragraph 1AC.35 are triggered.

Hence, the small entity must disclose:

- the amount of such transactions;
- the nature of the related party relationship; and
- other information about the transaction necessary for an understanding of the financial position of the small entity.

7.2 Investment property in a group

The triennial review introduced new paragraphs 16.4A and 16.4B. FRS 102 (March 2018), para 16.4A provides an accounting policy choice for investment property which is rented out to another group member. It is important to emphasise that this accounting policy option is only available **to groups only**. Any other investment property must be remeasured to fair value through profit and loss at each balance sheet date (except where a micro-entity has investment property and is preparing its financial statements under FRS 105).

FRS 102 (March 2018), paragraph 16.4A states:

'An entity that rents investment property to another group entity shall account for those properties either:

(a) at fair value with changes in fair value recognised in ***profit or loss*** *in accordance with this section (the Appendix to Section 2 provides guidance on determining fair value); or*

(b) by transferring them to property, plant and equipment and applying the cost model in accordance with Section 17.'

It is expected that most groups will choose to measure intra-group investment property using the cost model. If that is the case, then on transition to the new accounting policy the group member owning the investment property can use the fair value of the investment property as its deemed cost at the date of transition (which is 1 January 2017 for a 31 December 2018 year-end) and use that deemed cost going forward. Alternatively, the group member can use the historical cost of the property, and depreciate/impair the asset as if it had always been carried at cost.

If the entity chooses to take the fair value at the date of transition as deemed cost, the investment property will not be carried on a cost basis and will still be measured under the alternative accounting rules (i.e. at revaluation). Hence, any fair value uplift existing on transition must be recognised in a revaluation reserve and the additional disclosures required by paragraph 34 of Schedule 1 to the Regulations must be provided.

Please be aware that the new accounting policy choice in FRS 102 (March 2018), paragraph 16.4A cannot be early adopted on its own. If the group wishes to early adopt this accounting policy choice (ie for an accounting period starting earlier than 1 January 2019), then it must apply FRS 102 (March 2018) at the same time.

7.3 Tax effects of gift aid payments

This issue affects trading subsidiaries of charitable parents which 'gift' their profits up to the charitable parent. Prior to the changes to FRS 102, the primary issue

concerned whether, or not, a provision for the gift aid payment should be made in the subsidiary's financial statements.

Where a Deed of Covenant is in place, the issue does not present itself. This is because the Deed of Covenant creates a legal obligation for the subsidiary to pay its profits up to the parent.

Where a Deed of Covenant is not in place, the problem is twofold. Firstly, the issue is whether, or not, the gift aid payment can be recognised and secondly what creates the liability for the trading subsidiary.

The Basis for Conclusions in FRS 102 (March 2018), paragraph B29.12 states that gift aid payments are donations for tax purposes, but distributions for accounting purposes. This is consistent with the legal opinion obtained by ICAEW where such payments are concerned.

The gift aid payment itself is accounted for as a distribution and paragraph B29.13 of FRS 102 cross-refers to FRS 102, paragraph 32.8 which deals with the issue of dividends. Dividends can only be accrued in the financial statements if there is a legal obligation at the balance sheet date (i.e. if the dividend has been formally declared by the entity by the year-/period-end). Paragraph B29.14 of FRS 102 then goes on to state that just over half of the respondents to FRED 68 considered that a liability should be recognised for such a payment if there was past practice of making such payments. The FRC disagreed on the grounds that they do not consider that reason to be consistent with FRS 102 nor were they persuaded that a constructive obligation better reflects the substance of the transaction.

In addition there is also an issue as to what creates the liability where a Deed of Covenant is not in place. It is difficult to see how a resolution could create a liability for the trading subsidiary to gift its profit up to the parent. Unlike a dividend, the gift aid payment cannot be quantified prior to, or at, the balance sheet date so a board resolution will also be inadequate to create the legal obligation because the value of the subsidiary's liability cannot be quantified.

Where there is no Deed of Covenant in place, FRS 102 (March 2018) paragraph 29.14A outlines the accounting treatment where the **tax effects** of the gift aid payment are concerned as follows:

'As an exception, when:

(a) an entity is wholly-owned by one or more charitable[3] entities;

[3] In this context, 'charitable' refers to an entity that has been recognised by HMRC as being eligible for certain tax reliefs because of its charitable purposes.

(b) it is probable that a gift aid payment will be made to a member of the same charitable ***group****, or charitable* ***venturer****, within nine months of the reporting date; and*

(c) that payment will qualify to be set against profits for tax purposes,

the income tax effects of that gift aid payment shall be recognised at the reporting date. The income tax effects shall be measured consistently with the tax treatment planned to be used in the entity's income tax filings. A deferred tax liability shall not be recognised in relation to such a gift aid payment.'

Hence, the tax effects of the gift aid payment can be recognised if it is probable (i.e. more likely than not) that the gift aid payment will be made and will be eligible for corporation tax relief. However, the gift aid payment itself must not be recognised if there is no Deed of Covenant in place or no other evidence that an actual legal obligation exists.

7.4 Accounting treatment for gift aid payments

The tax effects of the gift aid payment is presented in profit or loss rather than within equity (which is where the gift aid payment itself is taken). This is because when there is a tax effect arising from a distribution, it affects taxable profits.

7.5 Undue cost or effort exemptions

The FRC have taken the decision to remove the undue cost or effort exemptions in FRS 102 on the grounds that these were not being applied correctly. It became apparent to the FRC that the undue cost or effort exemptions were being applied as accounting policy options, which was never the intention.

The Glossary to FRS 102 does not define 'undue cost or effort' and hence there have been interpretational issues faced by entities leading to the confusion.

Paragraph 2.14B of the *IFRS for SMEs* states that:

'Applying a requirement would involve undue cost or effort by an SME if the incremental costs (for example, valuers' fees) or additional effort (for example endeavours by employees) substantially exceed the benefits that those that are expected to use the SME's financial statements would receive from having the information.'

While the undue cost or effort exemptions have been removed because they were being applied as accounting policy choices, in some cases they have been replaced by accounting policy options. For example, where properties are rented out to group members (see 7.2 above).

The removal of the undue cost or effort exemptions will have an impact on some reporting entities; particularly those that have investment properties which they have not fair valued at each reporting date as they have exercised the undue cost or effort exemptions. Unless the property is rented out within a group, all investment property must be measured at fair value at each balance sheet date,

with changes in fair value going through the profit and loss account. Also don't forget to bring deferred tax into account!

Areas of FRS 102 where undue cost or effort exemptions have been removed are:

- Section 14 *Investments in Associates* – paragraph 14.10
- Section 15 *Investments in Joint Ventures* – paragraph 15.15
- Section 16 *Investment Property* – paragraphs 16.1, 16.3, 16.4 and 16.10
- Section 17 *Property, Plant and Equipment* – paragraph 17.1(a)

7.6 Net debt reconciliation

For those entities which are required to prepare a cash flow statement, the net debt reconciliation is brought back into FRS 102. This has been done on the grounds that the FRC consider the reconciliation provides useful information to users. As preparers will already be familiar with the net debt reconciliation, the costs of compliance will be negligible and software providers will usually include this reconciliation within their accounts production software systems in any event.

Staff Factsheet 3: FRS 102 *Illustrative Statement of Cash Flows* contains an example of how the net debt reconciliation may be presented where a statement of cash flows is presented as part of the entity's complete set of financial statements.

7.7 Intangible assets

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

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

Paragraph 18.8 has been heavily amended and the amended paragraph 18.8 states:

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

(a) the recognition criteria set out in paragraph 18.4 are met;

(b) the intangible asset arises from contractual or other legal rights; and

(c) the intangible asset is separable (ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, asset or ***liability****).*

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

An entity could choose to recognise additional intangible assets separately from goodwill for which the recognition in (a) above are met and where the intangible asset arises from contractual or other legal rights OR is separable. If the entity chooses to recognise such additional intangible assets, that policy must be applied consistently to all intangible assets in the same asset class and must be applied consistently to all business combinations.

It should also be noted that FRS 102 (March 2018), paragraph 18.28A states that where the entity has applied the accounting policy choice in paragraph 18.8 and has chosen to separately recognise additional intangible assets from goodwill, it must disclose the nature of those intangible assets and the reason why they have been separated from goodwill.

This accounting policy choice was included in FRS 102 (March 2018) as part of the triennial review. As a consequence, it applies for accounting periods commencing on or after 1 January 2019. Early adoption is permissible, provided that FRS 102 (March 2018) is applied at the same time; the accounting policy choice cannot be early adopted on its own.

8. Practical points on GDPR (Lecture A657 – 15.02 minutes)

For many accountants there was much to be done to ensure compliance with GDPR before May 2018. This section is not an exhaustive list of issues. Instead in focuses on some key issues when preparing financial statements and auditing.

Auditors are more likely to have to thoroughly document their work than accountants undertaking compilation engagements. But the considerations are similar.

8.1 Personal information

When preparing and auditing company financial statements, much of the data which is used and stored is not personal data. This makes it a more straightforward work stream, for GDPR purposes, than personal tax or payroll.

Yet accountants and auditors will have to use personal data in every assignment, which might include data about suppliers or customers and will certainly include payroll information.

Some items of personal data are more sensitive than others. A name and an address is less potentially damaging than details about salary or bank account numbers.

8.2 Handling personal data – minimise and anonymise

When handling data never handle more than you need and ***where possible*** ensure that the person to which it relates cannot be identified.

The golden rules are:

- When requesting data from a client, only ever ask for the data that you need. For example, don't ask for a full payroll print when you only require certain data fields.
- When you have used personal data, only document what you need to record e.g. don't keep a full list of customers, rather than just those that are tested.
- When you hold data, keep it securely.
- When you are no longer required to keep the data, destroy it.

8.3 Practical audit examples

Case study – payroll testing

To complete payroll testing the auditor requests the payroll records be downloaded into a spreadsheet, and sent to them.

Minimise the data requested

They ask for the employee name, payroll number, gross pay, deductions and net pay.

They do not need the residential address or bank account details.

Data security

The data is sent to the auditor using a secure portal, not email.

Minimise the data documented

After the testing has been completed, would it be sufficient just to document which employees were selected for testing and the results of the test, as a whole? It is possible that some file reviewers might want more information about how the test was done, particularly if junior staff did the work.

Alternatively, could the document just record the payroll number without the employee's name?

Access to data

Only specific staff involved with that audit can access the file.

Destruction of data

The firm has a policy of destroying the data after a period of time and it is no longer required to be kept.

In practice it can be very difficult to know when an audit file is no longer needed because the file might contain other useful information that might be needed at some future date, such as if there is an asset disposal.

Case study – grant payments in a charity

A charity has the objective of supporting injured workers and their dependents in a particular industry.

An auditor tests grant payments to ensure that they are in accordance with the charities policies and objectives. 10 claims are reviewed and most of the claims involve reviewing information from the claimants' medical records. Two of the claims are unusual and the audit senior writes up extensive notes about the nature of the claims.

Care needs to be taken to avoid recording medical information on file! All documentation could refer to a claim reference number rather than a name.

9. Withdrawal of Practice Notes 25 and 27

On 11 December 2018, the Financial Reporting Council (FRC) withdrew the following Practice Notes:

- Practice Note 25 *Attendance at Stocktaking*; and
- Practice Note 27 *The Audit of Credit Unions in the United Kingdom.*

Practice Note 25 was last revised in February 2011 and much of the material covered by the Practice Note is included in ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items* and other ISAs (UK). Therefore, the FRC considered that the Practice Note supported high quality work and hence has been withdrawn with immediate effect.

Practice Note 27 was last revised in May 2011 and related to a small sector of non-public interest entities which the FRC no longer considers necessary to provide guidance on. As a result, this Practice Note has also been withdrawn with immediate effect.

10. ISA (UK) 540 (Revised) (Lecture A658 – 18.24 minutes)

In June 2018, the International Auditing and Assurance Standards Board (IAASB) issued ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures*. ISA 540 (Revised) is applicable for audits of accounting periods beginning on or after 15 December 2019.

Unsurprisingly, the Financial Reporting Council (FRC) followed in the footsteps of the IAASB and issued an Exposure Draft of ISA (UK) 540 *Auditing Accounting Estimates and Related Disclosures* in July 2018 which was finalised in December 2018. ISA (UK) 540 is effective for audits of financial statements for periods beginning on or after 15 December 2019.

While the revised ISA (UK) 540 is not due to come into mandatory effect as yet, it is important to understand what has changed because audit methodologies will have to be changed to cope with the additional demands brought about by the revised ISA (UK).

10.1 What has changed?

ISA (UK) 540 (Revised) includes enhanced requirements for auditors on management estimates and disclosures. Revisions to IFRSs, for example IFRS 15 *Revenue from Contracts with Customers*, IFRS 16 *Leases* and IFRS 17 *Insurance Contracts* (IFRS 17 has not been endorsed for use in the EU at the time of writing these notes) will all mean that estimates in the areas of financial instruments and revenue recognition from contracts will increase. Changes brought about by ISA (UK) 540 (Revised) include:

- Enhanced requirements and application material in respect of risk assessment procedures and the auditor’s work effort in responding to the assessed risks of material misstatement. These include (in addition to addressing risks related to estimation uncertainty), specific attention to other risk factors in making accounting estimates such as complexity and subjectivity.
- Enhanced work effort requirements based on one, or more, of:
  - considering events which occur up to the date of the auditor’s report;
  - testing how management has made the accounting estimate; and
  - developing an auditor’s point estimate or range.

  Where the auditor develops a point estimate or range, the auditor is specifically required to determine the range which includes only amounts that are supported by sufficient appropriate audit evidence.

- Amendments made to the objective and the requirements to the effect that audit procedures address whether both the accounting estimates and the related disclosures are ‘reasonable’ in the context of the applicable financial reporting framework. The current version of ISA (UK) 540 only addresses whether the disclosures are ‘adequate’.

- Enhancements to reinforce the application of professional scepticism. These include using wording to drive questioning or challenging management where appropriate; more focus on identifying indicators of possible management bias; requiring further audit procedures to be designed and performed in a manner that is not iased toward obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory; and an enhanced retrospective review and an overall evaluation based on procedures performed.

- Emphasising the importance of the need to consider internal control, with improved cross-references to ISAs (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment* and ISA (UK) 330 *The Auditor's Responses to Assessed Risks* (those standards being more specific to the consideration of internal control).
- A new requirement to remind auditors of their responsibilities to communicate certain matters to those charged with governance and to consider the matters to communicate regarding accounting estimates, taking into account the reasons given to the risks of material misstatement.
- Enhanced documentation requirements.
- ISA (UK) 540 (Revised) applies to all estimates in the financial statements. It has been designed to be scalable and recognises that some estimates may not require significant judgements and the processes for making them may not be complex.

The table below outlines the other ISAs (UK) which are revised for the conforming amendments:

ISA (UK)	Amendment
ISA (UK) 200 (Revised June 2016) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing*	Identifying in the application material that ISA (UK) 540 (Revised December 2018) requires a separate assessment of inherent risk and control risk.
ISA (UK) 230 (Revised June 2016) *Audit Documentation*	Identifying in the application material that documentation providing evidence of the auditor's exercise of professional scepticism may include documenting how the auditor evaluated evidence which both corroborates and contradicts management assertions. It also identifies that examples of documentation of significant professional judgments include

	the basis for the auditor's evaluation of whether an accounting estimate and related disclosures are reasonable in the context of the applicable financial reporting framework.
ISA (UK) 240 (Revised June 2016) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	The application material is amended to be clear that a retrospective review is not necessarily restricted to the prior period.
ISA (UK) 260 (Revised June 2016) *Communication with Those Charged with Governance*	Identifying in the application material that those charged with governance may be interested in the auditor's views on the degree to which complexity, subjectivity or other inherent risk factors affect the selection or application of the methods, assumptions and data used in making a significant accounting estimate, as well as the auditor's evaluation of whether management's point estimate and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework; and, when applicable, whether a significant accounting practice of the entity relating to accounting estimates is considered by the auditor not to be most appropriate to the particular circumstances of the entity. In addition, the material on qualitative aspects of accounting estimates given in Appendix 2 is moved to ISA (UK) 540 (Revised December 2018).
ISA (UK) 500 *Audit Evidence*	In respect of 'external information sources', including a definition and amending the requirement in paragraph 7 to clarify that the auditor needs to consider the relevance and reliability of information to be used as audit evidence obtained from an external information source; and extensive additional application material.
ISA (UK) 580 *Written Representations*	Amending the illustrative representation

	letter to align it with the changes in ISA (UK) 540 (Revised December 2018).
ISA (UK) 700 (Revised June 2016) *Forming an Opinion and Reporting on Financial Statements*	The requirement in paragraph 13(c) is amended to reflect that the auditor evaluates whether related disclosures, as well as the accounting estimates, made by management are reasonable.
ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report*	Editorial changes are made to the requirement in paragraph 9 and related application material, including to reflect ISA (UK) 540 (Revised December 2018) references to a high 'degree of' estimation uncertainty.

11. ISA (UK) 210 Agreeing Terms of Audit Engagements (Lecture A659 – 11.56 minutes)

One of the most frequent criticisms by file reviewers concerns points raised on the letter of engagement. In some more serious cases, there is no letter of engagement in place. So what is the issue with engagement letters, and why do they seem to be so high on the reviewer's 'list' of priorities?

If we go right back to basics – the engagement letter is essentially a **contract** between the audit firm and the audit client. Its objective is to:

- minimise the risk of any misunderstanding between the auditor and client;
- confirm acceptance of the engagement; and
- set out the terms and conditions of the engagement.

The engagement letter outlines the responsibilities of both management and the auditor and it is important that both parties clearly understand the terms under which the audit will be carried out.

In most cases, the letter of engagement need not be changed each year but in some industries (such as academy schools), it will be necessary to revise the engagement letter to cater for changes made by the Department for Education or the Education and Skills Funding Agency as well as to update the dates of various guidance (e.g. the Academies Accounts Direction 2017/18 becoming Academies Accounts Direction 2018/19 for 31 August 2019 audit exercise).

In other cases, as mentioned above, the letter of engagement need not necessarily be revised each year. However, it is important that the auditor keeps abreast of developments or changes which may necessitate change. Such changes may include changes to:

- statutory duties due to new legislation;
- professional duties, perhaps due to new or amended ISAs (UK); or
- 'other services' requested by clients.

While most engagement letters need not be revised each year, the auditor must ensure that they **review** the current engagement letter **each year** to ensure that it is up to date. In addition, the auditor must also consider whether the client needs to be reminded of the terms of the engagement letter.

11.1 Content of the letter of engagement

Nowadays, the majority of engagement letters issued are generated from 'templates' issued by the professional bodies. Whilst these are a very good starting point for letters of engagement, they must be tailored so that they are client-specific.

Simply because they may be issued by a professional body does not mean that they are 100% tailored to the audit engagement – no two audits are the same!

The main contents of the letter of engagement must include:

- the objective and scope of the audit;
- the responsibilities of the auditor;
- the responsibilities of management;
- identification of the applicable financial reporting framework (e.g. FRS 102);
- reference to the expected form and content of reports to be issued; and
- a statement that there may be circumstances in which a report may differ from its expected form and content.

The following items will also be included:

- reference to professional standards, regulations and legislation applicable to the audit;
- limitations of an audit;
- expectation that management will provide written representations;
- the basis on which fees are calculated;
- agreement of management to notify the auditor of subsequent events after the auditor's report is signed;
- agreement of management to provide draft financial statements in time to allow for the audit to be completed by the deadline; and
- the form (and timing) of any other communication during the audit.

The letter of engagement should also contain the name of the engagement partner who is responsible for the audit.

Other matters which the engagement letter may include are:

- arrangements concerning the involvement of internal auditors; and
- limitation to the auditor's liability.

11.2 Preconditions for an audit

The term 'preconditions for an audit' are defined in paragraph 4 of ISA (UK) 210 as follows:

'The use by management[4] of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise[5] on which the audit is conducted.'

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[4] In the UK those charged with governance are responsible for the preparation of the financial statements.

[5] ISA (UK) 200 (Revised June 2016), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK),* paragraph 13.

It is important that the engagement letter contains the preconditions for an audit because without the preconditions present, the auditor must not accept the audit or withdraw from it.

ISA (UK) 210, paragraph 6 outlines the preconditions for an audit as follows:

'In order to establish whether the preconditions for an audit are present, the auditor shall:

(a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and

(b) Obtain the agreement of management that it acknowledges and understands its responsibility:

(i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;

(ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(iii) To provide the auditor with:[6]

a. *access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;*

b. *Additional information that the auditor may request from management for the purpose of the audit; and*

c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.'

As noted above, if the preconditions for an audit are not present, the auditor must discuss the matter with management, and should not accept the engagement unless required to do so by law or regulation.

11.3 Changes to the terms of the audit engagement

If the client requests a change to the terms of the engagement, this request must be **carefully** considered to ensure that the change is reasonable. In some cases, it

[6] Sections 499 and 500 of the Companies Act 2006 set legal requirements in relation to the auditor's right to obtain information.

may be advisable to seek the advice of your relevant professional body or a training company's technical team, such as SWAT/Mercia to ensure that you are not agreeing to changes which may result in problems further down the line.

The auditor must not agree to a change in the terms of an audit engagement where there is no reasonable justification for doing so.

If the change of terms is deemed to be reasonable by both management and the auditor, the new terms of the engagement are recorded in either a revised letter of engagement or other suitable form of written agreement.

Where the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor must:

(a) withdraw from the audit engagement if possible under applicable law or regulation; and

(b) determine if there is any obligation (contractual or otherwise) to report the circumstances to other parties, such as those charged with governance, owners or regulators.

11.4 Key points to remember

- The audit letter of engagement is a legally binding contract between the auditor and the client and hence the terms must be clearly understood by both parties.
- Most engagement letters need not be revised every year – although some entities will require a new engagement letter each year due to the industry in which they operate.
- Even if the engagement letter is not required to be revised, it must be reviewed on an annual basis and the auditor must consider whether the client needs to be reminded of the engagement terms.
- Letters of engagement must be revised whenever there are changes to regulation/legislation (e.g. a change in accounting standards or a change to an ISA (UK)).
- The preconditions for an audit must be present prior to accepting the engagement and these must be documented within the engagement letter.
- Professional body inspectors (e.g. ICAEW QAD and ACCA audit monitoring unit) will be looking to ensure that the engagement letter is up to date and remains appropriate.

12. The auditor and fraud (Lecture A660 - 12.07 minutes)

In many cases, auditors tend not to spot fraud when auditing a client's financial statements. However, when the issue of fraud raises its head, it can turn into a big problem for the auditor.

ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* provides extensive guidance to auditors in respect of fraud. The ISA (UK) recognises that a material misstatement in the financial statements can arise from either fraud or error. The distinguishing factor is whether the underlying action that results in the misstatement was intentional or unintentional.

ISA (UK) 240 recognises two types of intentional misstatements which are relevant to the auditor:

- misstatements arising from fraudulent financial reporting; and
- misstatements arising from misappropriation of assets.

In some circumstances, the auditor may discover fraud or suspect that fraud is taking place. What the auditor must not do is to make legal determinations of whether fraud has actually occurred – this is the job of the legal system to determine.

12.1 Responsibilities of management and those charged with governance

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. Management and those charged with governance are responsible for implementing internal controls that can prevent, detect and correct on a timely basis misstatements arising from fraud or error. Management are also responsible for implementing controls, reducing opportunities for fraud taking place. For example:

- adequate segregation of duties (e.g. one person preparing the payroll and a senior person reviewing it prior to finalisation);
- authorisation of company expenditure by a responsible official so that the company does not pay for items it does not need;
- authorisation of overtime so that employees are not paid for hours not worked;
- monitoring a clocking-in/out process so that employees are only paid for hours worked;
- setting up of new employees on the payroll by HR rather than payroll so that 'ghost' employees are not set up and paid via the payroll;
- suppliers are only set up on the purchase ledger by responsible officials so that payment to a fictitious supplier does not get made; and

- changing of supplier bank details to be confirmed directly with the supplier prior to changing to avoid 'scams' by paying amounts into the bank accounts of a fraudster.

The culture of management and those charged with governance must be such that they place an emphasis on fraud prevention so that individuals are persuaded not to commit fraud because of the likelihood of detection and punishment. Those charged with governance must consider the likelihood that an internal control (or multiple controls) could be overridden by management.

For example, by management overriding controls over the financial reporting process so that the financial statements present a better or worse picture than they would if the controls had not been overridden.

While the prevention and detection of fraud rests with management, the auditor has some responsibilities where fraud is concerned.

12.2 Responsibilities of the auditor

The external auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.

To discharge this responsibility adequately, the auditor must:

- Maintain an attitude of professional scepticism. This means that they must recognise the possibility that a material misstatement due to fraud COULD occur, regardless of the auditor's prior experience of the client's integrity and honesty.
- Consider any incentives to commit fraud, e.g. profit-related bonuses or applications for finance.
- Discuss among the engagement team the client's susceptibility to fraud.
- Identify and assess the risks of material misstatement due to fraud.
- Identify, through enquiry, how management assesses and responds to the risk of fraud.
- Enquire of management, internal auditors and those charged with governance if they are aware of any actual or suspected fraudulent activity.

The key point to emphasise where the auditor's responsibilities are concerned is that they cannot rule out the possibility that the financial statements are materially misstated due to fraud. Some firms have received significant criticism from reviewers because they have said at the planning stage:

'There was no fraud in previous audits so we do not expect fraud in this year's audit.'

This demonstrates a complete failure to exercise professional scepticism. ISA (UK) 240 is clear – the auditor must set aside their previous experiences of the honesty and integrity of management.

In addition, file reviewers are often critical of firms who conclude at the planning stage:

‘Fraud in relation to revenue recognition is not applicable.’

Fraud in relation to revenue recognition is considered a significant risk. Where significant risks are concerned, the UK ISA expects the auditor to do some work on reducing the risk of material misstatement due to fraud to an acceptable level.

12.3 Responses to assessed risks of fraud

The auditor’s responses to assessed risks of fraud include the following:

- Obtain written representations from management that they have informed the auditor of all known or suspected frauds.
- Test year-end journals and adjustments as these may be use to manipulate the figures in the financial statements.
- Test accounting estimates and areas of management judgement for reasonableness.
- Make audit procedures unpredictable so the client cannot hide fraud in areas the auditor is not expected to test.
- Use suitably experienced staff to audit areas of particular risk.

An inherent limitation of a fraud is the unavoidable risk that some material misstatements may not be detected even if properly planned procedures are put in place. This is because fraud, by its very nature, is designed not to be discovered.

The ability to detect fraud depends upon the skill of the perpetrator, collusion, relative size of the amounts involved and the seniority of the people committing the fraud.

Broadly, fraud is usually committed by employees manipulating weaknesses in the internal control environment. Management fraud generally involves overriding the control environment for personal financial gain.

12.4 Related parties

ISA (UK) 550 *Related Parties* contains specific requirements in respect of the risks of material misstatement associated with related party relationships and transactions.

ISA (UK) 550, paragraph 9(a)(i) states that the objective of the auditor is to recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud.

The standard recognises that the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement in the financial statements than transactions with unrelated parties.

For example:

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

As part of risk assessment procedures, ISA (UK) 550 requires the auditor to perform activities over related parties relevant to identifying the risks of material misstatement associated with related party relationships and transactions. Such activities are dealt with in ISA (UK) 550, paragraphs 12 to 17.

12.5 Understanding the entity's related party relationships and transactions

The engagement team must discuss the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.

In addition, the auditor must inquire of management concerning:

- the identity of the entity's related parties, including any changes from the previous period;
- the nature of the relationships between the entity and these related parties; and
- whether the entity entered into any transactions with these related parties during the reporting period and, if so, the type and purpose of these transactions.

The auditor must then inquire of management and others within the entity and perform other risk assessment procedures which the auditor considers appropriate in order to obtain an understanding of the controls (if any) that management has established to:

- identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- authorise and approve significant transactions and arrangements with related parties; and
- authorise and approve significant transactions and arrangements outside the normal course of business.

12.6 Maintaining alertness for related party information when reviewing records or documents

During the course of the audit, the auditor must remain alert when inspecting records or documents for arrangements, or other information, which may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

ISA (UK) 550, paragraph 15 specifically requires the auditor to inspect the following for the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- bank and legal confirmations obtained as part of the auditor's procedures;
- minutes of meetings of shareholders and of those charged with governance; and
- such other records or documents as the auditor considers necessary in the circumstances of the entity.

When the auditor identifies significant transactions outside the entity's normal course of business when performing the above audit procedures (or other audit procedures), the auditor must inquire of management about:

- the nature of these transactions; and
- whether related parties could be involved.

12.7 Sharing related party information with the engagement team

The auditor must share relevant information obtained about the entity's related parties with other members of the engagement team.

12.8 Risk assessment

The auditor is required to devise responses to the assessed levels of risk in accordance with ISA (UK) 330 *The Auditor's Responses to Assessed Risks*. In particular, the auditor is required to devise audit procedure that will generate sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. As a minimum, the auditor is required to carry out the following audit procedures:

Identification of previously unidentified related parties or significant related party transactions

If the auditor identifies arrangements or information which suggests the existence of related party relationships which management has not previously brought to the attention of the auditor, the auditor must determine whether the underlying circumstances confirm the existence of those relationships or transactions.

Where the auditor has discovered the related parties or transactions with those related parties and management has not identified or disclosed them to the auditor, the auditor must:

- promptly communicate the relevant information to the other members of the engagement team;
- where the applicable financial reporting framework establishes related party requirements:
  - request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and
  - inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
- perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;
- reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and
- if the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

Identified significant related party transactions outside the entity's normal course of business

Where the auditor has identified related party transactions which are outside the entity's normal course of business, the auditor must:

b) inspect the underlying contracts or agreements (if any) and evaluate whether:

  - the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
  - the terms of the transactions are consistent with management's expectations; and
  - the transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

obtain audit evidence that the transactions have been appropriately authorised and approve.

Assertion that transactions are on an arm's length basis

If management have made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor must obtain sufficient appropriate audit evidence about that assertion.

12.9 Evaluation of the accounting and disclosure of identified related party relationships and transactions

In forming an opinion on the financial statements, the auditor must evaluate:

- whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- whether the effects of the related party relationships and transactions:
  - prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or
  - cause the financial statements to be misleading (for compliance frameworks).

12.10 Written representations

The auditor must obtain written representations from management and, where appropriate, those charged with governance that:

- they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
- they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

12.11 Communication with those charged with governance

Unless all of those charged with governance are involved in managing the entity, the auditor must communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

12.12 Documentation

The auditor must include in the audit documentation the names of identified related parties together with the nature of the related party relationships.

13. Recap on the revised auditor's report (Lecture A661 – 17.03 minutes)

With audits of December 2018 year-ends on the horizon, it is worth examining some of the key provisions relating to the auditor's report; particularly as some auditors' reports are criticised by file reviewers for containing inappropriate elements (e.g. an Emphasis of Matter paragraph when one is not actually needed) or out-of-date terminology (e.g. references to ISAs (UK and Ireland) rather than ISAs (UK)).

When the FRC issued ISA (UK) 700 (Revised June 2016) *Forming an Opinion and Reporting on Financial Statements*, a noticeable change was the structure of the revised auditor's report. This revised structure has the following benefits:

- It enhances communication between auditors, those charged with governance and users.
- It increases attention by management and those charged with governance to the Key Audit Matters (KAM) section of the auditor's report (KAM is mandatory for listed entities although unlisted entities can include a KAM section if they so wish).
- It results in increased professional scepticism over KAM.

13.1 Objectives of the auditor

ISA (UK) 700 states that the objectives of the auditor are to:

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

In particular, the auditor must evaluate whether:

- the financial statements adequately disclose significant accounting policies;
- the accounting policies selected are consistently applied and appropriate;
- accounting estimates are reasonable;
- information is relevant, reliable, comparable and understandable;
- the financial statements contain adequate disclosures to enable the users to understand the effects of material transactions and events; and
- the terminology used is appropriate.

13.2 Content of an unqualified auditor's report

The table below outlines the content of an unqualified auditor's report:

Element	Purpose
Title	To clearly identify the report as an **independent** auditor' report.
Addressee	This will usually be to the shareholders or the members (or equivalent). The addressee is the intended user of the report.
Auditor's opinion	This provides the auditor's overall conclusion as to whether the financial statements give a true and fair view.
Basis for opinion paragraph	Provides a description of the professional standards applied by the auditor to provide confidence to the users of the financial statements that the report can be relied upon.
Key Audit Matters	This section is only compulsory for listed entities and draws attention to other significant matters which the users should be aware of to aid their understanding of the financial statements/the entity.
Other information	To clarify that management are responsible for the other information. The auditor's report does not cover other information (generally the auditor will only be concerned about the consistency of the other information with the financial statements). ISA (UK) 720 *The Auditor's Responsibilities Relating to Other Information* provides the guidance which auditors are required to follow where other information is concerned.
Responsibilities of management	This section of the auditor's report clarifies that management are responsible for preparing the financial statements and

	for the internal controls. This aims to reduce the expectation gap.
Auditor's responsibilities	This clarifies that the auditor is responsible for expressing **reasonable assurance** as to whether the financial statements give a true and fair view.
Other reporting responsibilities	To highlight any additional reporting responsibilities such as the adequacy of the accounting records and other information published within the financial statements.
Name of the engagement partner	This identifies the person responsible for the audit opinion.
Signature	Shows the engagement partner or firm responsible for the auditor's opinion.
Auditor's address	To identify the specific office of the engagement in case of any queries.
Date	To identify the date up to which the audit work has been performed. Any information which comes to light after this date will not have been considered by the auditor in forming their opinion.

A notable change in the structure of the revised auditor's report is that the opinion paragraph is first (rather than last as was the case under the old ISA (UK and Ireland) 700). This was done on the grounds that users often want to see, at a glance, what the auditor's opinion is on the financial statements rather than trawl through the entire report to find the opinion at the end.

13.3 Emphasis of matter paragraphs

Emphasis of matter paragraphs are dealt with in ISA (UK) 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.* At the outset it is important to understand that an emphasis of matter paragraph does not qualify the auditor's report in any way. Nor is an emphasis of matter paragraph a substitute for a qualified opinion.

An emphasis of matter paragraph is used to refer to a matter which has been adequately presented or disclosed in the financial statements by the directors. The auditor's judgement is that these matters are of such fundamental importance to the users' understanding of the financial statements that the auditor should emphasise the disclosure.

Examples of fundamental matters

- The directors have prepared the financial statements on a basis other than the going concern basis.
- The entity has early adopted an accounting standard.
- Corresponding figures have been restated.
- A significant subsequent events occurs between the balance sheet date and the date of the auditor's report.
- There is uncertainty in respect of litigation or regulatory action.
- The financial statements have been recalled and reissued or the auditor provides an amended auditor's report.
- A major catastrophe has had a significant effect on the entity's financial position.

Point to note

The important point to note where emphasis of matter paragraphs are concerned is that they are emphasising the importance of a disclosure note in the financial statements. Hence, the emphasis of matter paragraph will always cross-refer to the relevant disclosure. They can only be used when the directors have adequately disclosed something in the financial statements.

Where adequate disclosure has **NOT** been made, the opinion may need to be modified – an emphasis of matter paragraph should not be used and **must not be used as a substitute for qualifying the auditor's report**.

For listed entities that are required to present Key Audit Matters (KAM), an emphasis of matter paragraph may be presented either directly before or after the KAM, based on the auditor's judgement as to the significance of the information included in the emphasis of matter paragraph.

In addition, it should also be noted that an emphasis of matter paragraph is not used to draw attention to immaterial misstatements. The fact that they are immaterial means that they do not merit the attention of the shareholders.

Example – Emphasis of matter paragraph
Without qualifying our opinion, we draw attention to Note 28 of the financial statements which describes the effect of a flood at the company's central warehouse in August 2018. Our opinion is not qualified in respect of this matter.

13.4 Material uncertainties related to going concern

Where there is a material uncertainty related to going concern, management must make adequate disclosure of such uncertainties. ISA (UK) 570 *Going Concern* requires the auditor to assess the adequacy of such disclosures.

Where a material uncertainty exists which has been adequately disclosed in the financial statements by management, the auditor's report will contain a section headed up 'Material Uncertainty Related to Going Concern'. This paragraph acts in a similar manner to that of an emphasis of matter paragraph in that it cross-refers to the going concern uncertainty disclosed by management in the notes to the financial statements.

The key points to remember where a material uncertainty related to going concern paragraph are:

- they serve a similar purpose to an emphasis of matter paragraph but an emphasis of paragraph is not used where going concern uncertainties have been adequately disclosed by management; and
- they are not used when material uncertainties related to going concern have not been adequately disclosed in the financial statements as this will impact on the auditor's opinion which will be modified in respect of the inadequate disclosure if management do not rectify it.

13.5 Types of modified opinion

The expression of a modified (qualified) auditor's opinion is usually the 'last resort' after attempts have been made by the auditor to resolve the issue(s) giving rise to the modification. There are three types of modified opinion:

- qualified opinion;
- adverse opinion; and
- disclaimer of opinion.

The auditor decides on which type of opinion is appropriate having regard to the nature of the matter giving rise to the material misstatement or the inability to obtain sufficient appropriate audit evidence. In addition, the auditor must also consider the pervasiveness of the effects, or possible effects, of the matter on the financial statements.

In all cases, the auditor should always document their reasons for the opinion in the independent auditor's report. The auditor should also ensure that the audit evidence on file justifies the opinion as a lack of sufficient or appropriate audit evidence on file may mean questions are asked as to the appropriateness of, say, an unqualified opinion, during the course of any file review carried out by a professional body, the FRC or external reviewers.

13.6 Pervasiveness

A misstatement in the accounts may be material or it may be material *and* pervasive. Paragraph 5 of ISA (UK) 705 (Revised June 2016) contains the definition of 'pervasive' which is:

'A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

(i) Are not confined to specific elements, accounts or items of the financial statements;

(ii) If so confined, represent or could represent a substantial proportion of the financial statements; or

(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.'

The term 'pervasive' is therefore taken to mean that a misstatement is not only material, but could affect several areas of the financial statements.

Example

A large private company operates a defined benefit pension plan for its employees and has a year-end of 31 December 2018 and reports under full FRS 102 (September 2015). Due to a dispute with the actuarial firm, the company has refused to commission a valuation for financial reporting purposes of the pension scheme. The pension scheme is significantly material to the financial statements and the directors are insistent that they will not obtain a valuation.

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

13.7 Determining the type of modification

As noted in 13.5 above, the determination of the type of modification to the auditor's opinion will depend on a number of factors, including materiality, pervasiveness and the effects of any disclosure/non-disclosure.

Qualified opinion

A qualified opinion is expressed by the auditor when they conclude that a material misstatement (individually or in aggregate) exists but is not pervasive. The auditor will also include the phrase 'except for' when expressing a qualified opinion which states that 'except for' the matters giving rise to the material misstatement, the financial statements otherwise give a true and fair view and have been prepared in accordance with the applicable financial reporting framework and legislation (e.g. Companies Act 2006).

Example

A company operates in the pharmaceutical industry and has a significant amount of capitalised development expenditure on its balance sheet. The company reports under full FRS 102 and has a year-end of 30 September 2018. During the year the company capitalised an amount of £450,000 worth of development expenditure which is considered significantly material to the financial statements. No amortisation has been charged on the additional development expenditure as the project was still nearing completion at the year-end.

During the audit fieldwork, the auditor discovered that of the £450,000 worth of additions to intangible fixed assets, £220,000 was, in fact, research expenditure which should have been written off to the profit and loss account per paragraph 18.8E of FRS 102. The auditor concludes that this amount is material to the financial statements. Management have refused to correct this misstatement on the basis that they disagree with the auditor's conclusion and the auditor disagrees with management that it should be capitalised. All other misstatements identified during the audit have been corrected.

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

Qualified opinion

We have audited the financial statements of …

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

- give a true and fair view of the state of the company's affairs as at 30 September 2018 and of its profit for the year the ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Basis for qualified opinion

The company has recognised an amount of £220,000 of research expenditure as

capitalised development expenditure on the balance sheet as at 30 September 2018 which, in our opinion, is not in accordance with the requirements of FRS 102. The company should have recognised the research expenditure in profit and loss for the year-ended 30 September 2018 to comply with paragraph 18.8E of FRS 102. Accordingly, the company's intangible fixed assets should be reduced by an amount of £220,000 with a corresponding reduction in profit.

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

Adverse opinion

When the auditor has obtained sufficient appropriate audit evidence, but then concludes that misstatements – both individually and in the aggregate – are both material *and* pervasive to the financial statements, they must express an adverse opinion. Essentially, the auditor expresses an adverse opinion when the financial statements do not give a true and fair view and a qualified opinion is not appropriate due to the magnitude of the misstatements.

Example

The financial statements for a company with a year-end of 31 October 2018 are being audited. On 14 November 2018, the bank confirmed that they would no longer be willing to support the company as the company had defaulted on its loan terms, breached its overdraft facility on a number of occasions during the year and had failed to supply the bank with management accounts as requested. In addition, the company had entered into an arrangement with HMRC to pay an accelerated payment notice in respect of a tax avoidance scheme over a period of six months, but the company was already in arrears and HMRC have threatened to issue winding up proceedings.

The director has approached a number of other banks who have refused to help the company but is confident that eventually the company will find a bank to support it. The financial statements have been prepared using the going concern basis of accounting but the auditor disagrees that this basis is appropriate.

The director has refused to have the financial statements prepared on a basis other than the going concern basis of accounting as he feels this may influence the decision of any potential lender.

Paragraph 21 of ISA (UK) 570 *Going Concern* says that if the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgement, this basis is inappropriate, the auditor must express an adverse opinion.

This is because the effects of the inappropriate use of the going concern basis of accounting are both material and pervasive. The adverse opinion will be expressed as follows:

Adverse opinion

We have audited the financial statements of …

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

- do not give a true and fair view of the state of the company's affairs as at 31 October 2018 and of its loss for the year then ended;
- have not been properly prepared in accordance with United Kingdom General Accepted Accounting Practice; and
- have not been prepared in accordance with the requirements of the Companies Act 2006.

Basis for adverse opinion

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

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

Disclaimer of opinion

A disclaimer of opinion is expressed by the auditor when they are unable to obtain sufficient appropriate audit evidence in order to form an opinion on the financial statements and the auditor concludes that the potential effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

In practice, disclaimers of opinion are rare, but will often involve multiple uncertainties – for example if the company's accounting records have been destroyed and the financial statements reconstructed from incomplete records.

Example

A wholly-owned subsidiary has prepared its financial statements using the going concern basis of accounting for the year-ended 31 December 2018. Management of the subsidiary have prepared the financial statements on the going concern basis of accounting on the grounds that the parent of the group itself will support the business. The auditor of the subsidiary has discussed the issue with the group auditor who has confirmed that the group has a significant level of overdue debt owed to it and, in the group auditor's opinion, the group nor the parent, has been able to produce any detailed projections, in the form of budgets or forecasts, which demonstrate the group's ability to continue as a going concern. The subsidiary is reliant on additional finance/investment which has not yet been secured.

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

Disclaimer of opinion

We have audited the financial statements of …

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

Basis for disclaimer of opinion

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

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

accounting is appropriate in the company's circumstances.

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

Auditor's responsibilities for the audit of the financial statements

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

13.8 Summary

The table below summarises the impact on the auditor's opinion and the auditor's report:

	Material but not pervasive	Material and pervasive
Financial statements contain material misstatement	Qualified opinion 'Except for' Basis for qualified opinion paragraph	Adverse opinion Financial statements do not give a true and fair view Basis for adverse opinion paragraph
Inability to obtain sufficient appropriate audit evidence	Qualified opinion 'Except for' Basis for qualified opinion paragraph	Disclaimer of opinion Auditor does not express an opinion Basis for disclaimer of opinion paragraph

13.9 Use of 'Bannerman' paragraphs in auditors' reports

Bannerman paragraphs are worded as follows:

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.

Bannerman paragraphs are considered by some to be important for audit firms as was proved in the case of *Barclays Bank plc v Grant Thornton UK*. This case confirmed that a Bannerman paragraph does limit liability to third parties in respect of the contents of the auditor's report.

Relevance of Bannerman to the current auditors' reports

ICAEW suggest that the Bannerman paragraph be used in all auditors' reports issued by member firms as a means of protecting those member firms. ICAEW have advised to place the Bannerman paragraph at the end of the auditor's report above the auditor's signature with a heading 'Use of our report'.

ACCA member firms need to exercise caution when considering the use of a Bannerman paragraph. ACCA have confirmed in Technical Factsheet 84 *Use of Disclaimers in Audit Reports* that they do not encourage the use of disclaimers on the basis that they view such disclaimers as a means of devaluing the auditor's report. ACCA's view is that a member firm carrying out audit work in accordance with ISAs (UK) and other guidelines (e.g. ethical standards) would not need to include such a disclaimer.

ACCA has not placed an outright ban on the use of Bannerman paragraphs – they only state that they 'do not encourage their use'. ACCA acknowledge that they can be used in appropriate and defined circumstances but should not be used on a regular basis. Where such disclaimers are used in the auditor's report, it may be advisable to document the reasons why the audit engagement partner considers them to be appropriate in the event of any queries arising from the inspector during a routine ACCA audit monitoring visit.