Think Ahead ACCA

Technical factsheet

Accounting for Covid-19 grants and reliefs

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INTRODUCTION

The impact of Covid-19 (Coronavirus) has had a significantly detrimental effect on businesses across the country. On 23 March 2020, the government introduced strict 'lockdown' measures aimed at reducing the transmission rate of the virus. This included closing all non-essential businesses, furloughing employees and providing support to businesses in the form of various reliefs and grants.

This technical factsheet aims to address the accounting aspects of some of the grants and reliefs made available by the government due to Covid-19, including:

- The Coronavirus Job Retention Scheme
- Business rates relief
- Small business grants fund and retail, hospitality and leisure grant fund
- Rent holidays
- Coronavirus Business Interruption Loan Scheme
- 'Bounce Back' loans
- Time to pay arrangements with HMRC
- Going concern

General principles for government grants

FRS 102 (March 2018), *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with government grants in Section 24 *Government Grants*. For micro-entities choosing to report under FRS 105 (March 2018), *The Financial Reporting Standard applicable to the Micro-Entities Regime*, Section 19 *Government Grants* applies.

The term 'government grant' is defined in the Glossary to FRS 102 as:

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

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

Under both FRS 102 and FRS 105, an entity must not recognise government grants in the financial statements until there is reasonable assurance that:

(a) the entity will comply with the conditions attaching to them; and
(b) the grants will be received.

Once the recognition criteria have been met, the entity must then apply its chosen accounting policy to the grant. Entities reporting under FRS 102 will choose either the 'performance model' or the 'accrual model', both of which are examined below. For micro-entities choosing to report under FRS 105, only the accrual model can be used.

Performance model

FRS 102 paragraph 24.5B states that an entity applying the performance model must recognise grants as follows:

(a) A grant that does not impose specified future performance-related conditions on the recipient is recognised in income when the grant proceeds are received or receivable.

(b) A grant that imposes specified future performance-related conditions on the recipient is recognised in income only when the performance-related conditions are met.

(c) Grants received before the revenue recognition criteria are satisfied are recognised as a liability.

Accrual model

The accrual model requires the grant to be classified as either a 'revenue-based' grant or a 'capital-based' grant. Most, if not all, of the Covid-19 grants provided by the government will be revenue-based grants.

FRS 102 paragraph 24.5D states that grants relating to revenue must be recognised in income on a systematic basis over the periods in which the entity recognises the related costs for which the grant is intended to compensate. FRS 102 paragraph 24.5E then goes on to say that a grant which becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs shall be recognised in income in the period in which it becomes receivable.

In ACCA's view, most grants provided by the government in respect of Covid-19 will be treated in the same way regardless of whether the performance model or the accrual model is adopted by the entity, ie the grants are recognised immediately in profit or loss.

Coronavirus Job Retention Scheme (CJRS)

The CJRS grant relates to staff who have been furloughed due to Covid-19. The Chancellor announced that this scheme would run until October 2020 and employers who continue to furlough staff from 1 August 2020 will be asked to contribute to the costs. Up until 31 July 2020, the scheme ran as normal, ie employers could claim 80% of a furloughed employee's wages/salaries up to a maximum of £2,500 plus associated employer's costs (eg employer's national insurance contributions). This grant is paid to the employer by HMRC.

The table below shows how the CJRS worked until it ended in October 2020:

Source: Gov.uk	July	August	September	October
Government contribution: employer NIC and employer pension	Yes	No	No	No
Government contribution: wages	80% up to £2,500	80% up to £2,500	70% up to £2,187.50	60% up to £1,875
Employer contribution: Employer NIC and pensions	No	Yes	Yes	Yes
Employer contribution: wages	–	–	10% up to £312.50	20% up to £625.00
Employee receives	80% up to £2,500 per month	80% up to £2,500 per month	80% up to £2,500 per month	80% up to £2,500 per month

Regardless of whether an entity has an accounting policy option of the performance or the accrual model, this will not affect the accounting treatment for this grant. Under both models, the grant will be recognised in profit or loss.

The grant must be recognised within **income** and must not be offset against expenditure (eg payroll costs) in profit or loss. The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410), Schedule 1 paragraph 8 states:

'Amounts in respect of items representing assets or income may not be offset against amounts in respect of items representing liabilities or expenditure (as the case may be), or vice versa.'

The same restriction applies in The Small Companies and Groups (Accounts and Directors' Reports) Regulations 2008 (SI 2008/409).

FRS 102 paragraph 2.52 reflects the provisions in company law, which states:

'An entity shall not offset assets and liabilities, or income and expenses, unless required or permitted by an FRS.

(a) Measuring assets net of valuation allowances (for example, allowances for inventory obsolescence and allowances for uncollectible receivables) is not offsetting.

*(b) If an entity's normal **operating activities** do not include buying and selling **fixed assets**, including investments and operating activities, then the entity reports gain and losses on disposal of such assets by deducting from the proceeds on disposal the **carrying amount** of the asset and related selling expenses.'*

Therefore, the entries to record the CJRS grant in the financial statements is:

Dr Cash at bank	X
Cr Sundry income/grant income	(X)

It must also be noted that the CJRS grant is taxable income and hence is brought into the tax computation as such.

When a CJRS grant is receivable by the reporting date but has not been received, a debtor balance is recognised.

Business rates relief

Business rates relief is not a government grant and hence FRS 102, Section 24 and FRS 105, Section 19 will not apply. Where an entity has taken advantage of the business rates relief, it will be treated as an absent cost and the profit and loss account charge will be reduced for the period of the relief.

Small Business Grant Fund and Retail, Hospitality and Leisure Grant Fund

In ACCA's view, the accounting policy of the accrual model or the performance model would not make any difference to the accounting because under both models, the grants are recognised in income once the recognition criteria in FRS 102 or FRS 105 is met.

Under the performance model, income would be recognised once the entity's eligibility had been established.

Under the accrual model, FRS 102 paragraph 24.5E/FRS 105 paragraph 19.8 would apply. These paragraphs state that a grant that becomes receivable as compensation for expenses or losses already incurred, or for the purpose of giving immediate financial support to the entity with no future related costs, are recognised in income in the period in which it becomes receivable.

Hence, under both the accrual and performance model, the grants would be recognised immediately in income in profit or loss.

Disclosure requirements for grants

FRS 102 paragraph 24.6 requires an entity to disclose the following:

(a) the accounting policy adopted for grants (ie the performance model or the accrual model)

(b) the nature and amounts of grants recognised in the financial statements

(c) unfulfilled conditions and other contingencies attaching to grants that have been recognised in income

(d) an indication of other forms of government assistance from which the entity has directly benefited.

Small company applying FRS 102, Section 1A Small Entities

A small company choosing to apply the presentation and disclosure requirements of FRS 102, Section 1A is not required to apply the above disclosure requirements (other than to disclose the accounting policy selected). However, the directors are required to ensure that a true and fair view is given in the financial statements, and so where government aid is material, additional disclosures may be necessary.

Micro-entity choosing to report under FRS 105

Micro-entities choosing to report under FRS 105 are not required to make any disclosures where government grants are concerned. The directors could, however, always choose to make voluntary disclosures and, where this is the case, they should refer to FRS 102, Section 1A.

Rent holidays

Many landlords are providing tenants with rent holidays to support them throughout the Covid-19 crisis. In ACCA's view, it is unlikely that a rent holiday provided for a short period would constitute a 'lease incentive' unless the lease is new or is being renewed. Indeed, the definition of a 'lease incentive' in the Glossary to FRS 102 refers to:

'Incentives provided by the lessor to the lessee to enter into a new or renew an ***operating lease****'*

On 23 July 2020, the Financial Reporting Council (FRC) issued FRED 76 *Draft amendments to FRS 102 and FRS 105 – COVID-19-related rent concessions*. This FRED proposed amendments to FRS 102 and FRS 105, *The Financial Reporting Standard applicable to the Micro-entities Regime* to provide the accounting treatment in respect of rent concessions. The amendments were finalised by the FRC on 19 October 2020, and are effective for accounting periods commencing on or after 1 January 2020 with early application permitted.

The amendments to FRS 102 and FRS 105 state that rent concessions are to be recognised in the financial statements in the period that benefits from the concession and are not spread over the term of the lease. Similar treatments would be applied for lessors as there is no difference in accounting treatments between lessees and lessors under FRS 102 where operating leases are concerned.

The amendments only relate to Covid-19 rent concessions – they do not apply to other more broad concessions that may be granted as an alternative accounting treatment may be necessary. In addition, the concession only relates to lease payments that are originally due on or before 30 June 2021.

Prior to the amendments being published, ACCA confirmed that its view was that Covid-19-related rent concessions are to be recognised in the period that benefits from the concession and not spread over the remaining term of the operating lease.

Pay as You Grow

On 24 September 2020, the Chancellor announced his Winter Economy Plan. Included within this plan was the Pay as You Grow (PAYG) flexible repayment system.

The objective of PAYG is to reduce the burden on businesses who have taken out a Bounce Back Loan. Flexibility will be provided to such businesses when it comes to repaying this loan.

Among other things, there will be flexibility to extend the length of the loan from six years to 10 years. This is estimated to cut the monthly repayments by nearly 50%. Interest-only periods of up to six months and payment holidays will also be available to businesses to help their cashflow. It is hoped that the PAYG scheme will help to protect jobs and help businesses recover from the effects of the pandemic.

The Chancellor also announced plans to allow businesses that have taken out a Coronavirus Business Interruption Loan (CBIL) the opportunity to extend the length of the loan from a maximum of six years to 10 (consistent with the Bounce Back Loan scheme) where this will help the business to repay the loan. Where a business has already received a loan of up to £50,000 from the CBIL scheme and would like to transfer it to the Bounce Back Loan scheme, the borrower can agree with the lender to do this until 4 November 2020.

In addition, applications for the Coronavirus-related loan schemes and the Future Fund were extended until the end of November 2020. This will help more businesses to benefit from such schemes.

Coronavirus Business Interruption Loan Scheme (CBILS)

When a business takes out a CBILS loan, the bank may charge an arrangement fee and the government will make a Business Interruption Payment to cover the first 12 months of the interest and any lender-levied charges. The borrower remains 100% liable for the debt.

According to the British Business Bank, the borrower remains 100% liable for the debt even though the government will settle the first 12 months of interest and any lender-levied charges on behalf the company. Therefore, the interest charge and the related government grant is recognised in profit or loss.

Note: the values and rates used in these examples are for illustrative purposes only to demonstrate the accounting treatment. They are not reflective of actual interest rates which may be paid by clients in these types of loan arrangements.

Example 1: Entity takes out a CBILS loan on a five-year term

Emery Ltd takes out a CBILS loan for £250,000 over five years on 1 April 2020. The bank does not charge an arrangement fee but does levy a £200 document fee for taking a debenture for the first time which is paid by the government's scheme (not the customer). Repayments are £4,543 per month for 60 months (ie £54,516 per annum) and the first year's interest paid back to the bank is £4,516. The government has undertaken to pay any lender-levied fees and the interest charge in year 1 for this type of loan.

This loan would be treated as a basic financial instrument and hence would be accounted for under the provisions of FRS 102, Section 11 *Basic Financial Instruments*. Section 11 uses the amortised cost method to measure basic financial instruments which uses an effective interest rate.

You can use the Goal Seek function in Microsoft Excel (Data Tab | What-if Analysis | Goal Seek) to deal with the accounting for the loan. In the Goal Seek box we would enter:

Set Cell: E9 to Value: 0 By Changing Cell: C1. This would then result in the following (note set Cell C1 to two decimal places):

	A	B	C	D	E
1	Effective interest rate		3.55%		
2					
3		Bal b/f	Interest	Cash flow	Bal c/f
4	Year	£	£	£	£
5	1	250,000	0	(50,000)	200,000
6	2	200,000	7,102	(54,516)	152,586
7	3	152,586	5,418	(54,516)	103,488
8	4	103,488	3,675	(54,516)	52,647
9	5	52,647	1,869	(54,516)	-
10			18,064		

The formulas to use in the above spreadsheet are as follows:

	A	B	C	D	E
1	Effective interest rate		0.0355087139205015		
2					
3		Bal b/f	Interest	Cash flow	Bal c
4	Year	£	£	£	
5	1	250000	0	-50000	=B5+C5+D5
6	2	=E5	=C1*B6	-54516	=B6+C6+D6
7	3	=E6	=C1*B7	-54516	=B7+C7+D7
8	4	=E7	=C1*B8	-54516	=B8+C8+D8
9	5	=E8	=C1*B9	-54516	
10			=SUM(C5:C9)		

In year 1, the loan is accounted for as follows:

<u>On initial drawdown</u>
Dr Bank £250,000
Cr Loan payable £250,000

<u>Year 1 loan repayment</u>
Dr Loan payable £50,000
Cr Bank £50,000
Being loan repayments in year 1

The loan would then be presented in the balance sheet as a current liability of £47,414 and a non-current liability of £152,586 to comply with the statutory formats of the balance sheet.

<u>Government grant received</u>
The government undertook to pay the lender-levied fee of £200 for handling the debenture paperwork plus the bank loan interest of £4,516. This is recorded in the financial statements as follows:

Dr Finance costs (P&L) £4,716
Cr Grant/other income £4,716
Being CBILS grant from government

In the above example, if the loan was received part-way through the year (eg it only relates to a nine-month period), then the finance cost and grant/other income would be £3,537 (£4,716 x 9/12) with the balance recognised in the next accounting period. This is because the accounting period may not be the same as the government loan period for which no interest is charged. Initial recognition of the full grant in this example is unlikely to result in a material amount.

Modifications to a CBILS loan

FRS 102 paragraph 11.37 says:

'If an existing borrower and lender exchange financial instruments with substantially different terms, the entities shall account for the transaction as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, an entity shall account for a substantial modification of the terms of an existing financial liability or part of it (whether or attributable to the financial difficulty of the debtor) as an extinguishment of the original financial liability and the recognition of a new financial liability.'

FRS 102 does not define a 'substantial modification' and therefore professional judgement will be needed. Management do not have to look to IFRS if they do not wish to, but IFRS does contain more specific requirements in respect of modifications and may provide a useful starting point. Under IFRS 9 *Financial Instruments*, a modification is 'substantial' if the discounted present value of cashflows under the new terms, discounted using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cashflows of the original liability.

It is ACCA's understanding that in most cases the terms of a CBILS loan (including the interest rate) will remain unchanged or unknown at this stage if the entity extends the term of the loan.

Example 2: Determining if there has been a substantial modification

Continuing with Example 1 above, assume the entity were to change the terms of its loan following announcement of the PAYG scheme from five years to 10 years with effect from 1 October 2020. Management assumes there has been a substantial modification to the loan terms when the discounted present value of the cashflows under the new arrangement (including any fees paid net of any fees received), discounting using the original effective interest rate (3.55% in Example 1), is at least 10% different from the discounted present value of the remaining cashflows of the original liability.

Under the **new** arrangement agreed with the lender, the remaining payments for year 1 are £24,998 (£50,000 less what has already been paid of £25,002 (£4,167 x 6)). Payments in years two to 10 are £25,618 per annum. The present value of these arrangements is calculated as follows:

Cashflows		Present value
£		£
24,998	$1 / 1.0355^{1}$	24,141
25,618	$1 / 1.0355^{2}$	23,892
25,618	$1 / 1.0355^{3}$	23,073
25,618	$1 / 1.0355^{4}$	22,282
25,618	$1 / 1.0355^{5}$	21,518
25,618	$1 / 1.0355^{6}$	20,780
25,618	$1 / 1.0355^{7}$	20,068
25,618	$1 / 1.0355^{8}$	19,380
25,618	$1 / 1.0355^{9}$	18,715
25,618	$1 / 1.0355^{10}$	18,074
		211,923

Under the **old** arrangement, the remaining cashflows discounted at the original effective rate are as follows:

Cashflows		Present value
£		£
24,998	$1 / 1.0355^1$	24,141
54,516	$1 / 1.0355^2$	50,842
54,516	$1 / 1.0355^3$	49,099
54,516	$1 / 1.0355^4$	47,416
54,516	$1 / 1.0355^5$	45,790
		217,288

The difference in the present value of the cashflows under the new arrangement compared to the present value under the old arrangement is £5,365 (£217,288 - £211,923). This is not more than 10% different from the discounted present value remaining cashflows of the original liability and hence a substantial modification of the loan terms has not taken place.

If a substantial modification *had* taken place, then the original loan balance would be derecognised and the new loan balance recognised. The difference would be recognised in profit or loss.

Example 3: Accounting for a change in terms

In Example 1, the balance owing as at 30 September 2020 (ie immediately prior to the terms changing from a five-year loan to a 10-year loan) is £224,998 (£250,000 less what has already been paid of £25,002). There are six months left of the year 1 loan.

Except for a £4 rounding adjustment the loan interest remains unchanged, but the payments have reduced to reflect the increased term of the loan. The revised loan is profiled as follows:

Effective interest rate 1.66%

Year	Bal b/f £	Interest £	Cashflow £	Bal c/f £
1	224,998	0	(12,504)	212,494
2	212,494	3,536	(25,618)	190,412
3	190,412	3,168	(25,618)	167,962
4	167,962	2,795	(25,618)	145,139
5	145,139	2,415	(25,618)	121,936
6	121,936	2,029	(25,618)	98,347
7	98,347	1,636	(25,618)	74,366
8	74,366	1,237	(25,618)	49,985
9	49,985	832	(25,618)	25,199
10	25,199	419	(25,618)	(0)
		18,068		

In Example 3, the journals for the remainder of year 1 are:

Dr Loan payable £12,504
Cr Cash at bank £12,504
Being repayments of loan

At the end of year 1 the loan is presented in the balance sheet as a current liability of £22,082 (£212,494 - £190,412) and a non-current liability of £190,412.

In year 2, the journals will be:

Dr Finance costs (P&L) £3,536
Cr Loan payable £3,536
Being interest at EIR

Dr Loan payable £25,618
Cr Cash at bank £25,618
Being repayments of loan

At the end of year 2 the loan is presented in the balance sheet as a current liability of £22,450 (£190,412 - £167,962) and a non-current liability of £167,962.

Bounce Back loans

Under this scheme, a smaller business can access finance more quickly. A small or medium-sized business can borrow between £2,000 and up to 25% of their turnover. The maximum amount of the loan is £50,000.

The government guarantees 100% of the loan and there are no fees or interest to pay for the first 12 months. After 12 months, the interest is capped at 2.5% per year. The Chancellor has written to all lenders stipulating that the 2.5% interest charge is fixed.

Example 4 – Bounce Back loan

Smallco Ltd takes out a £50,000 Bounce Back loan. No loan arrangement fee is charged on this type of loan. Ordinarily, Smallco Ltd would pay a market rate of 5% on a bank loan.

When the loan is received, the entries in the books are:

Dr Bank £50,000
Cr Loan payable £50,000

In year 1, the interest charge is £1,250 (£50,000 x 2.5%). The government make a business interruption payment to cover the first 12 months interest. These transactions are recorded as follows:

Dr Finance costs £1,250
Cr Grant income £1,250
Being business interruption payment received from bank

Note that the company does not offset the grant income against the associate finance costs in profit or loss – both are shown separately as income and expense.

An issue that becomes apparent relates to the fact that Smallco would normally pay a market rate of 5% on another bank loan, whereas the rate on these loans is only 2.5%. The difference is unlikely to be material and since the market rate for these types of loans is 2.5%, it is ACCA's view that this should be the rate that is charged to profit and loss. Such loans are only available for viable businesses and at the time of writing base rates were very low.

Under the Chancellor's PAYG scheme, an entity can extend the payment term of the Bounce Back loan from, say, five years to 10 years for the same reasons as those under the CBIL scheme.

Example 5 – Change of loan terms in a Bounce Back loan

Westwood Ltd takes out a Bounce Back loan for a six-year term on 1 May 2020. There is automatically one year with no payments or interest and the Business Interruption Payment is £1,250 (£50,000 x 2.5%). Repayments start in year 2 at £887.37 per month. The loan is profiled using the amortised cost method as follows:

Effective interest rate		2.13%		
Year	Bal b/f £	Interest £	Cashflow £	Bal c/f £
1	50,000	0	0	50,000
2	50,000	1,065	(10,648)	40,417
3	40,417	861	(10,648)	30,630
4	30,630	652	(10,648)	20,634
5	20,634	440	(10,648)	10,426
6	10,426	222	(10,648)	0

Six months into year 1, the entity agrees to revised payment terms allowing the loan to be extended to a 10-year loan term.

The carrying amount of the loan is still the same as the entity is still in year 1 and there have been no repayments nor interest charges made as yet. Repayments under the new loan terms are agreed at £516.67 per month (£6,200 per annum).

The 10-year Bounce Back loan is profiled as follows:

Effective interest rate		2.25%		
Year	Bal b/f £	Interest £	Cashflow £	Bal c/f £
1	50,000	0	0	50,000
2	50,000	1,127	(6,200)	44,927
3	44,927	1,012	(6,200)	39,739
4	39,739	895	(6,200)	34,434
5	34,434	776	(6,200)	29,010
6	29,010	654	(6,200)	23,464
7	23,464	529	(6,200)	17,792
8	17,792	401	(6,200)	11,993
9	11,993	270	(6,200)	6,063
10	6,063	137	(6,200)	0

As the rate of interest in a Bounce Back loan is fixed at 2.5% there is not expected to be any change in the value of the grant recognised in the entity's financial statements. It is expected to remain at £1,250 in year 1 (£50,000 x 2.5%).

Time to pay arrangements

To help businesses with cashflow, HM Treasury has agreed to defer certain taxes. On 24 September 2020, the Chancellor announced that he will allow businesses to spread the VAT that was deferred earlier in 2020 to 31 March 2021 over 11 smaller repayments with no interest to pay.

Self-assessed income taxpayers will also benefit from paying their outstanding liability over 12 months from January 2021.

HMRC may grant a time to pay arrangement for a wide range of taxes, subject to individual applications. Any default in a time to pay arrangement, however, may result in action being taken by HMRC to recover the taxes due.

Amounts in respect of taxation do not meet the definition of a financial liability under UK GAAP because they arise from legislative requirements rather than contractual obligations. As a result, liabilities do not have to be adjusted where an entity agrees a time to pay arrangement with HMRC. In any event, a time to pay arrangement would only change the timing of the cash outflow and not the overall liability. Generally, interest will not be charged; however, in a small number of cases, a provision for interest may be needed depending on the agreement made with HMRC.

Taxation that has been deferred will always be presented within current liabilities in the reporting entity's balance sheet.

Going concern

While the concept of going concern has always been crucially important, its importance is accelerated in a Covid-19-related crisis. Many businesses are suffering as a consequence of the pandemic and this can have a direct impact on the going concern basis.

Auditors carrying out audits of financial statements must have regard to ISA (UK) 570 (Revised June 2016) or (Revised September 2019). The September 2019 edition of ISA (UK) 570 is effective for audits of financial statements for periods commencing on or after 15 December 2019.

FRS 102 paragraph 3.8 states:

*'When preparing financial statements, the management of an entity using this FRS shall make an assessment of the entity's ability to continue as a **going concern**. An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue.'*

FRS 102 paragraph 3.8 only refers to the situation of liquidation or cessation of trade in deciphering whether the going concern basis of accounting remains appropriate.

Even when a company is experiencing significant cashflow difficulties, the default presumption is to prepare the financial statements on a going concern basis (if management do not intend cease trading, liquidating or have no realistic alternative but to do so). Management must then disclose the material uncertainties related to going concern in the financial statements.

Given the unpredictability of Covid-19, there may be material uncertainties that cast significant doubt on the entity's ability to continue as a going concern. Disclosure of such material uncertainties will be required in order to make it clear to the users that the going concern basis is subject to material uncertainties.

It must be noted that just because an entity may not make any disclosures in respect of material uncertainties related to going concern, this is not a guarantee that the entity will be a going concern for the foreseeable future. The unpredictable nature of the virus and its impact on businesses could well have a detrimental impact on that assumption and this is an issue that must be carefully considered by auditors who may conclude that non-disclosure may not be appropriate in the company's circumstances.

Example 6 – Going concern basis is considered appropriate but a material uncertainty exists

Ratchford Retail Company Ltd operates from four outlets in the UK and has warehouses located in Spain and Italy. The company is preparing its financial statements for the year ended 31 July 2020 and the impact of Covid-19 has had an adverse effect on its operations. The company has also experienced significant problems in sourcing goods due to overseas restrictions and supply chains. In addition, on 27 August 2020 a large contract to supply goods was cancelled indefinitely. The company's overdraft facility was nearing its limit and the balance sheet as at 31 July 2020 is showing a large level of net current liabilities (due in large part to directors' loans that were introduced during the year). The company has approached its bank to apply for a CBILS loan two weeks ago but at the time of authorising the financial statements for issue, no decision had been made on the loan application.

The company prepares its financial statements under FRS 102. The directors have concluded that the going concern basis of accounting is appropriate, but there is a material uncertainty. Disclosure of the material uncertainty related to going concern may be as follows:

Note 20: going concern
The company has been materially and adversely affected by the effects of the Covid-19 pandemic. Demand for the company's products and services has reduced due to local lockdown restrictions and the loss of customers due to bankruptcy. Operating results have also been adversely affected.

The company's two warehouses in Spain and Italy have been subject to lockdown restrictions and this has impacted on the company's supply chain and significant delays have been experienced in receiving products from suppliers.

The company has incurred operating losses of (£X) in the year to 31 July 2020 (2019: Operating profit £X). In addition, the company has reported net current liabilities for the year ended 31 July 2020 amounting to £X (2019: net current assets £X).

Due to the rapid and ongoing nature of Covid-19, the directors are uncertain when, and if, the company will return to profitability and positive cashflows from operations. These uncertainties cast significant doubt upon the entity's ability to continue as a going concern for the foreseeable future. The company has applied for additional borrowings to provide working capital requirements, but the outcome of these applications is not yet known.

Small entities

Small entities choosing to apply the presentation and disclosure requirements of FRS 102, Section 1A *Small Entities* are encouraged under FRS 102 paragraph 1AE.1(c) to disclose material uncertainties relating to going concern.

Where there are material uncertainties relating to the small entity's ability to continue as a going concern, it is ACCA's view that if such disclosures are **not** made, it would be extremely difficult to justify that the financial statements give a true and fair view and hence are misleading. For ACCA member firms, this creates an ethical threat as member firms cannot have their names associated with financial statements that are misleading.

Directors of small entities must therefore be advised of the implications of not disclosing material uncertainties relating to going concern where the small entity does have such uncertainties. In particular, section 393 of the Companies Act 2006 prohibits directors from approving financial statements which they know do not give a true and fair view.

Going concern basis is not appropriate

As noted earlier, there are unfortunately going to be some instances when an entity cannot survive the impact of the pandemic and the going concern basis of accounting will not be appropriate.

FRS 102 paragraph 3.9 says:

*'When management is aware, in making its assessment, of **material** uncertainties related to events or conditions that cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.'*

Neither FRS 102 nor FRS 105 specify the basis on which the financial statements should be prepared in the event that the going concern basis is not appropriate. UK GAAP would require a basis other than the going concern basis to be used in such a circumstance.

Many accountants are familiar with the 'break-up' basis of accounting (sometimes referred to as the 'liquidation' basis). Under this basis, assets are restated to recoverable amount and long-term liabilities are restated as current, with provisions being made for unavoidable costs under onerous contracts and the costs of winding the business down. Hence, the accruals concept becomes secondary because under the break-up basis, the financial statements reflect a forecast of future realisation rather than how the business has performed up to, and its financial position as at, the reporting date.

When an entity decides that the going concern basis of accounting is not appropriate, there is no dispensation from applying the recognition and measurement principles of UK GAAP (including disclosure requirements also). As such, the normal recognition and measurement bases of accounting standards should be applied and these must only be deviated from where there is adequate justification.

In ACCA's view, the break-up basis should only be used in very rare situations because it is not compliant with the normal recognition and measurement principles of UK GAAP. The financial statements must only reflect the circumstances that exist as at the reporting date and hence it would be inconsistent with UK accounting standards to provide for liabilities that have not been committed to at the reporting date – for example, additional costs of winding the business down that may be incurred at a future point in time.

When an entity decides to cease trading, the financial statements should be prepared on a basis that is consistent with the recognition, measurement and disclosure requirements of UK GAAP. This basis is then amended to reflect the fact that the going concern basis of accounting is not appropriate.

Generally, this will involve writing assets down to recoverable amount and making provisions for contractual commitments that may have become onerous as a consequence of deciding to cease trading or liquidating the entity. Costs must only be recognised if they have been committed to as at the reporting date. Future costs that have not been committed to as at the reporting date are not included.

Decision to cease trading takes place after the reporting date

UK GAAP normally requires the financial statements to reflect the transactions, events and conditions that have arisen up to, and exist as at, the reporting date.

If an entity determines after the year end that it intends to liquidate the entity, or to cease trading, or has no realistic alternative but to do so, it must not prepare the financial statements on a going concern basis (FRS 102 paragraph 32.7A and FRS 105 paragraph 26.8). In this way, what would normally be a non-adjusting event (because it occurs after the reporting date) becomes an adjusting event if it means the entity is no longer a going concern. This is a necessary exception because going concern is a forward-looking concept.

Due to the severity of the pandemic and the impact that it is having on businesses, FRS 102 paragraph 32.7A and FRS 105 paragraph 26.8 become important considerations. A business may have yielded a profit for the year ended (say) 31 March 2020, but the situation could have got a lot worse since the reporting date due to various restrictions that are currently being imposed around local areas. This could force management into decided that there is no future for the business and they have no realistic alternative but to cease trading and/or liquidate the entity.

Example 7 – Going concern basis of accounting is not appropriate

Cooper Ltd has experienced a significant decline in profitability and cashflow since the Covid-19 pandemic. The company has prepared its financial statements for the year ended 30 June 2020 but on 16 July 2020, the directors decided the company will cease to trade as the bank has just confirmed that it is not willing to renew the company's borrowing facilities.

The financial statements for the year ended 30 June 2020 include the following note relating to the basis of preparation of the entity's financial statements:

Basis of preparation of the financial statements
As explained in Note 13 to the financial statements, the company will cease trading on 16 July 2020 and the financial statements have been prepared on a basis other than the going concern basis. This basis includes, where applicable, writing the company's assets down to net realisable value. Provisions have also been made in respect of contracts that have become onerous at the balance sheet date. No provision has been made for the future costs of terminating the business unless such costs were committed to at the reporting date.

Note 13: Going concern
The directors have concluded that the company is not a going concern and, as explained in the Basis of preparation of the financial statements above, the financial statements have been prepared on a basis other than the going concern basis.

The company has been unsuccessful in securing additional borrowing facilities to provide it with sufficient working capital to meet its day-to-day obligations. In addition, the loss of customer contracts and the impact of Covid-19 has meant the company is no longer viable in the directors' opinion and the company will cease to trade on 16 July 2020.

October 2020