Audit and Accounting

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1 Revenue recognition (Lecture A877/ A878/ A879 – 12.58/ 19.52/ 20.31 minutes)

There has been lots written in the professional press concerning the Financial Reporting Council's (FRC) periodic review of UK and Ireland accounting standards. In quarter 3, we examined the new lease accounting provisions and this quarter we will take a high-level look at the new revenue recognition treatments.

The periodic review amendments come into mandatory effect for accounting periods commencing on or after 1 January 2026, with early adoption permitted, provided all the periodic review amendments are applied at the same time.

In September 2024, the FRC issued new editions of UK and Ireland accounting standards which incorporate the periodic review amendments. It should be noted that where an entity has chosen **not** to early adopt the periodic review amendments, the provisions in the January/November 2022 editions continue to apply until accounting periods commencing on or after 1 January 2026.

FRS 102 (September 2024) also contains specific disclosure requirements in the statement of cash flows in respect of supplier financing arrangements. These additional disclosures become mandatorily effective for accounting periods commencing on or after 1 January 2025 with early adoption permissible.

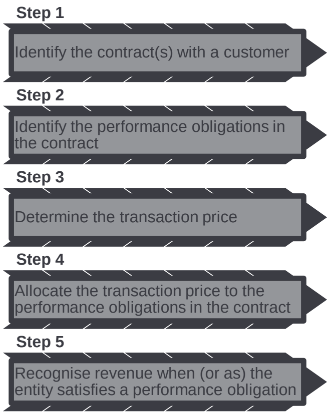
1.1 Revenue recognition under FRS 102 and FRS 105 (September 2024)

The new revenue recognition rules affect both FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*.

Both FRS 102, Section 23 and FRS 105, Section 18 have been given a new title *Revenue from Contracts with Customers* (which is consistent with IFRS® 15 *Revenue from Contracts with Customers*).

Included within both sections is a five-step comprehensive model for recognising revenue. FRS 102, para 23.4 clarifies that the objective of the model is for an entity to recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods and/or services.

The five-step model approach to recognising revenue works as follows:



Step 1: Identify the contract(s) with a customer

FRS 102, para 23.7 sets out specific criteria, all of which must be met, to account for a contract with a customer. These criteria are as follows:

(a) the parties to the contract have approved the contract and are committed to perform their respective obligations;

(b) the entity can identify each party's rights regarding the goods or services to be transferred;

(c) the entity can identify the payment terms for the goods or services to be transferred;

(d) the contract has commercial substance; and

(e) it is probable (i.e. more likely than not) that the customer will have the ability and intention to pay the consideration to which the entity will be entitled when it is due.

Example – Identifying a contract with a customer

The principal activity of Salinger Ltd is that of an IT services provider. One of its many services is providing support and repair services via the internet and onsite to both corporate customers and the general public.

Salinger Ltd enters into a contract with a new customer to scan its server for viruses and to clean up redundant files. An IT consultant has agreed a price with the customer by telephone. As the customer is new, and does not have credit facilities, the IT consultant took payment for the work over the telephone.

The services will be carried out by Salinger Ltd in the next week once the customer's premises are closed (to avoid any disruption during working hours). Salinger will be able to login to the customer's server and carry out the necessary work.

Salinger Ltd and its customer have entered into an oral contract. A contract need not be in writing for it to be enforceable (the three elements to a contract are: 'offer', 'acceptance' and 'consideration', all of which have been provided). The customer has provided payment details and consideration for the services to be provided, hence Salinger is committed to performing the work on the customer's server.

In this situation, all the criteria in FRS 102, para 23.7 are met and the contract is within scope of FRS 102, Section 23.

Step 2: Identify the performance obligations in the contract

A 'performance obligation' is defined as:

> *A promise in a **contract** with a **customer** to transfer to the customer either:*
>
> *(a) a distinct good or service (or a distinct bundle of goods or services); or*
>
> *(b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.*

Some contracts contain more than one performance obligation. For example, a client could sell an item of machinery to a customer and provide one year's servicing and maintenance. Similarly, a course provider might enter into a contract to provide five lectures at various different times and a textbook either on the first day of the course, or on receipt of payment or initial registration.

Example – Identifying performance obligations in a contract

Harper Ltd is a bookkeeping software developer. It enters into a three-year contract with its customer to provide a licence to access the bookkeeping software. The contract stipulates that Harper will provide periodic software updates and technical support throughout the duration of the contract.

The bookkeeping software is delivered electronically prior to installation, updates and technical support and is functional without the updates and/or technical support. This means the customer benefits from each good or service individually. Harper has also determined that the licence, installation, updates and technical support are all separately identifiable. Hence, in this scenario there are four performance obligations in the one contract:

- The licence to supply bookkeeping software
- The installation service
- Updates to the software

- Technical support

Step 3: Determine the transaction price

There are various sub-components in determining the transaction price and FRS 102, paras 23.43 to 23.64 cover the following issues:

Variable consideration	Paras 23.43 to 23.47
Sale-based or usage-based royalties	Para 23.48
Refund liabilities	Paras 23.49 to 23.50
Sale with a right of return	Paras 23.51 to 23.57
Time value of money	Paras 23.58 to 23.60
Non-cash consideration	Para 23.61
Consideration payable to a customer	Paras 23.62 to 23.64

The transaction price is the amount of consideration the entity expects in exchange for satisfying a performance obligation.

Example – Determining the transaction price with variable consideration

Sunnie Industries Ltd enters into 30 contracts with its customers to supply various chemicals. Each contract includes the sale of one type of chemical with a selling price of £1,200. The cost to Sunnie Industries of each of these types of chemicals is £700. Customers can return the products within 30 days for a full credit and any returned goods can be used in other chemical mixes or sold again at a profit.

The finance director can reliably estimate the return rate for this type of chemical based on previous experience. On this basis, the finance director has estimated that 26 products will not be returned, meaning four are likely to be returned.

As the customers can return the products, the consideration is variable. FRS 102, para 23.44 requires any of the following to be used when estimating variable consideration:

- the expected value method; or
- the most likely amount method.

Using the expected value method, the estimated variable consideration is £31,200 (26 products x £1,200). The variable consideration is included in the transaction price because, based on previous experience, it is highly probable that Sunnie Industries will be entitled to the cumulative amount of revenue recognised (£31,200) when the uncertainty associated with the variable consideration is subsequently resolved (FRS 102, para 23.46).

Revenue of £31,200 and a refund liability of £4,800 (4 products expected to be returned x £1,200) is recognised (FRS 102, paras 23.53(a) and (b)).

In addition, Sunnie Industries must derecognise the stock transferred to its customers. It will also recognise a refund asset (classified as stock) of £2,800 (4 products x £700) as well as a corresponding credit to cost of sales. This represents the entity's right to recover products from customers on settling the refund liability (FRS 102, para 23.53(c)).

Step 4: Allocate the transaction price

FRS 102, para 23.65 requires the entity to allocate the transaction price to each performance obligation identified on a relative stand-alone selling price basis, unless allocating discounts or variable amounts on an alternative basis.

Where a customer is offered a discount for purchasing a bundle of goods and services, the discount is allocated across all performance obligations within the contract in proportion to their stand-alone selling prices, unless observable evidence suggests that this would be inaccurate.

Example – Allocating the transaction price with a discount

Lemming Industries Ltd sells an industrial cutting machine with one year's free technical support for £100,000. The sale of the machine and the technical support have both been identified as separate performance obligations.

One a stand-alone basis, the machine would sell for £95,000. This is the first time Lemming has started to provide technical support for this type of machine. Other support services provided by Sunnie (all of which generate a profit), attract a markup of 50%. It is expected that the technical support service will cost £20,000.

The selling price of the machine on a stand-alone basis is £95,000 but there is no observable selling price for the provision of technical support. FRS 102, para 23.69 requires the stand-alone selling price to be estimated. FRS 102, para 23.70 suggests the following suitable methods:

(a) an adjusted market assessment approach;

(b) expected cost plus a margin approach; or

(c) residual approach.

The residual approach would attribute £5,000 (£100,000 - £95,000) to the technical support service. This does not, however, approximate the stand-alone selling price of similar technical support services, which generate a profit for the entity.

A more appropriate approach would be an expected cost plus a margin approach. Based on this approach, the selling price of the technical support service would be £30,000 (£20,000 x 150%).

The total of the stand-alone selling prices of the machine and technical support is £125,000 (£95,000 + £30,000). However, the total consideration is only £100,000. This means the customer is receiving a discount for purchasing a bundle of goods and services of 20% (£25,000 / £125,000).

FRS 102, para 23.74 assumes that discounts relate to all performance obligations within a contract unless this basis does not depict the amount of consideration to which the entity expects to be entitled (in which case the entity uses a method that does reflect such amounts).

The transaction price allocated to the machine is £76,000 (£95,000 x 80%).

The transaction price allocated to the technical support is £24,000 (£30,000 x 80%).

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

Revenue is recognised when (or as) the entity satisfies a performance obligation by transferring a good or service to a customer. A performance obligation is said to be satisfied **over time** if one of the following criteria in FRS 102, para 23.81 (a) to (c) are met:

(a) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

(b) The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.

(c) The entity's performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Example – Provision of payroll services

Paul's Payroll Services enters into a contract with Wolves Ltd to provide monthly payroll services at a contracted rate of £16,000 per annum. Paul's Payroll Services has a year end of 30 June 2024.

The provision of payroll is a separate performance obligation which is performed over time. This is because the customer simultaneously receives and consumes the benefit of the payroll service. Even if Wolves Ltd were to change payroll provider, the payroll would not need to be reperformed.

Paul's Payroll Services recognises revenue from the service over time. Hence, in the year to 30 June 2024, the entity recognises £8,000 as revenue (£16,000 x 6/12).

FRS 102, para 23.102 refers to ‘output methods’ (e.g. surveys of performance) and ‘input methods’ (e.g. costs incurred as a proportion of total expected costs) for measuring progress towards the satisfaction of a performance obligation.

If the progress cannot be reliably measured, revenue is only recognised up to the recoverable costs incurred.

Example – Construction contract

On 3 January 2026, Dwyer Ltd enters into a contract with Whitaker Ltd to construct a new building for £8 million plus a bonus of £1 million if the building is completed within 18 months. Estimated costs to construct the building have been calculated at £6 million.

The winter months are renowned for causing delays to construction and sourcing various materials can also be problematic at times which can contribute to delays in construction. Hence, Dwyer is uncertain whether the bonus will be received.

At the year end 31 December 2026, Dwyer is still uncertain whether its bonus target will be achieved due to other delays during the year, such as staffing issues and breakdowns of machinery. Dwyer decides to measure progress towards completion based on costs incurred (FRS 102, para 23.102(e)). Costs incurred on the contract to date are £2 million.

The construction of the building is a single performance obligation. The bonus element is variable consideration and must be excluded from the transaction price because it is not highly probable that it will be entitled to the cumulative amount of revenue (FRS 102, para 23.46).

The construction is accounted for as an obligation performed over time. Dwyer should recognise revenue based on progress towards satisfaction of the construction of the building. Using the costs incurred approach, the performance obligation is 1/3 (£2.0m / £6.0m) complete.

Accordingly, revenue and costs recognised at the year end are:

		£m
Revenue	(£8m x 1/3)	2.6
Costs	(£6m x 1/3)	(2.0)
Gross profit		0.6

1.2 Practical implications

The new revenue recognition requirements in FRS 102, Section 23 and FRS 105, Section 18 are completely new, and, in some cases, these new requirements may result in different revenue profiles than under the 2022 editions of the standards. Keep in mind there are new prescriptive requirements for transactions involving (among other things) non-refundable upfront fees and income arising from licensing and royalties.

2 Company law update (Lecture A880/ A881 – 9.00/ 10.58 minutes)

In March 2024, the previous government announced plans to implement various regulatory changes that are designed to ease the burdens placed on businesses in respect of non-financial reporting. One of those changes, which is of particular interest to accountants, is an increase in the thresholds that determine the size of a company or group.

The current company size thresholds have been in place since 2015, so it has been a while since they were last reviewed. Static thresholds mean that more companies are drawn into reporting requirements that may not be appropriate – especially given the effects of inflation since 2015 (and more recently, since 2020). In addition, the thresholds currently set out in company law are derived from EU legislation made in 2013, and are as follows:

Company and group size thresholds (net)				
2 out of 3 of:	Micro	Small	Medium	Large
Annual turnover (£)	≤632k	≤10.2m	≤36m	>36m
Balance sheet total (£)	≤316k	≤5.1m	≤18m	>18m
Average number of employees	≤10	≤50	≤250	>250
Group size thresholds (gross)				
2 out of 3 of:		Small	Medium	Large
Annual turnover (£)	Not applicable	≤12.2m	≤43.2m	>43.2m
Balance sheet total (£)		≤6.1m	≤21.6m	>21.6m
Average number of employees		≤50	≤250	>250

2.1 Update to company size thresholds

The previous government indicated that the new size thresholds would have a planned effective date of financial years commencing on or after 1 October 2024. Since then, there has, of course, been a change in government. When Labour came into power, it was notable that there was no mention of these reforms in the King's Speech in July 2024, indicating that it was a case of 'wait and see' if anything was to re-emerge where these plans were concerned.

On 14 October 2024, the Secretary of State for Business and Trade confirmed in a ministerial statement that the Labour government will take forward the previous government's plans to increase the company size thresholds. Legislation is expected to be laid before Parliament before the end of this year and is expected to come into force on 6 April 2025.

The company size thresholds are expected to be increased by 50% as follows:

Company and group size thresholds (net)				
2 out of 3 of:	Micro	Small	Medium	Large
Annual turnover (£)	≤1m	≤15m	≤54m	>54m
Balance sheet total (£)	≤500k	≤7.5m	≤27m	>27m
Average number of employees	≤10	≤50	≤250	>250
Group size thresholds (gross)				
2 out of 3 of:		Small	Medium	Large
Annual turnover (£)	Not applicable	≤18m	≤64m	>64m
Balance sheet total (£)		≤9m	≤32m	>32m
Average number of employees		≤50	≤250	>250

Many companies currently classed as medium-sized will be able to move down to the small category. This will potentially enable them to apply a less rigorous financial reporting regime (e.g. FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, including Section 1A *Small Entities*, if they wish). The government estimates that this will save companies more than £240m per year. It is expected that most newly small companies will choose to adopt a less rigorous reporting regime, provided there is no objection to doing this from stakeholders, such as banks or shareholders.

The other potential saving will come in the form of audit exemption as companies that are reclassified as small may be able to claim audit exemption. The audit exemption thresholds are directly linked to the small companies' thresholds, hence any increase in the small company thresholds means that the audit exemption thresholds automatically increase at the same time.

Not all companies that are reclassified as small will be able to claim audit exemption, but most will. It should be noted that the current government also plan to make various technical corrections to the audit regulatory framework, which is briefly examined in the audit update section of the course (see section 10).

2.2 Changes to the directors' report

The reforms will also make changes to the directors' report in respect of non-financial reporting, aimed at removing several obsolete or overlapping requirements in respect of the directors' report and the directors' remuneration report (for large companies).

Specifically, the proposals set out to:

- Remove the information requirements related to the employment of disabled people
- Remove the information requirements on financial instruments
- Remove the information requirements on branches
- Remove the information requirements on employee engagement
- Remove the information requirements on engagement with suppliers, customers and others
- Remove the information requirements on important events, future developments and research and development

2.3 Medium-sized companies

The previous government announced plans to consult on redefining a 'medium-sized business'. This would have involved increasing the employee headcount criterion from 250 (as it currently is) to 500. In addition, the previous government announced that it would consult on providing an exemption from medium-sized companies having to include a Strategic Report in the annual report.

The Labour government announced that it will **not** be taking forward these proposals at the current time on the grounds that feedback suggests a more holistic review of the thresholds and the wider reporting framework is necessary.

2.4 Future of corporate reporting

The Secretary of State announced that the Department of Business and Trade would undertake a consultation on the *Future of Corporate Reporting*, aimed at simplifying and modernising non-financial reporting to better meet business and investor needs.

In addition, the proposals concerning medium-sized companies (as discussed above) would also be considered as part of the *Future of Corporate Reporting* consultation, as this is much broader.

The government plans to launch this consultation in 2025.

2.5 Economic Crime and Corporate Transparency Act update

On 16 October 2024, Companies House published a 'Transition Plan' for implementation of some of the key provisions of The Economic Crime and Corporate Transparency Act (ECCTA) which are not yet in force.

As previously updated, the ECCTA will be introduced in tranches and will require over 50 Statutory Instruments (SIs) to be issued to implement the various measures contained in the Act. It will also require Companies House' systems and processes to be changed to cater for the new measures and Companies House have estimated that it will take until 2027 to complete the transition.

Key provisions already in force

Various SIs were passed on 29 February 2024 which made some initial changes effective from **4 March 2024**, including:

- greater powers to query information and request supporting evidence;
- stronger checks on company names;
- new rules for registered office addresses;
- a requirement for all companies to provide a registered email address;
- a requirement for all companies to confirm they are carrying out lawful activities when they incorporate, and to confirm its intended future activities will be lawful on the Confirmation Statement (form CS01);
- the ability to annotate the register when information appears confusing or misleading;
- taking steps to clean up the register, using data matching to identify and remove inaccurate information; and
- sharing data with other government departments and law enforcement agencies.

Further regulations, which came into force on **2 May 2024** provide the Registrar of Companies with the ability to issue a financial penalty to companies and individuals in breach of Companies Act 2006 as an alternative to pursuing a criminal prosecution. Any aggravating or mitigating factors can be taken into consideration.

How the Transition Plan currently looks

This table provides a summary of the key dates, together with details of some of the more notable elements:

Timeline	Reforms
By Autumn 2024	Companies House will start using its powers to issue financial penalties for relevant offences
By Winter 2024 into 2025	Companies House will expedite the striking-off of companies formed on a false basis and begin annotating the register in a wider range of circumstances
By Spring 2025	The process for registration of Authorised Corporate Service Providers will open Individuals will be able to voluntarily verify their identity Companies House will begin processing applications from individuals seeking to have residential addresses suppressed from public disclosure in certain circumstances
By Summer 2025	Certain trust information on the Register of Overseas Entities will be available to access on request
By Autumn 2025	Identity verification will become a compulsory part of new incorporations, the appointment of new directors and notifications of new Persons with Significant Control (PSCs) A 12-month transition phase for existing directors and PSCs to verify their identity will begin
By Spring 2026	Identity verification for individuals filing information with Companies House to be compulsory Third-party agents filing on behalf of companies will need to be registered as Authorised Corporate Service Providers
By end of 2026	Transition phase for individuals to become ID verified to end and compliance action will be taken against any non-verified individuals Limited partnerships will be required to submit more information Companies House to facilitate greater cross-checking and data-sharing among agencies

ID verification

ID verification is a common issue that is asked about by accountants. When the measures are fully implemented, it will require directors, all members of LLPs, PSCs and individuals delivering documents to Companies House to verify their identity.

ID verification is expected to be a one-off requirement. Hence, an individual that has several directorships will only need to have their identity verified once.

ID verification is expected to be possible using a number of methods, such as the GOV.UK ID Check application; the One Login web journey; or at Post Office. In addition, Authorised Corporate Service Providers will be able to provide ID verification services if they wish.

By Spring 2025, individuals will be allowed to voluntarily verify their ID and by Autumn 2025, Companies House will aim for ID verification to be compulsory on incorporation and on the appointment of new directors and registration of new PSCs.

It is likely that this will also extend to the incorporation of LLPs and the registration of new members within the LLP (though the Transition Plan is not specific on this issue).

Given there are more than 7 million existing directors and PSCs, a 12-month transition phase is expected to commence between Autumn 2025 and Autumn 2026.

It will require companies to ensure that the directors and PSCs are ID-verified at the time of filing the first Confirmation Statement during that period. It is likely that LLPs will follow the same timetable.

Companies House filings

The ECCTA provides restrictions on who can file information at Companies House. These changes are expected to come into force in Spring 2026 and will mean that a firm delivering a return to Companies House will have to have that return filed on its behalf by an ID-verified individual who is an officer or employee of that firm (or of a corporate officer of that firm), or by an Authorised Corporate Service Provider acting on its behalf. Individuals that are delivering returns on their own behalf will need to be ID-verified. Individuals that are disqualified from being a director will be prevented from filing and will need to use an Authorised Corporate Service Provider instead.

Third-party providers, such as accountants, wanting to become Authorised Corporate Service Providers must be supervised by one of the UK's relevant Anti-Money Laundering Supervisory Bodies (e.g. ICAEW or ACCA) and will need to register their business as an Authorised Corporate Service Provider before they can continue to submit information to Companies House on behalf of clients.

Changes not included in the Transition Plan

The table below outlines other reforms arising from the ECCTA, but which are not included in the Transition Plan:

Minor changes to company administration	The ECCTA makes changes to administrative requirements such as removing the requirement to maintain a register of directors and secretaries. These issues do not have a direct impact on Companies House requirements and so are not referred to in the Transition Plan.
Prohibitions on using corporate directors	The Transition Plan does confirm that the ban on corporate directors will come into force, but it does not specify when. It should be noted that only corporate entities that have legal personality and are UK-based will be eligible to act as a corporate director.
Accounts reform	There are a number of accounting reforms brought in by the Act. The Transition Plan indicates that Companies House will be moving to a software-only filing regime for company accounts in the future. There is no indicative timetable for these changes.
Register of Overseas Entities Regime	Certain provisions of this regime came into effect on 4 March 2024. However, other amendments, such as requirements to disclose property title information, additional information concerning trusts and registrable beneficial owners in a period prior to 31 January 2023, have not yet come into effect and are not referred to in the Transition Plan.
Failure to Prevent Fraud offence	This new offence (which is currently only applicable to large companies) is not in the remit of Companies House and so is not mentioned in the Transition Plan.

It is important that accountants keep up to date with developments in this area as there will be a significant number of Statutory Instruments issued over the next couple of years that will implement various measures in the ECCTA. As developments progress in this area, they will be covered in the various quarterly updates as necessary.

3 Statements of Recommended Practice updates (Lecture A882 – 4.31 minutes)

There are currently nine SORP-making bodies as follows:

- Charity Commission for England and Wales
- Office of the Scottish Charity Regulator
- Charity Commission for Northern Ireland
- Further Education/Higher Education SORP Board
- National Housing Federation (including Community Housing Cymru, Scottish Federation of Housing Associations and Northern Ireland Federation of Housing Associations)
- The Investment Association
- The Association of Investment Companies
- The Consultative Committee of Accountancy Bodies
- Pensions Research Accountants Group

SORPs can only be issued by a SORP-making body. A SORP-making body is a body that has been recognised by the Financial Reporting Council (FRC) for the purposes of producing a SORP for a particular industry or sector. The FRC require the SORP-making body to act in the public interest when developing, maintaining and issuing SORPs.

All SORPs must carry a statement issued by the FRC that the SORP does not appear to contain any fundamental points of principle that are unacceptable in the context of current financial reporting practice, auditing practice or actuarial practice; nor does it conflict with an FRC standard or undermine the FRC's broader objectives.

3.1 Recent changes to UK and Ireland GAAP and the impact on SORP-making bodies

As has been widely publicised, the FRC issued the amendments to UK and Ireland accounting standards arising from its periodic review in March 2024. The impact of these amendments is likely to result in all nine SORP-making bodies revising their SORPs. Some of the SORP-making bodies will need to make more extensive revisions to SORPs than others, but it is expected that there will be amendments to pretty much all the SORPs.

Prior to starting work on the development, or revision, of a SORP, the SORP-making body must seek approval from the FRC. This aims to ensure:

(a) agreement over the nature and scope of the SORP; and

(b) that the SORP's recommendations do not overlap with an FRC project or address a matter that the FRC would prefer to deal with itself.

All SORPs must be developed in line with current FRC standards and best practice. It should be emphasised that the requirements of a SORP **cannot** override the provisions in law, regulatory requirements or FRC standards.

In September 2024, the FRC issued revised editions of UK and Ireland accounting standards. This will trigger the SORP-making bodies to consider revisions to their SORPs. When a more recently issued FRC standard, change in legislation or other development, creates a conflict with the provisions in an existing SORP, the relevant provisions of that SORP will cease to have effect. Hence, if a SORP-making body does not update its SORP to bring it into line with an FRC standard, the FRC standard will always take precedence and must be applied. It is the responsibility of the relevant SORP-making body to update its SORP on a timely basis to reflect any applicable changes.

3.2 FRC review of consultation drafts

All consultation drafts and statements of intent are required to be presented to the FRC for comment and/or review prior to publication. The FRC will carry out a review of the consultation draft or statement to determine whether the proposals:

- are being developed in accordance with FRC policy;
- contain fundamental points of principles that are unacceptable in the context of current practice;
- contain proposed requirements that conflict with the requirements or principles of an FRC standard; and
- support matters that fall within the FRC's broader responsibilities, to the extent that this is relevant to the industry, sector or area of work in question.

4 Cash flow statements (Lecture A883 – 5.25 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with the cash flow statement (or 'statement of cash flows' as it is referred to in FRS 102) in Section 7 *Statement of Cash Flows*.

The cash flow statement is one of the primary financial statements and hence is given equal prominence to that of the profit and loss account, balance sheet and statement of changes in equity.

In recent years, the cash flow statement has been the subject of criticism from professional bodies and regulators due to some common errors that can result in the statement becoming misleading. This article examines the accounting concepts in FRS 102, Section 7. The auditing aspects will be considered later.

4.1 Cash flow classifications

The cash flow statement provides the user with information about how the reporting entity has generated cash and what it has spent that cash on. The statement itself is prepared on a cash basis and forms a link between the profit and loss account and the balance sheet. This link allows the user to assess various factors which could affect the entity's liquidity, financial flexibility, profitability and overall risk.

Operating activities

Operating activities are the day-to-day revenue-producing activities of the business. FRS 102, para 7.4 contains the following examples of operating cash flows:

(a) *cash receipts from the sale of goods and the rendering of services;*

(b) *cash receipts from royalties, fees, commissions and other* ***revenue****;*

(c) *cash payments to suppliers for goods and services;*

(d) *cash payments to and on behalf of employees;*

(e) *cash payments or refunds of* ***income tax****, unless they can be specifically identified with financing and investing activities;*

(f) *cash receipts and payments from investments, loans and other contracts held for dealing or trading purposes, which are similar to* ***inventory*** *acquired specifically for resale; and*

(g) *cash advances and loans made to other parties by* ***financial institutions****.*

Please note, FRS 102 (September 2024) contains an additional operating cash flow in respect of payments for short-term leases, payments for leases of low-value asset and variable lease payments not included in the measurement of the lease liability as required by FRS 102, Section 20 *Leases*. FRS 102, para 7.4(h) is effective for accounting periods commencing on or after 1 January 2026 with early adoption permissible provided all the periodic review amendments are applied at the same time.

A further small amendment in FRS 102 (September 2024) relates to paragraph 7.4(f) where the term 'contracts' is set in **bold** type to confirm that this is a defined term in the Glossary.

Example – Operating activities

During the year, Greaves Industries Ltd paid corporation tax of £22,000 to HM Revenue and Customs. The company prepares its financial statements under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and is not a qualifying entity.

The corporation tax payment would be shown separately and classified as an operating cash flow unless the tax can be specifically identified with financing and investing activities

Investing activities

Cash flows from investing activities arise from the acquisition and disposal of an entity's long-term assets and other investments which are not included in cash equivalents. FRS 102, para 7.5 provides the following examples of investing activities:

(a) *cash payments to acquire **property, plant and equipment** (including self-constructed property, plant and equipment), **intangible assets** and other long-term assets. These payments include those relating to capitalised **development** costs and self-constructed property, plant and equipment;*

(b) *cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;*

(c) *cash payments to acquire equity or debt instruments of other entities and interests in **joint ventures**, including the net cash flows arising from obtaining **control** of **subsidiaries** or other businesses (other than payments for those instruments classified as cash equivalents or held for dealing or trading);*

(d) *cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures, including the net cash flows arising from losing control*

of subsidiaries or other businesses (other than receipts for those instruments classified as cash equivalents or held for dealing or trading);

(e) *cash advances and loans made to other parties (except those made by financial institutions – see paragraph 7.4(g));*

(f) *cash receipts from the repayment of advances and loans made to other parties;*

(g) *cash payments for futures contracts, forward contracts, (a) (option contracts and swap contracts, except when the contracts are held for dealing or trading, or the payments are classified as financing activities; and*

(h) *cash receipts from futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading, or the receipts are classified as financing activities.*

When a contract is accounted for as a hedge (see Section 12 Other Financial Instruments Issues), an entity shall classify the cash flows of the contract in the same manner as the cash flows of the item being hedged.

Example – Investing activities

Ratchford Enterprises Ltd manufactures chemicals for use in domestic detergent products. It has four branches throughout the UK and has a year end of 30 September 2024. Demand for the company's products has seen a sharp rise in the last two years and on 1 January 2024, the company opened another branch in the south of the UK and purchased a building outright to house their operations which resulted in a cash outflow of £100,000.

Only expenditure which results in a recognised asset on the balance sheet is eligible to be classified as an investing activity and in this instance the cash payment of £100,000 will be treated as a cash flow from investing activities.

Financing activities

Financing activities are those activities which result in a change in the size and composition of the contributed borrowings and equity structure of the business. FRS 102, para 7.6 provides the following examples of financing cash flows:

(a) *cash proceeds from issuing shares or other equity instruments;*

(b) *cash payments to* ***owners*** *to acquire or redeem the entity's shares;*

(c) *cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;*

(d) *cash repayments of amounts borrowed; and*

(e) *cash payments by a lessee for the reduction of the outstanding **liability** relating to a **finance lease**.*

FRS 102 (September 2024) reflects some small amendments to paragraph 7.6 made by the FRC in its periodic review. Paragraph 7.6(e) has been reworded to state:

Cash payments by a lessee for the principal portion of the lease liability.

Example – Financing activities

Naylor Industries Ltd has a year end of 30 June 2024. On 20 June 2024, the company declared a dividend to its ordinary shareholders which gave rise to a cash outflow of £50,000 that took place on 23 June 2024. The entity has presented the cash outflow as a financing cash flow in the cash flow statement.

Dividends and interest payments are permitted to be treated as operating, investing or financing cash flow because they can be regarded as any of these. However, they must be treated consistently and presented separately from other cash flows. If Naylor Industries has a policy as treating dividends as a financing cash flow and follows that policy consistently, the treatment is appropriate.

It is worth noting that if the dividend was not settled prior to the year end, it would not be shown in the current year's cash flow statement

4.2 Methods of reporting operating cash flows

FRS 102, Section 7 provides for two possible methods for reporting cash flows from operating activities:

(a) the indirect method; or

(b) the direct method.

Indirect method

Under the indirect method, the net cash flow from operating activities is arrived at by adjusting profit or loss for the effects of non-cash items reported in profit or loss and fluctuations during the accounting period in stock, debtors and creditors as well as other items for which the cash effects relate to investing or financing activities of the entity.

Example – Indirect method		
	2024 £	**2023 £**
Operating profit	6,261	6,063
Depreciation charges	539	475
Loss on disposal of fixed assets	-	62
Gain on disposal of fixed assets	(125)	-
Equity-settled share-based payment expense	156	208
Decrease (increase) in trade and other debtors	(140)	139
Decrease (increase) in stock	27	(14)
(Decrease) increase in trade and other creditors	222	149
Cash generated from operations	**6,940**	**7,082**
Interest paid	(1,650)	(1,110)
Interest received	12	14
Tax paid	(1,254)	(1,657)
Cash flow from operating activities	**4,048**	**4,329**

Direct method

The direct method of preparing the cash flow statement is useful for the users because it reports the major classes of gross operating cash receipts and gross operating cash payments. However, the reality is that the indirect method is the method which is most common (and is equally acceptable).

Under the direct method, information is disclosed about the major classes of gross receipts and gross cash payments. An example is shown below:

Example – Direct method		
	2024 £	**2023 £**
Collections from trade debtors	4,217	4,420

Payments to suppliers	(2,142)	(2,162)
Payments to employees	(657)	(569)
Payments of corporation tax	(64)	(138)
Payments relating to retirement benefits	(235)	(252)
Cash flows from operating activities	**1,119**	**1,299**

4.3 Reconciliation of net debt

FRS 102, para 7.22 requires the entity to disclose an analysis of changes in net debt from the beginning of the reporting period to the end, showing changes arising from:

(a) the cash flows of the entity;

(b) the acquisition and disposal of subsidiaries;

(c) new finance leases entered into;

(d) other non-cash changes; and

(e) the recognition of changes in market value and exchange rate movements.

FRS 102, para 7.22 states that when several balances (or parts thereof) from the balance sheet have been combined to form the components of opening and closing net debt, sufficient detail must be shown to enable the users to identify these balances. In addition, the analysis of net debt need not be presented for prior periods.

Example – Reconciliation of net debt

Analysis of changes in net debt	**At 1 January 2024**	**Cash flow**	**At 31 December 2024**
	£	£	£
Net cash: Cash at bank	122,487	459,925	582,412
Bank overdrafts	(4,605,484)	(15,249)	(4,620,733)
	(4,482,997)	**444,676**	**4,038,321)**
Borrowings:			
Borrowings falling	-	(46,768)	(48,768)

due within one year			
Borrowings falling due after more than one year	-	(201,232)	(201,232)
	-	(250,000)	(250,000)
Total	**(4,482,997)**	**194,676**	**(4,288,321)**

FRS 102, para 7.22 states that when several balances (or parts thereof) from the balance sheet have been combined to form the components of opening and closing net debt, sufficient detail must be shown to enable users to identify these balances. In addition, the analysis of net debt need not be presented for prior periods.

4.4 Supplier finance arrangements

At the same time as publishing the periodic review amendments, on 24 March 2024, the FRC finalised a further amendment to FRS 102, Section 7 to introduce disclosure requirements for supplier finance arrangements where a third-party finance provider pays an entity's supplier, and the entity repays the finance provider.

The amendments to FRS 102, Section 7 are based on the IASB®'s amendment to IAS® 7 *Statement of Cash Flows* and IFRS® 7 *Financial Instruments: Disclosures*.

Entities preparing a cash flow statement under FRS 102 (January 2022 and September 2024) will be required to disclose information, in aggregate, concerning supplier finance arrangements which will include key terms and conditions, carrying amounts of liabilities subject to the arrangements, including the effects of non-cash changes, and ranges of payment dates.

Qualifying entities (subsidiaries and intermediate parents) were previously exempt from all the requirements of FRS 102, Section 7. However, they will now only be exempt from the supplier finance disclosure requirements if equivalent disclosures are included in the consolidated financial statements.

What would be a supplier finance arrangement?

In a nutshell, a supplier finance arrangement is where a finance provider offers to pay the supplier of goods or services of an entity, and the buyer agrees to pay the financer at the same date or at a later date.

Keep in mind that for the transaction to be in scope of a supplier finance arrangement, the buyer must have a liability to the supplier and the finance provider must be offering to pay that supplier.

Alternative references to 'supplier finance arrangements' include:

- Supply chain finance
- Payables finance
- Reverse factoring

What would NOT be a supplier finance arrangement?

There are some common types of working capital arrangements which do not involve a financier paying amounts owed by an entity to its suppliers. These sorts of transactions would not be in scope of a supplier finance arrangement and hence would not be disclosable as such. Examples would include:

- Receivable financing (e.g. invoice discounting/factoring)
- Inventory financing (e.g. a revolving line of credit from a financier)
- Credit enhancements (e.g. financial guarantees or letters of credit)
- Credit card facilities or other such types of facility

Disclosure requirements

The following disclosures are required **in aggregate** for supplier finance arrangements:

- Key terms and conditions of the arrangements. Note, where terms and conditions are dissimilar, they should be disclosed separately.
- At the end of the reporting period:

    i. carrying amounts and associated line items presented in the balance sheet of the financial liabilities that are part of a supplier finance arrangement;

    ii. the range of payment due dates (e.g. 30 days from invoice date) for both the financial liabilities disclosed under i above and comparable trade creditors that are not part of a supplier finance arrangement. (Comparable trade creditors are, for example, trade creditors of the entity within the same line of business or jurisdiction as the financial liabilities disclosed in i above.

    If ranges of payment due dates are wide, an explanatory information disclosure about those (additional) ranges (e.g. stratified ranges) are disclosed.

Example – Qualitative disclosure information

The company participates in a supply chain financing arrangement. Under the terms of this arrangement, the bank agrees to pay amounts to a participating supplier in respect of invoices owed by the company and receives settlement from the company at a later date. The primary purpose of this arrangement is to facilitate efficient payment processing and to enable the willing suppliers to receive payments from the bank prior to the invoice settlement date.

Example – Quantitative disclosure information

	31.12.2025
	£'000
Carrying amounts of liabilities that are part of a supplier financing arrangement:	
Presented within trade and other creditors	X
Range of payment due dates:	
Liabilities that are part of the arrangement	X days after invoice date
Trade creditors that are not part of the arrangement	X days after invoice date

FRS 102, para 7.20C(c) also requires the type and effect of non-cash changes in the carrying amounts of the financial liabilities relating to supplier finance arrangements at the end of the reporting period. Examples include:

- The impact of business combinations, such as when the acquiree has supplier finance arrangements.
- Exchange differences, such as when financial liabilities are subject to supplier finance arrangements denominated in a foreign currency.
- Other transactions that do not require the use of cash or cash equivalents.

Example disclosure – Impact of non-cash changes
There were no material business combinations or foreign exchange differences or other non-cash transfers relating to the carrying amount of liabilities subject to supplier finance arrangements.

Effective date

It should be noted that this amendment was **not** part of the periodic review amendments (it was subject to a separate consultation). These additional disclosure requirements are mandatory for accounting periods commencing on or after 1 January 2025. Early adoption is permitted.

5 Amortised cost for financial instruments (Lecture A884 – 7.05 minutes)

The accounting and disclosure requirements for financial instruments are dealt with in FRS 102, Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*. This section examines the accounting issues for basic financial instruments as this is an area that has been cited as posing particular challenges for preparers and auditors.

5.1 Understanding what a financial instrument is

It is useful to go 'back to basics' to understand exactly what constitutes a financial instrument. This is because some transactions may, at first glance, appear to be a financial instrument but are not.

Definitions

Financial asset

Any asset that is:

- cash;
- an equity instrument of another entity;
- a contractual right:
    - to receive cash or another financial asset from another entity, or
    - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and is:
    - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
    - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity

Financial liability

Any liability that is:

- a contractual obligation:
    - to deliver cash or another financial asset to another entity; or
    - to exchange financial assets or financial liabilities that are potentially unfavourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and is:
    - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
    - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the

	instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.	future receipt or delivery of the entity's own equity instruments.

From the definitions above, you can see a financial asset requires a 'contractual right' to be in force. Conversely, a financial liability requires a 'contractual obligation' to have arisen on the part of the reporting entity.

Certain transactions, such as tax receipts or payments, may, at first glance, appear to be in scope of a financial instrument because they are either settling an overpayment made by the entity (e.g. in respect of s455 corporation tax); or paying a liability (e.g. in respect of a corporation tax liability arising on the entity's profits).

Tax receipts and payments are not in scope of financial instruments because they arise due to legislative requirements as opposed to contractual rights/obligations. In addition, FRS 102, Section 29 *Income Tax* deals with the accounting requirements for taxation transactions.

Other transactions, such as provisions for warranties, do not meet the definition of a financial asset or financial liability because the cash has already changed hands. It is therefore important to ensure that the transaction does, in fact, meet the definition of a 'financial instrument', 'financial asset' or 'financial liability' to ensure the subsequent accounting treatment is correct.

5.2 Amortised cost method

Generally, basic financial instruments (e.g. trade debtors, trade creditors, basic bank loans and finance leases) are measured at amortised cost using the effective interest method. The term 'amortised cost (of a financial asset or financial liability') is defined as:

> *The amount at which the **financial asset** or **financial liability** is measured at initial **recognition** minus principal repayment, plus or minus the cumulative **amortisation** using the **effective interest method** of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.*

The term 'effective interest method' is defined as:

> *A method of calculating the **amortised cost** of a **financial asset** or a **financial liability** (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.*

The amortised cost using the effective interest method is the **only** way of subsequently measuring basic financial instruments. Bases such as the 'level-spread method'; or 'sum-of-the-digits method' are not permitted because they are not recognised methods in FRS 102.

It should also be noted that FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* does not recognise the amortised cost and effective interest method because these methods are deemed too onerous for micro-entities. Consequently, micro-entities preparing financial statements under FRS 105 measure such loans at cost. The interest recognised in profit and loss will be the actual amount paid to the financier/bank.

Loan arrangement fees

Another issue that appears to be contentious is the accounting treatment for loan arrangement fees under FRS 102. Some practitioners recognise loan arrangement fees, for example, in profit or loss as they have arisen. Other practitioners have recognised them in prepayments and released them to profit and loss over the life of the loan.

These treatments are not compliant with FRS 102 and the examples in FRS 102, para 11.13 clarify the accounting treatment as follows:

Example 1 – Financial liabilities

For a loan received from a bank at a market rate of interest, a payable is recognised initially at the amount of the cash received less separately incurred transaction costs.

Example – Basic bank loan with an arrangement fee

Bauer Ltd takes out a five-year bank loan for £750,000. The bank charges a 1.25% loan arrangement fee which is non-refundable and is payable on inception of the loan.

Initial recognition

The loan is initially recorded as follows:

	£
Dr Bank	740,625
Cr Loan payable	740,625

Being initial recognition of loan, net of transaction costs

Subsequent measurement

The loan is then subsequently measured using the amortised cost method, which uses the effective interest rate. In this example, the interest has been calculated at 3.71% (see below) using the Goal Seek function in Microsoft Excel. For simplicity, the repayments in the table below have been annualised but for a more accurate interest figure, the payments should be profiled on a monthly basis:

Year	Opening balance	Cash flow	Interest at EIR	Closing balance
	£	£	£	£
1	740,625	(165,000)	27,459	603,084

2	603,084	(165,000)	22,360	460,444
3	460,444	(165,000)	17,071	312,515
4	312,515	(165,000)	11,587	159,101
5	159,101	(165,000)	5,899	-

In year 1, the journals to record the loan are:

	£
Dr Loan payable	165,000
Cr Bank	165,000

Being loan repayments made in the year

Dr Interest expense	27,459
Cr Loan payable	27,459

Interest calculated at the effective interest rate

The loan is then split between the creditor falling due within one year of £142,640 (£603,084 - £460,444) and the amount falling due after more than one year £460,444 to comply with the statutory formats of the balance sheet.

Incorrect treatment of the loan arrangement fee

If it is assumed that the preparer has debited the loan arrangement fee to profit and loss, i.e.:

	£
Dr Bank	740,625
Dr Profit and loss	9,375
Cr Loan	750,000

The interest charge debited to profit and loss will be affected because the effective interest rate will essentially be lower (i.e. the rate will be 3.26% rather than 3.71%) as can be seen as follows:

Year	**Opening balance**	**Cash flow**	**Interest at EIR**	**Closing balance**
	£	**£**	**£**	**£**
1	750,000	(165,000)	24,476	609,476
2	609,476	(165,000)	19,890	464,366

3	464,366	(165,000)	15,155	314,521
4	314,521	(165,000)	10,264	159,785
5	159,785	(165,000)	5,215	-

This will also mean the loan has not been properly accounted for in accordance with FRS 102, Section 11.

5.3 Calculating the effective interest rate

A quick way of proving the effective interest could be to use the Internal Rate of Return function in Microsoft Excel. Using the figures in the example above, this is how you could do it:

	A	B
1	(740,625)	
2	165,000	
3	165,000	
4	165,000	
5	165,000	
6	165,000	
7		3.71%

Formula is =IRR(A1:A6)

Another way of dealing with the effective interest rate is to use the Goal Seek function in Microsoft Excel.

This is done by profiling the loan as follows:

	A	B	C	D	E
1	Effective interest rate				
2					
3	**Year**	**Opening balance**	**Cash flow**	**Interest at EIR**	**Closing balance**
4		**£**	**£**	**£**	**£**
5	1	740,625	(165,000)	0	575,625
6	2	575,625	(165,000)	0	410,625
7	3	410,625	(165,000)	0	245,625
8	4	245,625	(165,000)	0	80,625
9	5	80,625	(165,000)	0	(84,375)

For clarity, the formulas in the spreadsheet above are as follows:

	A	B	C	D	E
1	Effective interest rate				
2					
3	Year	Opening balance	Cash flow	Interest at EIR	Closing balance
4		£	£	£	£
5	1	740625	-165000	=C1*B5	=B5+C5+D5
6	2	=E5	-165000	=C1*B6	=B6+C6+D6
7	3	=E6	-165000	=C1*B7	=B7+C7+D7
8	4	=E7	-165000	=C1*B8	=B8+C8+D8
9	5	=E8	-165000	=C1*B9	=B9+C9+D9

The highlighted cell C1 will be used to calculate the effective interest rate.

To use the Goal Seek function, go to the Data tab, select 'What-if Analysis' and then 'Goal Seek'. A box will appear, and you enter the following information:

Goal Seek

Set cell: E9

To value: 0

By changing cell: C1

Cancel OK

When you click 'OK', Excel automatically calculates the effective interest rate as follows:

	A	B	C	D	E
1	Effective interest rate		3.71%		
2					
3	**Year**	**Opening balance**	**Cash flow**	**Interest at EIR**	**Closing balance**
4		**£**	**£**	**£**	**£**
5	1	740,625	(165,000)	27,459	603,084
6	2	603,084	(165,000)	22,360	460,444
7	3	460,444	(165,000)	17,071	312,515
8	4	312,515	(165,000)	11,587	159,101
9	5	159,101	(165,000)	5,899	(0)

6 QAD monitoring report 2024 (Lecture A885 – 17.29 minutes)

In the year to 31 March 2024, ICAEW Quality Assurance Department (QAD) carried out 476 (2023: 496) audit monitoring visits to ICAEW regulated firms.

71% of 761 audits reviewed were either ‘good’ or ‘generally acceptable’ and this is the same figure as the previous year. The report does confirm that the following points need to be considered when putting this figure into context:

- The audit files selected by QAD are those considered to be the audit firm’s most complex and/or risky, hence the overall result is not representative of the average audit quality across all firms’ audits (which is likely to be higher).

- Only 8% of audit files were rated as ‘requiring significant improvements’ with the balance requiring improvements (which can be limited to missing documentation).

In addition, 88% of audits reviewed at the largest (i.e. Tier 1) firms were either good or generally acceptable. Only one of the 50 audit files reviewed at the largest firms required significant improvements.

Furthermore, ICAEW have identified several factors which appear to be contributing to the drop in the overall headline result from pre-pandemic levels, such as:

- New ways of working remotely.

- A significant shortage of staff (mirroring pressures in the wider UK economy).

- Audit client staff working remotely who are sometimes reluctant to engage with the auditor in person.

- Increased workload arising from new/revised auditing standards.

QAD continues to focus on those areas of the audit which they know are challenging to firms. Consequently, it continues to find weaknesses in certain areas such as those requiring estimates and judgements as well as group audits.

Audit monitoring reports published by the various professional bodies often appear to concentrate on what is going wrong with firms’ audit work. However, this year’s QAD report confirms that it is important to highlight that it sees a lot of good practice during audit monitoring exercises.

Many firms produce high-quality audit work carried out by experienced audit team members and the documentation ‘tells the story’ of how the audit was conducted and the resulting audit engagement partner’s opinion on the financial statements. In addition, QAD have mentioned it also sees demonstrable scepticism being applied in these audits.

6.1 Challenges in audit work

The following challenges have been identified by QAD:

- Estimates and judgements
- Group audits
- Audit team structure and resources
- ISQM (UK) implementation
- Insights from root cause analysis

Estimates and judgements

Estimates include:

- valuations of assets, such as property or intangible assets;
- determination of a provision, such as against stock or a legal claim; and
- cash flow forecasts which underpin the directors' going concern conclusions.

Auditors must document how they have approached the audit of that estimate and the work they have done on the appropriateness and integrity of any underlying models. This includes documenting the work carried out on understanding key assumptions and sensitivity to changes in those assumptions.

Examples of weak audit work includes valuation or other reports copied and placed on the audit file without any work carried out on the report. This, of course, demonstrates a lack of professional scepticism.

Group audits

Group audits were featured in the 2022/23 QAD report. The key principle in group audits is that the UK group auditor must be able to supervise and direct audit work, even where the component auditor is located overseas.

It should also be borne in mind that ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* has been revised for December 2024 year ends (and short periods) and the responsibilities of the group auditor have been set out even clearer.

Under ISA (UK) 600 (Revised), the group auditor will need to adopt an approach that starts at the consolidated financial statement level and conduct a risk assessment **across** the group rather than a 'bottom up' approach as has been seen in the past.

There are significant differences between the outgoing version of ISA (UK) 600 and ISA (UK) 600 (Revised) which must be clearly understood by audit firms. Some of these differences have been covered in previous quarterly updates.

Challenges may be faced by smaller audit firms where groups have subsidiaries that are located overseas. The principal risk for all firms is that they view the role of group auditor as that of an 'administrative' nature because they take inappropriate assurance from the involvement of component auditors without the necessary timely engagement and review of their work.

Audit team structure and resources

Deficiencies in audit work can (and often do) arise because of an ineffective audit team structure and a lack of resources. This has been particularly the case over the last couple of years due to a shortage of audit staff in the market.

The principal risk of an under-resourced audit team is that audit work is not carried out; or not carried out in accordance with the ISAs (UK). A lack of supervision and review processes throughout the duration of the audit can also contribute to deficient audit work.

Where deficiencies are pervasive (i.e. they affect multiple areas of the audit), there is a risk that the firm is reported to the Audit Registration Committee for further action.

ISQM (UK) implementation

QAD had previously stated in 2022/23 that part of its focus would be on ISQM (UK) implementation.

Where QAD had concerns about ISQM (UK) implementation, it asked for follow-up information to check progress following the visit.

In addition, it is important to emphasise that the firm's ISQM (UK) procedures must be evaluated on an annual basis to assess its effectiveness.

Root cause analysis

Approximately 90% of firms visited had implemented the ISQMs (UK). One of the key features of the ISQMs (UK) is root cause analysis. This is a relatively new concept for many firms so best practice will evolve in the fullness of time. However, QAD's initial observations are as follows:

- Development of ability within the firm to conduct effective root cause analysis, facilitating open and constructive discussion on 'what went wrong' is likely to have wider benefits in strengthening a positive culture of accountability rather than blame.

- Training organisations will provide valuable support and independence and objectivity to the process, but the effectiveness of their work will be very reliant on those in the firm arranging interviews and meetings with relevant individuals and so this is more complex to outsource than routine reviews of completed engagements or provision of training courses.

- Whoever performs the root cause analysis, it must be a timely process to enable development of action plans and implementation of any changes within a reasonable timeframe.

6.2 Focus on 2024/25

QAD have confirmed that their focus for 2024/25 will be in the following areas:

ISQM (UK) 1

By 2024/25 firms should have their ISQM (UK) procedures in place. Remember, it is a requirement of ISQM (UK) 1, paras 53 and 54 to evaluate the firms' system of quality management and this evaluation must be documented indicating whether the system provides:

(a) reasonable assurance;

(b) reasonable assurance except for deficiencies that have a severe but not pervasive effect; or

(c) does not provide reasonable assurance.

Ethical Standard 2024

The Ethical Standard issued by the FRC was changed in January 2024. QAD will focus on whether firms have carefully considered the requirement to assess fee dependency from a collection of entities with the same beneficial owner or controlling party, rather than simply for a company and its subsidiaries (which was previously the case).

Continuing changes in the audit market

The movement of larger and more complex audit clients from larger firms to smaller ones (including expanding consolidation) is likely to continue.

Audit firms wishing to take advantage of these opportunities must ensure they have robust audit acceptance criteria in place to ensure sufficient resources are available with the necessary competence to undertake this work to an acceptable standard.

6.3 ACCA quarterly audit monitoring report

ACCA issue a quarterly audit monitoring report and the September 2024 report focuses on ISQM (UK) 1 implementation.

ACCA notes that their monitoring team find that firms often either:

- do not have a system of cold file reviews in place; or
- have not communicated the results of any such reviews sufficiently to the wider audit team.

ACCA's report clarifies that ISQM (UK) 1 makes it clear that monitoring and remediation is more than just completing cold file reviews and firms need to be aware that all areas of the system of quality management must be considered.

ACCA has also confirmed that an audit monitoring review of the firm **cannot** be used as a cyclical review. However, the results can be used to inform the timing of the next review.

In terms of the **annual evaluation**, this must be completed at a point in time. The person with ultimate responsibility must carry out this assessment and reach a conclusion to confirm the system is:

ACCA have identified firms:

- have asserted that they have conducted an annual evaluation, but have not documented the process;
- have not reached a conclusion having completed the review; or
- have not completed an annual evaluation.

ACCA have also commented that during its monitoring review, a consistent finding has been that firms do not have an appraisal system for those persons with responsibility for the system of quality management. Firms should implement a periodic appraisal which considers the results of any monitoring activities as well as the conclusion of any monitoring activities and the conclusion of the annual evaluation.

7 Application of s401, Companies Act 2006 (Lecture A886 – 7.35 minutes)

Companies Act 2006, section 401 provides an exemption to an intermediate parent company from preparing consolidated financial statements (and obtaining an auditor's report on those consolidated financial statements) in certain circumstances.

This means that a UK intermediate parent with a non-UK parent is exempt from preparing consolidated financial statements, subject to certain conditions, including that the consolidated financial statements of the non-UK parent are prepared under:

- UK and Ireland GAAP or equivalent; or
- UK-adopted IFRS or equivalent.

The issue that has come to light is whether people are aware of how to apply these exemptions correctly. The consequence of any incorrect misinterpretation of the rules would mean that consolidated financial statements are not prepared, and an auditor's report is not obtained on those consolidated financial statements. In addition, audit firms must ensure that any exemption has been correctly claimed – especially when it comes to conclusions involving directors' judgement on the 'equivalence' test.

7.1 Conditions for s401 exemption

An intermediate parent based in the UK which has an overseas parent may be exempt from the requirement to prepare consolidated financial statements if it meets the conditions in section 401 of Companies Act 2006. These conditions include the company and all of its subsidiary undertakings being included in the consolidated financial statements of a larger group drawn up to the same date, or an earlier date in the same financial year. Those accounts and, where appropriate, the group's annual report, must be drawn up:

- in a manner that is equivalent to the requirements of Part 15 of Companies Act 2006 (section 401(2)(b)(ii));
- in accordance with UK-adopted international accounting standards (section 401(2)(b)(iii); or
- in accordance with accounting standards that are *equivalent* to UK-adopted IFRS (section 401(2)(b)(iv)).

Whether the condition in section 401(2)(b)(iii) is met will generally be straightforward to determine because it is a matter of fact whether (or not) the group financial statements in which the UK intermediate parent is consolidated have been drawn up in accordance with UK-adopted IFRS. If they have not, the directors of the UK intermediate parent will need to consider whether the condition in section 401(2)(b)(ii) or (iv) is met instead.

The UK government has granted equivalence of certain accounting standards to UK-adopted IFRS. This will determine whether the condition in section 401(2)(b)(iv) is met. However, meeting the condition in section 401(2)(b)(ii) does not depend on equivalence having been formally granted. Consequently, the directors may make their own assessment of equivalence in determining whether the company qualifies for the exemption, following the principles in section 401 of Companies Act 2006 and FRS 100.

In revising the equivalence guidance in November 2022, the FRC took the decision to include less prescriptive guidance and allow the directors to make their own assessment of equivalence when considering section 401(2)(b)(ii) issues. This is because different jurisdictions have different legal requirements and these can change on a regular basis, hence a more professional judgement approach was deemed necessary.

Important point

This will potentially be a very important point for auditors to consider in terms of whether the directors have arrived at the correct equivalence conclusion where they have taken advantage of a section 401 exemption.

There are some other important points where the s401 exemption is concerned as follows:

a) exemption from preparing group accounts is conditional on the company (and all of its subsidiary undertakings) being included in consolidated accounts for a larger group drawn up to the same date; or to an earlier date in the same financial year, by a parent undertaking;

b) those group accounts must be audited by one or more persons authorised to audit accounts under the law under which the parent undertaking which draws them up is established;

c) the company must disclose in its individual accounts that it is exempt from the obligation to prepare and deliver group accounts;

d) the company must provide, in its individual accounts, the name of the parent undertaking which draws up group accounts, the address of the undertaking's registered office (whether in or outside the UK) and, if it is unincorporated, the address of its principal place of business; and

e) the company must deliver copies of the group accounts and, where appropriate, the consolidated annual report together with the auditor's report on them.

One of the most common issues we note is a failure to comply with e) above where the group accounts are not delivered to the Registrar of Companies.

7.2 Assessing 'equivalence'

Both FRS 101 *Reduced Disclosure Framework* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* provide certain exemptions from disclosures under a reduced disclosure framework. Those exemptions are, in some cases, subject to equivalent disclosures being provided in the consolidated financial statements of a group in which the entity is consolidated. FRS 102 also permits an alternative measurement option for certain share-based payment transactions provided an equivalent basis is used.

Use of the exemptions requires a careful analysis of whether the framework (or specified elements of it) that are applied in practice is **equivalent** to another framework (or specified element of it). The Application Guidance in FRS 100 *Application of Financial Reporting Requirements* will need to be consulted in these cases.

An important point to emphasise where the equivalence test is concerned is that references to 'equivalence' to another financial reporting framework does not mean compliance with *every* detail of that framework. It is necessary to consider whether the *basic* requirements of that framework are met (e.g. the requirement to give a true and fair view, or present fairly, in all material respects).

The equivalence guidance in FRS 100 clarifies that a qualitative approach is more in keeping with the deregulatory nature of the exemption rather than a requirement to consider the detailed requirements on a checklist basis.

7.3 Equivalent GAAPs

The UK government has recognised the equivalence to UK-adopted IFRS of the following GAAPs, which includes those GAAPs previously recognised by the EC as equivalent to EU-adopted IFRS:

- GAAP of Canada
- GAAP of the People's Republic of China
- GAAP of Japan
- GAAP of the Republic of Korea
- GAAP of the United States of America
- IFRS as adopted by the EU
- IFRS as adopted by the IASB (International Accounting Standards Board)

8 Auditing the cash flow statement (Lecture A887 – 9.15 minutes)

The frequency of questions raised in relation to cash flow statements (11% of companies reviewed, 2022/23: 8%) remains disappointingly high in our top ten. It also remains one of the most common reasons for companies restating their prior year financial statements as a result of our enquiries, with the number restating their cash flow statement more than doubling to 16 compared within seven last year.

FRC Corporate Reporting Review 2024

Excerpt from 2023/24

As can be seen from the comments raised by the Financial Reporting Council (FRC) Corporate Reporting Review Panel (CRRP), cash flow statements are in the 'top ten' of the most common deficiencies identified in its review of financial statements. While the CRRP's focus is that of public interest entities and listed entities all reporting under IFRS Accounting Standards, the comments raised by the FRC can be taken on board by preparers and auditors of financial statements prepared under UK and Ireland GAAP.

As noted earlier in the course, the cash flow statement (or 'statement of cash flows' as it is referred to in FRS 102, Section 7 *Statement of Cash Flows*) is one of the primary financial statements. This means that it is given no more, and no less, prominence than the other primary statements (the profit and loss account, balance sheet, other comprehensive income statement and statement of changes in equity).

A concern of file reviewers and professional bodies during their reviews of audit files is that a review will often reveal that no audit work (or very little audit work) has been carried out on the cash flow statement, despite it being a primary financial statement and listed as one of the statements that has been audited in the auditor's report. Often there is a misconception that if the cash flow statement balances and audit work has been carried out on the profit and loss account, other comprehensive income statement, balance sheet and statement of changes in equity, then the cash flow statement must, by default, be correct. This is, however, a reckless approach as the cash flow statement could still be materially misstated.

8.1 Objective of the cash flow statement

Generally, the cash flow statement provides an insight as to how an entity has generated and spent cash. However, it is also used to:

- assess the entity's ability to generate future cash flows;
- assess the entity's ability to pay dividends and to meet obligations (e.g. payment of interest and capital to lenders);

- understand the differences between the measure of profit used and the net cash flow from operating activities; and
- assess the cash and non-cash investing and financing activities during the period.

Whilst fraud at the financial statement level is usually associated with profit and loss account and balance sheet accounts, fraud in the cash flow statement can exist and can be potentially significant. This could happen, for example, if the entity boosts operating cash flows by shifting cash inflows from financing activities into it or shifting operating cash outflows into financing or investing activities.

The audit of cash and cash transactions is critical because cash is the primary target of employee (and management) fraud.

Challenging the treatment of some unusual cash flows in the cash flow statement demonstrates that the audit team has exercised professional scepticism (provided, of course, this is adequately documented in the audit working papers).

Example – Assets acquired under finance leases

During the year to 30 September 2024, a company acquired a large amount of heavy-duty machinery via finance leases. The audit team had obtained sufficient appropriate audit evidence to confirm that each lease classification as a finance lease was correct and there was also sufficient appropriate audit evidence obtained that the entity had correctly accounted for these finance leases.

The cash flow statement included the value of additions to property, plant and equipment within the investing activities section of the cash flow statement and this agreed to the property, plant and equipment (PPE) note that provides a breakdown of cost, depreciation and net book value.

The problem with the finance lease transactions is in the cash flow statement. The total additions to PPE include assets acquired under finance leases. These are not cash outflows. The cash outflows in respect of finance leases are the amounts paid to reduce the principal amount of the lease liability (shown as an investing cash flow) and actual amounts of interest paid, rather than the interest calculated using the effective interest rate.

An adjustment to the cash outflows for the acquisition of PPE is needed as well as a corresponding adjustment to the investing cash flows for capital repayments and in the operating cash flows for actual interest paid as well as the non-cash impact of the effective interest charged to profit and loss on the finance leases, all of which should tie back to the audit work carried out on the lease liabilities.

As you can see, the scope for errors in the cash flow statement is high when it comes to issues such as finance leases and bank loans. Quite often, accounts production software systems will automatically calculate certain values based on the movement between the current year's trial balance and the prior year one. However, the system may not necessarily present them properly in the cash flow statement.

For auditors, the important point to bear in mind here is that while a cash flow statement might, on the face of it, balance, when the cash flows are subject to audit procedures, those procedures may well reveal errors in the cash flow statement.

8.2 Audit procedures for the cash flow statement

For most audited entities, the cash flow statement will be automatically calculated – usually from movements between the current year and prior year trial balance. However, it is important that the auditor exercises professional scepticism throughout the audit and, where the cash flow statement is concerned, keeps in mind that there could be manipulation of the figures presented in the cash flow statement (e.g. to boost net cash inflows from operating activities or even to turn net cash outflows from operating activities into net cash inflows from operating activities).

As noted in the example above, the auditor must also bear in mind that cash flows may be misstated, even though the statement itself balances.

Typical audit procedures for the cash flow statement include the following (note, the list below is not comprehensive):

- Agree and reconcile all amounts in the cash flow statement to amounts that appear elsewhere or to the auditor's working papers (e.g. tax paid and interest paid amounts to bank statements). Ordinarily, the auditor would expect to see an adjustment in the operating cash flows section for the non-cash impact of the effective interest charge taken to profit or loss when the entity has applied the amortised cost method.

- Agree the reconciliation of profit (loss) to net cash flow from operating activities to other areas of the financial statements, e.g.:

    - the measure of profit (loss) to the profit and loss account;

    - depreciation charge to the fixed assets lead schedule;

    - gain or loss on disposal of fixed assets to the reperformance of the disposal account; and

    - movements in working capital to the balance sheet items;

- Reperform the cash flow statement from the audited profit and loss account, balance sheet and statement of changes in equity to ensure accuracy.

- Cast the cash flow statement for mathematical accuracy.
- Confirm that amounts reported in investing and financing activities have been correctly classified and that the amounts are reasonable (e.g. calculating the capital amount of loan repayments agrees to the recalculation of the loan liability at the year end).
- For foreign currency cash flows, ensure these have been translated using the exchange rate at the date of the cash flow (or an average exchange rate if exchange rates have not fluctuated significantly during the reporting period) – where average rates are used, recalculate the average rate and agree this to the one used.
- For unrealised gains and losses arising from changes in exchange rates, recalculate the effect of the exchange rate change on cash and cash equivalents held in a foreign currency and ensure this has been presented separately from cash flows from operating, investing and financing activities.
- Agree non-cash transactions to supporting documentation and ensure they have been excluded from the cash flow statement (e.g. conversion of debt to equity or the acquisition of a subsidiary via a share-for-share exchange).
- Review the disclosures for non-cash transactions for adequacy. The use of an up-to-date disclosure checklist is strongly advised here.
- Agree the components of cash and cash equivalents to the balance sheet including the components of the reconciliation of amounts presented in the cash flow statement to the equivalent items presented in the balance sheet.
- Agree the analysis of changes in net debt to supporting information and ensure sufficient detail has been shown to enable users to identify balances where several balances (or parts therefore) in the balance sheet have been used.

8.3 Errors identified by the FRC

The FRC have raised queries where its review has identified:

- the purchase of non-controlling interests classified as investing, rather than financing activities;
- contingent remuneration paid to employees of an acquired business classified as investing, rather than operating, activities;
- cash flows from derivatives classified inconsistently with the transactions they related to, such as payments on swaps used to hedge debt classified as investing activities, with the cash flows related to the hedged debt classified as financing activities;

- the settlement of debt related to the acquisition of a subsidiary classified as an investing cash flows; and
- the repayment of a loan from a group undertaking classified as an operating, rather than financing, cash flows.

Requests for further information

The FRC have requested further information when:

- There appeared to be material inconsistencies between amounts or descriptions in the cash flow statement and other information in the report and accounts, for example, when cash flows in relation to an acquisition of a subsidiary did not agree to the acquisitions note.
- Gross or net presentation of cash flows appeared inconsistent with other disclosures, such as a refinancing exercise when gross cash inflows and outflows had been disclosed, or when payments to group undertakings in cash pooling arrangements had been offset against receipts from group undertakings.
- It appeared that non-cash transactions were included in the cash flow statement, for example when a subsidiary had been acquired via a share-for-share exchange or when right-of-use assets had been acquired under leases.
- Descriptions of items in the cash flow statement did not appear to accurately reflect the nature of the amounts.

Queries raised with companies

The FRC raised queries with companies when:

- It was unclear why amounts invested in certificates of deposit had been included in cash and cash equivalents.
- The reason for excluding restricted cash balances from cash and cash equivalents was not clear from the disclosures given.
- A bank overdraft was included within cash and cash equivalents in the parent company cash flow statement, but not in the consolidated cash flow statement.

8.4 What auditors should be checking...

It is not possible to provide a prescriptive set of audit procedures because every audit is different. However, where the cash flow statement is concerned, auditors should (at the very least) be checking:

- The classification of cash flows, as well as cash and cash equivalents, comply with relevant definitions and criteria in FRS 102 and cash flows are not inappropriately netted in both the group and (where applicable) the parent company's cash flow statement. The relevant procedures and the conclusions drawn must be adequately documented on the audit file.

- Amounts and descriptions of cash flows are consistent with those reported elsewhere in the accounts. Keep in mind the potential for error where finance leases have been entered into during the year.

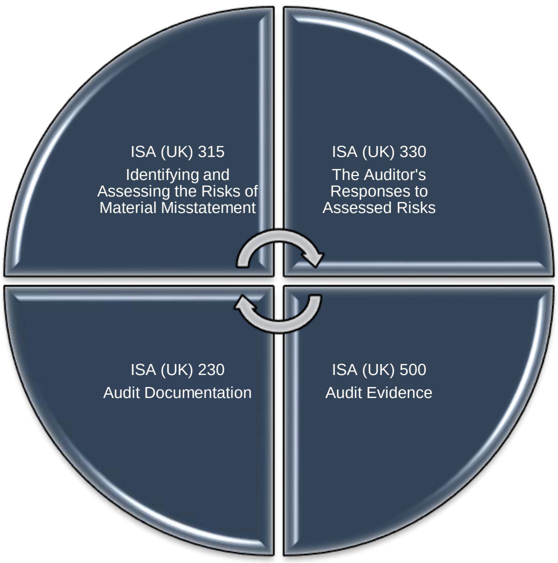
- Non-cash investing and financing transactions are excluded from the statement and disclosed elsewhere if material.

Do not rely on automated accounts production software to get this completely right as often the cash flow statement is the one primary statement that will invariably require user-input to arrive at the correct values to be included in the statement and related notes.

9 Assessing risk in line with other ISAs (UK) (Lecture A 888 – 15.04 minutes)

All audits are carried out on a risk basis and risk is a critical aspect of audit planning. Audit planning is carried out in accordance with the ISAs (UK) in the 300 series and ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement* is the ISA (UK) that focuses specifically on identifying risks. ISA (UK) 330 *The Auditor's Responses to Assessed Risks* then requires the auditor to obtain sufficient appropriate audit evidence concerning the assessed risks of material misstatement by designing and implement appropriate responses to those risks.

Reviews of audit files has indicated that firms are getting better at risk assessment, though there are some deficiencies identified when looking at how firms have implemented the latest edition of ISA (UK) 315. In addition, there is often overlap with the ISAs (UK) and in this respect we will look at how risk interacts with the other ISAs (UK) as follows:



9.1 ISA (UK) 315

ISA (UK) 315 is not a light read by any stretch of the imagination and is a very detailed standard. The objective of this ISA (UK) is to require the auditor to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels to provide a basis for designing and implementing responses to the assessed risks of material misstatement.

The **financial statement level** refers to the financial statements as a whole. For example, the risk that the going concern basis of accounting has been used inappropriately. The **assertion level** refers to the individual transactions, balances and disclosures (such as the valuation assertion for trade debtors or the completeness assertion for revenue). For completeness, ISA (UK) 315 defines 'assertions' as:

Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement.

Acquiring an understanding of the entity and the environment in which it operates is critical as it impacts the auditor's risk assessment. From the risk assessment process comes the specific audit procedures that the auditor will apply which respond to those risks. If the auditor fails to gain a sufficient understanding of the entity and the environment in which it operates, together with the client's system of internal control, they will be unable to carry out a thorough risk assessment. This increases audit risk (which is the risk that the auditor forms an incorrect opinion on the financial statements) and the whole point of audit planning is to reduce this risk to an acceptable level.

Example – Understanding the entity

Morley Industries Ltd is in the technology sector and operates from five sites. It has been established for many years, achieving high profits and paying a high level of dividends to its shareholders. Eight months ago, the company recruited a new finance director who overhauled the finance department and introduced a new bespoke accounting system as well as new financial policies and procedures.

During initial discussions with the finance director, it was brought to the auditor's attention that new entrants to the market have become a threat to the client because of their competitive pricing structures. The audit firm has acted for Morley Industries for four years and the auditor is aware that the client has a significant market share, hence the emergence of these competitors could impact on that share and could ultimately affect the client's going concern status.

The auditor must obtain an understanding of how these threats impact on the entity so that appropriate audit procedures can be devised to address these risks – for example, performing additional audit procedures over going concern.

These additional risks may have had an impact already on Morley Industries' financial performance during the year. It is important that the auditor develops a sound understanding of how these additional risks *could* impact the financial statements. For example, management may manipulate the revenue figure in the financial statements to achieve a higher profit to secure any additional financing requirements which the company may be applying for; or it may manipulate the financial statements to portray a healthier financial performance and position than it really has.

In addition, the auditor will also need to look at the entity's business operations in its entirety. The company operates from five sites and so the audit engagement team will need an understanding of how each site operates and the controls that are present at each site. This is important in light of the new financial controls that the finance director has implemented when overhauling the financial policies and procedures.

The new finance director has implemented a new accounting system so the auditor must perform a thorough review of this new system by reviewing and testing new and existing controls in addition to:

- carefully documenting the new system and considering general IT controls;
- devising procedures to ensure transactions and balances from the old to the new system have been transferred correctly;
- reviewing any parallel running of the old and new accounting system to ensure the new system works correctly; and
- devising procedures to test controls over the new system to ensure their operating effectiveness.

The example above demonstrates why it is important not to simply 'carry over' planning from one year to the next because significant changes may have arisen from the prior year which could impact on the current year. In the example above, several changes have taken place which are likely to impact on the audit procedures that will be devised, notably:

- A new finance director has been recruited in the year. The finance director will need time to get used to the transactions and accounting systems of the client, hence giving rise to a risk of material misstatement.
- A new structure has been put in place within the finance department, which will invariably bring with it new policies and procedures. These new policies and procedures may be ineffective and/or contain fraud risk factors.
- A new accounting system has been introduced which the audit firm may not have experience of working with before (especially as it is a bespoke system). If the system is particularly complex, this introduces an added risk of material misstatement due to the system's complex nature.
- Additional competitors have emerged into the market which may threaten the client's ability to continue as a going concern.

Inherent risk and control risk assessments

Remember to separately consider inherent risk and control risk. 'Inherent risk' is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material (either individually or when aggregated with other misstatements) **before** considering any related controls. Inherent risk is presumed high if not assessed as less than high.

'Control risk' is the risk that a misstatement that could occur in an assertion (about a class of transaction, account balance or disclosure) and that could be material (either individually or in the aggregate with other misstatements) will not be:

- prevented; or
- detected **and** corrected, on a timely basis,

by the entity's system of controls.

Control risk is assessed if the auditor plans to test the operating effectiveness of the entity's controls. If not, the assessment of the risk of material misstatement is the same as the assessment of inherent risk.

9.2 ISA (UK) 330

Once the auditor has carried out the risk assessment, the next step is to devise responses to those risks.

At this stage in the planning process, the auditor looks at general business risks and the risks of material misstatement of the financial statements whether due to fraud or error. 'Business risks' are generally those risks external to the entity; for example, if the client operates in an industry that is in decline, this could mean there are potential going concern issues.

All businesses will face risks in their normal course of operations, so the auditor must obtain a sound understanding of the business and the environment in which it operates. Business risks can often arise because of:

- **Political factors** – due to changes in government policy, tax rates and changes in governments at home and abroad. This may affect companies that operate globally where, in some countries, the political climate may be volatile.
- **Economic factors** – due to changes in the economic situations of the country in which the client operates such as levels of inflation or interest rates. The auditor must consider the risks applicable in all the countries that the client operates.
- **Legislative factors** – changes in law or regulation may result in restrictions to operations or the prohibition of operations (e.g. due to sanctions imposed by governments or the banning of certain products which the client may manufacture). Changes in environmental legislation may give rise to additional costs having to be borne by the client to clean up operations.
- **Compliance factors** – risks of material misstatement may arise due to non-compliance with tax legislation or other laws and regulations. However, other legislation such as employment law may be breached by the entity, which could result in material misstatement (for example, a failure to recognise a provision for liabilities).

- **Physical factors** – natural disasters such as a fire or flood may affect the client's ability to continue as a going concern.

- **Financial factors** – credit risk, foreign exchange risk and interest rate risk are all beyond the client's control. Such factors can have a detrimental impact on the results of the entity and a previously profitable client may end up reporting current year losses.

- **Technological risk** – some clients manufacture and/or sell goods which have a relatively short shelf life due to technical obsolescence. If a business fails to spot opportunities or developments in emerging technologies, it may find itself being overtaken by competitors. This could have a detrimental impact on going concern.

- **Market risk** – factors such as increased competition, price wars and development of new products can cause a risk to a client's business.

The auditor must also consider how the financial statements themselves are at risk of material misstatement, including an assessment as to whether a material misstatement could arise because of fraud or error.

The outcome of this risk assessment will influence the audit strategy (the document that explains how the auditor will tackle the audit). This, in turn, influences the audit plan (the document that contains all the planned audit procedures, such as after-date cash receipts testing and purchase invoice sampling).

Once the auditor has identified the risks of material misstatement, responses to those risks are then required. At the planning stage of the audit, the response itself does not have to be a detailed audit procedure; rather, it is the approach that the audit engagement team will take to address the risk and the detailed audit procedures will follow during the audit fieldwork stage.

The auditor will also determine whether tests of controls could be effective in addition to substantive procedures.

The risks and response phase may involve detailed testing of internal controls, transactions and balances. When the auditor plans to rely on the client's system of internal control, tests of those controls must be carried out.

Important point

An important point to bear in mind is that tests of controls are not designed to detect material misstatements. This is because the auditor uses substantive procedures (tests of detail and substantive analytical procedures) to determine whether the financial statements give a true and fair view. In addition, tests of control do not focus on the monetary amount in the financial statements – they focus on the controls that

effectively generate the financial reports.

The table below provides some examples of risks that may be identified during the planning stage of audit, together with an appropriate auditor's response:

Audit risk	Auditor's response
New entrants to the market have resulted in a small number of customers switching to a more competitively priced supplier. There is a risk that if the business loses customers, revenue, profitability and cash flows will be affected and hence there could be a negative impact on the entity's ability to continue as a going concern.	Discuss with the directors how the threat by the new entrants to the market is being managed and whether the lost customers have been replaced. Review the cash flow forecast, budgets and current order levels to ascertain if there is a threat to the entity's ability to continue as a going concern.
A new bonus scheme has been introduced in the year to boost sales and profitability. There is a risk that revenue is overstated to achieve bonus targets.	Detailed cut-off procedures to be carried out on revenue recognition to ensure that revenue is recognised in the correct accounting period, and tests to ensure that fictitious revenue is not being recorded.
The time spent on the audit in the prior year was increased by 50% due to several deficiencies in the client's system of internal control. If these deficiencies have not been addressed by management, there may be a risk that misstatements will be present in the current year's financial statements.	Discuss with management whether recommendations to improve internal controls in the prior year have been implemented and, if so, devise procedures to test those controls. The audit team must apply professional scepticism throughout the course of the audit and extend detailed substantive testing over high-risk areas of the financial statements.
A new accounting system has been introduced in the year which can now prepare more detailed financial reports. If the opening balances from the old system have not been transferred correctly, the closing figures will not be correct hence a misstatement will be	Document the new accounting system in full and carry out detailed substantive procedures to assess if the closing figures in the old system have been correctly transferred to the new system.

present in the financial statements.	
The company plans to apply for a listing on the London Stock Exchange (LSE) and the board of directors and shareholders are excited about this possibility. There is a risk that the financial statements may be manipulated to show a desired level of profit and/or financial position.	The audit team must maintain professional scepticism, keeping in mind that there is a higher risk of material misstatement due to the company applying for a listing to the LSE.

9.3 ISA (UK) 230

Documenting the planning phase is, of course, important. Audit documentation 'tells the story' of how the audit was conducted and how the audit engagement partner ultimately formed their opinion on the truth and fairness of the financial statements.

Many of the ISAs (UK) now include 'stand back' provisions and ISA (UK) 315 is one of those standards. The idea of the stand back provision is to provide the auditor with an opportunity to assess whether they have picked up all the relevant information. Hence, where ISA (UK) 315 is concerned, it would be an opportunity for the auditor to review the risks they have identified to check if there are any other significant risks that may have been omitted; or whether identified risks are complete in terms of the impact they may have on the financial statements.

Some risks will clearly be more important than others – particularly significant risks. 'Significant risks' include:

- Changes in the accounting system
- Risk of management override of controls
- Fraud in relation to revenue recognition

An important point to keep in mind is that the auditor must **always** carry out procedures over significant risks.

Documenting risks concisely and completely will also aid the review process. Often audit firms document the risk assessment in the planning section, which is fine.

However, during file reviews it is not uncommon to see the list of significant risks communicated to management and those charged with governance not reconciling with the planning documentation.

The risk assessment must be consistent throughout the audit file and needs to be thoroughly documented.

It is also not uncommon to see missing or incomplete documentation on significant risks.

Example – Construction contract revenue

The principal activity of Chambers Ltd is that of the construction of commercial buildings. The audit of the financial statements for the year ended 31 October 2024 is being planned and is currently at the risk assessment stage.

This is not a new client for the audit firm and there have been no significant changes in the business of Chambers Ltd since the previous year.

A significant risk of material misstatement has been identified in respect of revenue recognition. The company has a number of construction contracts in progress at the year end, all of which are at different stages of completion.

There should be clear documentation of this risk in the planning section of the file, together with the auditor's responses to those risks, such as:

- Ascertaining whether controls over construction contract revenue recognition have operated effectively during the year.
- Identifying that revenue has a presumptive fraud risk, hence, is a significant risk by default.
- Considering how management identify the stage of completion at the year end and whether this method has been effective in previous audits, or whether exceptions were noted (if exceptions were noted, a more substantive approach should be adopted).
- If an external surveyor is used to assess the stage of completion, whether this surveyor is independent, has the technical competence and capabilities and has experience in valuing such work in progress. The provisions in ISA (UK) 620 *Using the Work of an Auditor's Expert* will be applicable to assess the external surveyor's work.

It is always advisable to have a separate working paper on file that document the significant risks and the auditor's approach to dealing with such risks.

9.4 ISA (UK) 500

Once all risks have been identified, auditor's responses to risks documented and the audit strategy and audit plan developed, the next step is to obtain sufficient appropriate audit evidence to **reduce audit risk**.

As noted earlier, audit risk is the risk that the auditor forms an incorrect opinion on the financial statements (e.g. expressing an unqualified audit opinion when a qualified opinion is more appropriate).

The 'traditional' audit risk model considers three essential components of audit risk to be:

Inherent risk → Control risk → Detection risk

As noted above, the auditor is required to carry out separate assessments of inherent risk and control risk. However, their combined effect is the **risk of material misstatement** (i.e. the risk that controls will not detect misstatements that arise due to inherent risk). The 'residual risk' is detection risk.

The auditor has no control over inherent or control risk. The only risk under the auditor's control is detection risk.

'Detection risk' refers to the risk that the audit procedures will not detect a misstatement that exists and that could be material (either individually or in the aggregate with other misstatements). There are two elements to detection risk:

- Sampling risk; and
- Non-sampling risk.

Sampling risk

This is the risk that the auditor's conclusion based on a sample is different from the conclusion that would be reached if the auditor had tested the entire population rather than just a sample.

Non-sampling risk

This is the risk that the auditor's conclusion is inappropriate for any other reason. For example, the application of inappropriate audit procedures; or the misinterpretation of audit evidence.

Keep in mind there is an **inverse relationship** between detection risk and control risk. The auditor could conclude that the risk of material misstatement is low, which means the auditor's assessment that the financial statements contain a material misstatement is low. In turn, this also means that the auditor is seeking to place reliance on the entity's system of internal control. If the risk of material misstatement is low, detection risk becomes high. This is because the auditor is seeking to place more reliance on the entity's system of internal control and will therefore do less substantive testing.

Conversely, if the auditor concludes that the entity's system of internal control cannot be relied upon and hence deems the risk of material misstatement to be high, detection risk becomes low because the auditor will undertake more detailed substantive procedures.

The level of audit evidence needed to address identified risks will be entity-specific and there is no definitive answer to this. However, ISA (UK) 500 requires audit evidence to be **sufficient** and **appropriate**.

'Sufficiency' relate to the quantity of evidence required. 'Appropriateness' relates to the quality of that evidence (i.e. its relevance and reliability in supporting the conclusions on which the audit evidence is based.

Example – Attempting to achieve a desired outcome

During the audit of Savoy Enterprises Ltd, an audit team member discovered a potential claim for damages brought against the client by a third-party for a breach of contract. The finance director informed the audit team member that the company is actively defending the claim and the board have decided not to include a provision for liabilities. The documentation reviewed by the audit team member indicates that the company should make a provision for liabilities as the solicitors handing the claim have informed the company that it is more than likely it will be unsuccessful.

The finance director contacted the audit engagement partner and stated:

'Look, we have worked closely with your firm for a number of years and I'd rather not have to make a provision in these accounts because not only will it look bad, but it will also have an impact on our pre-tax profit which is already lower than the previous year and the CEO wants to report as high a pre-tax profit figure as possible as the bank are about to review our borrowing facilities. Can I suggest we simply include a contingent liability disclosure, as I have already done? We do pay a lot of money for our audit and it would be a shame to have to change auditors just because of this disagreement.'

In this scenario, there are a couple of 'red flags':

- There is a risk that the audit engagement partner may 'give in' to the client and instruct the team to attempt to obtain audit evidence that supports what the client has already done (i.e. that a contingent liability is appropriate, and ignoring the audit evidence that points to a provision being more appropriate).
- If the audit engagement partner gives in to the client, audit risk is exceptionally high. If the provision is material (either in isolation or in the aggregate) or material

by nature (i.e. it turns a profit into a loss), then the audit engagement partner will be forming an incorrect opinion on the financial statements if he/she expresses an unqualified opinion.

- The levels of professional scepticism will clearly be called into question. Essentially, the audit team will be ignoring audit evidence suggesting a provision for liabilities is more appropriate and, presumably, none of this will be documented on file in an attempt to make the audit evidence stack up to the disclosure of a contingent liability being more appropriate.
- The finance director's remarks to the audit engagement partner create an intimidation threat. The finance director is effectively threatning the audit engagement partner with the firm's removal if they disagree with the finance director's treatment. The finance director has already admitted that the provision will have a detrimental impact on the financial statements and this may impact the bank's lending decision.
- In addition to the intimidation threat above, the finance director's comments may mean the financial statements have been deliberately misstated in other areas to achieve the outcome desired by the board.
- If the audit engagement partner fulfils the finance director's wishes, the audit work performed will undoubtedly be challenged by a file review or a professional body carrying out audit monitoring. This can leave the audit firm exposed to potential disciplinary action.

The key message is that the auditor cannot be put into a situation where they are attempting to get audit evidence that supports what the client has done where there is a risk that an accounting treatment or disclosure is clearly incorrect. This is particularly the case in areas which require significant amount of judgement and estimate.

If the audit evidence obtained by the auditor points to an incorrect treatment in the financial statements, the auditor **must** challenge management and ensure that this challenge is adequately documented. The auditor must also 'stand their ground' and not give in to the client – even if this results in a qualified audit opinion and subsequent loss of a client.

In addition, where risks and audit evidence are concerned, the auditor must remain alert to any audit evidence which indicates the presence of a **fraud risk factor**. However, just because the auditor may conclude that the audit evidence obtained points to a fraud risk factor being present, it does not necessarily mean that a fraud has occurred; it just means there is a higher chance of fraud occurring due to the risk factor present, which will require increased professional scepticism by the audit team. Examples of fraud risk factors include:

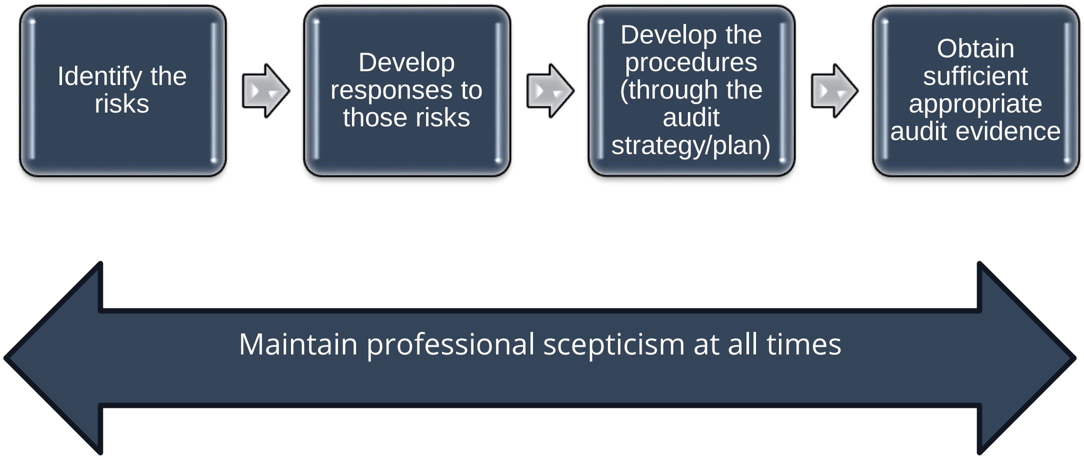
- incentives, pressures and opportunities;
- fraudulent financial reporting;

- weak internal controls (e.g. a lack of segregation of duties);
- risk of management override of internal controls;
- toleration of petty theft;
- corruption; and
- dissatisfied employees.

9.5 Practical 'takeaways' to keep in mind

There is a lot of overlap with the ISAs (UK) and the risk assessment phase will always overlap with the documentation and evidence-gathering stages. This is because the audit procedures will ultimately be dictated by the risk assessment.

Where risks and evidence are concerned, the key aspects to bear in mind are:



10 Changes to Audit Regulations

As noted earlier in the course, there are various amendments to company law proposed by government. Notably, an increase in company size thresholds and changes to the Directors' Report and Strategic Report.

In addition, the government have also highlighted changes that are needed to the Audit Regulations.

The Statutory Auditors and Third Country Auditors Regulations (SATCAR) 2013 and SATCAR 2016 were both retained in UK law following Brexit. A number of problems have emerged since Brexit as follows:

- References to 'audit committees' in the Audit Regulation and SATCAR 2016 are unclear because they are not defined. In addition, other references in the Audit Regulation are outdated following Brexit.

- The FRC's powers to deregister auditors in SATCAR 2013 require clarification because they do not explicitly provide for deregistration in certain circumstances.

- Article 5 of the UK Audit Regulation can result in Public Interest Entities (PIEs) running a less competitive tender process or contribute to the failure of this process to identify a first and second choice for auditor appointment. Article 5 also prohibits certain services that a PIE can obtain from its auditor and auditors often find they cannot tender for an audit because of minor amounts of non-audit work they have previously provided. SATCAR 2016 does provide an exemption from the application of this prohibition, but it is too limited and inflexible to be of any value.

- The FRC does not have the power to inspect audits by UK auditors of UK traded overseas entities incorporated in third countries with any form of equivalence status.

- The threshold for defining those 'large debt securities issuers' that are exempt from the regulatory framework for UK traded overseas companies are outdated and are expressed in € rather than £.

The government plan to issue technical corrections to the audit regulatory framework to remedy the above. It is expected that the updated regulations will be effective at the same time as the other company law reforms on 6 April 2025 (although timelines must always be viewed as being subject to change).