Audit and Accounting Quarterly Update – April 2024

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1 FRC issues FRED 85 (Lecture A849 – 1.58 minutes)

In December 2023, the FRC issued FRED 85 *Draft amendments to FRS 101 Reduced Disclosure Framework 2023/24 cycle*.

As noted in previous quarters, the FRC carries out an annual review of FRS 101 to provide additional disclosure exemptions as IFRS® Accounting Standards evolve and to respond to stakeholder feedback concerning other possible improvements.

1.1 What is changing?

Minor amendments are necessary to FRS 101 to enable consistency with IAS® 1 *Presentation of Financial Statements*. Paragraph A2.9B(c) is amended as follows (inserted text is underlined, deleted text is struck through):

> *Differences in the definition of 'creditors falling due within or after one year' (the terms used in the Regulations) and 'current and non-current liabilities' (the term used in UK-adopted international accounting standards). Under the Act a loan is treated as due for repayment on the earliest date on which a lender could require repayment, whilst under UK-adopted international accounting standards the due date is based on when the entity expects to settle the liability or has no right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period.* [footnote]

> [footnote] *For accounting periods beginning before 1 January ~~2023~~ 2024, the due date is based on when the entity expects to settle the liability or has no unconditional right to defer payment, unless the entity ~~chooses to apply~~ applies Classification of Liabilities as Current or Non-current (Amendments to IAS 1) early.*

1.2 Comment period

The comment period for these amendments closed on 4 March 2024.

2 Goodwill (Lecture A850 – 15.31 minutes)

Goodwill has been a subjective issue for many years and can prove to be a challenging area of the financial statements – especially for auditors. Over the course of 2024, we will be exploring certain elements of goodwill because the issue is quite vast to identify the challenges faced by practitioners and the issues that need to be borne in mind where goodwill is concerned.

2.1 Identifying goodwill

FRS 102, Section 18 *Intangible Assets other than Goodwill* specifically scopes goodwill out from other intangible assets. Goodwill is dealt with in FRS 102, Section 19 *Business Combinations and Goodwill*.

Most businesses will assume there is some element of goodwill attached to it for example, the shareholders of a long-established and profitable business will assume that when it comes to selling, a purchaser will usually pay more than the underlying identifiable assets of the business may be valued at; hence an element of goodwill is inherent in the business. Goodwill has not been without controversy over the years – largely because of its subjective nature. This subjective nature was tested in the case of *Commissioners of Inland Revenue v Muller & Co Margarine* [1901] AC 217. The presiding judge, Lord MacNaghten said:

> *What is goodwill? It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation and connection of the business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old established business from a new business at its first start. Goodwill is composed as a variety of elements. It differs in its composition in different trades and in different businesses in the same trade. One element may preponderate here, and another there.*

One of the reasons that goodwill is not in the same section as other intangible assets in FRS 102 is because internally generated goodwill is not recognised on the balance sheet under any circumstances. Goodwill should only be recognised when a business combination takes place (i.e. when a parent acquires a subsidiary, or when a trade and assets purchase of a business takes place).

It is also worth noting that the Companies Act 2006 only permits goodwill to be recognised on the balance sheet to the extent that it is acquired for valuable consideration.

2.2 Basic accounting requirements

FRS 102, para 19.22 requires an acquirer at the date of acquisition to:

FRS 102, para 19.22

(a) *recognise goodwill acquired in a business combination as an asset; and*

(b) *initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net amount of the identifiable assets, liabilities and contingent liabilities recognised and measured in accordance with paragraphs 19.15 to 19.15C.*

Example – Goodwill on acquisition

On 2 January 2024, The Harper Group Ltd acquired 100% of Churchill Ltd for a consideration of £900,000. Extracts from Churchill's financial statements at the date of acquisition are as follows:

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

Churchill has unutilised corporation tax losses amounting to £35,000 and The Harper Group intends to utilise these tax losses among other group members in its portfolio through group relief. The Harper Group pays tax at 25%.

Goodwill arising on the acquisition of Churchill is as follows:

	Book value	Fair value	Tax written down value	Timing diffs	Tax rate	Deferred tax - rounded
	£'000	£'000	£'000	£'000		£'000
Property	300	400	210	190	25%	48
Plant & machinery	200	250	75	175	25%	44
Other current assets	100	100	100	-	-	-
Liabilities	(40)	(40)	(40)	-	-	-
Tax loss c/fwd	-	N/A	N/A	(35)	-	(9)
	560	**710**	**345**	**330**		**83**

Goodwill	**£'000**
Cost of investment	900
Net assets acquired	(710)
Deferred tax liability	83
Goodwill	**273**

Subsequent measurement

After initial recognition, goodwill is measured at cost less accumulated amortisation and accumulated impairment losses.

Important point

FRS 102 requires all goodwill (and intangible assets) to be amortised over their useful economic lives. There is no option under UK and Ireland GAAP to assign indefinite useful lives to goodwill (or intangible assets). This is notably different than under IFRS Accounting Standards which prohibits the amortisation of goodwill and, instead, requires goodwill to be tested for impairment every year in accordance with IAS® 36 *Impairment of Assets*.

FRS 102, para 19.23(a) requires goodwill to be amortised on a systematic basis over its useful life. This paragraph confirms that goodwill cannot have an indefinite useful life and, in exceptional cases, where management is unable to make a reliable estimate of the useful life of goodwill, the amortisation period cannot exceed ten years. It can be shorter, but it cannot be longer.

As noted above, goodwill under IFRS is not amortised; instead, it is tested annually for impairment. Under FRS 102, management would still need to assess if there are any indicators of impairment of goodwill and, if there are, to carry out an impairment test in accordance with FRS 102, Section 27 *Impairment of Assets*. Impairment of goodwill is examined in **2.4** below.

2.3 Negative goodwill

In most cases, positive goodwill arises in the group accounts as the consideration paid in the business combination will usually be higher than the share of the net assets acquired. However, this is not necessarily the case in every business combination and there may be circumstances giving rise to a 'bargain purchase' – i.e. where the consideration paid to the outgoing shareholders is less than the fair value of the net assets acquired. This can often take place in, say, a distressed sale, where a company is in financial distress and the outgoing shareholders agree to sell the company to an acquirer at less than the fair value of the net assets.

Negative goodwill is dealt with in FRS 102, para 19.24. This paragraph takes a different approach to negative goodwill when compared to IFRS 3 *Business Combinations*. IFRS 3 requires negative goodwill to be recognised immediately in profit or loss.

However, under FRS 102, para 19.24 there are three steps to take when dealing with negative goodwill:

FRS 102, para 19.24

(a) *Reassess the identification and* ***measurement*** *of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination.*

(b) *Recognise and separately disclose the resulting excess on the face of the* ***statement of financial position*** *on the acquisition date, immediately below goodwill, and followed by a subtotal of the net amount of goodwill and the excess.*

(c) *Recognise subsequently the excess up to the fair value of non-monetary assets acquired in* ***profit or loss*** *in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of non-monetary assets acquired shall be recognised in profit or loss in the periods expected to be benefited.*

Professional judgement will be required where (b) and (c) are concerned. For example, an acquirer may decide to allocate the negative goodwill on a pro-rata basis or to allocate it to specific assets where these can be identified. In practice, amounts which are allocated to, say, stock will be eliminated quickly; whereas amounts allocated to fixed assets may take a longer period of time to eliminate depending on depreciation policies.

2.4 Impairment of goodwill

FRS 102, para 27.24 recognises that goodwill, on its own, cannot be sold. Goodwill does not generate cash flows for an entity which are independent of the cash flows of other assets. Hence, the fair value of goodwill cannot be measured directly. Consequently, the fair value of goodwill must be derived from measurement of the fair value of the cash-generating unit (CGU) to which it belongs.

FRS 102, para 27.26 says:

FRS 102, para 27.26

Part of the recoverable amount of a cash-generating unit is attributable to the ***non-controlling interest*** *in goodwill. For the purpose of impairment testing of a non-wholly-owned cash-generating unit with goodwill, the carrying amount of that unit is notionally adjusted, before being compared with its recoverable amount, by grossing up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the non-controlling interest. This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired.*

Therefore, where a parent does not wholly-own a subsidiary, FRS 102, para 27.26 requires the goodwill to be grossed up to include the goodwill attributable to the non-controlling interests (NCI).

This grossing up calculation must be done **before** conducting the impairment review because it is the notionally adjusted goodwill figure which is then aggregated with the other net assets of the CGU. The aggregate amount is then compared to recoverable amount to determine the value of any write-down.

Example – Notionally adjusted goodwill

Topco Ltd owns 80% of Subco Ltd and the group has an accounting reference date of 31 August each year. On 31 August 2023, the carrying amount of Subco's net assets were £880,000, excluding goodwill of £120,000 (net of amortisation). Management have decided to restructure the group and announced this restructuring exercise immediately prior to the reporting date.

The finance director has calculated recoverable amount of Subco's net assets to be £950,000.

FRS 102, para 27.26 requires Topco to notionally adjust the goodwill to take into account the NCI. The impairment loss is calculated as follows:

	£'000	£'000
Goodwill	120	
Unrecognised NCI (£120k x 20/80)	30	
Notionally adjusted goodwill		150
Net assets		880
Carrying amount		1,030
Recoverable amount		(950)
Impairment loss		80

All £80,000 is allocated to the notionally adjusted goodwill, but as the subsidiary is only 80% owned, only £64,000 is actually recorded as the other £16,000 is allocated to the NCI and will normally appear in their financial statements.

Important point relating to reversals of impairment losses on goodwill

Impairment losses in respect of goodwill cannot be reversed at a subsequent date. This applies even if the circumstances giving rise to the original impairment loss cease to apply (FRS 102, para 27.28). This prohibition arose because of amendments to the Accounting Regulations in 2015 so once an impairment loss on goodwill has been recognised, it remains.

3 Leasing (Lecture A851 – 15.52 minutes)

FRS 102 deals with leasing in Section 20 *Leases*. The current accounting treatments are planned for significant change once the FRC has completed its periodic review of UK and Ireland GAAP. It is expected the FRC will issue the final amendments to FRS 102 in respect of leasing during the first half of 2024. It should be emphasised that there are no planned changes to lease accounting under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*.

The remainder of this section will examine the accounting treatments under the current regime in FRS 102 (January 2022).

3.1 Lease term

To understand many of the requirements of FRS 102 (and FRS 105), it is necessary to understand what is meant by the phrase 'lease term' which is used throughout the relevant sections. The Glossary to FRS 102 defines 'lease term' as follows:

> *The non-cancellable period for which the lessee has contracted to **lease** the **asset** together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the **inception of the lease** it is reasonably certain that the lessee will exercise the option.*

*FRS 102 Glossary **lease term***

A certain amount of judgement will be required to determine the lease term for the purpose of FRS 102. For example, if a lease has an initial term of five years, but there is an option to continue for a further five years, it must be established whether the lease term is five or ten years. The definition states that if it is 'reasonably certain' that the lessee will exercise the option, then the lease term will be determined to be ten years.

In practice, a number of factors will need to be considered – some of which will be easier to judge than others. For example, if the rent in the secondary period is just a peppercorn rent, or otherwise much lower than in the primary term, it may be easy to conclude that the option to extend the lease will be taken. However, if the secondary period will have a market rate rental, then consideration will be needed as to the likelihood of the option to extend being taken. Information, such as whether the business's plans and budgets assume they are staying in the leased premises for ten years, or using the leased assets for ten years, will help in forming a judgement. Additionally (especially for leasehold premises), if fixtures and fittings or other improvements have been made, with a life suggesting that the intention is to stay for ten years, this would indicate that it is potentially reasonably certain that the option to extend the lease will be taken.

Overall, all of the factors indicating whether, or not, the lease term will be extended (or curtailed if it is an option to cancel the lease) need to be considered by management and a conclusion on the lease term reached. It is a good idea to document the reasoning and any evidence that management have used, especially if the entity is audited, as the auditor will require such information.

3.2 Lease classification

UK and Ireland GAAP states that a lease is classified as a finance lease if the lease transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

A 'finance lease' is defined in the Glossary to FRS 102 as:

> *A **lease** that transfers substantially all the risks and rewards incidental to ownership of an **asset**. Title may or may not eventually be transferred. A lease that is not a finance lease is an **operating lease**.*

*FRS 102 Glossary **finance lease***

An 'operating lease' is defined as:

> *A **lease** that does not transfer substantially all the risks and rewards incidental to ownership. A lease that is not an operating lease is a **finance lease**.*

Correct classification of a lease as a finance or operating lease is crucial. In practice, some entities would prefer to have an operating lease as the lease is then not reported on the balance sheet which improves gearing ratios and the overall financial position on the balance sheet. This is one of the 'stinging points' surrounding the proposals by the FRC to overhaul lease accounting for lessees so that the vast majority of leases are reported on-balance sheet.

FRS 102 requires the classification of a lease between finance and operating to be done on the basis of the substance of the arrangement and not its legal form. Essentially, a lease is treated as a finance lease when the **risks and rewards** incidental to ownership pass from the lessor to the lessee. If substantially all the risks and rewards incidental to ownership do not pass from the lessor to the lessee, the lease is an operating lease. Some of the more common examples of risks and rewards are shown below:

Risks	Rewards
• Losses incurred due to idle capacity of the leased asset. • The leased asset becomes technically obsolete due to enhancement or changes in technology.	• The entity expects to benefit from increases in the value of the leased asset. • The entity will benefit from profitable operations over the useful life of the

• Economic conditions give rise to a reduced level of economic benefits.	leased asset.

FRS 102 and FRS 105 both provide eight indicators that a lease falls to be classified as a finance lease as follows:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term.

When legal title transfers to the lessee at the expiration of the lease, the lessee will essentially legally own the asset and hence the risks and rewards of ownership will continue. It should be noted that on inception, and during, the lease, the lessee does not legally own the leased asset; but in substance has acquired an asset which has been financed through a leasing arrangement. This is the reason why the asset subject to the finance lease is recognised on the balance sheet with a corresponding liability in respect of the lease obligations.

(b) The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.

An option to purchase the asset at a price that is sufficiently lower than fair value is essentially a call option (the lessor has a corresponding put option for the same value of the leased asset). In a finance lease, the lessee has the option to purchase the asset at a price less than fair value of the asset and so it will almost certainly exercise that right. This means it will hold the asset for its entire useful life and hence indicates that the lease is a finance lease.

(c) The lease term is for the major part of the economic life of the asset even if title is not transferred.

In this instance, it is presumed that the lessee will consume the economic benefits within the asset over the major part of the useful economic life to such an extent that the residual value at the end of the lease term is so low that the lessor would derive no significant benefit from either selling the leased asset or leasing it to another party once the lease has expired. Accounting standards do not provide guidance on what constitutes the 'major part', nor do they provide benchmarks and hence this criterion will involve professional judgement.

(d) At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

This criterion tests whether the lessor receives a full return on the initial investment in the asset. Professional judgement will be needed to determine whether the present

value of the minimum lease payments equates to at least substantially all of the fair value of the leased asset. The substance of the lease must also be considered and whether substantially the risks and rewards of ownership are passed from lessor to lessee.

(e) The leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Some assets may have been specifically constructed for the lessee and third parties would only be able to use them if major modifications are made. In these situations, the market value of specialised assets is limited and hence the lessor will attempt to recover its investment in the asset through the finance lease.

There are three additional indicators of situations that individually, or in combination, could also lead to a lease being classified as a finance lease as follows:

(a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

Evidence that the lessee will suffer a financial penalty by cancelling the lease before its expiry date is an indicator that, at the inception of the lease, both parties do not intend for cancellation to occur.

(b) Gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee (e.g. in the form of a rent rebate equalling most of the sales proceeds at the end of the lease).

Even if legal title of the asset does not pass to the lessee at the end of the lease, the lessee may bear the risks and rewards of fluctuations in the asset's fair value. Additional analysis will be required where gains and losses from the fluctuation in the residual value are shared between the lessee and the lessor to establish whether, or not, the lessor retains a significant share. If evidence suggests that the lessor retains a significant share in the residual value, but only in circumstances which are considered to be remote, classification as a finance lease will still be appropriate.

(c) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

The rent for the secondary period would be significantly lower than what would otherwise be charged. This criterion suggests that the lessor has received their required return and that the lessee is likely to continue the lease into the secondary period.

3.3 Finance leases: lessees

On initial recognition of a finance lease, FRS 102, para 20.9 states that the lessee must recognise its rights and obligations under a finance lease as an asset and a liability in the balance sheet at an amount equal to the fair value of the leased asset or, if lower, the present value of the minimum lease payments which are determined at the inception of the lease.

Any directly attributable costs in negotiating and arranging the lease are added to the amount recognised as an asset.

In a finance lease, the lessee has effectively acquired an asset which has been financed through a leasing arrangement. The amount capitalised as an asset represents the lessee's right to use the asset and the liability represents the lessee's obligations to pay rentals to the lessor over the life of the lease. Where there are no directly attributable costs involved in negotiating and arranging the lease, and no initial deposit, the two amounts will be equal at initial recognition.

Subsequent measurement

After initial recognition of a finance lease at either fair value of the present value of the minimum lease payments, FRS 102, para 20.11 states that the lessee must apportion the minimum lease payments between the finance charge (interest) and the reduction of the outstanding liability (principal) using the effective interest method. The finance charge is allocated to each accounting period during the lease term so as to produce a constant periodic rate of return of interest on the remaining balance of the liability. Contingent rents are charged as an expense in the periods in which they are incurred.

FRS 102 requires the use of the effective interest method which is used in Section 11 *Basic Financial Instruments* and is a method which exactly discounts the estimated future cash payments for a lessee, or future cash receipts for a lessor, over the life of the lease. This can be easily calculated using the Goal Seek function in Microsoft Excel.

In addition to allocating interest over the life of the lease, FRS 102, para 20.12 requires the lessee to depreciate the asset in accordance with Section 17 *Property, Plant and Equipment* or Section 18 *Intangible Assets other than Goodwill*. In situations where there is uncertainty as to whether the lessee will obtain ownership at the end of the lease term, the asset is fully depreciated over the shorter of the lease term and the asset's useful life. In addition, FRS 102, para 20.12 requires the lessee to assess whether the leased asset is showing signs of impairment in accordance with Section 27 *Impairment of Assets*.

Example – Finance lease

Morley Industries Ltd enters into a finance lease for an item of machinery that has a fair value of £35,000 (this is also equivalent to the present value of the minimum lease payments).

The term of the lease is for five years, which is also considered to be the major part of the economic life of the machine and hence the lease qualifies for treatment as a finance lease per FRS 102, para 20.5(c).

The machine is not expected to have any residual value at the end of the five-year lease.

The monthly payments, comprising capital and interest, are £685 per month and there is an option to purchase fee payable at the end of the lease term for £150 which is included in the final payment. The company has not incurred any arrangement fees in connection with this lease.

In years one to four, the company will pay £8,220 (£685 x 12) and in year five it will pay £8,370 (£685 x 12 + £150). The lease provisions are profiled in an Excel spreadsheet as follows:

	A	B	C	D	E
1	**Effective interest rate**				
2					
3	**Year**	**Opening liability**	**Cash flow**	**Interest at EIR**	**Closing liability**
4		£	£	£	£
5	1	35,000	(8,220)	0	26,780
6	2	26,780	(8,220)	0	18,560
7	3	18,560	(8,220)	0	10,340
8	4	10,340	(8,220)	0	2,120
9	5	2,120	(8,370)	0	(6,250)

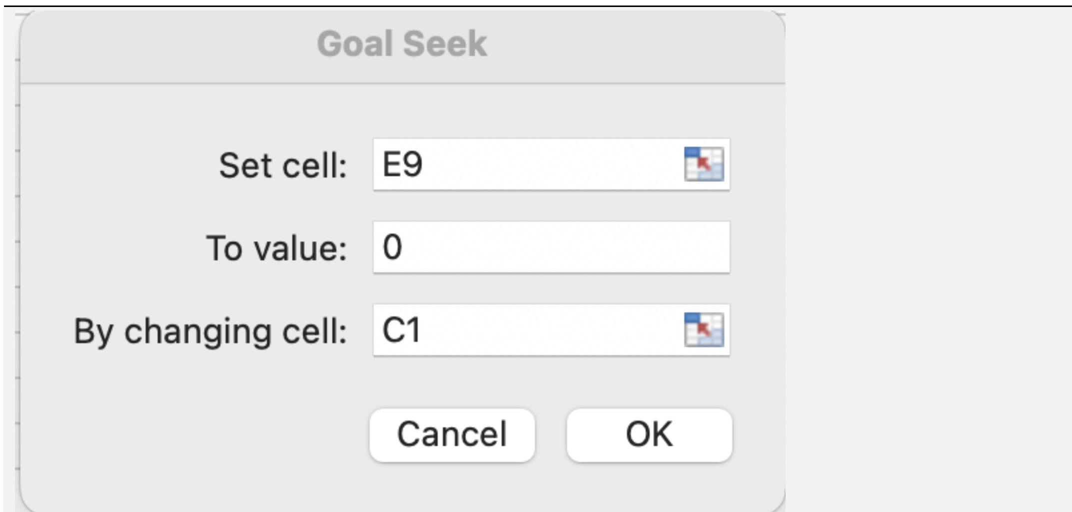
The formulas in the above spreadsheet are as follows:

	A	B	C	D	E
1	**Effective interest rate**				
2					
3	**Year**	**Opening liability**	**Cash flow**	**Interest at EIR**	**Closing liability**
4		£	£	£	£
5	1	35000	-8220	=C1*B5	=B5+C5+D5
6	2	=E5	-8220	=C1*B6	=B6+C6+D6
7	3	=E6	-8220	=C1*B7	=B7+C7+D7
8	4	=E7	-8220	=C1*B8	=B8+C8+D8
9	5	=E8	-8370	=C1*B9	=B9+C9+D9

The Goal Seek function in Excel can be used to work out the effective interest rate in cell C1 that can then be applied to cells D5 to D9 resulting in cell E9 becomes £nil.

To use the Goal Seek function go to the Data tab at the top of the Excel worksheet and then select ‘What-if Analysis’.

The objective is to get cell E9 to show a value of £nil by changing C1 so as to work out the effective interest over the life of the lease. Once the Goal Seek function is selected, the following information is entered:



Click 'OK' and Excel will calculate the effective interest rate in cell C1 and the interest expense in cells D5 to D9 automatically as follows:

	A	B	C	D	E
1	**Effective interest rate**		5.72%		
2					
3	**Year**	**Opening liability**	**Cash flow**	**Interest at EIR**	**Closing liability**
4		£	£	£	£
5	1	35,000	(8,220)	2,004	28,784
6	2	28,784	(8,220)	1,648	22,211
7	3	22,211	(8,220)	1,272	15,263
8	4	15,263	(8,220)	874	7,917
9	5	7,917	(8,370)	453	(0)

The effective interest rate has been calculated at 5.72% and is allocated to each period during the term of the lease in order to produce a constant periodic rate of interest on the remaining liability. You will note that interest charges are higher in the earlier years of the lease and lower in the later years.

The depreciation charges on this machine are charged over the life of the lease at an amount of £7,000 as there is no residual value left at the end of the useful life of five years.

The journals in year 1 are as follows:

	£
Dr Plant and machinery additions	35,000
Cr Finance lease obligation	35,000

Initial recognition of machine on lease	
Dr Depreciation expense	7,000
Cr Accumulated depreciation	7,000
Being year 1 depreciation charge	
Dr Finance lease obligation	8,220
Cr Cash at bank	8,220
Being payments to lessor in year 1	
Dr Interest expense	2,004
Cr Finance lease obligation	2,004
Being interest on finance lease at EIR	

At the end of year 1, the finance lease obligation of £28,784 is split between the amount falling due within one year of £6,573 (£28,784 - £22,211) and the amount falling due after more than one year of £22,211 to comply with the statutory formats of the balance sheet.

While the effective interest rate is inherently more complex than, say, the level-spread method, it does produce a more realistic interest expense in profit and loss as it is based on the remaining liability.

3.4 Operating leases: lessees

When a lessee enters into an operating lease, the risks and rewards incidental to ownership of the asset remain with the lessor and so the leased asset is not recognised on the lessee's balance sheet; nor is a corresponding lease liability. The lease payments are simply recognised in profit or loss on a straight-line basis as an expense over the life of the lease to comply with FRS 102, para 20.15.

FRS 102, para 20.15 recognises two exceptions to the straight-line recognition method and an alternative basis can be used by an entity if:

(a) *another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis; or*

FRS 102, para 20.15

(b) *the payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary because of factors other than general inflation, then this condition (b) is not met.*

The following example is reproduced from FRS 102, para 20.15.

Example of applying FRS 102, para 20.15(b)

X operates in a jurisdiction in which the consensus forecast by local banks is that the general price level index, as published by the government, will increase by an average of 10% annually over the next five years. X leases some office space from Y for five years under an operating lease. The lease payments are structured to reflect the expected 10% annual general inflation over the five-year term of the lease as follows:

Year 1	CU100,000
Year 2	CU110,000
Year 3	CU121,000
Year 4	CU133,000
Year 5	CU146,000

X recognises annual rent expense equal to the amounts owed to the lessor as shown above. If the escalating payments are not clearly structured to compensate the lessor for expected inflationary cost increases based on published indexes or statistics, then X recognises annual rent expense on a straight-line basis: CU122,000 each year (sum of the amounts payable under the lease divided by five years).

3.5 Lease incentives

FRS 102, para 20.15A states that a lessee is to recognise the aggregate benefit of lease incentives as a reduction to the operating lease expense over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset. Any costs which are incurred by the lessee (such as costs for termination of a pre-existing lease, relocation or leasehold improvements) are to be accounted for in accordance with the relevant section of FRS 102 or FRS 105.

The term 'lease incentives' is defined as follows:

*Incentives provided by the lessor to the lessee to enter into a new or renew an **operating lease**. Examples of such incentives include up-front cash payments to the lessee, the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with pre-existing lease commitments of the lessee), or initial periods of the **lease** provided by the lessor rent-free or at a reduced rent.*

*FRS 102 Glossary **lease incentives***

Example – Accounting for a lease incentive

Dwyer Ltd enters into an operating lease with Walker Ltd to rent a commercial building for ten years. No rent is payable in the first two years and thereafter the rent is payable at £15,000 per annum.

The rent-free period of one year should be allocated over the entire lease term by spreading the total lease rental for the lease term using the straight-line basis.

The total rental expense for the ten-year lease term is 8 years x £15,000 = £120,000. The expense for each period, including years 1 and 2 will be £120,000 / 10 = £12,000.

At the end of years 1 and 2, the balance sheet will show accrued rent payable of £12,000 and £24,000 respectively. This is reduced by £3,000 over the remaining eight years.

3.6 Finance leases: lessors

Initial recognition

FRS 102, para 20.17 requires a lessor to recognise assets held under a finance lease in the balance sheet and to present them as a receivable (i.e. a debtor) at an amount equal to the net investment in the lease. The net investment in the lease is the lessor's gross investment in the lease discounted at the interest rate implicit in the lease. FRS 102, para 20.17 then goes on to clarify that the gross investment in the lease is the total of:

(a) the minimum lease payments receivable by the lessor under a finance lease;

(b) any unguaranteed residual value accruing to the lessor.

Therefore, when a lessor enters into a finance lease with a lessee, the lessor must derecognise the asset and then recognise a new asset, which is the net investment in the lease. Differences between the two values will be recorded as a profit or loss on disposal (unless the lessor is a manufacturer or dealer).

The net investment in the lease is the equivalent of the present value of the future rentals receivable plus the residual asset that goes back to the lessor at the end of the lease. The difference between the **gross** investment in the lease and the **net** investment in the lease is unearned finance income.

Where the lessor incurs any directly attributable costs (i.e. costs which are incremental in negotiating and arranging the lease such as legal fees), these are included in the initial measurement of the finance lease receivable and reduce the amount of income

recognised over the term of the lease. General overheads (such as marketing costs) are not included.

Subsequent measurement

FRS 102, para 20.19 states that the recognition of finance income is to be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease. Lease payments which relate to the accounting period (excluding costs in respect of services) are applied against the gross investment in the lease to reduce both the capital amount and the unearned finance income (interest). FRS 102, para 20.19 then goes on to state that if there is an indication that the estimated unguaranteed residual value using in calculating the lessor's gross investment in the lease has changed significantly, the income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognised immediately in the profit and loss account.

Contingent rents are excluded from the minimum lease payments and hence from the net investment included in the balance sheet. As a result, where contingent rents arise, the lessor should include them as an additional finance income of the period in which they arise. In addition, where the lessor grants any lease incentives to the lessee, the calculation of the minimum lease payments and the determination of the interest rate implicit in the lease will include nil payments by the lessee during such rent-free periods.

Manufacturer or dealer lessors

Manufacturer or dealer lessors are dealt with in FRS 102, paras 20.20 to 20.22. Paragraph 20.20 states that a finance lease of an asset by a manufacturer or dealer lessors will give rise to two types of income:

(a) profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts;

(b) finance income over the lease term.

FRS 102, para 20.21 then goes on to state that the sales revenue which the manufacturer or dealer lessor recognises at the commencement of the lease term is the fair value of the asset or, if lower, the present value of the minimum lease payments accruing to the lessor which are calculated using a market rate of interest. Cost of sales in the manufacturer or dealer lessor's books is the cost, or carrying amount where different, of the lease asset less the present value of the unguaranteed residual value. The difference between the sales value and the cost of sale is the selling profit which is recognised in accordance with the entity's policy for outright sales.

FRS 102, para 20.22 states that where artificially low rates of interest are quoted, selling profit must be restricted to that which would apply if a market rate of interest were charged. Costs that are incurred by a manufacturer or dealer lessor in connection with

negotiating and arranging a lease are to be recognised as an expense when the selling profit is recognised.

3.7 Operating leases: lessors

FRS 102, para 20.24 requires a lessor to present assets subject to operating leases in its balance sheet depending on the nature of the asset.

Generally, such assets will be presented in the balance sheet as property, plant and equipment in accordance with Section 17 *Property, Plant and Equipment*. However, where an entity routinely sells assets which they have held for rental to others (e.g. car hire companies), they can transfer those assets to stock at their carrying amount when they cease to be rented and become held for sale.

Revenue

FRS 102, para 20.25 requires a lessor to recognise lease income from operating leases (excluding amounts in respect of services such as insurance and maintenance) in profit or loss on a straight-line basis. Similar principles exist in FRS 105, para 15.24. Unlike FRS 105, FRS 102 recognises two exceptions to the straight-line method of income recognition which are where:

FRS 102, para 20.25 (a) and (b)

(a) another systematic basis is representative of the time pattern of the lessee's benefit from the leased asset, even if the receipt of payments is not on that basis; or

(b) the payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary according to factors other than inflation, then condition (b) is not met.

In practice, most rental income will be recognised on straight-line basis. However, differences may arise where rental receipts are either not constant throughout the term of the lease or accounting periods are not coterminous. In such cases, the lessor will recognise the amount of income receivable in the current accounting period, which may result in accrued or deferred income balances being recognised.

Lease incentives

Lease incentives for lessors are dealt with in FRS 102, para 20.25A and FRS 105, para 15.25. Both of these paragraphs require the aggregate cost of lease incentives to be recognised over the lease term on a straight-line basis, unless another systematic basis is representative of the time pattern over which the lessor's benefit from the leased asset is diminished.

Lease incentives should not be recognised immediately in the lessor's profit and loss account because this would not be consistent with the lease term (unless, of course, the lease term was shorter than the accounting period itself).

Expenses

FRS 102, para 20.26 and FRS 105, para 16.26 require a lessor to recognise as expenses, costs including depreciation which are incurred in earning lease income. The lessor's depreciation policy for depreciable leased assets must be consistent with the lessor's normal depreciation policy for similar assets.

To apply the provisions in paragraphs 20.26/15.26 of FRS 102/FRS 105, the principles in Section 17 *Property, Plant and Equipment* and Section 18 *Intangible Assets other than Goodwill* (FRS 102) and Section 12 *Property, Plant and Equipment and Investment Property* (FRS 105) and Section 13 *Intangible Assets other than Goodwill* will apply.

Initial direct costs

Lessors are required to add to the carrying amount of a leased asset any initial direct costs which it incurs in negotiating and arranging an operating lease and must recognise these costs as an expense over the term of the lease on the same basis as lease income.

In practice, such costs will usually involve legal fees in drawing up the lease. Such costs will be added to the carrying amount of the leased asset as they are directly attributable in negotiating and arranging the lease and will be recognised within the depreciation charge in profit or loss in the relevant accounting period. General overhead costs, e.g. marketing fees, are not to be included and must be expensed to the profit and loss account in the period in which they are incurred.

Impairment

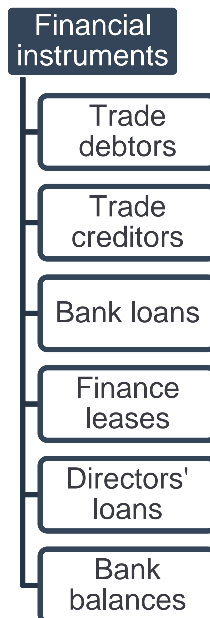
The impairment provisions of FRS 102, Section 27 *Impairment of Assets* and FRS 105, Section 22 *Impairment of Assets* apply equally to leased assets. At each reporting date, the lessor must assess whether the leased asset is showing indicators of impairment and where the leased asset's recoverable amount is lower than carrying amount, an impairment loss is to be recognised in profit or loss.

Manufacturer and dealer lessors

Manufacturer and dealer lessors recognise no selling profit on entering into an operating lease because it is not the equivalent of a sale.

4 Disclosing accounting policies: financial instruments (Lecture A852 – 9.45 minutes)

Pretty much all financial statements will have some form of financial instrument or another in it. Examples of financial instruments include:



FRS 102, para 8.5 requires an entity to disclose its significant accounting policies comprising:

(a) the measurement basis (bases) used in preparing the financial statements;

(b) the other accounting policies that are relevant to an understanding of the financial statements.

The FRC's periodic review plans to change the requirement to requiring entities to disclose **material accounting policy information** rather than significant accounting policies. This should provide more clarity as to what does, and what does not, require disclosure in terms of the entity's accounting policies.

4.1 Financial instruments

During file reviews, it is not uncommon to notice deficiencies in the accounting policies section of the financial statements. A lot of these deficiencies concern 'boilerplate' disclosures – which is where an accounting policy merely regurgitates the requirements of an accounting standard without any entity-specific tailoring to make the policy concise and appropriate to the entity. Other deficiencies are generally due to over-reliance on accounts production software systems.

All accounting policies should be tailored to be entity specific. Just because an automated accounts production software system may churn out an accounting policy, does not mean that it is right or that it is even appropriate in the entity's circumstances (the policy could be irrelevant or it could relate to an immaterial area of the financial statements).

Many entities will have financial instruments of some guise included in the financial statements.

As noted earlier, these may comprise several different types of financial instrument and therefore it is important to look at the accounting policy in the financial statements to consider its appropriateness.

Consider the following example from a set of financial statements:

Financial instruments

The company recognises a financial instrument when it becomes a party to the financial instrument. A financial instrument is a contract that gives rise to a financial asset of the company or a third party and a financial liability or equity instrument of the company or a third party.

This sort of accounting policy is a 'mishmash' of the definition of a financial instrument from FRS 102. It does not discuss how the entity classifies financial instruments, it does not explain the recognition and measurement policies that have been selected by the entity and it does not talk about derecognition issues.

What would a reasonable disclosure look like?

There is no right or wrong way to disclose accounting policies – but the key is to avoid boilerplate policies and over-reliance on accounts production software generated policies in their entirety.

Keep in mind that financial instruments will still need user-input where accounting policies are concerned because software systems are not that enhanced (as yet) in identifying key aspects of financial instruments (e.g. whether the policy is to recognise at, say, amortised cost or fair value through other comprehensive income).

The example below is taken from a set of financial statements which contains material financial instruments, including debtors and creditors, bank loans and finance leases. It

is not meant to be a ‘template’, but is intended to demonstrate the detail that may be required.

Financial instruments

The company has elected to apply (where applicable) the provisions of Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* of FRS 102 to all of its financial instruments.

Financial instruments are recognised when the company becomes a party to the contractual provisions of the instrument.

Financial assets are offset, with the net amounts presented in the financial statements, when there is a legally enforceable right to set-off the recognised amounts and there is an intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

Basic financial assets

Basic financial assets, which include trade and other debtors, amounts owed by group undertakings and cash and bank balances, are initially measured at transaction price including transaction costs and are subsequently measured at amortised cost using the effective interest rate. The exception to this would be where the arrangement constitutes a financing transaction – in which case, the financial asset is measured at the present value of the future receipts discounted at a market rate of interest.

Impairment of financial assets

Financial assets, other than those held at fair value through profit or loss, are assessed for indicators of impairment at each balance sheet date.

Financial assets are impaired when there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows have been affected. If an asset is impaired, the impairment loss is the difference between the carrying amount and the present value of the estimated cash flows discounted at the asset's original effective interest rate. All impairment losses are recognised in profit or loss.

If there is a decrease in the impairment loss arising from an event occurring after the impairment was recognised, the impairment is reversed. The reversal is such that the current carrying amount does not exceed the carrying amount that would have been recognised had the impairment not previously been recognised. Impairment reversals are recognised in profit or loss.

Derecognition of financial assets

Financial assets are derecognised only when:

- the contractual rights to the cash flows from the asset expire or are settled; or
- when the company transfers the financial asset and substantially all the risks and rewards of ownership to another entity; or
- if some significant risks and rewards of ownership are retained but control of the asset has transferred to a third party which is able to sell the asset in its entirety to an unrelated party.

Classification of financial liabilities

Financial liabilities (and equity instruments) are classified depending on the substance of the contractual arrangements entered into.

Basic financial liabilities

Basic financial liabilities, including trade and other creditors, bank loans, finance leases, accruals and amounts owed to group undertakings, are initially recognised at transaction price unless the arrangement constitutes a financing arrangement, where the debt instrument is then measured at the present value of the future payments discounted at a market rate of interest.

Debt instruments are subsequently measured at amortised cost using the effective interest method.

Derecognition of financial liabilities

Financial liabilities are derecognised when, and only when, the company's contractual obligations are discharged, cancelled or they expire.

Equity instruments

Equity instrument issued by the company are recorded at the fair value of the proceeds received, net of transaction costs. Dividends payable on equity instruments are recognised as liabilities once they are no longer at the discretion of the company.

Remember, the point of accounting policy information is to disclose those significant (i.e. material) policies and to ensure they are as entity specific as possible. This should then result in accounting policy information which is concise, understandable and relevant.

4.2 Other disclosure information for financial instruments

In addition to accounting policy information, don't forget that FRS 102, Section 11 requires extensive disclosures to be made in the financial statements relating to financial instruments. A summary of these disclosures is shown in the table below:

Disclosures relating to:	Relevant paragraphs:
Accounting policies for financial instruments	11.40
Statement of financial position – categories of financial assets and financial liabilities	11.41 to 11.44
Derecognition	11.45
Collateral	11.46
Defaults and breaches on loans payable	11.47
Items of income, expense gains or losses	11.48
Financial instruments at fair value through profit or loss	11.48A
Financial institutions and retirement benefit plans	11.48B and 11.48C
Interest rate benchmark reform	11.49 to 11.50

For entities that have financial instruments within the scope of FRS 102, Section 12, the above disclosure requirements must be made. If hedge accounting is being used, the relevant disclosure requirements for such accounting is in paragraphs 12.27 to 12.29A.

5 Accounting for insurance proceeds (Lecture A853 – 9.09 minutes)

Sometimes, things happen in business whether they are expected or unexpected and it may require a claim on the company's insurance. Other businesses may have insurance cover for losses triggered by a specific event, such as business interruption or third-party claims.

The key question for preparers and auditors is whether it is appropriate to recognise the expected proceeds from an insurance claim and, if so, whether they are recognised in full in the accounting period; or whether some is deferred to be carried over into a subsequent accounting period. To make this judgement call, the entity will need to consider the nature and timing of the insured event.

Under UK and Ireland GAAP, the accounting for insurance proceeds depends on whether the entity recognises a provision for the insured event. The relevant area of FRS 102 is that of Section 21 *Provisions and Contingencies* but then there is more consideration as to the detailed technical accounting issues that may arise which we will examine later in this section.

5.1 Reimbursement assets

When an external event happens, a business may struggle to fulfil its legal or contractual obligations. Many examples of this were noted during the Covid-19 pandemic when work on construction sites had to be suspended indefinitely due to government restrictions being imposed on non-essential businesses. Consideration then had to be given as to whether the business needed to recognise a provision or disclose a contingent liability at the balance sheet date. However, the business may have had insurance from which to claim reimbursement for some, or all, of the expenditure necessary to settle the provision.

Insurance proceeds to settle a provision are accounted for as reimbursements under FRS 102, Section 21 (and FRS 105, Section 16 *Provisions and Contingencies*).

Care must be taken with reimbursement assets, particularly where there is uncertainty at the balance sheet date as to whether the reimbursement will be made. This is because in order for a reimbursement asset to be recognised, its receipt must be **virtually certain**. This is a higher hurdle to pass than the probability criterion for the recognition of a liability. For a liability, there must be a *probable* requirement to settle the liability; whereas for a reimbursement asset, its receipt must be virtually certain.

FRS 102 does not define the term 'virtually certain' but it should be taken to mean that the entity has received written confirmation that the insurer or third party will reimburse the entity for some, or all, of the expenditure necessary to settle the provision.

Example – Receipt is probable

On 26 November 2023, Watson Ltd suffered a fire at its main warehouse which damaged 40% of its stock. The company has had to incur a significant amount of money in cleaning up the damage. Watson Ltd has a financial year end of 31 December 2023.

On 30 November 2023, an insurance claim was lodged. A loss adjuster has been out to the business to survey the damage and to look at the costs currently incurred by the business in cleaning up the damage as far as possible. The insurance company has said that the claim is in the process of being looked at in detail, and they estimate an eight-week turnaround time for a decision on whether, or not, it will pay out on the claim.

The first thing to think about, before even considering appropriate accounting treatments for an insurance claim, is impairment. In this scenario, 40% of stock has been damaged and hence an impairment write-down will be needed. In addition, there may be damage to the building which will also need to be considered for impairment. Keep in mind that impairment reviews should occur on the date of the damage.

The finance director has estimated that the insurance proceeds will be £0.7m and has recognised a sundry debtor with a corresponding income for insurance claim in profit or loss. She has justified this on the grounds that the event is an insured event, there has been a visit by the loss adjuster and the claim was submitted on a timely basis.

The finance director is incorrect to recognise a reimbursement asset in this example. There is no confirmation from the insurance company by the balance sheet date that they will pay out on the claim. Hence, the finance director cannot justify that the receipt is virtually certain.

Consequently, the finance director must remove the reimbursement asset and corresponding income. She should, however, disclose a contingent asset which presents:

- a description of the nature of the contingent asset at the balance sheet; and
- if practicable, an estimate of the financial effect. If it is impracticable to disclose

this information, that fact shall be stated.

Example – Lost profits

On 16 December 2023, Padgate Ltd had to close its business due to water and gas works that had to be completed as a matter of urgency. These works were beyond the control of Padgate and an insurance claim for loss of profits has been lodged with the company's insurers.

Compensation for business interruption is not a reimbursement right under FRS 102, Section 21 because a loss of profits, by themselves, do not give rise to a provision. However, a loss of profits would invariably trigger the impairment requirements of FRS 102, Section 27 *Impairment of Assets*.

However, a company can recognise the reimbursement asset for business interruption as a debtor when it has an unconditional right to receive that compensation. This would usually arise when:

- the entity has an insurance contract under which it can claim for compensation; and
- the loss event that creates a right for the company to assert a claim at the balance sheet date has occurred and the claim is not disputed by the insurance company.

5.2 Other accounting issues

There may be situations when an insurer agrees to pay out on a claim but the rectification work which gave rise to the original claim may span two accounting periods. Consider the following example:

Example – Car demolishes a restaurant

On 16 December 2023, an out-of-control vehicle smashed into the front of a restaurant causing a considerable amount of damage. No diners or staff were injured in the accident because it occurred when the restaurant was closed.

The insurance company has agreed to pay out on the claim and the proceeds were received on 20 February 2024. Work to repair the building is expected to commence

on 26 February 2024 and is expected to take 10 weeks to complete. The restaurant's year end is 31 March 2024.

For the purposes of this example, costs incurred in repairing the damage are recognised in profit or loss as and when they are incurred. The insurance proceeds are recognised as income in profit or loss at the year end depending on how much work has been completed. Therefore, if at 31 March 2024, it is estimated that 70% of the rectification work is complete, then 70% of the insurance proceeds are recognised in income with the remaining 30% being recorded as deferred income in the balance sheet and presented as an amount falling due within one year. The 30% will then be recognised on full completion of the rectification work expected in the year ending 31 March 2025.

Accounting for insurance proceeds can be a tricky area for the financial statements. Auditors must ensure that any reimbursement asset that has been received has been recorded correctly (i.e. that the receipt is **virtually certain** rather than probable – remember, the 'probability' criterion only applies to provisions for liabilities). It is quite an easy area of the financial statements to manipulate and management may have the incentive to do this, particularly if an external event has had a significant and detrimental impact on the business.

6 FRC revises the Ethical Standard (Lecture A854 – 19.05 minutes)

On 15 January 2024, the FRC issued an updated Ethical Standard (ES). This updated version followed a consultation draft which was issued in August 2023. There are three main points that the updated ES does:

1. It provides simplifications and clarifications aimed at enabling the ES to be more concise.

2. It aligns the ES to that of the International Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants (IESBA) to ensure high standards of independence and ethical behaviour are applied consistently by UK audit firms and their networks.

3. It places a restriction on fees from entities that are controlled by a 'single controlling party'.

Some of the more notable changes arising from the updated ES are as follows:

6.1 Other Entity of Public Interest (OEPI)

In the original consultation draft, the FRC proposed to remove the OEPI category. There was widespread support throughout the profession for this (but only once a final statutory definition became effective). Many also wanted the new definition of a 'public interest entity' to be simpler and aligned to the definitions in law, the ES and the IESBA Code.

The FRC does have the power to amend or withdraw the OEPI category but will not do so until a new statutory definition introduced. The FRC has acknowledged that once details of any new statutory definition are known, it is highly likely the FRC will amend or withdraw the OEPI category given the unanimous nature of stakeholder feedback during the consultation.

6.2 Breaches

There was a lot of concern when the consultation draft was issued because the proposals in the draft required any breaches, which the firm's policies and procedures failed to prevent or detect, to be treated as 'not inadvertent'. In other words, if a breach arose which was completely unintentional, it would have been considered a deliberate breach.

Thankfully, these proposals were dropped and, instead, the previous requirement to use professional judgement to determine whether, or not, a breach is inadvertent has been carried over into the revised ES. The FRC acknowledged that introducing this new requirement would have driven inconsistent reporting behaviours.

However, care must be taken to ensure a sound understanding of the requirement to report breaches (either to the FRC for listed and public interest entities; or to the relevant supervisory body for unlisted and non-public interest entities) because there are specific requirements in this respect. The revised ES requires firms to report all breaches to the 'Competent Authority' (i.e. FRC or relevant supervisory body, such as ICAEW or ACCA) on a biannual basis. Where a breach relates to a specific engagement(s), the ES requires the breach to be reported to those charged with governance in a timely manner (see paragraph 1.23 of the ES).

Paragraph 1.24 of the ES requires the firm to report individual breaches outside of the biannual timetable where the Competent Authority would reasonably expect notice. This may be due to the nature or seriousness of the breach, including, for example, where the firm may need to consider resigning from the engagement.

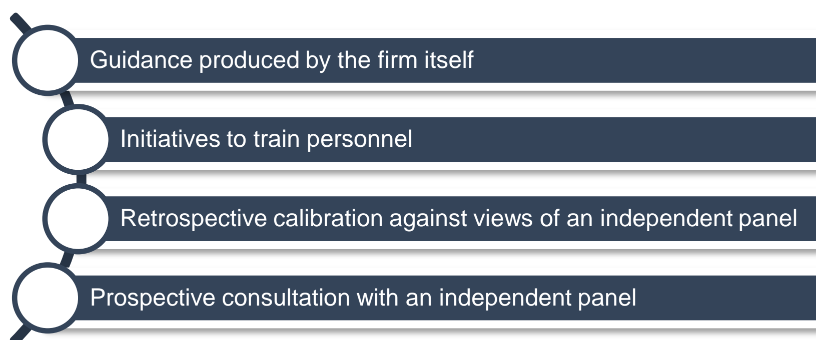
The ES requires the engagement partner (and ethics partner, where there is one) to consider the perspective of an **objective, reasonable and informed third-party test** (ORITP test – see **6.3** below) on whether it is necessary to resign from an engagement or, alternatively, what safeguards could be put in place.

6.3 ORITP

As noted above, the revised ES includes requirements for audit and assurance practitioners to consider threats to independence from the perspective of an ORITP. The FRC has published guidance on how this may be applied in practice because it has observed that some firms have struggled to apply this test. In other words, would the third-party deem the threat to be so serious the firm should resign or not accept the engagement, as the case may be; or would they deem the threat to be mitigated to an acceptable level with appropriate safeguards in place?

Paragraph I14 of the revised ES talks about the 'third-party test' and states that such a person is informed about the respective roles and responsibilities of an auditor (or reporting accountant as applicable), those charged with governance and management of an entity, and is not another practitioner. The perspective offered by an informed investor, shareholder or other public interest stakeholder best supports an effective evaluation required by the third-party test, with diversity of thought being an important consideration.

The guidance suggests the following measures to enhance ORITP judgements:



6.4 Fees

There have been some significant changes made to the ES in respect of fees received by the firm. It is well-known that prior to the revisions to the ES, where total fees for services from a public interest entity, or other listed entity, and its subsidiaries exceeded 10% of total fee income, the firm must resign or not stand for reappointment.

Where the fees are from a **collection of entities** which have the same beneficial owner or controlling party, which is not a corporate entity, this will also contribute towards the 10% limit. This is something that audit firms will need to be extremely careful of to ensure they do not breach this threshold, particularly where they act for a very large group. Keep in mind that the revised ES looks wider (than simply at a group of companies) for other entities that are connected in substance if not in legal form. For example, common ownership that is not a group is now caught when previously it was not.

During the consultation, some concerns were raised from smaller firms that if they were to breach the aggregate fee threshold, they could be caught in a downward spiral which would result in them having to withdraw from engagements which would then have a knock-on effect on their fee income. This could also bring other engagements above fee limits.

The FRC pressed ahead with the fee income proposals anyway and said that they will continue to engage with those practitioners that raised concerns.

Most audit firms (especially the larger ones) will already have systems and controls in place to protect against these fee levels. However, given that the FRC has made changes to the ES in this respect, it may be the case that there have been some firms that have not had such systems and controls in place resulting in breaches of the fee thresholds given that the changes have been triggered through audit inspection and enforcement cases.

6.5 Financial interests of individuals

Generally, it is much easier for anyone in the audit firm *not* to have a financial interest in an audit. This is because there is clearly a threat to independence where a member of staff or a partner does have such an interest. The revised ES strengthens the rules in this area.

As well as disposing of the financial interest (or partially disposing of it) and not being involved in the audit engagement the ES then states that where the breach arises from a material prohibited financial interest or a prohibited transaction in a financial instrument, that individual must be excluded from **any** role which means they are operating in the same office or business unit as the audit engagement partner. In addition, the ES at paragraph 2.9 requires the firm to not accept, or must withdraw from, the engagement.

This effectively means that the person holding the financial interest would be required to change office or department. Hence, it is much easier to ensure that nobody involved in audit work has any financial interest in an audit client.

6.6 Conclusion and effective date

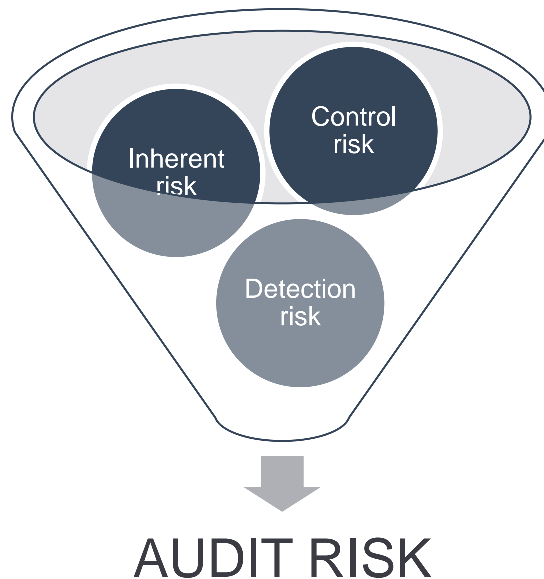
These are just some of the 'headline' changes that have been reflected in the ES and a clear understanding of the up-to-date version must be obtained to ensure compliance across the entire ES. The updated ES comes into effect on 15 December 2024.

7 Audit risk and response (Lecture A855 – 21.29 minutes)

Risk assessment is a critical aspect of planning. Understanding how business risk and financial statement risk may impact the audit client is crucial because this can highlight areas where the financial statements contain material misstatement. If planning and/or risk assessment has not been carried out properly, audit risk is increased considerably.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements contain a material misstatement. Audit risk is a function of the risks of material misstatement and detection risk (see below).

There are three components of audit risk:



7.1 Inherent risk

This is the susceptibility of an assertion about a class of transaction, account balance or disclosure to material misstatement **BEFORE** the auditor considers any related controls. This risk is beyond the control of the auditor and arises for various reasons include the nature of the industry in which the client operates, the nature of the entity itself or the nature of the item. Inherent risk is a broad concept and can result in material misstatement at the assertion level. For example, where an audit client has a portfolio of derivative financial instruments, material misstatement could arise because such financial instruments are inherently complex to account for.

Notwithstanding the fact that there is guidance in the form of accounting standards for complex financial instruments and disclosure issues, the client could misinterpret, or fail to understand, the requirements which is likely to result in a material misstatement arising in the financial statements.

7.2 Control risk

This is the risk that a misstatement that could occur and that could be material, either individually or in aggregate, will not be prevented, or detected and corrected on a timely basis by the entity's system of internal control. Control risk primarily arises in two instances: either controls in place are inadequate or non-existent; or they have not been applied effectively during the reporting period.

Example – Weak bank reconciliation controls

Birchwood Ltd requires bank reconciliations to be carried out every month as part of its month end routine.

In the last four months of the financial year, the bank reconciliation has contained small unreconciled differences. The finance director has informed the audit manager that these will be written off at the year end.

If reconciling items on the bank reconciliation are not investigated and corrected on a timely basis, the cash at bank balance could be misstated in the balance sheet. Unreconciled differences on bank reconciliations may represent a control weakness and even small differences could represent large differences that net off to a small amount.

In combination, inherent risk and control risk make up the risk of material misstatement. This is the risk that the financial statements contain material misstatement prior to the audit fieldwork commencing. Material misstatement could arise due to fraud or error occurring during the year and it is important that the auditor undertakes a thorough programme of planning to identify such risks.

7.3 Detection risk

This is the risk that the audit procedures performed by the auditor to reduce audit risk to an acceptable level will not detect a misstatement that exists and which could be material.

Out of the entire audit risk model, detection risk is the only risk that is under the control of the auditor and comprises:

- **Sampling risk** – which is the risk that the auditor's conclusion based on a sample is different from the conclusion that would be reached had the auditor tested the entire population.

- **Non-sampling risk** – which is the risk that the auditor's conclusion is inappropriate for any other reason such as the application of inappropriate audit procedures, or the failure to recognise a misstatement.

7.4 Responses to assessed risks

Once the auditor has identified those risks which may cause material misstatement at the assertion level, they must devise appropriate responses.

Some of the more common risks that are identified in practice, together with their associated responses, are shown in the table below (the table below is not comprehensive and is based on a client preparing financial statements under FRS 102). An auditor's response is not a detailed procedure, the response merely demonstrates the approach the auditor will take in tackling a specific risk. Detailed procedures are developed into an audit plan.

Audit risk	Auditor's response
This is the first year the audit firm has audited this client. The risk is that the firm has no prior experience of the client and hence detection risk is increased. Opening balances may be misstated as the firm did not carry out the audit last year and the firm is unfamiliar with the accounting systems and policies of the client.	Devote more time to obtain an understanding of the client at the start of the audit to include documenting systems and controls and devising larger sample sizes to reduce detection risk. Understand the accounting systems and policies and ensure the latter are compliant with FRS 102. Apply additional procedures over opening balances as required by ISA (UK) 510 *Initial Audit Engagements – Opening Balances* and agree these to the prior year's audit file of the predecessor auditor. Review the previous auditor's responses to the firm to identify any issues which may be relevant to this year's audit.
There is concern that the company may not be a going concern, as there have been significant reductions in sales and little financial headroom.	ISA (UK) 570 *Going Concern* sets out the specific requirements in terms of auditing and reporting on going concern. This will nearly always be a complex area, as it will involve estimates of future performance, the availability of finance or the ability to take mitigating actions (such as selling an asset or

	part of a business). Where there are indicators of going concern problems, care must be taken to allow sufficient time and expertise to look at the area thoroughly.
During the year an amount of £120,000 was capitalised as development expenditure. FRS 102, Section 18 *Intangible Assets other than Goodwill* allows capitalisation of development expenditure if it meets the recognition criteria. If research expenditure has been capitalised, there is a risk that intangible assets and profit are overstated.	Review a schedule of capitalised development expenditure and ascertain the stage of the project to ensure that the costs capitalised are of a development nature and are not research expenditure. (Note: Intangible assets are a subjective area of the financial statements and hence where there are material amounts of intangible assets that have been capitalised during the year, appropriate responses by the auditor must be developed).
The company acquired a complex piece of machinery during the year and staff were required to be trained in its use. The cost of the training was £16,000. Training costs are specifically excluded from the cost of an item of property, plant and equipment. If the training costs have been capitalised, fixed assets and profit are overstated.	Review the costs capitalised in respect of the new machine and ensure the costs of training have been written off to profit or loss as required by FRS 102, para 17.11(c).
During the inventory count, a batch of damaged inventory was identified whose estimated selling price less costs to complete and sell was less than cost. If a write-down to estimated selling price has not been carried out, inventory will be overvalued and cost of sales understated.	Trace the damaged items to the final inventory valuation and assess whether the items have been written down to estimated selling price. Discuss with management any other items of inventory whose estimated selling price may be lower than cost to assess whether any further write-downs may be necessary.
The company manufactures complex work in progress (WIP) and the	Review the calculation of WIP and agree the components of the calculation to supporting

amounts of WIP at the year end are likely to be material. Determining the quantity and value of WIP may be complex and hence there is a risk of material misstatement in the valuation of WIP.	documentation, such as purchase invoices for materials and payroll records for labour costs. Ascertain the stage of completion of WIP and assess this for reasonableness. Consider whether the audit firm should use an auditor's expert to carry out the valuation of WIP.
The company stores inventory at third party bonded warehouses. It is impractical for the audit firm to attend all these warehouses. There is an increased detection risk over the completeness, existence and valuation of inventory where the auditor does not attend the third-party warehouses.	Establish those warehouses which hold material amounts of inventory and attend those. Also attend those warehouses which have had a history of exceptions. For those warehouses not attended, obtain external confirmation from the warehouse regarding the quantity and condition of the inventory or consider asking another audit firm to attend those which the auditor cannot attend.
Trade debtor days in the 90 to 120 days column on the debtors listing have increased from the prior year. There is a risk that debtors may be overvalued if specific bad debt provisions have not been made against these debtors.	Extended post-year-end after date cash testing to establish whether cash has been received from the se debtor after the year. *Note: Obtaining a debtors circularisation letter from these customers would be an irrelevant response in this respect because a debtor's circularisation letter does not confirm the valuation assertion (it only confirms existence).* Discuss with management whether any of the balances in the 90 to 120 days column are irrecoverable and hence whether additional specific bad debt provisions are required. *Note: Under FRS 102, general bad debt provisions (e.g. 5% of total trade debtors) are not allowed. Only specific provisions are allowed.*
At the year end, several correcting journals were included in the financial statements to correct errors. There is a risk that transactions and	Review the correcting journals and agree that these are appropriate by reference to corroborating evidence. Also consider the possibility of fraud and whether there is evidence that contradicts any corroborating

balances are misstated due to errors.	evidence. Extend cut-off procedures on sales and purchases to ensure transactions are recorded in the correct accounting period. Discuss with management the reasons for the errors and consider whether the controls over the year-end process require improvement.

7.5 Other areas of risk

Other areas the auditor may generally have concerns about at the planning stage, and hence which must be factored into account when carrying out risk assessment procedures including the following (note the list below is not comprehensive):

- Manipulation of the financial statements where there are loan covenants in place in respect of borrowings to maintain those covenants.
- Directors' bonuses which are profit dependent as there is a risk the financial statements may have been manipulated to achieve these bonuses.
- Large profits or losses on disposal of assets recorded in profit or loss as this may indicate that the entity's depreciation policies are inappropriate.
- Complex revenue recognition policies as this could result in revenue being misstated.
- Poor internal controls as this increases the risk of material misstatement.
- Aggressive management styles.
- A desire to achieve a certain level of profit or a desire to reduce profit as much as possible to reduce associated tax liabilities.
- A frequent change of auditor.
- Errors in opening balances that remain uncorrected.
- A tolerance of petty theft (this is a fraud risk factor).
- A failure to address issues raised by the auditor in previous audits (e.g. poor or absent internal controls).
- Inadequate disclosures being made in the financial statements (for example in relation to provisions and contingent liabilities, post-balance sheet events or going concern issues).

- An unwillingness by management to accept any other audit opinion other than an unqualified opinion (this creates an intimidation threat for the auditor).

8 Evaluating misstatements (Lecture A856 – 5.00 minutes)

During the audit, the auditor will document all misstatements identified on an 'audit error schedule' or 'summary of unadjusted errors schedule' and will discuss these errors with management and, where applicable, those charged with governance.

The auditor must consider the effect of uncorrected misstatements on the financial statements as a whole in line with ISA (UK) 450 *Evaluation of Misstatements Identified During the Audit*. This is achieved by:

- Recording all uncorrected misstatements identified during the detailed audit fieldwork on an unadjusted error schedule unless the misstatements are clearly trivial. The 'clearly trivial' benchmark is set at the planning stage of the audit and must be documented on file.

- Consider whether the identified misstatements indicate the presence of other misstatements within the financial statements which may be material when aggregated. If this is the case, the audit plan and audit strategy should be revised accordingly. Where the audit plan and strategy has been revised, the reasons for such revision should be documented.

- Assess the materiality of the uncorrected misstatements keeping in mind that it is not just about the numbers where materiality is concerned. If a material disclosure is either inadequate or has not been made (for example, a material related party disclosure), this will also be regarded as an uncorrected misstatement which should be corrected. Disclosures which are inconsistent with the financial statements (including those in the directors' report and/or strategic report) should also be corrected.

- Report all misstatements identified to an appropriate level of management or, where applicable, to those charged with governance.

- Request that all misstatements are corrected.

- If management refuse to correct some, or all, of the misstatements, the auditor must consider their reasons for refusing to correct them and take these into account when establishing whether the misstatements are material both in isolation and in the aggregate.

- Revisit the materiality levels calculated at the planning stage and, where applicable, revised during the detailed audit fieldwork to assess whether they remain appropriate at the completion stage having regard to the audit conclusions and evidence in each area.

- Report any uncorrected misstatements to those charged with governance and explain the effect that this may have on the audit opinion.

- Request a written representation from those charged with governance that they believe the effects of uncorrected misstatements are immaterial.

A copy of the uncorrected misstatements must be supplied to those charged with governance. This usually accompanies the letter of comment or is supplied beforehand.

8.1 Reporting

Once the above procedures have been completed, the auditor must consider the impact of the uncorrected misstatements on the audit opinion. Where the impact is immaterial, an unqualified opinion can be expressed. Where the impact is material, the qualification will all depend on the materiality and pervasiveness of the uncorrected errors.

If the uncorrected misstatements are material but not pervasive, a qualified 'except for' opinion may be expressed. If the uncorrected misstatements are material and pervasive an adverse or disclaimer of opinion may be expressed.

Uncorrected misstatements which are immaterial do not need to be dealt with in the auditor's report by way of an Emphasis of Matter paragraph. Some audit files have been criticised for including an Emphasis of Matter paragraph dealing with uncorrected misstatements. This is technically incorrect on two counts:

- Immaterial misstatements do not need to be brought to the attention of the shareholders because they are immaterial.

- An Emphasis of Matter paragraph is only used to draw attention to a fundamentally important issue that has been adequately presented or disclosed in the financial statements.

9 Communicating with management and those charged with governance

Communicating with senior members of the client's staff during the course of an audit is critical and should result in the performance of a good quality audit. Indeed, at the end of the audit, the auditor must consider whether the two-way communication between the client and the auditor has been effective enough to yield an adequate audit.

Two-way communication is important because it assists both the auditor and those charged with governance in understanding matters which are related to the audit as well as serving to develop a good constructive working relationship. In addition, effective communication between the auditor and the client is important so that the auditor can obtain the information needed to carry out the audit.

The auditor has specific reporting responsibilities to management and those charged with governance. Significant issues which arise during the audit and significant deficiencies in internal controls must be reported.

There are two specific ISAs (UK) which the auditor must comply with where communication is concerned:

- ISA (UK) 260 *Communication with Those Charged with Governance*
- ISA (UK) 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

'Those charged with governance' is defined as:

> *The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.*

ISA (UK) 260, para 10(a)

Those charged with governance includes the board of directors as a whole, including both executive and non-executive directors and the audit committee (if one exists). Those charged with governance are responsible for the strategic direction of the company and for overseeing management.

'Management' is defined as:

The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

ISA (UK) 260, para 10(b)

The individuals making up the management team of an organisation are responsible for the day-to-day operations. Management includes the executive directors but would not normally include the non-executive directors.

Those charged with governance and the management team are not always two separate groups of people. For example, in an owner-managed business the managing director meets the definition of both those charged with governance and management and it is likely that no one else is performing a governance role. The identity of the relevant person(s) to whom the communication will be addressed may be clarified in the engagement letter.

Example – Management and governance structures

Wrigley Ltd is a large mobile phone retailer with branches across the country and a head office in central London. It has 12 directors and approximately 50 shareholders. There is a small audit committee in place.

For Wrigley there are separate management and governance responsibilities. The directors will clearly have management responsibilities to run the company in the best interests of the shareholders. Those charged with governance will include the audit committee to whom the auditor will communicate any significant deficiencies in the entity's system of internal control. The auditor may also determine it necessary to discuss significant deficiencies in the system of internal control with the directors.

Contrast the governance structure of Wrigley with that of Bauer, which is a retailer of children's clothing. It operates from three stores in a vibrant city centre location. The company is owned by two shareholders: Les and Lisa, who are a married couple, and both are 50% shareholders in the business. In addition, Les and Lisa are the directors.

In this scenario, Les and Lisa act as both management and those charged with governance. There is no other person involved in a governance role.

In this particular structure, any matters required to be communicated to management need not be communicated twice (i.e. the matters don't also need to be communicated to Les and Lisa in their capacity as those charged with governance). However, the auditor needs to be satisfied that communicating with those individuals with management responsibilities adequately informs all of those with whom the

auditor would also communicate with in their governance capacity.

9.1 Communicating with those charged with governance

ISA (UK) 260 sets out the objectives of the auditor as follows:

ISA (UK) 260, para 9

(a) *To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;*

(b) *To obtain from those charged with governance information relevant to the audit;*

(c) *To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and*

(d) *To promote effective two-way communication between the auditor and those charged with governance.*

ISA (UK) 260 requires certain issues to be communicated as a minimum:

The auditor's responsibilities

This will usually be included in the engagement letter. This will include the scope of the audit and any specific responsibilities that have been agreed (e.g. reporting to regulators in certain industries).

Planning, scope and timing of the audit

Providing those charged with governance with information about how the audit is planned to take place will help them to understand practical issues such as timing of interim and final audit work. It also enables those charged with governance to ask questions about the planned audit approach. At the planning stage of the audit, the auditor will discuss significant risks and how the audit team plan to address those risks. However, care must be taken not to go into too much detail about the planned nature, timing and extent of audit procedures to the extent that audit procedures become too predictable.

Significant findings from the audit

These are the issues that are communicated towards the end of the audit, after the main audit fieldwork has been completed. However, even at this stage of the audit, the auditor may use this communication as a way to complete the audit evidence obtained, such as asking those charged with governance to confirm their understanding of particular facts or situations, such as going concern or a significant subsequent event.

ISA (UK) 260 provides a list of the significant findings from the audit which should be communicated as follows:

- The auditor's views concerning qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be the most appropriate to the particular circumstances of the entity.

- Significant difficulties, if any that have been encountered during the audit.

- Unless all of those charged with governance are involved in managing the entity:

    - significant matters arising during the audit that were discussed, or subject to correspondence, with management; and

    - written representations the auditor is requesting.

- Circumstances that affect the form and content of the auditor's report, if any.

- Any other significant matters arising during the audit that, in the auditor's professional judgement, are relevant to the oversight of the financial reporting process.

The point is that these matters must be brought to the attention of those people responsible for the accounting and financial reporting function of the entity. Those

responsible can then discuss the matters and decide any actions that need to be taken in respect of them. For example, if the management of the entity was totally unaware that a material misstatement exists within the financial statements, they can then resolve the problem by making the necessary adjustments. Those charged with governance must be given the opportunity to correct the financial statements in order to avoid a qualified auditor's opinion.

Auditor's independence

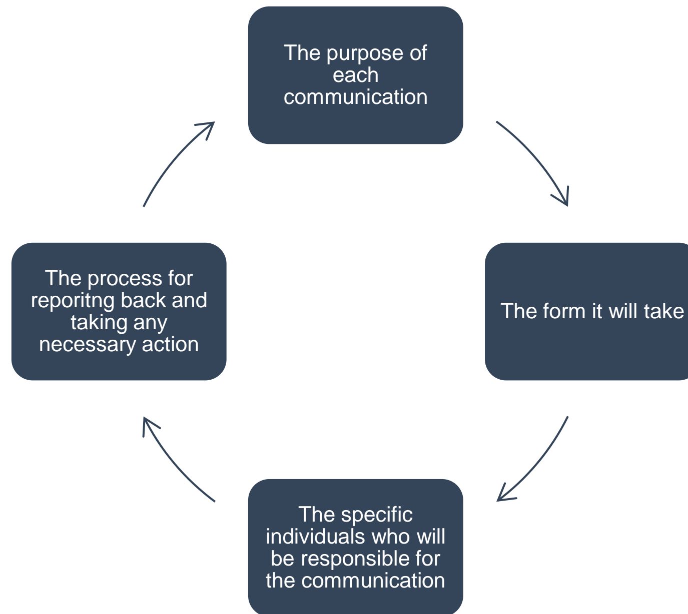
The matters communicated regarding independence should normally include a discussion of any threats to independence that arose during the audit and the safeguards that have been used to reduce those threats to an acceptable level. This communication is particularly important where the client has established an audit committee, as part of the remit of the audit committee is to have oversight on issues relating to auditor objectivity.

To put this into context, we can summarise some of the more notable communications that take place at each stage of the three stages of the audit process:

Stage of the audit	Communication
Planning	• Significant risks identified by the auditor • How the auditor plans to address those significant risks • Materiality and how it will be applied during the course of the audit • How (and the extent to which) reliance will be placed on internal controls
Audit fieldwork stage	Any situation that presents itself that warrants communication with management
Completion	• Major findings from the audit • Any un-cooperation from management or others within the entity from whom the auditor has requested information • Problematic issues discovered

9.2 The communication process

Given the importance of the issues that are discussed with those charged with governance, it is critical that the auditor establishes a clear communication process. Remember, that communication is a **two-way** process, so both the auditor and the client needs to be aware of:



While written forms of communication are generally most appropriate, ISA (UK) 260 does not require that all communications are in writing but does explain that for some issues, for example, significant findings from the audit, oral communication is unlikely to be adequate. Usually, matters are discussed at a meeting between the auditor and representatives of those charged with governance, so it is important that these meetings have accurate minutes to serve as a record of the discussion and action points agreed.

Effective communication could be made using a presentation by the auditor as well as less formal discussions. When communication is made orally it is important that the auditor has a written record within the audit working papers of the discussion of significant matters with management. Email serves as a written record of matters discussed.

9.3 Timing

In terms of timing of communications, significant issues should be communicated without delay (for example if a fraud has been discovered or significant deficiencies in internal control are discovered or the auditor faces a limitation in the scope of their

work which is imposed by management). Timely communication means that the problem can be quickly investigated and resolved.

9.4 Evaluating the two-way communication

ISA (UK) 260 requires the auditor to evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor must evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence and take appropriate action.

No specific procedures need to be performed as part of this evaluation. Instead, the effectiveness of the two-way communication can be assessed based on the auditor's observations. For example, of the ease by which matters have been resolved by those charged with governance, their willingness to meet with the auditor and the openness of discussions.

The auditor may determine that the two-way communication has **not** been effective. This may arise because audit issues have not been taken seriously by those charged with governance or because they have not appeared to understand the issues raised.

In such instances, the auditor is in a difficult position. The auditor may consider that there is a lack of integrity of those charged with governance; or just a lack of understanding of their responsibilities in relation to the audit. Either of these could have serious consequences for the audit.

In more serious situations, where those charged with governance have been severely un-cooperative, the auditor may consider qualifying the audit opinion due to a limitation of scope. They could also consider communicating with the shareholders, for example at the AGM, about the difficulties faced. They could even consider withdrawing from the audit and taking legal advice.

9.5 Communicating significant deficiencies in internal control

ISA (UK) 265 deals with how the auditor should report on problems that they have identified with the client's internals control to the client. This is not a communication to shareholders – the point of the reporting is to alert management to internal control deficiencies, explain why they are a problem and provide a constructive recommendation (usually via the 'management letter' or 'letter of comment').

According to ISA (UK) 265, a deficiency in internal control exists when:

(a) a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or

(b) a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

A 'significant deficiency' is defined in ISA (UK) 265 as:

> *A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.*

ISA (UK) 265, para 6

ISA (UK) 265, para 9 requires significant deficiencies to be notified to those charged with governance in writing. Deficiencies that are not considered to be significant should be reported to management if, in the auditor's professional judgement, the deficiencies are of sufficient importance to merit management's attention.

Examples of matters which the auditor would usually consider when determining whether a deficiency in internal controls is significant include:

- *The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.*
- *The susceptibility to loss or fraud of the related asset or liability.*
- *The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.*
- *The financial statement amounts exposed to the deficiencies.*
- *The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.*
- *The importance of the controls used in the financial reporting process, for example:*
    - *General monitoring controls (such as oversight of management).*
    - *Controls over the prevention and detection of fraud.*
    - *Controls over the selection and application of significant accounting policies.*
    - *Controls over significant transactions with related parties.*
    - *Controls over significant transactions outside the entity's normal course of business.*
    - *Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).*

ISA (UK) 265, para A6

- *The cause and frequency of exceptions detected as a result of the deficiencies in the controls.*
- *The interaction of the deficiency with other deficiencies in internal control.*

Example – Control deficiencies and the auditor's response

During the audit of Greaves Industries Ltd for the year ended 31 December 2023, the auditor came across several deficiencies in internal control and evidence of absent controls.

The audit manager and audit engagement partner have reviewed the audit evidence obtained and have concluded that the audit evidence is insufficient to support the audit opinion. The audit manager has asked the audit engagement partner if there is anything else that can be done to remedy the situation.

There are some options available to the audit team before concluding that the audit opinion should be qualified:

Extend controls testing

The audit team could extend the testing of controls in those areas where deficiencies have been noted. This could have the result that the controls are not as deficient as first thought, although absent controls will need to be communicated to management together with their implication.

Raise the issue with those charged with governance

If the auditor concludes that the deficiencies in internal control are significant deficiencies, they should be communicated with those charged with governance.

Perform additional substantive procedures

Remember, substantive procedures aim to detect misstatements in the financial statements. The audit team could perform additional substantive testing on areas where controls are weak. This is usually the best approach because substantive procedures will help to quantify the extent of errors and compensates for a weak control system.

Issue a qualified auditor's opinion

If the issue of a lack of audit evidence cannot be addressed by other means, the auditor will have no alternative but to express a qualified opinion. Depending on the

magnitude of the lack of audit evidence, a disclaimer of opinion may be appropriate.

Management letter points

Deficiencies in internal control will usually be addressed in the management letter to the client at the end of the audit. Depending on the number of deficiencies noted, and the level of detail provided on each, it may be included in the main body of the letter itself or as an appendix.

ISA (UK) 265 requires particular issues to be communicated in writing in respect of significant deficiencies in internal control:

ISA (UK) 265, para 11

(a) A description of the deficiencies and an explanation of their potential effects; and

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that:

(i) The purpose of the audit was for the auditor to express an opinion on the financial statements;

(ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the financial statements; and

(iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Example – Reporting significant deficiencies in internal control

Summer Superstores Ltd is a supermarket chain with over 350 stores across the country. It also has a significant online grocery division with over 450,000 regular customers.

During the audit, the audit senior made the following note during her review of the company's fixed assets procurement cycle:

While carrying out audit procedures, we found that only capital expenditure over

£35,000 is routinely approved by a senior manager. Capital expenditure in excess of £100,000 must go through a tendering process which involves at least three potential suppliers. When the suppliers sends the invoice for payment, the invoice is passed to the employee who requested the item to be purchased, who then approves the payment and passes the invoice to the finance department for processing.

There are some deficiencies in the fixed assets procurement cycle that must be brought to management's attention. This will usually be included in the form of a 'letter of comment' or 'report to management' which outlines the deficiency, the implication and the auditor's recommendation as follows:

Deficiency	**Implication**	**Recommendation**
Approval is not routinely sought for capital expenditure with a value under £35,000.	The company is exposed to the risk that items under £35,000 could be ordered which are not required by the business, incurring unnecessary cash outflows.	All capital expenditure requisitions should be reviewed and approved by a responsible official. A limit that is less than £35,000 may be more appropriate to reduce the risks.
Capital expenditure below £100,000 in value does not go through a tendering process.	Best prices may not be achieved resulting in the company paying too much for their assets. Value for money will not be achieved.	Management should review the threshold for requiring a tendering process and set a more appropriate, lower, level.

There is no segregation of duty in that the person who requested the item also approves the payment.	This creates a significant risk of fraud. There is nothing to stop employees ordering capital items for their personal use, e.g. new computer equipment and approving it for payment.	Segregation of duty should be introduced so that different individuals are responsible for ordering the items, receiving the goods and approving payment.

It is a matter of judgement as to how much detail the auditor should provide when communicating significant deficiencies. Providing sufficient detail, especially regarding the implications of control deficiencies, should encourage management to take action to address the deficiencies described.

The implications do not have to be quantified, though this could serve to indicate the severity of the issue and encourage management to take action.

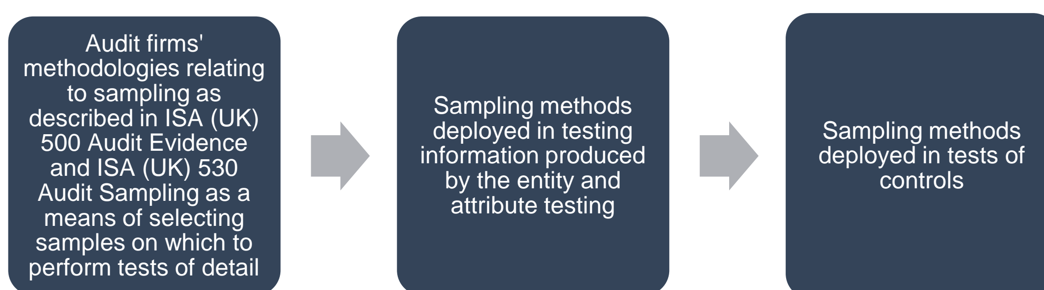
10 FRC thematic review on sampling (Lecture A857 – 11.28 minutes)

On 24 November 2023, the FRC published its thematic review of audit sampling. The FRC recognises that audit sampling is a fundamental tool for auditors which allow the auditor to draw conclusions about a population based on the sample selected.

The purpose of the thematic review is threefold. Its purpose is to:

- Identify common practice, concerns, and good practice across firms in the sample to drive improvement and support the FRC's monitoring of firms' system of quality management.
- Share findings to educate the wider audit market, as sampling has been an area of repeated Audit Quality Review findings for smaller firms.
- Support audit committees in understanding and evaluating the approach taken by audit teams.

The three key areas in scope of the review were:



10.1 High-level observations

Some high-level observations noted by the FRC are as follows:

- Audit sampling for tests of detail and controls is still widespread despite the increasing use of Audit Data Analytics.
- Most firms' methodologies are based on similar statistical models with firms building on these with their own guidance and preferences. This has led to substantial variation in the firms' final methodologies.
- This variation does not indicate one approach is better, but stakeholders, such as audit committees, need to be aware of these variances to understand how the firms obtain audit evidence.

- When applying these methodologies in practice, professional judgement is key, with significant professional judgements made throughout the use of audit sampling. Judgement is needed to use firms' sample size calculators, including to assess inherent risk and determine the contribution of evidence from other procedures. The extent of firms' guidance to support these judgements is variable.

- Previous Audit Quality Review findings, and the FRC's sample review of ongoing audit inspections, indicate sufficient evidencing of the key professional judgements made when determining sample sizes. Evidencing these key judgements is vital.

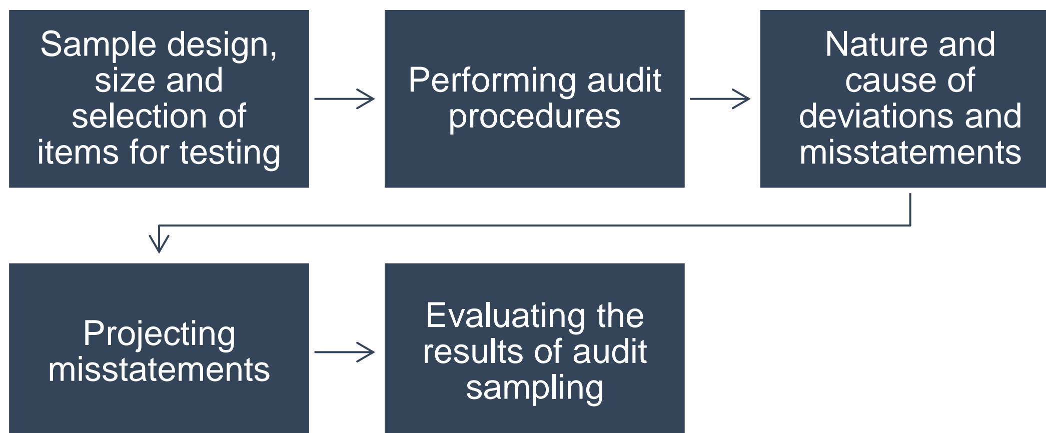
10.2 Objective of audit sampling

The objective of audit sampling is described in ISA (UK) 530, para 4 as follows:

> *The objective of the auditor, when using audit sampling, is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.*

ISA (UK) 530, para 4

ISA (UK) 530 then goes on to set requirements in relation to the following key areas:

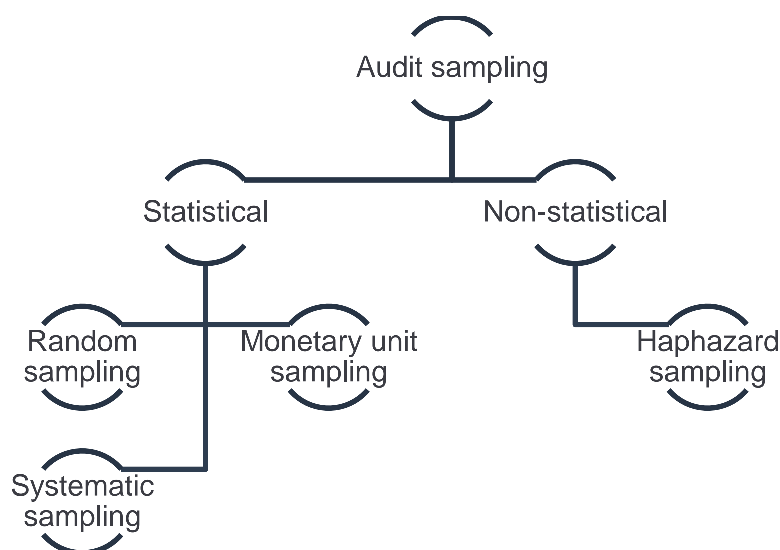


'Audit sampling' itself, is defined as:

> *The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.*

ISA (UK) 530, para 5

Audit sampling consists of **statistical** sampling and **non-statistical** sampling, a summary of which is shown below:



When reviewing firms' methodologies and guidance, the FRC noted no significant deficiencies in meeting the objectives of ISA (UK) 530. The methodologies applied by audit firms provided a range of statistical and non-statistical tools for engagement teams to use.

The FRC did note that most firms sampling methodologies are based on the American Institute of Public Accountants (AICPA) *Audit Sampling Guide* which introduces statistical and non-statistical sampling approaches and includes case studies, monetary unit sampling size tables and methods for projecting errors across the population. ISA (UK) 530 does not prescribe the AICPA's approach but the FRC acknowledge it has become the most common foundation model for the audit firms within its thematic review.

Only three firms made small additions to the AICPA approaches, usually in their approaches to calculating sample sizes, and their methodologies were very similar, or identical to those included within the AICPA sampling guide. Four other firms in the thematic review sample build significantly on the AICPA model with substantial additional guidance, case studies to assist engagement teams and stated preferences for certain approaches, while still enabling engagement teams to judge when other techniques may be appropriate.

Five firms in the FRC's thematic review sample did not express a preference for any approach over another when selecting samples for tests of detail and leave the method of sample selection to the engagement teams' judgement. One firm's methodology stated a preference for monetary unit sampling. This firm stated that it preferred monetary unit sampling as it can be easier to apply in a consistent manner. One firm had stated a preference for the use of non-statistical sampling although it noted that the outcomes are broadly consistent with established statistical principles.

Most firms made use of internally developed tools which facilitate the deployment of their sampling methodologies, including:

Sample size calculators

These range from reasonably simple spreadsheet-based tools to more complex bespoke solutions. Generally, engagement teams are required to input the population size and materiality, indicate if any key items or transactions are tested elsewhere and select the determined level of inherent risk. The engagement team is usually required to input if they obtained any evidence over the balance or transactions from other procedures, for example if they have performed tests of controls. Some tools will select a random sample for the audit team while other provide just a sample size and teams select items themselves.

Monetary unit sampling (MUS) tools

These tools are used at some firms to aid in the semi-automated use of MUS. These tools require similar inputs as more general sample size calculations but will typically select a sample automatically for the engagement team to examine.

The FRC note that although all methodologies have a statistical model as their basis, one of the key determining factors in effective audit sampling is professional judgement and the application of this judgement to key decisions made throughout the process, specifically around the following:

- **Level of inherent risk** – The level of risk attributed to a balance or series of transactions has a significant effect on the number of items selected when sampling as this is a key input into a sample size calculator. Balances or transactions at the lower end of the spectrum of inherent risk will require fewer samples to be tested for an engagement team to be able to conclude.

- **Level of evidence obtained from other procedures** – The amount of evidence obtained from other procedures has a significant impact on the sample size. Where engagement teams state that they have obtained assurance from other procedures (such as substantive analytical procedures), most firms' methodologies allow the engagement team to select smaller sample sizes.

10.3 Sampling in tests of details

The FRC found that sampling undertaken when carrying out tests of details forms only part of most audit firms' approaches to obtaining sufficient appropriate audit evidence. Substantive analytical procedures, audit data analytics and tests of controls are usually used alongside sampling to obtain sufficient appropriate audit evidence. Moreover, the overall amount of audit evidence is driven by the risk assessment of the balance being

audited, with audit teams typically placing balances or transactions at three or four points along the spectrum of inherent risk from significant risk to low risk.

The FRC found that audit firms often express this spectrum as a range of confidence levels (CL). Each of the risk levels (high, medium and low) are assigned a required CL that must be obtained through all sources of evidence for an engagement team to conclude that it has sufficient and appropriate audit evidence.

In the context of audit sampling, the CL is the % probability that the auditor is required to have that a balance is not materially misstated. For example, a test performed to a 95% CL is interpreted by the auditor to mean that there is a 95% probability that the balance being tested is not materially misstated. Generally, firms' methodologies require CLs are in the range of:

It should be noted that these are a generic representation of the levels used across the seven firms in the FRC's scope. Although no specific CL is required by the ISAs (UK), audit firms must be satisfied that a given CL is sufficient for obtaining evidence to support their conclusions over the specific risk.

Many firms attach a numerical measure to the procedures, other than the test of detail element, so that engagement teams are able to understand the extent of sampling required to reach a final conclusion on a balance. Generalised indicative ranges, based on the seven firms in the FRC's review, are explained below:

Type of procedure	CL % from other procedures	Observations
Controls testing over relevant assertions	Ranges across firms in scope	In most methodologies this is a binary choice to take controls reliance or not, though some firms allow for engagement teams to take enhanced reliance where they have tested additional controls above the minimum required.
Substantive analytical procedures	CL in the range of 40% to 60%	The CL obtainable is usually dependent on the tolerable difference between the actual amount and auditor's expectation. Substantive analytical procedure performed with a lower tolerable difference will usually

		generate higher amounts of evidence, for example to achieve a 60% CL, the difference between actual and the auditor's expectation would need to be very small.
Data analytics	CL in the range of 20% to 60%	The CL obtainable is dependent on the sophistication of the analytic being used and in instances where the analytic involves setting an expectation, how close that expectation is to actual.

The FRC recognise that in practice the calculation is usually undertaken within the audit firms' sample size calculator, where an engagement team is able to select the amount of evidence obtained from other procedures from drop-down boxes. Determining how much assurance is obtained from other procedures is challenging as CLs are calculated statistically by reference to populations and cannot easily be assigned to other types of procedures with a non-statistical basis. Some firms do not assign a numerical value and leave the determination of amount of evidence obtained to auditor judgement.

The FRC state that given the importance of this key professional judgement on the sample size calculator, audit firms should ensure they provide audit teams with sufficient guidance to support professional judgement in this area. Firms with less guidance and support should consider expanding it.

10.4 Key items selection and selecting specific items

The thematic review clarifies that selecting specific items is a means of selecting items to test where an auditor does not apply sampling techniques. Engagement teams select items based on their understanding of the entity, the assessed risk of material misstatement and the characteristic of the population being tested.

Most firms in the FRC's scope provide guidance to engagement teams on selecting key items, with a focus on high-value items and those which indicate an increased risk of fraud. Two firms provide limited guidance which focuses almost exclusively on the size of the items, with less consideration given to other risk factors. Two firms have substantially more detailed guidance than other firms on the range of factors that may indicate that something is a key item, with a particular focus on understanding the risks associated with items in the population.

AQR comments state that in several reviews, the FRC saw insufficient documentation of the reasons for selecting items either as key items when audit sampling, or as specific items. When the FRC did see justification, it was generally focused on size, such as 'selecting everything over 50% of performance materiality', with no consideration of why that was an appropriate threshold.

The AQR also notes that it did see good practice in one review, where they selected specific items for testing based on risk, understood the population well and documented their judgements and conclusions effectively.

10.5 Haphazard sampling

This type of sampling was historically most useful when transaction listings were not available in electronic format that would allow for random sampling. Today, transaction listings and trial balances can be exported into a format suitable for analysis and use in sampling tools and makes random sampling substantially easier to perform. However, there may still be instances where haphazard sampling is the most appropriate method, for example in a stock count when testing stock in a two-way direction.

The AQR have commented that it has seen confusion in the method of sample selection applied. The sample calculator stated 'random' as the means of sample selection, but 'haphazard' was actually used by the engagement team. This led, in some cases, to potentially inaccurate projection of errors and to improper consideration of bias in the sample.

In multiple reviews, the AQR saw no documentation or consideration of why haphazard sampling is the most appropriate method when random was clearly a plausible option and would have reduced bias.

The thematic review suggests that while haphazard sampling is permissible in the context of the ISAs (UK) and, in some cases, be the most appropriate sampling technique, firms' methodologies should actively encourage the use of random sampling over haphazard where it is feasible to do so.

10.6 Sampling methodologies for information produced by the entity (IPE) and attribute testing

IPE testing, in a similar manner to controls testing, uses fixed sample sizes, with engagement teams using these samples to ensure that reports provided to them by the client are reliable. For example, it could be used to test completeness by ensuring that supplier invoices are included in the creditors report.

Attribute testing is used to gather sufficient evidence to either accept or reject a characteristic of interest (i.e. a 'correct' or 'incorrect' conclusion). It does not provide evidence over the monetary amount within a population. For example, attribute testing can be used to test if a sample of sales invoices have had the correct rate of VAT applied to them.

Some firms' methodologies allow engagement teams to test IPE by either testing the controls relevant to the report or by performing tests of details on the report itself. Other firms only allow engagement teams to make use of test of details approaches,

though often with fixed sample sizes. Even at those firms where testing controls is an available approach, tests of detail has been the approach most commonly seen by AQR inspections.

These approaches are summarised below:

Approach 1: Test of controls

- Test controls relevant to the extraction of the information from the system.
- Approach to calculating sample size is firm dependent:
  - sample sizes used for test of controls; or
  - other fixed sample size.
- Deviations are addressed in line with controls testing methodology and the number of deviations planned in testing. This may involve concluding the information is NOT reliable if deviations indicate controls cannot be relied upon.

Approach 2: Tests of detail

- Test the detail of the report, agreeing a sample back to the system.
- Approach to calculating sample size is firm dependent:
  - sample size calculator used for test of details; or
  - specific IPE sample calculator; or
  - Fixed sample size.
- Errors are addressed in line with tests of detail methodology. This may involve concluding the information is NOT reliable where errors are found and are not determined to be isolated.

Most firms in the FRC's thematic review included guidance within their methodology on how to undertake dual-purpose testing. Dual-purpose testing is where an engagement team selects a sample and performs both IPE or attribute testing and undertakes additional procedures to obtain assurance over the monetary value of the population.

Firms without extensive additional guidance and case studies within their IPE and/or attribute testing methodologies should consider how their inclusion could support more effective deployment of IPE testing, especially more complex techniques such as dual-purpose testing.

10.7 Controls testing and sampling

ISA (UK) 330 *The Auditor's Responses to Assessed Risks* defines a 'test of control' as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

All firms' methodologies in the review included controls testing as a tool available to engagement teams, though two firms explained that they use controls testing less routinely as their clients typically have less mature control environments.

All audit firms provide guidance to staff on selecting a sample of control occurrences to test. Two audit firms have a separate sample size set by a central team, specifically to be used for testing a control operating multiple times a day where a deviation is expected. Other firms do not have a centrally set sample size for that situation, but would expect engagement teams to consult a sampling expert if they were anticipating control deviations.

The FRC emphasise that as with audit sampling in substantive testing, the application of appropriate professional judgement is the key to ensuring the effective use of audit sampling methodology in test of controls. Firms should ensure that engagement teams understand the importance of appropriate professional judgements and are able to evidence their judgements appropriately.

10.8 Sampling and ISQM (UK) 1

All the firms in the FRC's thematic were driven by a global methodology, usually developed centrally outside the UK.

Three firms relied heavily on their global methodology teams to address the FRC's questions and the FRC were surprised by the extent to which some firms relied on them to explain how underlying statistical models were used to develop methodology applied in the UK.

ISQM (UK) 1 states that even when firms belong to networks and make use of resources, the firm 'remains responsible for its system of quality management, including professional judgements made in the design, implementation and operation of the system of quality management.

To that end, the FRC emphasise that firms must ensure they have a proper and full understanding of the sampling techniques developed globally and are able to understand and apply those methodologies in the UK.

In addition, the FRC's thematic review notes that some firms struggled to explain how their methodologies were developed from more general statistical models, often due to the time that had elapsed from the model's original development. Audit firms must ensure that their understanding of how their methodology relates to key statistical concepts is current.