Audit and Accounting Quarterly Update – January 2024

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1 FRED 84 issued (Lecture A838 – 1.52 minutes)

On 28 September 2023, the Financial Reporting Council (FRC) published FRED 84 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Supplier finance arrangements*.

A 'supplier finance arrangement' is one where a finance provider offers to pay an entity's suppliers and the entity then agrees to pay according to the terms and conditions of the arrangements at the same date as, or a date later than, the suppliers are paid. Effectively, this provides the entity with extended credit terms which serves to improve cash flow. It can also work the other way, whereby the entity's suppliers are paid earlier than the related due date of the invoice.

Currently, FRS 102 provides no disclosure requirements on these sorts of arrangements. Consequently, the FRC recognises that users are not informed about the entity's use of supplier finance arrangements and the impact these have on the entity's financial position and cash flows.

The amendments proposed in FRED 84 are based on the IASB's® amendments to IAS® 7 *Statement of Cash Flows* which was issued in May 2023. These amendments added disclosure requirements to IAS 7 and IFRS® 7 *Financial Instruments: Disclosures*. However, the FRC have not proposed to include additional disclosure requirements based on those introduced in IFRS 7 on the grounds that these relate to the requirements on liquidity risk. Liquidity risk is not specifically addressed in FRS 102, other than for financial institutions.

As the amendments are proposed to be made to FRS 102, Section 7 *Statement of Cash Flows*, small entities and qualifying entities taking advantage of the disclosure exemption from the requirements of Section 7 will not be impacted by the proposed changes.

1.1 Proposed changes

The FRC propose to introduce paragraph 7.20B which provides a description of what is, and what is not, a supplier finance arrangement. The paragraph recognises that arrangements which are credit enhancements, such as financial guarantee contracts, or financial instruments which are used to settle directly with a supplier (such as a credit card) are not supplier finance arrangements.

Paragraph 7.20C is then proposed which sets outs the disclosure requirements as follows:

An entity shall disclose in aggregate for its supplier finance arrangements:

FRED 84, draft para 7.20C

(a) the terms and conditions of the arrangements (eg extended payment terms and security or guarantees provided). However, an entity shall disclose

separately the terms and conditions of arrangements that have dissimilar terms and conditions;

(b) as at the beginning and end of the reporting period:

*(i) the **carrying amounts** and associated line items presented in the entity's statement of financial position of the **financial liabilities** that are part of a supplier financing arrangement;*

(ii) the carrying amounts, and associated line items, of the financial liabilities disclosed under sub-paragraph (i) for which suppliers have already received payment from the finance providers; and

(iii) the range of payment due dates (eg 30-40 days after the invoice date) for both the financial liabilities disclosed under sub-paragraph (i) and comparable trade payables that are not part of a supplier finance arrangement. Comparable trade payables are, for example, trade payables within the same line of business or jurisdiction as the financial liabilities disclosed under sub-paragraph (i). If ranges of payment due dates are wide, an entity shall disclose explanatory information about those ranges or disclose additional ranges (eg stratified ranges); and

*(c) the type and effect of non-cash changes in the carrying amounts of the financial liabilities disclosed under sub-paragraph (b)(i). Examples of non-cash changes include the effect of **business combinations**, exchange differences or other transactions that do not require the use of cash or cash equivalents (see paragraph 7.18).*

1.2 Proposed effective date and transition

The FRC propose to bring these requirements in for accounting periods commencing on or after 1 January 2025. The FRC does not expect that entities will need a significant amount of time to prepare the required information and early adoption of the amendments will be permissible.

It should also be noted that FRED 84 proposes relief from providing comparative information in the first year of adoption, including in respect of the opening balance information for the amounts which suppliers have received payments and the range of due dates.

2 FRC Annual Review of Corporate Reporting (Lecture A839 – 8.17 minutes)

On 5 October 2023, the FRC published its *Annual Review of Corporate Reporting* ('the Review') which reports the findings of the FRC's monitoring activities, together with expectations for the forthcoming reporting season.

While the Review is primarily concerned with public interest entities and listed companies, the feedback from the Review can be used by UK and Ireland GAAP preparers on the grounds that FRS 102 is broadly aligned to the requirements of IFRS Accounting Standards.

The FRC reviewed 263 sets of company reports and wrote to 112 companies raising queries about their accounts. Following these enquiries, 25 companies were required to restate their financial statements.

The quality of financial reporting has been maintained and the FRC report improvements in a number of areas such as Alternative Performance Measures (which has fallen out of the 'top ten' issues for the first time in several years). However, the most frequently raised issues in 2022/23 were impairment, and judgements and estimates. The FRC suspect this may reflect the heightened economic uncertainties which companies should factor into their financial reporting.

The focus of the FRC's work during 2022/23 was on companies in sectors that the FRC considered were of higher risk as follows:

- Travel, hospitality and leisure
- Retail
- Construction and materials
- Gas, water and multi-utilities

In 2023/24, the FRC will focus on the following sectors:

- Travel, hospitality and leisure
- Retail and personal goods
- Construction and materials
- Industrial transportation

2.1 The 'top ten' issues

The FRC ranks the topics which frequently result in a substantive question to companies, and these were as follows:

1. Impairment of assets

Companies must ensure that key inputs and assumptions applied in impairment testing have been disclosed and explained.

This must include relevant values and a sensitivity analysis, where required.

The FRC has reminded companies that additional disclosures are required where headroom is low, and heightened uncertainties over inflation, consumer demand and interest rates may drive a wider range of reasonably possible outcomes for future cash flows and discount rates.

Companies are reminded that users should be able to understand how assumptions are consistent with the discussion of uncertainties elsewhere in the annual report.

In addition, the FRC reminds companies to ensure that impairment testing methodology complies with the requirements of IFRS, in particular:

- that the grouping of assets into cash-generating units is appropriate;
- the treatment of inflation in the discount rate and cash flows is consistent; and
- cash flows used in 'value in use' calculations reflect the current condition of assets before any future enhancement expenditure.

2. Judgements and estimates

Companies are required to ensure that all significant judgements, including those applied in performing going concern assessments, have been adequately described. It will not be sufficient to simply list the matters that require judgement.

There should be adequate disclosures concerning estimates, including values, sensitivities and an explanation of significant changes. All sources of estimation uncertainty with a significant risk of resulting in a material adjustment within one year should be clearly distinguished from other estimates.

Companies are also reminded to reassess disclosures on an annual basis to ensure all relevant matters are captured, immaterial issues are not rolled forward and the assumptions and ranges of reasonably possible outcomes remain appropriate in the company's individual circumstances.

3. Cash flow statements

Down from the 'number one' spot to number three in 2022/23, cash flow statements still appear to be causing issues for some reporting entities. The FRC emphasises the need for a robust pre-issuance review to be performed prior to publishing the annual report.

A drop from the number one spot in the previous year to number three confirms the FRC have found fewer 'routine' errors, but they continue to identify basic consistency checks when they compare the cash flow statement to other information in the financial statements. Other errors the FRC have noted during their desktop reviews relate to classification, netting and reporting non-cash movements in the cash flow statement.

4. Strategic report and other Companies Act 2006 matters

No surprises here as the strategic report tends to raise issues for many companies (including private ones). The FRC reminds companies that the strategic report must provide a fair, balanced and comprehensive review of the company's development, position, performance and future prospects.

This should include an **unbiased** discussion about:

- both positive and negative aspects of the business;
- a clear articulation of the effects of economic uncertainty on the business; and
- should address significant movements in the financial statements (including those in the cash flow statement and balance sheet).

The FRC has also reminded companies to ensure that all statutory requirements for the payment of dividends have been met. This includes ensuring the requirement to file interim accounts where distributions are not supported by the most recent audited accounts.

5. Financial instruments

Down from the number two spot to number five in 2022/23 are financial instruments. Again, no surprises here because these also seem to cause problems for many companies. Companies must ensure that material risks arising from financial instruments are adequately disclosed together with how these risks are managed. This includes risks driven by inflation and rising interest rates as well as any related hedging instruments.

Companies are also reminded to provide adequate information concerning banking covenants. The exception to this requirement would be where the likelihood of any breach is considered remote.

6. Income taxes

Any forward-looking assessments which support the recovery of deferred tax assets must be based on appropriate assumptions concerning future taxable profits. Deferred tax assets arising from utilised tax losses have always been a contentious issue due to accounting standards taking a pessimistic approach to their recognition. To that end, the FRC reminds companies that where the company has been loss-making, the nature of the **convincing evidence** supporting recognition of the deferred tax asset must be disclosed.

Companies must also ensure that tax-related disclosures throughout the report and accounts are consistent. Material reconciling items in the effective tax rate reconciliation should also be adequately explained.

7. Revenue

It should not come as a shock that one of the issues is in relation to accounting policies. The FRC has reminded companies that accounting policies must be provided for all significant revenue stream. These policies should describe the methodology applied, including the timing of revenue recognition, the basis for recognising any revenue over time, and any significant judgements made in applying those policies.

Where there are any inflationary features contained in customer contracts, these should be adequately described in the financial statements together with the corresponding accounting treatment.

8. Provisions and contingencies

Companies must ensure they provide clear and specific descriptions of the relevant exposure. This includes the basis for determining the best estimate of the relevant cash outflow and the timeframe over which it is expected to crystallise.

The FRC has also found it necessary to remind companies to ensure the calculation and presentation issues comply with IFRS. This is also an issue that UK and Ireland GAAP preparers can take on board as well. Remember, the provision cannot be presented in the balance sheet net of any reimbursement asset. The FRC has also reminded companies to ensure that a consistent approach is taken when reflecting the effects of inflation in cash flows and discount rates.

9. Presentation of financial statements

The financial statements must contain **company-specific** information concerning material accounting policies and transactions. This information must also explain how the policies apply to the company's particular circumstances.

The FRC have also reminded companies to ensure that the financial statements are carefully reviewed. Common issues found during the FRC's reviews include:

- errors in the classification of inter-company receivables balances between current and non-current; and
- a failure to disclose material impairments of receivables on the face of the income statement (profit and loss account).

10. Fair value measurement

Finally, at number ten, is fair value measurement. There is no change in position for this one.

The FRC has reminded companies to ensure that fair value measurements use market participants' assumptions and provide high-quality disclosures. The FRC has found the most issues in the disclosure of recurring Level 3 measurements, for which the significant unobservable inputs should be quantified, and a sensitivity analysis provided.

The FRC has also reminded companies to consider the need for specialist third-party advice where there is no internal expertise available.

3 Economic Crime and Corporate Transparency Act (Lecture A840 – 19.29 minutes)

On 26 October 2023, the Economic Crime and Corporate Transparency Act 2023 ('the Act') received Royal Assent and became law. The Act introduces several wide-ranging reforms with the objective of tackling economic crime and improving transparency over corporate entities. However, it should be emphasised that at the time of preparing these notes, secondary legislation was needed to implement a majority of the measures contained in the Act and the timing of this secondary legislation is unclear. There will also be changes made to the systems at Companies House to deal with the Act.

The Act builds on the Economic Crime (Transparency and Enforcement) Act 2022 which was introduced in light of Russia's invasion of Ukraine. Together, these Acts provide additional powers to tackle money laundering and other unorthodox acts. The long-awaited Companies House reforms also form part of the Act.

As a high-level overview, the new measures include:

- Reforms that prevent the abuse of limited partnerships.
- New powers to enable the seizure and recover suspected crypto assets.
- Reforms to provide businesses with more confidence to share information and tackle economic crime.
- A new 'Failure to Prevent Fraud' offence which will only apply to large corporates.
- New identity verification for registered company directors, people with significant control and those who file on behalf of companies.
- Improvements to the information filed on the public record (ie, financial information) so that it is more accurate.
- The Registrar will have more effective investigation and enforcement powers.
- Introducing better cross-checking of data with other governmental bodies.
- Enhancing the protection of personal information sent to Companies House.
- New filing requirements for small companies.

3.1 Failure to Prevent Fraud

A new offence of 'Failure to Prevent Fraud' has been introduced by the Act. This will hold an organisation to account if they profit from fraud committed by their employees.

Potentially, this new offence is very unusual and very significant because it is a strict liability criminal offence.

This new offence essentially builds on the existing offence of failure to prevent bribery under the Bribery Act 2010 and a failure to prevent the facilitation of tax evasion under the Criminal Finances Act 2017. Secondary legislation is awaited where this new offence is concerned (in particular guidance is awaited on the 'reasonable procedures' defence to the offence).

As noted earlier, this offence only applies to larger companies and partnerships which meet at least two of the following criteria in the financial year preceding the year of the fraud offence:

- more than 250 employees;
- more than £36 million turnover; and/or
- more than £18 million in total assets on the balance sheet.

An organisation which is the parent undertaking of a group will also be within scope of the offence when it meets at least two out of the following criteria in the financial year preceding the year of the fraud offence:

- an aggregate turnover of over £36 million net (or £43.2 million gross);
- total assets over £18 million net (or £21.6 million gross); and/or
- more than 250 aggregate employees.

Under the Act, such an organisation will be liable if it fails to prevent a specified fraud where:

- an 'associated person'[1] of the organisation commits the fraud; and
- the fraud is intended to benefit the organisation or a person to whom services are provided on behalf of the organisation.

An important point to emphasise where this offence is concerned is that it is not confined to just the UK. If an associated person commits fraud under UK law (or targets UK victims), the organisation can be prosecuted even when the organisation and associated person are based overseas.

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[1] An 'associated person' is defined as an employee, agent or subsidiary of the organisation (as well as any others who perform services for, or on its behalf). This is broader than the definition in the Bribery Act 2010, which includes a rebuttable presumption that an employee is an associated person, but in relation to agents and subsidiaries applies a test to determine if the associated person performs services for, or on behalf of, the organisation in the circumstances.

Schedule 13 to the Act contains specific fraud offences which includes:

- fraud by false representation;
- fraud by abuse of position; and
- fraud by failing to disclose information.

Secondary legislation can be passed by the government which can add or remove offences from Schedule 13.

An organisation will have a defence where it can show it had either 'reasonable procedures' in place to prevent the fraud; or that it was not reasonable for the organisation not to have such procedures in place.

As noted earlier in this section of the notes, the government will need to publish guidance on what it considers to be 'reasonable procedures' in this regard. Organisations caught under the scope of this new offence will need to carry out a risk assessment to re-examine their fraud detection and prevention procedures.

3.2 New identity procedures

New identity (ID) procedures for individuals are brought in by the Act with the aim of improving the information at Companies House. This will apply to all new and existing directors registered at Companies House, People with Significant Control (PSCs) and those who are delivering documents to Companies House.

The verification procedures will be carried out either by Companies House itself (using electronic ID checks) or by an authorised company service provider (eg, an accountancy firm using normal Anti-Money Laundering Regulations protocol).

Again, secondary legislation will need to be published by the government and an update of the systems at Companies House to enable relevant ID checks to be carried out.

3.3 Filing requirements

Probably *the* issue of most interest to accountants acting for small and micro-entities.

The first thing to note is that small companies will no longer have the option to prepare and file abridged accounts. The Act also removes the option to file 'filleted' accounts. Instead, small companies will be required to file **both** the profit and loss account and directors' report. Micro-entities will be required to file their profit and loss account (although there is no requirement for micro-entities to prepare a directors' report, hence there will be no need to lodge one at Companies House).

It has been difficult for Companies House to determine whether an exemption taken by the company was valid. For example, whether the entity is, in fact, a micro-entity, or not, because the profit and loss account was not lodged with the Registrar so one of the criteria for taking the exemption was unavailable. The Registrar was therefore reliant on the two remaining criteria (being balance sheet total and employee numbers) so provided these were within the limits, the Registrar had to accept the exemption was available.

The Act includes provisions which allow the Registrar to make the profit and loss accounts of small or micro-entities (or parts thereof) unavailable for inspection. This may provide some element of relief for those concerned about trading information becoming publicly available which could be deemed ‘commercially sensitive’. Hence, filing the profit and loss account with Companies House will enable them to verify that companies are filing the accounts correctly (ie, the company is, in fact, a micro-entity or small hence relevant exemptions taken by the entity are valid). We are currently waiting on the regulations, so there is still uncertainty concerning how this will be finally implemented.

Many small companies and micro-entities are currently entitled to claim audit exemption. Where advantage of audit exemption is taken, a statement under s477 of the Companies Act 2006 is required to made on the balance sheet. The Act includes a further requirement where companies (including dormant companies) claim audit exemption. This additional statement must identify the exemption being taken and confirming that the company qualifies for the exemption.

3.4 Register of Overseas Entities

The Register of Overseas Entities aims to enhance transparency around aspects of ownership. Where an entity does not declare their beneficial owner, they will face restrictions on selling their property. Where it can be proven that a person has broken the rules, they can face up to five years in prison.

This particular register came into force in August 2022. All companies on the register will need to lodge an updated statement on an annual basis confirming that the information held by Companies House is correct and up to date. This is required even if nothing has changed. Entities on the register should note that it is a criminal offence not to file the updated statement and the offence is punishable by prosecution or a financial penalty should they not file.

4 FRS 102 versus FRS 105 (Lecture A841 – 8.39 minutes)

The two 'main' accounting standards in the suite of UK and Ireland GAAP consist of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Both standards are applied widely throughout the UK and Republic of Ireland and questions often arise as to the suitability of each standard depending on whether the client is a micro-entity or small entity. This section of the course considers the differences between the two standards to help aid practitioners in advising clients as to the appropriateness of each one.

The section has been written in the context of a micro-entity that is eligible to apply *either* FRS 102 or FRS 105. It also looks at the factors to consider when a small company contracts so that becomes eligible to use FRS 105.

At the outset it is worth noting that FRS 105 is an optional standard. Just because a micro-entity may be eligible to use FRS 105 does not mean it has to (and there are genuine reasons why FRS 105 may not be appropriate to a micro-entity). FRS 105 should therefore be considered on a case-by-case basis.

4.1 FRS 102

FRS 102 contains a separate section in the form of Section 1A *Small Entities*. FRS 102, Section 1A only deals with the presentation and disclosure requirements applicable to an entity eligible to report under Section 1A. Recognition and measurement principles are dealt with in full FRS 102.

The idea of this is that if a small company outgrows Section 1A (ie, it becomes, say, a medium-sized entity) then the disclosure requirements become more comprehensive as they are based on individual sections of FRS 102 rather than Section 1A. The recognition and measurement of amounts are still the same hence this avoids having to restate prior year comparatives (ie, do a transition).

FRS 102, Section 1A contains the disclosures required by company law. The section itself is optional – a small company need not apply Section 1A if they do not wish to, although most small entities do choose to apply Section 1A. If the company grows from small to medium-sized, Section 1A will not apply.

The same recognition and measurement principles apply to all entities, regardless of size, that report under FRS 102. Therefore, a micro-entity choosing to report under FRS 102 will use the same recognition and measurement principles as a large entity. You cannot 'cherry pick' between standards so a micro-entity that chooses to report under FRS 102 cannot then apply certain provisions of FRS 105.

There is one exception to full recognition and measurement principles which is available only to small entities (including small LLPs) in FRS 102, para 11.13A which relates to a loan to a small entity.

FRS 102, para 11.13A allows a small entity which receives a loan from a person who is within a director's group of close family members (as defined in the Glossary to FRS 102), when that group of close family contains a least one shareholder, to recognise the loan at transaction price (ie, at cost).

In practice, this would apply to a loan provided by a director-shareholder/a member of the close family of the director, which is covered by formal terms, and which is at below market rates of interest. The exception in paragraph 11.13A means the small entity does not have to impute a market rate of interest and then discount the loan on initial recognition. If the loan does not contain formal loan terms, then it need not be discounted in any event because it would be repayable on demand, so would be recognised as a current liability in the entity's financial statements. This is an accounting policy choice, and a small entity can choose to apply discounting to the loan if it wishes.

FRS 102, Section 1A contains five **encouraged** disclosures which preparers cannot disregard which are found in Appendix E *Additional disclosures encouraged for small entities* as follows:

FRS 102, para 1AE.1

(a) a statement of compliance with this FRS as set out in paragraph 3.3, adapted to refer to Section 1A;

*(b) a statement that it is a **public benefit entity** as set out in paragraph PBE3.3A;*

*(c) the disclosures relating to **material** uncertainties related to events or conditions that cast significant doubt upon the small entity's ability to continue as a **going concern** as set out in paragraph 3.9;*

(d) dividends declared and paid or payable during the period (for example, as set out in paragraph 6.5(b)); and

*(e) on first-time adoption of this FRS an explanation of how the transition has affected its **financial position** and financial performance as set out in paragraph 35.13.*

Proposed amendments via the periodic review

As noted in previous updates, the FRC is proposing to extend the mandatory disclosures for small entities in the UK. It is now able to do this given that the UK has now left the EU and hence is no longer subject to the EU Accounting Directive. The disclosures expected to become mandatory are as follows:

- A requirement to make an explicit and unreserved statement of compliance with FRS 102, including Section 1A. Currently this is an encouraged disclosure (FRS 102, para 1AE.1(a)).

- Mandatory going concern disclosures to comply with para 3.8A, which states:

When an entity prepares financial statements on a going concern basis, it shall disclose that fact, together with confirmation that it has considered information about the future as set out in paragraph 3.8. It shall also disclose, in accordance with paragraph 8.6, any significant judgements made in assessing the entity's ability to continue as a going concern.

FRS 102, para 3.8A

In addition, the small entity will be required to provide disclosures relating to material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern as set out in paragraph 3.9. Currently, this is an encouraged disclosure (FRS 102, para 1AE.1(c)).

- Disclosures in respect of leasing arrangements, including short-term leases, leases of low-value assets and variable lease payments.
- Disclosures in respect of:
    - provisions and contingencies;
    - share-based payment transactions;
    - promises in contracts with customers; and
    - deferred tax.
- Dividends declared and paid or payable during the period. Currently this is an encouraged disclosure (FRS 102, para 1AE.1(d)).
- Transition information on first-time adoption of FRS 102. Currently this is an encouraged disclosure (FRS 102, para 1AE.1(e)).

Currently, these additional mandatory disclosures are expected to apply to small entities preparing their financial statements under FRS 102, Section 1A for accounting periods commencing on or after 1 January 2026.

4.2 FRS 105

FRS 105 is viewed as a 'compliance framework' rather than a 'true and fair framework'. The standard is prescriptive and includes much simpler recognition and measurement principles and a vastly reduced disclosure regime (for UK-based micro-entities at least). There is only one format permitted for the profit and loss account (a Format 2 profit and loss account which presents expenses by nature) and there is no requirement for additional primary financial statements to be presented.

A notable feature of FRS 105 is the presumption in law that if the micro-entity's financial statements are prepared in accordance with the minimum legal requirements (i.e. FRS 105), the financial statements are presumed in law to give a true and fair view. This means the directors need not consider making any additional disclosures, beyond those required in the standard, to achieve a true and fair view.

Other notable simplifications in the standard are shown in the following table:

Transaction	Simplification
Deferred tax	Micro-entities are prohibited from accounting for deferred tax.
Revaluations and the use of fair values	Micro-entities cannot revalue assets; nor can they apply fair value accounting. This is because the Alternative Accounting Rules and Fair Value Accounting Rules are prohibited in the micro-entities' legislation.
Equity-settled share-based payments	Micro-entities need not account for equity-settled share-based payments prior to the issue of the shares. This is because of the prohibition in using fair values (see above) and the lack of disclosures.
Defined benefit pension plans	These are accounted for in the same way as defined contribution pension plans, ie, contributions into the plan are accounted for as an expense. A liability is recognised in respect of any agreement to fund a deficit (a Schedule of Contributions) because the pension obligation is not presented on the balance sheet.
Foreign currency	There is no distinction between functional and presentation currency and the micro-entity must use contracted rates to translate assets and liabilities denoted in a foreign currency rather than the closing rate.
Borrowing and development costs	All borrowing and development costs must be expensed to profit or loss when they are incurred. There is no option to capitalise such costs as micro-entities are afforded no accounting policy choices.

Government grants	These are recognised under the accrual model. The performance method of grant recognition is prohibited under FRS 105.
Financial instruments	Micro-entities are not required to use the effective interest method as this is considered to be too onerous for micro-entities. Financial instruments are recognised and measured at transaction price (ie, cost).
Imputed market rates of interest	Imputed market rates of interest are not required. The costs of applying this treatment would outweigh the benefits for micro-entities.
Recognition of separately identifiable intangible assets in a trade and asset acquisition	This is not required under FRS 105 because they are not required items in the financial statements.
Hyperinflation	The accounting issues relating to hyperinflation are not included as it is likely to be irrelevant for micro-entities.
Specialised activities	This consists only of agriculture. Activities such as extractive industries, service concessions, heritage assets and funding commitments are unlikely to apply to micro-entities.

4.3 Transitioning between frameworks

Applying the correct financial reporting framework at the outset cannot be over-emphasised. Over the years, a common question asked by practitioners is whether FRS 102 could be applied in year 1, then if appropriate, FRS 105 in year 2, switch back to FRS 102 in year 3 and so on. This is not how the standards are designed to work.

A micro-entity (which is eligible to use FRS 105) should consider all the benefits and drawbacks of the standard before deciding on applying the standard. If, for example, the micro-entity has an investment property on the balance sheet and the directors want to reflect the property's fair value at each reporting date, FRS 105 will not be appropriate because the investment property must be measured at cost less depreciation less impairment under that standard. Similarly, if an entity has a history of revaluing certain fixed assets, then FRS 105 will also not be appropriate and the micro-entity should be advised to report under FRS 102, including applying the presentation and disclosure requirements of Section 1A if they wish.

Some micro-entities do outgrow FRS 105 and therefore will need to transition to FRS 102 (including Section 1A, if applicable). Conversely, some small entities will contract and hence become eligible to use FRS 105.

Whenever there is a switch between financial reporting frameworks, a transition must be carried out. This involves restating the transition date balance sheet (ie, the opening balance sheet position at the start date of the comparative year) and then restating the closing comparative year to comply with the requirements of FRS 102 or FRS 105.

The table below provides some non-comprehensive factors to consider when switching between frameworks:

From FRS 102 to FRS 105	From FRS 105 to FRS 102
Remove any fair values and revalued amounts (a revaluation reserve should never be seen on a micro-entity's balance sheet).	Consider additional accounting policies permitted in FRS 102, such as revaluing fixed assets and capitalising development expenditure. Also FRS 102 requires all investment property (except intra-group investment property) to be measured at fair value.
Remove any deferred tax balances.	Recognise deferred tax balances.
Apply the disclosure requirements per FRS 105 (which does not include issues such as related party transactions and transitional information).	Consider whether the entity will apply the presentation and disclosure requirements of Section 1A or whether full FRS 102 disclosures are to be made (related party disclosures are limited under Section 1A but are more comprehensive under Section 33 *Related Party Disclosures* and the disclosure of transitional information is encouraged).
Restate foreign exchange assets and liabilities to contract rate where applicable.	Only use closing rate for such assets and liabilities – contracted rates are not allowed under FRS 102.
Present the profit and loss account in Format 2.	Use a Format 1 (expenses by function) or Format 2 (expenses by nature) presentation.
Remove additional statements such as the	Small entities are encouraged to present a

statement of changes in equity and other comprehensive income statement.	statement of changes in equity and other comprehensive income statement.
Restate basic financial instruments as the effective interest method is not permitted.	Basic financial instruments are measured at amortised cost using the effective interest method. A small entity can apply the simplification in FRS 102, para 11.13A(a) for directors' loans to the entity at below market rates.
Remove transactions related to equity-settled share-based payment transactions that have not yet been issued.	Recognise equity-settled share-based payment transactions even if the shares have not yet been issued.
Remove the defined benefit pension liability and account for the defined benefit pension plan as a defined contribution plan but recognise a liability in respect of an agreement to fund a deficit in the form of a schedule of contributions.	Remove the liability in respect of an agreement to fund a deficit in the form of a schedule of contributions and apply defined benefit accounting (ie, bring the defined benefit obligation onto the small entity's balance sheet).

This section has considered some of the more notable issues relating to FRS 102 and FRS 105 and how they interact with each other – especially when it comes to transitioning between the frameworks. The section has not covered every eventuality and preparers must, therefore, have a sound understanding of the differences of each framework in order to advise their client of the most appropriate framework correctly.

5 Share restructures

Many companies undertake share restructures, and such a restructure may need a special resolution to be in place. A company may choose to restructure its shares and issue different classes of shares for a variety of reasons, typically:

- to raise capital;
- to reduce debt;
- to attract investment;
- incentivise key company executives; or
- launch a new subsidiary or 'spin off' a company.

Ensuring that the share restructure is dealt with correctly (including the relevant filing requirements at Companies House) will avoid any potential disputes further down the line, including issues such as voting rights and dividend payments.

5.1 Ordinary shares and preference shares

The most common types of shares in issue for private entities are ordinary shares and preference shares. Ordinary shares are generally awarded to shareholders when no other class of share is created. Dividends on ordinary shares are usually paid at the discretion of the company (ie, there is no mandatory requirement to pay dividends). Ordinary shares are simple to administer and ensure a simple and easy way to understand the ownership apportionment of the company.

Preference shares take precedence over other shares in respect of dividends. On the flip side, these types of shares often limit the voting rights of the holder. They are usually issued in situations where a third party is investing in a company but has no plans to be involved in the running of it. The key advantages of preference shares are:

- they allow money to be raised via investment, without the need to sacrifice control;
- they allow money to be raised via investment, without taking a loan which reduces debt; and
- they facilitate growth by attracting investors because they will be entitled to any profits of the company first.

FRS 102, Section 22 *Liabilities and Equity* deal with the treatment of these types of shares. Ordinary shares are usually recognised as equity because the payment of dividends is generally at the discretion of the company and there is usually no redemption feature for such shares. Preference shares are recognised as a financial liability if there is a mandatory redemption feature at any point in the future, or there is a requirement to pay a 'dividend' to the preference shareholder(s).

5.2 Company purchase of own shares

It is not unusual for a private company to decide to purchase their own shares from shareholders.

This might arise when a shareholder wishes to exit the business (eg, due to retirement, ill-health or disagreement with how the company is being run) and other shareholders are unwilling to purchase those shares.

It is crucial that the legal, tax, accounting, reporting and business planning issues are carefully considered. There are also some ethical issues that need careful consideration, particularly where the accountant is advising **both** the company purchasing the shares and the shareholder selling the shares.

Reductions in share capital are dealt with in the Companies Act 2006 (CA 2006), Chapter 10 *Reduction of share capital,* sections 641 to 653. Part 18 *Acquisition by limited company of its own shares* deals with share buybacks in sections 658 to 737.

The following legal requirements apply:

Requirement	Process
A private company wishes to redeem or purchase its own shares out of capital.	An ordinary resolution must be passed together with a statement by each of the directors confirming the company's solvency supported by an auditor's report as to the reasonableness of such a statement.
A private company wishes to reduce its capital.	The company can issue a solvency statement and pass an ordinary resolution. This process does not require an auditor's report.
A public company wishes to reduce its capital.	It must apply to court.

Example – Company wishes to provide financial assistance
Ann wishes to sell her 40% shares in Gregory Industries Ltd. Gregory Industries is a private company and the company wishes to provide financial assistance for the

purchase of its own shares.

As Gregory Industries Ltd is a private company, it is able to provide financial assistance for the purchase of its own shares provided that it does not result in an unlawful reduction in capital.

Example – Company wishes to provide financial assistance

Sue wishes to sell her 5% shares in Breary Enterprises PLC. Breary Enterprises PLC is a public company and the company is looking into providing financial assistance for the purchase of its own shares.

The Companies Act 2006 prohibits a public company from providing financial assistance, either directly or indirectly, for the purpose of acquiring its own shares, or those of its holding company, or for the purpose of reducing or discharging any liabilities incurred in the acquisition of such shares (s678 and 679, CA 2006).

In respect of the financing of share buybacks, the law allows off-market share buybacks to be authorised by ordinary resolution. Reference to an 'off-market' share buyback means one where the purchase of a company's own shares does not take place on a recognised investment exchange.

The following is also available:

- Private limited companies are allowed to pay for their own shares by instalments if the share buyback is in connection with an employee share scheme.

- Private limited companies can buy back shares in respect of an employee share scheme to finance the purchase out of capital using a simplified procedure. This consists of the directors signing a solvency statement and the shareholders passing a special resolution.

- Private limited companies can buy back shares using 'small' amounts of cash if authorised to do so by the articles and without having to identify the cash as coming from reserves. The term 'small' is the **lower** of £15,000 and the cash equivalent of 5% of its share capital in each financial year. In addition, s692 of CA 2006 allows a private company to purchase a limited amount of its own shares without using the three other sources of finance permitted by CA 2006, these being:

  - distributable profits;

  - the proceeds of a fresh issue of shares; and

  - capital (for private companies).

Treasury shares

Treasury shares are the company's own shares that it has bought back from an existing shareholder which have not been immediately cancelled. In other words, following the buyback, the shares still exist and so the company's share capital has not changed.

SI 2013/999 simplified the rules for share buybacks and company law allows all companies limited by shares to hold their own shares in treasury (see s724 to 732 of CA 2006).

5.3 Accounting issues

S686, CA 2006 allows redeemable shares to be redeemed **only** if they are fully paid. S691 allows a limited company to purchase its own shares **only** if they are fully paid (unless purchasing the shares in relation to an employees' share scheme).

Capital redemption reserve

The capital redemption reserve (CRR) is dealt with in s733, CA 2006. Where shares are redeemed or purchased wholly out of distributable profit, an amount equal to the amount by which the company's share capital is reduced on cancellation of the shares is transferred to the CRR. This is to maintain protection for creditors.

In addition, where the redemption or purchase if financed wholly, or partly, by the issue of new shares, the transfer to the CRR is reduced by the proceeds of the new share issue. For a private company, the transfer is further reduced to the extent that the company can make a permissible capital payment.

If treasury shares are cancelled by virtue of s729(4), CA 2006, the amount by which a company's share capital is reduced must be transferred to the CRR.

The use of the CRR is very restricted. It can only be used to make a bonus issue of shares.

Share premium account

Where shares to be redeemed or purchased were originally issued at a premium and a fresh issue of shares is made for the purpose of redeeming or repurchasing the shares, any premium payable on redemption or purchase may be charged against the share premium account.

Keep in mind that the premium so charged **cannot** exceed the **lower** of:

(a) the premium received on the issue of the shares now being redeemed or purchased;

(b) the current balance on the share premium account, including any premium on the new share issue; and

(c) the proceeds of the fresh share issue.

Hence, if there is no fresh share issue, no amount can be charged to the share premium.

Permissible capital payments

This only applies to private companies. The permissible capital payment (PCP) is the amount by which the purchase or redemption cost exceeds the amount of distributable profits **plus** the proceeds of any new share issue.

When the PCP is less than the nominal value of the shares redeemed or purchased, the difference is transferred to the capital redemption reserve to comply with s734(2), CA 2006. Therefore, a private company should use its available profits and any share proceeds prior to making a payment out of capital.

If the PCP is more than the nominal value of the shares redeemed or purchased, the excess can be used to reduce any of the following:

(a) The capital redemption reserve

(b) The share premium account

(c) The revaluation reserve

(d) Fully paid share capital

The following procedures **must** be followed before a payment out of capital can be made lawfully:

- The payment must be approved by a special resolution (s716(1), CA 2006)
- The directors must make a statement (s714(1-3), CA 2006)
- A report of the company's auditors must accompany the directors' statement (s714(6), CA 2006)
- Within a week of the date of the special resolution, a notice of the proposed capital payment, providing the information specified in s719, CA 2006, must be published in *The Gazette*
- Within a week of the date of the special resolution, a notice of the proposed capital payment, providing the information specified in s719, CA 2006, must be published in a national newspaper or a written notice provided to each creditor.

Example – Share buyback at par

Bauer has the following balance sheet:

	£
Assets	
Cash at bank	35,000
Equity	
Ordinary £1 shares	10,000
Retained earnings	25,000
	35,000

The directors decided to buy back 2,000 ordinary £1 shares at par from a shareholder who has chosen to retire. The entries are as follows:

	£
Dr Ordinary share capital	2,000
Cr Bank	2,000
To redeem shares at par	
Dr Retained earnings	2,000
Cr Capital redemption reserve	2,000
To maintain capital at original amount	

The balance sheet now looks like this:

	£
Assets	
Cash at bank	33,000
Equity	

Ordinary £1 shares	8,000
Capital redemption reserve	2,000
Retained earnings	23,000
	33,000

If there had been a fresh issue of shares, the second journal (transferring the £2,000 from retained earnings to the capital redemption reserve) would not have been necessary, except to the extent that the fresh issue fell short of £2,000.

Example – Share buyback at a premium

Using the facts in the example above, consider that the shares were bought back at a £0.75 premium. The entries to record the transaction are as follows:

	£
Dr Ordinary share capital	2,000
Dr Retained earnings	1,500
Cr Bank	3,500
To redeem shares at a premium	
Dr Retained earnings	2,000
Cr Capital redemption reserve	2,000
To maintain capital at original amount	

The balance sheet will now look like this:

	£
Assets	
Cash at bank	31,500
Equity	
Ordinary £1 shares	8,000
Capital redemption reserve	2,000
Retained earnings	21,500
	31,500

Example – Redemption and fresh share issue both at a premium

The balance sheet of Olive Industries Ltd is as follows:

Assets	£
Cash at bank	32,500
Liabilities	
Redeemable preference shares £1 each	4,000
Net assets	**28,500**
Equity	
Ordinary £1 shares	10,000
Share premium	1,800
Retained earnings	16,700
	28,500

The directors decided to redeem all the preference shares at a premium of £0.25 per share which were originally issued at a £0.20 premium. In addition, the company wishes to make a fresh issue of 2,000 ordinary shares at £1.25.

The entries to record this transaction are:

	£
Dr Bank	2,500
Cr Ordinary share capital	2,000
Cr Share premium	500
Being issue of shares at a premium	
Dr Preference shares	4,000
Dr Share premium	800
Dr Retained earnings	200

Cr Bank	5,000
Redemption of preference shares at a premium	
Dr Retained earnings	800
Cr Capital redemption reserve	800
To maintain capital	

The balance sheet will then look like this:

Assets	£
Cash at bank	30,000
Equity	
Ordinary £1 shares	12,000
Share premium	1,500
Capital redemption reserve	800
Retained earnings	15,700
	30,000

Example – Redemption of shares with insufficient reserves

Dudson Ltd has the following balance sheet:

	£
Assets	
Cash at bank	21,000
Equity	
Ordinary £1 share capital	20,000

Retained earnings	1,000
	21,000

The director decides to buy back 10,000 ordinary £1 shares at par. Clearly, the distributable reserves are insufficient to carry out this transaction without a permissible capital payment. Provided the procedures in company law are carried out correctly, the journal entries to record the buyback will be as follows:

	£
Dr Ordinary share capital	10,000
Cr Cash at bank	10,000
Share buyback at par	
Dr Retained earnings	1,000
Cr Capital redemption reserve	1,000
To maintain capital as far as possible	

Following the buyback, the balance sheet will look like this:

Assets	£
Cash at bank	11,000
Equity	
Ordinary £1 share capital	10,000
Capital redemption reserve	1,000
	11,000

5.4 FRS 102 issues to be aware of in respect of distributable profits

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* requires certain accounting treatments to be applied that create profits which are not distributable under company law.

In addition, there are also some other issues that need to be carefully considered as follows:

Investment property

Investment properties are revalued to fair value at each balance sheet date. Fair value gains are credited to profit and loss. These gains are not distributable until the property is sold.

Goodwill and intangible assets

Goodwill and intangible assets may be amortised more quickly under FRS 102 than another financial reporting framework. This will reduce profits available for distribution.

Financial instruments

There are several financial instruments that are measured at fair value through profit or loss at each reporting date. This will result in some realised profits and losses and hence will directly affect profits available for distribution if those financial instruments can be readily converted into cash.

6 ICAEW practice monitoring review (Lecture A842 – 8.06 minutes)

In 2022, the ICAEW Quality Assurance Department (QAD) carried out more than 1,500 practice assurance reviews. All of which reverted back to pre-pandemic review procedures.

The report confirms that in 2022, the Practice Assurance Committee considered 45 reports (in comparison to 24 in the prior year). Some of the reasons for these reports are as follows:

Money laundering	17 cases had significant weaknesses in compliance with Anti-Money Laundering Regulations. Some failed to fulfil assurances provided at the previous review to improve their procedures. In some cases, they also failed to fully comply with Clients' Money Regulations.
Clients' Money Regulations	4 cases had significant breaches of the Clients' Money Regulations.
No responses	7 failed to respond to findings raised at a QAD review.
Use of description 'chartered accountants'	5 cases used the description 'chartered accountants' when they were not eligible to do so.
Practising certificate	3 cases related to ICAEW members being in public practice without a practising certificate.
Professional indemnity insurance	4 cases had significant gaps in their professional indemnity insurance.

The Practice Assurance Committee issued penalties of between £245 and £11,200 to 19 of these firms. 17 were referred to ICAEW's Conduct Department for further investigation.

6.1 Most common findings

The report outlines the most common findings as follows:

Finding	What QAD find

Money Laundering Regulations	ICAEW publish an annual report on anti-money laundering (AML) which explains the findings from their monitoring reviews, together with information on their regulatory role and how they fulfil. ICAEW recommends members read the report for a breakdown of AML compliance issues and relevant resources.
Clients' Money Regulations	Non-compliance with Clients' Money Regulations remains one of the top areas of concern. ICAEW identified that: • 96 firms did not have a bank trust letter to acknowledge the status of clients' money bank accounts. • 46 firms had not carried out and documented an annual clients' money compliance review. • 37 firms were not using designated clients' money accounts when holding £10,000+ for more than 30 days. • 26 firms had used their office account to hold clients' money. • 22 firms had held clients' money which did not relate to accountancy services, in breach of Regulation 8A.
Eligibility issues, ICAEW records, annual return and notifying ICAEW of changes	The report confirms that finding errors in firms' annual return data and/or ICAEW records is the third highest area of concern. The report clarifies that when firms are completing their annual return, the firm should carefully check all standing data. Where an error is spotted, the firm should contact ICAEW and let them know where to correct it. Firms are also reminded that they must notify ICAEW of any changes to the structure of the firm within 10 business days. The annual return is not to be used for this purpose as otherwise the firm will be in breach of the Practice Assurance Regulations.
Basis of fees and complaints and engagement letters	ICAEW found 164 firms had not informed their clients on the basis on which fees are charged or the firm's complaints procedure, including the client's right to complain to ICAEW. While the firm need not issue engagement letters to clients, these are two matters that must be communicated to all clients in writing. Where a firm chooses not to issue an engagement letter, ICAEW suggests the following ways of communicating these matters: • a standard terms of business letter; • a brochure provided to the client; or • a paragraph in the body of initial correspondence. ICAEW also found issues where firms were not keeping

	engagement letters up to date, did not cover specialist services and/or were incorrectly informing clients that they were able to carry out work requiring a DPB (Investment Business) licence when this was not the case.
Code of Ethics, referral fees and commissions	ICAEW have identified gaps in accounting for unregulated commission and/or referral fees at 51 firms. Typically, this is where firms have not told their clients in writing how much they received and/or obtained their consent to retain it. ICAEW's Code of Ethics, sections 330.12 A1 to 330.14A1, sets out the requirements as follows: • notify all relevant clients in writing of the amounts you have received; • obtain their written consent to retain it; and • treat the amounts received as clients' money and bank them in a client account until you have permission to retain the money. For unregulated activities, the firm can obtain advanced informed consent by including an appropriate paragraph in the engagement letter that contains examples of likely commissions and amounts. However, the firm will still need to inform the client of the amount once received.
Professional indemnity insurance	ICAEW state that their main findings in this area is inadequate coverage and/or having a policy that does not comply with the ICAEW PII Regulations. Firms must ensure that PII meets the ICAEW's minimum requirements: • The cover should be at least two and a half times your gross fee income for the accounting year preceding the start of the policy (subject to a minimum requirement of £100,000 and a maximum of £1.5m). • The policy needs to be with a participating insurer who has agreed to meet the requirements of ICAEW's minimum policy wording. This can be reviewed at icaew.com/pii. There were several findings relating to notifications not being made to the insurers and errors on proposal forms. Both can result in problems should a claim arise.
Data protection	41 firms had not registered with the Information Commissioner's Office. In addition, 12 firms had still not put adequate procedures in place to meet the requirements of the General Data Protection

	Regulation (GDPR).
DBP boundary issues and referrals to financial advisers	Issues were found in respect of referrals at 89 firms. ICAEW reminds firms that they should only refer clients to financial advisers who are able to give sufficiently objective advice. Hence, the firm will need to know whether the chosen financial adviser is independent or restricted by the FCA. To make a referral to a restricted adviser, you need to ensure that your client's needs will be addressed appropriately by making an assessment of whether the restricted adviser places business with product providers who account for a large majority of the relevant market or offer the sector of the market which is most suitable for your client's needs. If you are not confident that you have the knowledge to make this assessment, you should only refer to independent financial advisers. Firms should also be aware that some types of referrals to financial advisers may require a DPB (Investment Business) licence. In addition, firms must not forget to review the requirements outlined in the ICAEW Code of Ethics, when considering making referrals to financial advisers.

6.2 Future areas of focus

The focus of Practice Assurance reviews for 2023 is anti-money laundering (AML). In addition to routine AML monitoring procedures, they will also cover:

- The role of the Money Laundering Reporting Officer.
- Firm-wide risk assessments.
- Sanctions.
- Prohibition of accountancy services to Russia.
- Suspicious Activity Reports.
- Client due diligence.

7 ISA (UK) 505 amendments (Lecture A843 – 6.12 minutes)

On 5 October 2023, the Financial Reporting Council (FRC) issued a revised ISA (UK) 505 *External Confirmations*. The revisions follow recent enforcement findings which demonstrate that the work undertaken by auditors in respect of investigating exceptions (eg, when confirmations do not contain the information expected) has sometimes been insufficient and that some auditors have also placed too much reliance on negative confirmations when such confirmations were unlikely to provide sufficient evidence to support a conclusion.

7.1 Key changes

The key changes are as follows:

Additional clarification on what constitutes an electronic external confirmation

ISA (UK) 505 has been revised to provide clarity on the modern use of electronic confirmations. This is contained within the definition of an 'external confirmation' which is set out as follows:

> *Audit evidence obtained as a direct written response to the auditor, or by the auditor directly, from a third party (then confirming party), in paper form, or by electronic or other medium. Electronic or other medium could include auditors directly accessing information held by third parties through web portals, software interfaces or other digital means.*

ISA (UK) 505, para 6(a)

Prohibition on the use of negative confirmations

Negative confirmations, where the confirming party responds directly only if they disagree with the information provided in the request, are prohibited in ISA (UK) 505 (Revised). The reason for this prohibition is that it will improve the quality of audit evidence obtained when auditors make the use of external confirmations.

In addition, enforcement findings noted that auditors have inappropriately relied on negative confirmations, for example where a response was unlikely ever to be received even if there were relevant matters, hence calling into question the suitability of a negative confirmation. The FRC also concluded that negative confirmations are also a less persuasive form of audit evidence in comparison to positive confirmations.

In practice, negative confirmations were not used as extensively as positive ones. There is also a conforming amendment to ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* to remind group auditors that they should communicate this prohibition to component auditors undertaking work in respect of the opinion on the group financial statements.

Designing confirmations to provide evidence for relevant assertions

ISA (UK) 505 (Revised) contains a list of factors to consider when designing confirmation requests, which include:

- *The assertions being addressed.*
- *Specific identified risks of material misstatement, including fraud risks.*
- *The layout and presentation of the confirmation request.*
- *Prior experience on the audit or similar engagements.*
- *The method of communication (for example, in paper form, or by electronic or other medium).*
- *Management's authorization or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorization.*
- *The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).*

ISA (UK) 505, para A4

Enhanced requirements in relation to investigating exceptions

The FRC have included enhanced requirements in relation to auditor responsibilities when investigating exceptions. This is in response to enforcement findings that in some cases auditors are failing to appropriately consider risk when confirmations are not as expected.

The enhanced requirements direct auditors to consider if exceptions are indicative of fraud or a deficiency in the entity's system of internal control and how follow-up procedures will allow the auditor to obtain sufficient appropriate audit evidence.

7.2 Effective date of ISA (UK) 505 (Revised)

The effective date of ISA (UK) 505 (Revised) is for audits of financial statements for periods commencing on or after 15 December 2024 (ie, 31 December 2025 year ends and short periods).

8 FRC fines KPMG for the Carillion collapse (Lecture A844 – 10.41 minutes)

On 12 October 2023, the FRC announced that they had issued sanctions against KPMG LLP, KPMG Audit PLC and two former partners. These sanctions were in relation to the audit of Carillion PLC ('Carillion'), a company which collapsed and sent shock waves through the business community.

8.1 Background

Carillion was a multinational construction and facilities management company based in Wolverhampton, in the UK. Over the years the company was very successful, and its logo was often seen hanging at the front of large construction sites. The company was not very old, despite its success, having been founded in 1999, so in total lasted some 18 years before its demise in January 2018.

The company's demise caused significant cost to not only the taxpayer, but also to investors, pension holders and employees. The FRC imposed record fines on KPMG due to significant failings in the audit work carried out on Carillion – a problem that seems to keep cropping up time and time again of late.

KPMG were the auditors of Carillion and its group companies for the financial years 2014, 2015 and 2016. In each of these years, KPMG expressed an unmodified (unqualified) audit opinion on those financial statements stating that the financial statements gave a true and fair view of the state of Carillion's affairs. KPMG's auditor's report for the financial year 2016 was dated 1 March 2017 and in July and September 2017, Carillion announced expected provisions totalling £1.045 billion. These losses primarily arose from expected losses on a number of its construction contracts and there was a goodwill impairment charge of £134 million. This was effectively the start of some colossal problems that would eventually lead to the collapse of the company.

8.2 FRC investigation

The FRC stated that their investigation was '… *exceptionally complex and required the analysis of a very substantial volume of information and documents*.' During the investigation, the FRC noted an '… *unusually large number of breaches of Relevant Requirements*.'

In their investigation, the FRC concluded that the breaches found contributed to Carillion's eventual demise. The company was not subject to rigorous, comprehensive and reliable audits and in the 2016 audit, the work on going concern and Carillion's financial position was deemed to be 'seriously deficient'. Both KPMG and the audit partner, Mr Peter Meehan, failed to respond to numerous indicators that the company's core operations had become loss-making and that it was reliant on short-term and unsustainable measures to support its cash flow.

Other deficiencies in the audit work included:

- A failure to gather sufficient appropriate audit evidence to enable a conclusion to be formed that the financial statements gave a true and fair view.

- A failure to consider (adequately or at all) the implications for the audit evidence suggesting that Carillion's accounting may have been incorrect or unreliable.

- A failure to conduct its audit work with a suitable degree of professional scepticism.

- A failure to challenge management's judgements and estimates, even when those judgements and estimates appeared unreasonable and/or appeared to be inconsistent with accounting standards and might have suggested management bias.

- Other breaches were found in respect of Carillion's reported debt and its status as a going concern in 2016, including consideration of Carillion's use of a supply chain finance facility.

- A number of other discrete areas were found to contain deficiencies, such as in the 2016 pension liability and the testing for goodwill impairment.

During the investigation, it became apparent that Carillion was an important client for both KPMG and key members of the audit engagement team for the years in which the firm carried out the audit. This created an ethical threat to the firm's and the team's independence and objectivity. Such threats can result in the audit engagement team 'turning a blind eye' to transactions or events which may need further challenge or scrutiny. The FRC concluded that in a number of instances, both Mr Meehan and other members of the audit engagement team did not adopt a rigorous and robust approach. They simply accepted the information concerning the financial statements that was presented to them and which suited Carillion's management.

The FRC also found that in the 2016 audit, Mr Meehan and KPMG failed to ensure that the audit engagement was adequately managed and supervised. For example, audit procedures in a number of areas were not completed until more than six weeks **after** (yes, after!) the date the auditor's report had been signed. Records of the preparation and review of working papers were not only deemed to be unreliable, but, in some cases, misleading. This meant that Mr Meehan did not have a suitable basis to be satisfied that the audit opinion provided in the 2016 audit was, in fact, appropriate.

But that was not the end of the story …

Another audit engagement partner, Darren Turner, was responsible for the audit of Carillion for the financial year ended 2013.

The FRC carried out a review of the audit work performed on the 2013 financial statements, in particular in respect of transactions entered into by Carillion in 2013 that involved changing its provider of outsourced IT services and business process services.

At the same time as finalising the contracts for those services, Carillion finalised other agreements with the same counterparty that involved the assignment of certain intellectual property rights in exchange for a significant sum plus 'exit fees' payable to the former outsourcing provider. These transactions were treated as being independent of each other in Carillion's financial statements, contributing to a significant increase in Carillion's reported profit for 2013.

The FRC noted that a key failing by KPMG and Mr Turner was that they failed to obtain sufficient appropriate audit evidence concerning the accounting treatment of these transactions (i.e. whether the accounting was correct).

Both KPMG and Mr Turner:

- did not approach the audit of these transactions with a sufficient level of professional scepticism (i.e. challenging management's accounting treatment);
- failed to consider and respond to the risk of fraud;
- failed to obtain sufficient appropriate audit evidence concerning the accounting treatment adopted; and
- failed to identify that the disclosures in the 2013 financial statements about these transactions may be misleading.

It should be noted that the FRC also concluded that the breaches by KPMG Audit PLC and Mr Turner were not deemed to be intentional, dishonest, deliberate or reckless.

8.3 Sanctions

The FRC had two lots of sanctions to arrive at: one in respect of KPMG LLP and Mr Meehan and the second in respect of KPMG Audit PLC and Mr Turner.

Decision 1: KPMG LLP

The FRC imposed the following sanctions on KPMG LLP:

- A financial sanction of £26.5 million. This was reduced by 30% to £18.550 million on the grounds of the firm's co-operation and admissions. The firm also received a severe reprimand.
- A declaration that the auditor's reports signed on behalf of the firm did not satisfy the Relevant Requirements.

- An order requiring KPMG LLP to take remedial action to prevent these breaches reoccurring. This includes evaluating and reporting as to whether the measures taken by the firm since 2017 are sufficient in this respect.

Decision 1: Mr Meehan

The FRC imposed the following sanctions on Mr Meehan:

- A financial sanction of £500,000. This was reduced by 30% to £350,000 to reflect Mr Meehan's co-operation and admissions.

- A severe reprimand.

- Exclusion from membership of the ICAEW for ten years which runs concurrently with the period of exclusion already imposed in other proceedings.

Decision 2: KMPG Audit PLC

The FRC imposed the following sanctions on KPMG Audit PLC:

- A financial sanction of £3.5 million. This was reduced by 20% to £2.450 million on the grounds of the firm's co-operation and admissions.

- A severe reprimand.

- A declaration that the auditor's report signed on behalf of KPMG did not satisfy the Relevant Requirements.

Decision 2: Mr Turner

The FRC imposed the following sanctions on Mr Turner:

- A financial sanction of £100,000. This was reduced by 30% to £70,000 on the grounds of Mr Turner's co-operation and admissions.

- A severe reprimand.

The whole Carillion debacle has had massive repercussions. Not only has a company collapsed, but a significant number of jobs have been lost, professionals have had their careers cut short and the auditing profession is, once again, in the spotlight for all the wrong reasons.

It would seem that a lot of this could have been avoided had the auditors applied suitable levels of professional scepticism and management challenge. Accepting information at face value is a reckless strategy nowadays and can result in decisions being made that are the wrong ones. In addition, the Carillion collapse highlighted an overlap of a self-interest threat which clouded the judgement of the audit team given that Carillion was such an important client to the firm and the team.

9 ISA (UK) 315 – practical issues to consider (Lecture A845 – 17.19 minutes)

ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement* is a vast standard that seems to be causing a number of issues with audit firms (as evidenced during file reviews).

Many of the issues found during file reviews appear to be with documenting the systems and controls and the risks associated with those systems and controls. General IT controls seem to be particularly problematic in terms of how they are documented and the risks arising from those controls.

9.1 Going 'back to basics'

ISA (UK) 315 (Revised) does not require the auditor to become an IT auditor. What it is trying to do is to get the auditor to think about the controls that are in place over the client's IT system as a means of assessing the risks of material misstatement in the financial statements.

Illustration 1

Many people nowadays work from home and from the office (known as 'hybrid' working). This will usually involve logging onto the firm's server to carry out their work.

The employee will enter various logon details, including passwords and there may also be a two-way authentication process whereby the user has to input a code that has been sent to another trusted device. Once the user's credentials have been correctly input, the system will allow access.

These are all IT controls to prevent unauthorised access to the IT system.

Illustration 2

A client operates in the haulage business shipping goods from a central warehouse on behalf of its customer. Due to the nature of the business, the warehouse operates 24 hours a day, seven days a week. Warehouse staff are required to work shifts and must enter and exit the warehouse using a swipe card which has their details stored on it electronically. This swipe card records the number of hours worked, including overtime worked.

The electronic time recording system is also linked to the company's payroll system. Each week, the payroll department will import the hours worked from the electronic time recording system into the payroll system. A report is produced detailing the number of hours worked which is reviewed by the warehouse manager. The payroll cannot be finalised until the warehouse manager has signed off that week's hours worked report.

The payroll system automatically calculates the gross pay, statutory deductions and net pay. It also calculates the PAYE/NIC liability due to HM Revenue and Customs each month.

In this cycle, the auditor should review and document:

- The controls in place at the warehouse which aim to prevent employees being paid for hours not worked (entering and exiting the warehouse using the swipe card).
- The controls that are in place to ensure that the hours worked are accurately imported from the time recording system into the payroll system (the warehouse manager authorising the hours worked or a reconciliation carried out by the payroll department).
- Access controls over the payroll system itself.
- Controls over the payroll processing – ie, whether any reviews of information output from the payroll system is reviewed by a senior official prior to the payroll being finalised.
- Controls over the payment of the payroll to employees, ie, looking for segregation of duties between the payroll department and the physical payment of the payroll to employees.

Flowcharts may be a useful way of identifying any missing controls in this process.

Here, the auditor is trying to identify the controls over the IT systems (and the payroll cycle itself) to ensure that there is a control in place at each stage of the process.

9.2 Use of spreadsheets by a client

Despite many modern accounting systems being powerful, clients tend to maintain spreadsheets for several aspects of the accounting system. These can be straightforward documents, or highly sophisticated ones containing many thousands of formulae to produce information that management needs for the decision-making process.

A commonly quoted statistic is that as many as 90% of spreadsheets contain mistakes. While many of these errors are generally minor, from an auditing perspective, a lot of small errors can add up and end up being material. It is important that the auditor carries out procedures that provides them with confidence that the data they have been given is reliable.

Risk is also another factor that auditors need to keep in mind where spreadsheets are concerned. If an IT system produces reports in the form of a spreadsheet (which most systems do nowadays), there is a risk that the data can be manipulated by the user. Manipulation can involve changing amounts/formulae/deleting information either intentionally or unintentionally. Either way, this invariably becomes a risk of material misstatement at the financial statement level.

Example – Sophisticated Enterprise Resource Planning (ERP) system

Sunnie Enterprises Ltd has a bespoke ERP system in place which includes the accounting system. The financial controller prepares monthly management accounts and prepares the year-end trial balance. The finance director prepares the draft accounts ready for the auditors from the year-end trial balance.

The ERP system has been fully documented by the audit engagement team and tests of controls have been carried out during an interim audit which revealed the IT controls are working effectively.

A lot of the data from the ERP system is exported into manual spreadsheets which are used in the financial reporting process. As the financial controller prepares this documentation from a sophisticated accounting system, there are no further checks on this data.

In this situation, despite the business having a sophisticated accounting system with effective controls, these controls essentially become redundant once the data is worked on in a manual spreadsheet. Once work on the spreadsheets starts, no further checks are carried out.

The difficulty in this situation is that there is little in the way of an audit trail where the spreadsheets are concerned. Hence it is difficult for the auditor to track changes and understand who made those changes.

ISA (UK) 500 *Audit Evidence* requires the auditor to evaluate when information provided by the audited entity is sufficiently reliable for the purposes of the audit. This includes obtaining audit evidence concerning the accuracy and completeness of the information and evaluating whether the information is sufficiently precise and detailed.

At the planning stage of the audit, the audit engagement team would need to devise appropriate audit procedures over these spreadsheets, including ensuring the correct version is being audited.

The other issue that is often encountered when carrying out audit work is that some clients will often present information that has been exported from an accounting system into a spreadsheet and the information presented to the auditor is presented in a PDF format. Basic checks, such as checking for arithmetical accuracy, can be carried out on the PDF, but the important issue the auditor must consider is whether the underlying data is correct. For example, are the formulae correct and has the 'raw' data from the accounting system been exported correctly into the spreadsheet (the auditor could perform a reconciliation of the information in the accounting system to the information presented in the spreadsheet). In any event, it is important that the auditor asks for the original spreadsheet so they can carry out audit procedures to verify the underlying information and ensure accuracy.

Analytical review procedures

The auditor can use analytical procedures over a spreadsheet as a means of identifying potential sources of misstatement. For example, recalculating amounts in the spreadsheet, or using ratios can provide the auditor with indicators that the amounts in the spreadsheet need to be challenged, or they can confirm that the results are reasonable.

Trend analysis is also a key tool at the auditor's disposal, especially where spreadsheets are concerned. These sorts of charts can assist an auditor identify patterns or trends that either contradict the auditor's expectations or confirm them.

Substantive procedures

Substantive procedures on a spreadsheet are often the most effective in identifying misstatements. Remember, substantive procedures aim to detect misstatements so carrying out such testing on spreadsheets is very useful. Such tests may include:

- Reviewing formulae to identify if there are any errors or omissions (particularly with larger spreadsheets).
- Inspecting the spreadsheet as Excel has a function to inspect a workbook and identify potential issues.
- Identifying any inconsistencies in the spreadsheet which may be manipulating the final result or output of the information in the spreadsheet (eg, balancing figures).
- Reperforming calculations to assess if the auditor's output is consistent with the client's output.

9.3 Summary

The technical provisions of ISA (UK) 315 (Revised) have been covered a lot in previous updates. A lot of what is in the standard is common sense and requires a logical thought process to be put in place. For example, how do transactions and balances start their journey from initial entry into the accounting system to the financial statements? What processes and controls are there during this journey to ensure they end up in the right place? The key is then documenting this journey and the controls in place to ensure the transactions and balances end up at the right destination in the financial statements.

10 Attendance at the inventory count

The December 2023 reporting season is almost upon us and auditors will be considering the planning for their December year end audits, particularly attendance at the client's year-end inventory count.

Auditors are required to attend inventory counts when the value of stock and work in progress is material to the financial statements. It should be borne in mind that the process itself is an important observation test. Attendance at stock counts is dealt with in ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items*.

The overarching objective to attending the inventory count is for the auditor to gather evidence to cover the following assertions:

- existence;
- valuation;
- completeness; and
- rights and obligations.

While not a financial statement assertion, the auditor must also assess the **condition** of the inventory during the count. The primary reason for this is to ensure that any damaged inventory is valued appropriately in line with the applicable financial reporting framework (eg, FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Section 13 *Inventories*).

Remember, when the auditor attends the inventory count, they are essentially carrying out a **test of control**. A test of control focuses on the operating effectiveness of the entity's controls. It does not focus on the monetary amounts in the financial statements because this is the job of substantive procedures. In any event, the auditor will be unable to carry out any substantive procedures over the inventory valuation at the inventory count because the final valuation will not have been established at this stage. This is because the auditor attends the inventory count **during** the counting process to observe whether the process conforms to management's instructions and whether those instructions will reduce the risk of material misstatement in the final inventory valuation.

10.1 Objective of ISA (UK) 501

ISA (UK) 501 requires the auditor to:

- attend the physical inventory count (unless impracticable (see **10.2** below)), if inventory is material to the financial statements; and

- perform procedures on the final inventory records to determine whether they accurately reflect the count results.

It is **not** the responsibility of the auditor to carry out the inventory count. The auditor's responsibility is to evaluate management's instructions and procedures for the count; observe the performance of the count; inspect the inventory and perform test counts.

10.2 Prior to the inventory count

Before the auditor attends the inventory count, they must undertake an element of planning which would normally include:

- performing analytical procedures and discussing any significant variances with management;
- discussing counting arrangements and procedures with management;
- familiarising themselves with the nature of the inventory, volume, identification of high value items and the general accounting method of inventory valuation;
- considering the location of the inventory;
- considering the quantity and nature of work in progress, quantity of inventory held by third parties and whether an auditor's expert may be required;
- considering the internal controls relating to inventory to identify problems areas (eg, problems in relation to cut-offs);
- considering whether any internal audit function exists and deciding the extent to which reliance can be placed on internal audit (note – internal audit cannot provide any direct assistance to the external auditor);
- reviewing the results of previous inventory counts; and
- reviewing the prior year audit working papers.

Paragraph 4 of ISA (UK) 501 requires the auditor to attend the inventory count if the value of the inventory (including work in progress) at the balance sheet date is (likely to be) material to the financial statements. As noted above, the attendance at inventory count is that of an observation test, ie, to observe whether the procedures adopted by management would reduce the risk of material misstatement in the final inventory valuation.

The auditor is required to obtain sufficient and appropriate audit evidence regarding the existence and condition of the inventory, in addition to other procedures, unless physical attendance at the inventory count is impracticable.

The term 'impracticable' does not mean general inconvenience (eg, because the year-end inventory count is happening on, say, New Year's Eve); nor would impracticability be due to difficulty, time or costs involved. It may be impracticable for an auditor to attend the inventory count due to factors such as the nature and location of inventory, such that the location may pose threats to the safety of the auditor.

Where it is impracticable for the auditor to attend the inventory count (and impracticability can be justified), alternative audit procedures will be required. For example, inspection of invoices for the purchase and subsequent sale of specific items of inventory which could provide audit evidence concerning the existence and condition of the inventory at the year end.

If attending the inventory count is impracticable and there are no further audit procedures which can generate sufficient appropriate audit evidence concerning the existence and condition of inventory at the reporting date, the auditor will need to modify their opinion due to a limitation in audit scope (most likely a qualified 'except for' opinion). ISA (UK) 705 *Modifications to the Opinion in the Independent Auditor's Report* provides guidance to auditors where modified opinions are to be expressed.

10.3 During the inventory count

Auditors should attend the inventory count whilst the count is underway as one of the objectives is to ensure that management's instructions are being carried out correctly. Auditors must also ensure that:

- inventory 'teams' are in place so that one person counts whilst another person records the quantities on the 'rough' stock sheets;
- no movements of inventory take place during the count;
- sequentially numbered count sheets and a sequence check is performed of these inventory sheets once the count is complete;
- count sheets show the description of the goods but do not show the quantities expected to be counted; and
- damaged and/or obsolete items are separately identified so they can be valued appropriately.

The auditor will usually use an audit programme to undertake the work; however, the auditor should carry out some substantive procedures during the audit which often include:

- selecting a sample of items from the inventory count sheets and physically inspecting the items in the warehouse (this verifies **existence**);
- selecting a sample of physical items from the warehouse and tracing to the inventory count sheets to ensure that they are recorded accurately (this verifies **completeness**);
- enquiring of management whether goods held on behalf of third parties are segregated and recorded separately (this verifies **rights and obligations**);

- inspecting the inventory being counted for evidence of damage or obsolescence that may affect estimated selling price (this verifies **valuation**);

- recording details of the last deliveries prior to the year end. This information will be used in final audit procedures to ensure that no further amendments have been made thereby overstating or understating inventory (this verifies **completeness** and **existence**);

- obtaining copies of inventory count sheets at the end of the inventory count, ready for checking against the final inventory listing after the inventory count (this verifies **completeness** and **existence**); and

- attending the inventory count (if one is to be performed) at the third-party warehouses (this verifies **completeness** and **existence**).

The timing of the inventory count is a critical factor to consider. For example, the client may have an accounting reference date of 31 December, but the year-end inventory count may not be undertaken on this particular day (it may be carried out before or after 31 December) and therefore additional procedures may need to be carried out by the auditor, such as roll-back or roll-forward procedures. Such additional procedures will have to be built into the audit plan.

The auditor must consider the controls in place over the count. For example, whether the teams carrying out the inventory count are objective and have the necessary experience; what controls the client has over the inventory and the susceptibility of inventory to theft or deterioration; the degree of fluctuation in inventory levels and whether there are any inherent difficulties when it comes to estimates included in the inventory valuation.

Sources of evidence relating to the existence of inventory are:

- evidence from audit procedures relating to the reliability of accounting records upon which the inventory valuation in the financial statements is based;

- evidence from tests of controls over inventory (and work in progress), including the counting procedures; and

- substantive evidence from physical inspections at the inventory count.

Where the entity does not maintain detailed inventory records, the quantification of inventory is likely to be based on a full, physical inventory count at the balance sheet date, or very close to the balance sheet date. Evidence to satisfy the existence assertion is therefore greater when the inventory count is carried out at the year end, or at a date very close to the year end. This could well provide sufficient and appropriate audit evidence; however the auditor must also be satisfied that the records of inventory movement are also reliable in the intervening periods.

10.4 After the inventory count

The auditor is required to carry out certain procedures after the inventory count, which are normally carried out during the detailed audit fieldwork on the financial statements. Such procedures include:

- tracing the items counted during the inventory count to the final inventory list to ensure it is the same as the one used at the year end and to ensure that any errors identified during counting procedures have been rectified (this verifies **completeness**);

- casting the list to ensure arithmetical accuracy and agree the total valuation to the financial statements and relevant disclosures (this verifies **completeness** and **classification**);

- inspecting purchase invoices for a sample of inventory items to agree their cost (this verifies **valuation**);

- inspecting purchase invoices to ensure the goods are in the name of the client (this verifies **rights**);

- inspecting post-year-end sales invoices for a sample of inventory items to determine if estimated selling price is reasonable. This will also assist in determining if inventory is held at the lower of cost and estimated selling price less costs to complete and sell (this verifies **valuation**);

- inspecting the ageing of the inventory items to identify old and/or slow-moving amounts that may require an allowance and discussing these with management (this verifies **valuation**);

- recalculating work in progress and finished goods valuations using payroll records for labour costs and utility bills for overhead absorption (this verifies **valuation**);

- tracing the goods received immediately prior to the year end to year-end creditors and inventory balances (this verifies **completeness** and **existence**);

- tracing goods dispatched immediately prior to the year end to the nominal ledger to ensure the items are not included in inventory and sales (and debtors where relevant) have been recorded (this verifies **completeness** and **existence**);

- calculating inventory turnover/days ratio and comparing this to the prior year to assess whether inventory is being held longer and therefore requires a provision to bring the value down to the lower of cost and estimated selling price less costs to complete (this verifies **valuation** and is an analytical procedure); and

- calculating gross profit margins and comparing this to the prior year. The auditor should investigate any significant differences which may highlight an error in cost of sales and closing stock (this verifies **valuation** and is an analytical procedure).

10.5 Inventory held at third parties

Where a third-party holds inventory on behalf of the client the auditor should obtain external confirmation from the third party of the quantity and condition of the goods to confirm **rights** and **obligations**.

If the goods held by the third party are material, the auditor should attend the inventory count to verify **existence** of the inventory.

The auditor may also obtain a report from the third party's auditors confirming the reliability of the internal controls at the third party.

10.6 New audit engagements

A common issue is where an audit firm engages a new client but is engaged after the reporting date has passed and inventory is material to the financial statements. No auditor has attended the year-end inventory count and hence has been unable to gather sufficient appropriate audit evidence to corroborate the existence, completeness and condition of inventory at the balance sheet date.

Alternative audit procedures can be applied such as reviewing purchase invoices and subsequent sales invoices for evidence of existence and condition of the inventory and such procedures may avoid a modified audit opinion being expressed, provided the audit evidence is sufficient and appropriate.

However, in certain situations, it may be the case that the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence, completeness and condition of the inventory at the reporting date. In such cases, a modified opinion will be necessary due to a limitation on the scope of the audit work.

There will be a 'double whammy' for the client in this situation because not only will the current year's audit opinion be qualified, but the next year's will be as well as the current year's closing stock rolls into the profit loss account as opening stock.

Ideally, clients should appoint auditors well before their reporting date so arrangements can be put in place for an auditor's attendance at the year-end inventory count. However, client's do not always do this and while a modified audit opinion is not always the default, it is important that the auditor considers whether alternative audit procedures are capable of generating sufficient appropriate audit evidence concerning the existence, completeness and condition of the client's inventory at the year end.

10.7 Cut-off testing

The question that the auditor must ask themselves when attending the inventory count and carrying out cut-off testing is ‘*Are inventory movements around the year end recorded in the correct period?’*

Ideally, the client will halt all movements in or out of the premises while the inventory count is conducted. However, sometimes this is not possible (eg, where a business operates 24 hours a day, seven days a week). Where it is not possible to halt movements of inventory, the client should be requested to move the items requiring dispatch to a different location to that being counted before the inventory count takes place. Any deliveries of goods should be made to a different location while the count is ongoing to enable the count to be carried out without movement of items.

A separate count can then be performed on the items delivered during the count and these can be added to the count sheets accordingly.

By having these controls in place, the completeness and existence of inventory at the date of the inventory count can be verified as well as the cut-off assertion for sales and purchases.

In addition, the auditor will usually carry out cut-off testing while attending the inventory count, such as:

- Trace goods received notes from immediately prior to the year end (which have been identified during the count) to year-end trade creditors and inventory balances.

- Trace the goods dispatched notes from immediately prior to the year end (which have been identified during the count) to the nominal ledger to ensure the items were removed from inventory prior to the year end and have been recorded in trade debtors at the year end.

10.8 Perpetual inventory systems

A perpetual inventory system is also known as a ‘continuous inventory system’ whereby all lines of inventory are counted periodically (eg, each month) throughout the year so that by the end of the year all lines of inventory have been counted.

The objective of the auditor where a client uses a perpetual inventory system is the same, ie, to identify whether the client’s inventory system reliably records, measures and reports inventory balances.

There are both advantages and disadvantages to the auditor with these types of inventory systems:

Advantages	Disadvantages
The auditor is less time-constrained and can pick and choose particular locations and inventory lines to count at any time to ensure the system is reliable.	The auditor will need to gain sufficient evidence that the system operates effectively at all times, not just at the time of the count.
Slow-moving and damaged inventory should be identified and adjusted for in the client's records on a continuous basis, thus improving the valuation at the year end.	Additional procedures will need to be devised to ensure that the year-end inventory balance is reliably, especially with regards to cut-off and year-end provisions or estimates.

Typical audit procedures that can be applied where a client operates a perpetual inventory system include the following:

- Attend at least one inventory count to ensure that adequate controls are applied during the counts (much in the same way as for a year-end count).
- Inspect the number and value of adjustments made as a result of the count. If significant adjustments are required each month, this indicates that the system figures for inventory cannot be relied on at the year end and a full count will be required.
- If the system balance for inventory is considered reliable as a result of these audit procedures, further procedures to verify cut-off, valuation and rights and obligations will still need to be carried out.
- Inspect goods received notes and goods dispatched notes around the year end to confirm correct cut-off.
- Carry out a net realisable value test to ensure goods are being sold in excess of cost.
- Compare the inventory holding period (stock days) with the prior year to assess any potential valuation issues.
- Inspect purchase invoices for inventory to ensure they are in the name of the client to confirm rights to the inventory.

11 Proposed revisions to ISA (UK) 250 (Lecture A846 – 5.15 minutes)

On 18 October 2023, the Financial Reporting Council (FRC) issued an Invitation to Comment – Proposed Revisions to ISAs (UK) 250 A and B.

ISA (UK) 250, Section A *Consideration of Laws and Regulations in an Audit of Financial Statements* provides guidance to the auditor in respect of an entity's compliance with laws and regulations.

ISA (UK) 250, Section B *The Auditor's Statutory Right and Duty to Report to Regulators of Public Interest Entities and Regulators of Other Entities in the Financial Sector* deals with circumstances in which the auditor of a regulated entity is required to report information which comes to the auditor's attention directly to a regulator.

Both of these ISAs (UK) are up for revision and the FRC is requesting comments on this consultation by 12 January 2024.

11.1 ISA (UK) 250, Section A

The current extant of ISA (UK) 250, Section A makes reference to **direct** laws and regulations (ie, those which have a direct effect on the amounts and disclosures in the financial statements – such as tax legislation); and **other** laws and regulations which have an **indirect** effect on the financial statements (eg, health and safety legislation).

Currently, the auditor is required to obtain sufficient appropriate audit evidence in respect of compliance with direct laws and regulations.

In respect of other laws and regulations, the auditor is only required to carry out specified audit procedures to identify any non-compliance with those other laws and regulations which may have a material effect on the financial statements. This is because non-compliance with other laws and regulations (eg, employment law) can impact the financial statements as the entity may need to make a provision for future legal costs and fines. In the worst-case scenario, this could also affect the ability of the entity to continue as a going concern.

The FRC is proposing to make changes to ISA (UK) 250, Section A by proposing a more risk-based approach. This approach will direct the auditor's attention to identifying those laws and regulations where non-compliance may have a material impact on the financial statements. It will also enable the auditor to devise specific audit procedures to address this risk of material misstatement.

Using this risk-based approach will mean there will be more professional judgement needed on the part of the auditor. It is also likely to mean more work will need to be undertaken in identifying such laws and regulations. There will also be additional risk assessment procedures needed which will lead to an increased level of responses to those risks [of non-compliance with laws and regulations].

The FRC has established a number of additional risk assessment requirements, such as:

- Understanding those laws and regulations that relate to the applicable financial reporting framework or which arise from regulatory factors.
- Understanding management's process concerning compliance with laws and regulations and how those charged with governance oversee this.
- Determining whether there are any deficiencies in internal control relevant to non-compliance with laws and regulations.
- Making inquiries of management, those charged with governance and other individuals to obtain their views on which laws and regulations could have a material impact on the financial statements.
- Inspecting documentation for indications of non-compliance with laws and regulations.

The FRC has also proposed explicit requirements for the auditor to identify, assess and respond to the risks of material misstatement due to fraud or error relating to non-compliance with laws and regulations.

As we have seen in other revised ISAs (UK), the FRC has started to introduce 'stand back' requirements. The proposed revisions to ISA (UK) 250, Section A are no exception and the FRC plans to introduce a stand back requirement in the next edition. This will require the auditor to assess whether they have obtained sufficient appropriate audit evidence regarding whether there is a material misstatement of the financial statements relating to non-compliance with laws and regulations.

The FRC also proposes to introduce a requirement for the auditor to conclude whether non-compliance (or suspected non-compliance) with laws and regulations has resulted in a material misstatement of the financial statements.

Effective date

The FRC proposes an effective date of ISA (UK) 250, Section A (Revised) to be for audits of financial statements for periods commencing on or after 15 December 2024 (ie, 31 December 2025 year ends or short periods). Earlier adoption would be permitted.

11.2 ISA (UK) 250, Section B

The proposed amendments to this standard amount to pretty much a new ISA (UK) on the grounds that the current content is outdated and the FRC would like to introduce a more principles-based standard covering reporting and communicating to an appropriate authority. The numbering of the ISA (UK) is expected to change, and the title is expected to be *Special Considerations for Audits of Public Interest Entities – Communicating and Reporting to An Appropriate Authority Outside the Entity*.

There is a new definition of 'reportable matters' which is information about which the auditor becomes aware during the audit that the auditor is either required to report to an appropriate authority or that the auditor determines should be reported an appropriate authority outside the entity.

The FRC is also proposing to include in the definition of 'reportable matters' information that is of such significance that it is in the public interest to report even where law, regulation or relevant ethical requirements do not require it.

The structure of the revised ISA (UK) will be in two parts:

- Requirements 11 to 13 will apply to all audits of public interest entities.
- Requirements 14 to 21 will apply only if the auditor becomes aware of information that may relate to a reportable matter.

The proposed scope of the new standard is public interest entities. However, the FRC has stated that it is intending that the new standard will apply to all entities caught by the new definition of 'public interest entity'.

Effective date

The FRC proposes an effective date of this revised ISA (UK) to be for audits of financial statements of public interest entities for periods commencing on or after 15 December 2024 (ie, 31 December 2025 year ends or short periods). Earlier adoption would be permitted.

12 ICAEW proposed changes to the audit regulations (Lecture A847 – 8.54 minutes)

ICAEW has proposed to make some changes to its UK Audit regulations and Guidance to address three policy areas:

- Rules around CPD
- Rules about alternate registered auditors
- Rules on sanctions

Comments on these proposals closed on 27 October 2023 and it is expected that the revised regulations will come into force early in 2024.

12.1 CPD

The new rules around CPD have been well-publicised. This is off the back of a request by the Irish Auditing and Accounting Supervisory Authority (IAASA) and the FRC requesting more rigorous regulation around CPD and the record-keeping of this by audit staff and principals.

The new CPD rules came into effect on 1 November 2023.

There are three categories under the new regime: Category 1, 2 and 3. Members that work in practice but do not perform any of the specified roles for category 1 or 2 will fall into category 3.

Examples of roles that would result in category 1 classification include:

- Acting as responsible individual/key audit partner/engagement partner or spending 30% or more of your professional time on:
    - audits of public interest entities (PIEs);
    - major local audits;
    - audits of central government departments or devolved administrations; or
    - CASS audits.

  It should be noted that each of these categories are assessed individually, not in the aggregate.

- Leading, managing, or spending 30% or more of your professional time on delivery of internal audit or assurance services to PIEs, a major local audit entity or central government departments or devolved administrations.

- Working in an audit regulatory role, including monitoring and enforcement, within an accountancy professional body, a training organisation, or an oversight body.

- Being an insolvency practitioner who is authorised to take on insolvency appointment.

- Providing direct or indirect tax services to large companies, listed or international companies or groups, or high net-worth individuals.

- Spending 30% or more of your professional time providing ESG assurance services to PIEs, local bodies where the audit is a major local audit, central government departments and devolved administrations.

Examples of roles that would result in category 2 classification include:

- Acting as responsible individual/key audit partner/engagement partner or spending 30% or more of your professional time on large company audits.

- Acting as engagement partner or spending 30% or more of your professional time on the audit of public sector bodies (excluding those which are in category 1 classification).

- Spending 30% or more of your professional time working on performance or value for money audits of public sector bodies.

- Leading, managing, or spending 30% or more of your professional time on the delivery of internal audit or assurance services to large companies or public sector bodies (excluding those which are in category 1 classification).

- Being an insolvency practitioner who holds non-appointment taking insolvency licences.

- Spending more than 30% of your time on

  – insolvency or restructuring engagements which are not related to insolvency appointments;

  – forensic accounting work; or

  – ISAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* or ISRS 4400 *Agreed-Upon Procedures* work on behalf of a recipient of a grant from a public sector body as defined by ONS (these categories are assessed individually, not in the aggregate).

- Undertaking probate work.

- Undertaking DPB (Investment Business or Consumer Credit) licensed activities.

- Provision of corporate finance advice to individuals, public sector bodies or businesses.
- Provision of direct or indirect tax services to individuals or entities outside the category 1 classification.
- Spending less than 30% individually, but more than 40% collectively on:
  - PIE audit engagements;
  - major local audits;
  - audits of central government departments or devolved administrations;
  - CASS audits;
  - large company audits; or
  - audits or performance of value for money audits of public sector bodies.

The CPD requirements for members in practice are shown in the following table:

Category	Total hours	Verifiable hours
1	40	30
2	30	20
3	20	10

Exemptions

There are only limited exemptions available to the new CPD policy:

- ICAEW members who are not working in accountancy, finance or legal services or that have not worked at all in a CPD year are exempt (although the basis of the exemption should still be documented).
- Being a director of a micro-entity providing this is the only role that would bring an individual into scope.
- Reciprocal members (those who have membership because of a reciprocal agreement with another body), who are not responsible individuals or key audit partners, and who have satisfied the CPD obligations of their home professional body.
- Holders of the ICAEW Business and Finance Professionals designation and are not regulated by the ICAEW for certain activities (although you will still be required to carry out at least 1 hour of ethics training and also undertake any training to meet these identified development needs).

12.2 Alternate registered auditors

The appointment of alternates is currently compulsory across all three institutes for firms that hold client money. However, this new regulation will extend to audit. The introduction of compulsory alternates for sole practices will help to reduce risk both to the consumer and the practice. As part of the firm's overall succession planning, it will help to avoid uncertainty if the practitioner falls ill or sadly dies.

ICAEW recognises that arrangements for the appointment of an alternate may take some time and hence there is a transitional period of six months prior to the obligation becoming compulsory.

12.3 Sanctions

Historically, the Audit Registration Committee (ARC) has applied regulatory penalties and restrictions to firms and not to responsible individuals (RIs).

The only options currently available to the ARC regarding an RIs actions are removal of RI status or referral to the Conduct Department for disciplinary investigation. Both of these options will still be available to the ARC under the updated audit regulations.

However, there is an implicit requirement in the FRC's delegation agreement for the powers of the FRC set out in The Statutory Auditors and Third Country Auditors Regulations (SATCAR) 2016 to be mirrored in those of the RSBs. As the FRC often apply penalties and restrictions to RIs as well as firms, this is a power which should be recognised within the audit regulations. In addition, the new requirements on CPD where the responsibility falls equally on the firm and individual require that the individual, as well as the firm, is held to account through the sanctions available.

13 ICAEW audit monitoring report (Lecture A848 – 21.55 minutes)

On 16 November 2023, the ICAEW issued their audit monitoring report for 2022/23. During the year, the Quality Assurance Department (QAD) reviewed 496 audit monitoring review visits, incorporating the review of firms' work on 893 audits.

There were some positive signs coming out of the largest firms in Tier 1 (being either good or generally acceptable). However, on the flip side, QAD note a drop to 71% (from 76%) of audits rated good or generally acceptable, although it is recognised that the list of firms reviewed in 2022/23 would have been different to the list of firms reviewed in the prior year.

13.1 Key points raised

41 reports were raised by QAD to the Audit Registration Committee (ARC). The ARC imposed conditions and restrictions on the continuing audit registration of 33 firms and withdrew audit registration from a further five.

Three particular areas have been identified by QAD as the main 'drivers' behind audits requiring improvement or significant improvement. These are the more challenging aspects of an audit, such as:

- Group audits
- Stock and long-term contracts
- Valuation
- Revenue

Group audits

ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* must be closely followed in a group audit. Consolidation adjustments must be properly audited according to their underlying purpose.

Goodwill and intangible assets arising on consolidation must also be assessed for indicators of impairment and by audit work done on a full impairment review conducted by the audited entity where appropriate.

Investments in a parent entity's balance sheet must also be carefully compared to the consolidated position of the group which those investments represent. Where a group member is loss-making, those investments must be carefully assessed for impairment bearing in mind the primary risk for a loss-making entity is that the investment is **overstated** in the balance sheet. Work on valuations of the consolidated group must include a proper explanation where investments are higher than the net asset value and be supported by robust and justifiable forecasts and assumptions relating to future performance.

For non-PIE audits, it is common for the audit firm to provide non-audit services relating to the preparation of group financial statements. This is permissible provided there are robust safeguards put in place to ensure that the audit engagement team applies the same level of scrutiny that would be expected on the same financial statements if the non-audit work had been carried out by the client.

The audit of group accounts presents its own challenges where the group engagement team is also directing and supervising the work of component auditors to support the group audit opinion.

Issues might arise where audited entities appoint a relatively small audit firm as group auditor of a worldwide group (possibly with component auditors that are members of a large international network). QAD reminds such audit firms that while group audit fees are likely to be lower than fees that would be charged by the UK member firm of an international network, it is essential that these smaller audit firms are just as robust in their involvement (including direction and supervision of the component auditor) as when dealing with another lower profile firm.

Conversely, UK audit firms may be dealing with a component auditor who is unable to communicate in English. The UK audit firm is responsible for obtaining its own language skills and translation such that effective direction, communication and review takes place on the audit.

Stock

Stock is usually a material aspect of the balance sheet and we have covered some aspects relating to attendance at stock counts in this quarter's update. QAD have identified certain risks for trading companies, including retail and wholesale businesses in respect of existence, valuation and cut-off.

Existence can be checked in smaller, more simple audits through attending the full inventory count at the year end. Stock quantities must be checked through to the final stock valuation with any variances properly investigated in order to form a conclusion.

Larger entities often have multiple stock locations and could operate a perpetual inventory counting system. While multiple locations do not have to be visited annually, the auditor is expected to plan and justify a suitable cycle (ideally with an element of unpredictability) so that the audit client does not have a significant period of notice that a certain site will be visited.

Straightforward valuation tests for stock usually include checking to purchase invoices for cost and recent sales invoices for evidence of net realisable value. Where there are no recent sales invoices, checks are sometimes performed on the last two to three years sales invoices and QAD have seen firms ignoring the evident risk of the need for full or partial provision over the value of that stock.

Long-term contracts

These will typically occur in construction and engineering sectors (but this is not absolute). There are inherent accounting complexities with long-term contracts which present challenges for auditors. For example, there are often complex judgements and estimates required as well as a need to rely on experts.

QAD recognise that it is hard to envisage circumstances where it is deemed effective to audit individual financial statement line items as opposed to taking a holistic approach to auditing a sample of the contracts in the accounts with their respective contributions to revenue, expenditure, assets and liabilities.

Reliance on controls must be based on evidence that the relevant controls are operating effectively. This is not the same as obtaining an understanding of the controls that are in operation. QAD highlight that typical controls in a long-term contract business will include a process for contract management and regular contract review meetings between members of the finance team and operational staff. Auditors will need to attend at least one of these meetings as part of their tests of control to understand key elements of the meeting, such as:

- standing agenda items;
- financial information prepared as a basis for discussion; and
- the process to resolve and feedback on any questions, requests for further information or uncertainties raised; and
- to document and record the key points raised.

The most common weakness identified where long-term contracts are concerned is in the assessment of provisions and costs to complete.

Property valuations

Audit firms must assess evidence in respect of property valuations objectively and test the assumptions in the valuation against whatever reliable data is available. Specialists may often need to be called upon when auditing property valuations.

QAD has stated that they often find little evidence to support valuations and, where there is a valuation that has been carried out by a specialist valuer, there is little or no evidence of evaluating the valuer's competency and objectivity, the relevant and reasonableness of assumptions or completeness and accuracy of source data.

Management estimates are inherently riskier due to the fact that they are internally generated. In some cases, QAD have seen no attempt by the auditor to challenge these sorts of valuations objectively. Audit work is sometimes limited to obtaining a written representation, but this does not provide any evidence by itself (written representations should complement other forms of audit evidence). In addition, QAD has come across situations where professional valuers have valued the bulk of an investment property portfolio but has left one or two exceptions which the audit firm has done nothing to consider.

QAD have also come across situations where auditors have stated they do not have the expertise to assess assumptions. In these situations, the auditor must consider whether to engage their own expert and, of course, these are issues that should be considered prior to accepting the audit engagement. In some cases, however, auditors should be able to test estimates for non-specialist properties (eg, residential, office or light industrial properties) using suitably reliable, publicly available information without having to engage the services of a specialist.

Business valuations

QAD report similar challenges in business valuations with estimates and judgements being a key component of frequently complex valuation models. The first step is to verify the integrity of the model. Once this is done, the auditor will then need to consider whether there is a need for an expert.

QAD have identified a small number of audits that have problems in this area.

Revenue

The audit of revenue seems to crop up a lot. QAD have noted that revenue issues are common across all audits requiring improvement or significant improvement and, in some cases, are linked to the approach to long-term contract accounting (see above). There is also interaction with judgements and estimates relating to the determination of revenue.

Income completeness is also a key area that QAD finds weaknesses on. The first step in the audit of revenue is to understand the client's accounting policy (eg, whether revenue is recognised on dispatch of the goods; or whether revenue is recognised when the customer receives those goods). Hence, the auditor must then determine whether the point of revenue recognition is appropriate.

When tests of detail are carried out, the auditor should 'stand back' and consider the sufficiency of the audit evidence. Methodologies which 'cap' sample sizes often give a false sense of security. Hence, a business with huge amounts of small transactions, a sample of 60 or 100 represents a small proportion of the activity.

Substantive analytical procedures and reviews of the operating effectiveness of controls can provide high-quality audit evidence, provided they are used in the correct circumstances. All of the inputs into a substantive analytical review will need to be fully audited and verified; and controls must be seen in operation consistently throughout the period through observation, examination of documentation or tests of IT controls.

QAD have stated that despite a wide range of weaknesses which may result in them concluding that the audit of revenue needs improvement, or significant improvement, in some cases, it appears to be a lack of audit work (either in relation to material revenue streams, or even revenue as a whole) that contributes to such a conclusion.