# Audit and Accounting Quarterly Update – July 2022

## Contents




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**Source material**

# 1 FRC periodic review update (Lecture A793 – 4.21 minutes)

As discussed in previous quarters' audit and accounting updates, the Financial Reporting Council (FRC) are currently underway with the periodic review of UK GAAP. Whilst the focus of the periodic review is primarily on FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, it is likely that other standards in the suite will see some consequential amendments.

## 1.1 Progress update

On 4 April 2022, the FRC published an update on the progress of its periodic review.

Over 450 stakeholder comments were received from the Request for Views phase which closed on 31 October 2021. This number is probably unsurprising given that the Request for Views phase opened at the start of March 2021 and so had a very long lead time.

Generally, it would appear that the standards are working well but the FRC have received feedback on specific areas, including:

- Government grants
- Share-based payment
- Accounting for climate-related matters
- Other targeted amendments

## 1.2 Aligning FRS 102 with IFRS®s 9, 15 and 16

As a reminder of the 'major' IFRSs:

- IFRS 9 *Financial Instruments*
- IFRS 15 *Revenue from Contracts with Customers*
- IFRS 16 *Leases*

Previous updates have covered the issues raised where these major IFRSs are concerned. However, the FRC have provided the following feedback in these areas:

**IFRS 9**

Mixed feedback has been received by the FRC concerning the expected credit loss (ECL) model. As noted in previous updates, this model is more arduous in its application than the current incurred credit loss model which features in UK and Ireland accounting standards. The ECL model is forward-looking and hence would invariably require more impairment losses to be recognised in the financial statements. The FRC will have to make significant simplifications to the ECL model in order for it to be appropriate for private entities in the UK and Ireland as well as to maintain consistency with their principles of standard-setting, one of which is that they must be cost-effective to apply.

The FRC's periodic review is being carried out at the same time as the comprehensive review of *IFRS for SMEs*. The International Accounting Standards Board (IASB) are proposing a hybrid model in *IFRS for SMEs* whereby the ECL model will be used for all financial assets (e.g. loans receivable) but trade receivables and contract assets will be exempt from the ECL model. At the time of writing, this model had not been finalised so it will be interesting to see how the FRC proceed when they issue their Exposure Draft of proposed changes.

**IFRS 15**

The FRC have heard support for updating the revenue section in FRS 102 (Section 23 *Revenue*) to align it with the five-step model contained in IFRS 15. IFRS 15 is a complex standard and so there would need to be simplifications made to make FRS 102, Section 23 proportionate to its users.

The FRC have said that the IASB propose to rewrite Section 23 in *IFRS for SMEs* and incorporate simplifications, which would provide the FRC with a starting point.

**IFRS 16**

The FRC have heard support for on-balance sheet accounting for leases (from the perspective of the lessee). This is likely to be an area that will receive push-back from some practitioners. As noted in the previous quarter's update, the IASB have decided to tentatively leave lease accounting unchanged in *IFRS for SMEs* but the FRC take the view that they do need to review this area so it will be interesting to see the Exposure Draft of how they propose to do this.

## 1.3 Next steps

During the course of May and June 2022, the FRC will perform outreach events to interested parties.

An Exposure Draft of potential changes to UK GAAP will be published but not before September 2022 and will follow the IASB's *IFRS for SMEs* Exposure Draft which is currently expected in the second half of 2022 as well.

Once the Exposure Draft is published, there will be a public consultation on the amendments which will be no less than three months. Final amendments are expected to be published no less than 12 months prior to the date of implementation.

The final amendments to UK GAAP arising from the periodic review are not expected to be effective before 1 January 2025.

As always, it should be borne in mind that these dates are tentative and hence could be subject to change depending on developments over the course of the next few months.

## 2 FRS 100 amendments (Lecture A783 – 7.39 minutes)

On 20 May 2022, the Financial Reporting Council (FRC) issued FRED 80 *Draft amendments to FRS 100 Application of Financial Reporting Requirements – Application Guidance – The Interpretation of Equivalence*.

The UK exited the EU in January 2020 and various changes were made to company law to ensure that it continues to operate effectively. The FRC issued *Amendments to UK and Republic of Ireland accounting standards – UK exit from the European Union* in December 2020 which contained relevant amendments to accounting standards arising from changes to company law.

Paragraph 9 of the amendments document noted that the Application Guidance *The Interpretation of Equivalence* to FRS 100 would be updated for changes to UK company law and decisions on equivalence. In January 2022, all the FRSs in the suite of UK GAAP were re-issued to consolidate all amendments made to the standards since March 2018. However, FRS 100 was not reissued pending the finalisation of these amendments.

FRED 80 proposes to amend FRS 100 to replace the Application Guidance as well as making other consequential amendments.

Comments on FRED 80 are open until 26 August 2022.

### 2.1 What is changing?

The Application Guidance is contained in FRS 100, currently in paragraphs AG1 to AG10. It is proposed that all of these paragraphs are deleted and are replaced with new paragraphs AG1 to AG 28. The table below summarises these paragraphs:

| Section | Relevant paragraphs |
|---|---|
| Introduction | AG1 to AG4 |
| Assessing equivalence | AG5 to AG6 |
| The exemptions from consolidation | |
| • For UK entities: Section 401 of the Act | AG7 to AG8 |
| • The condition in section 401(2)(b) subparagraph (iv) | AG9 to AG10 |
| • The condition in section 401(2)(b) subparagraph (ii) | AG11 to AG14 |
| • For Irish entities: Section 300 of the Companies Act 2014 | AG15 to AG16 |

| | |
|---|---|
| • The condition in section 300(4)(b) subparagraph (iv) | AG17 to AG18 |
| • The condition in section 300(4)(b) subparagraph (ii) | AG19 to AG22 |
| The exemptions in financial reporting standards | |
| • Equivalent disclosures are included in the consolidated financial statements of the group | AG23 to AG26 |
| • Alternative measurement option for share-based payment transactions | AG27 to AG28 |

Intermediate parents in the UK whose immediate parent is not established under the law of any part of the UK may be able to claim exemption from preparing group accounts if it meets the conditions in s401 Companies Act 2006 (CA06). These conditions include the company and all of its subsidiaries being included in the group accounts for a larger group drawn up to the same accounting reference date, or an earlier date in the same financial year. Those accounts and, where appropriate, the group's annual report, must be drawn up:

(a) in a manner that is equivalent to the requirements of Part 15 of CA06 (Section 401(2)(b), subparagraph (ii));

(b) in accordance with UK-adopted IFRS (Section 401(2)(b), subparagraph (iii)); or

(c) in accordance with accounting standards which are equivalent to UK-adopted IFRS, as determined in accordance with Commission Regulation (EC) No 1569/2007 of 21 December 2007, as amended by *The Official Listing of Securities, Prospectus and Transparency (Amendment etc.) (EU Exit) Regulations 2019* (SI 2019/707) (see paragraph AG9) (Section 401(2)(b), subparagraph (iv)).

The Application Guidance in FRS 100 provides guidance on interpreting the meaning of equivalence in the circumstances set out above.

## 2.2 Assessing equivalence

Claiming exemption from preparing consolidated financial statements requires an analysis of whether the framework (or specified elements of it) applied in practice are equivalent to another framework (or specified elements of it). The proposed Application Guidance will assist reporting entities in adopting a consistent approach in making this assessment.

References to equivalence to another framework do not mean compliance with every aspect of that framework. Instead, it is necessary to consider whether the basic requirements of that framework are met (particularly the requirement to give a true and fair view). The proposed Application Guidance clarifies that a qualitative approach is more in keeping with the deregulatory nature of the exemption rather than a requirement to consider the detailed requirements on a checklist basis.

## 2.3 Which GAAPs have been recognised?

Paragraph AG9 of the proposed Application Guidance clarifies that the UK government has recognised the equivalence to UK-adopted IFRS of the following GAAPs, which includes those GAAPs previously recognised by the EC as equivalent to EU-adopted IFRS:

| GAAP |
| --- |
| GAAP of Canada |
| GAAP of the People's Republic of China |
| GAAP of Japan |
| GAAP of the Republic of Korea |
| GAAP of the United States of America |
| IFRS as adopted by the EU |
| IFRS as issued by the IASB |

At the present time, the UK has not formally granted the equivalence of any other country's accounting standards, including EEA states national accounting standards or the *IFRS for SMEs* Standard, to UK-adopted international accounting standards.

## 2.4 How can I respond to the FRED?

Ideally, the FRC would like comments to be sent in by email to: ukfrs@frc.org.uk

Hard copy comments can be sent to:

Accounting and Reporting Policy team

Financial Reporting Council

8th Floor

125 London Wall

London EC2Y 5AS

## 3 New Charities Act 2022 (Lecture A784 – 5.39 minutes)

In February 2022, the Charities Bill received Royal Assent and became the Charities Act 2022.

Some of the more notable changes in the Charities Act 2022 are below:

**Amending governing documents**

Charities and trustees will be able to amend their governing documents or Royal Charters more easily. This will apply to unincorporated charities and will enable efficiencies in keeping governing documents up to date.

Permission from the Charity Commission will still be needed in some situations. For example, where a charity wishes to make changes to its objects, dissolution clause, trustee or member benefit rules and restrictions on permanent endowment.

**Access to more professional advisors**

Charities will have access to a much wider pool of professional advisors on land disposal. In addition, there will be more straightforward rules on what advice charities must receive which should save time and money when it comes to disposing of land.

For example, previously trustees were required to engage a surveyor who is RICS-qualified to provide a detailed report on a property that is to be disposed of. Under the Charities Act 2022, trustees will be able to obtain advice from a wider pool of surveyors. In addition, if the board of trustees includes a surveyor who they deem to be suitably qualified, they will not have to engage the services of an external advisor at all. This is a positive move for charities as it will save on costs and time in this area.

**Use of a ‘permanent endowment’**

Charities are given more flexibility to make use of a ‘permanent endowment’. This is money, or property, which was originally intended to be held by the charity indefinitely. The changes include allowing trustees to borrow a sum of money up to 25% of the value of their permanent endowment funds without obtaining approval from the charity regulator provided it is paid back within 20 years.

Prior to the Charities Act 2022, a permanent endowment fund could only be invested for a financial return. Under the new Act, a charity can use a permanent endowment fund to make ‘social investments’ that have a negative or uncertain financial return. It is expected that the Charity Commission will issue regulations on how this will work and it is likely this will tie in with its proposed new guidance on ‘responsible investment’.

**Ex-gratia payments**

The Charities Act 2011 contains rules concerning ex-gratia payments where a charity feels obliged to make a payment which does not further its objects. The new Act relaxes this rule so that smaller ex-gratia payments (possibly up to £20,000, depending on the level of the charity's income) can be made without needing authority from the Charity Commission.

A key point to note is that this does not mean that charities are free to make any payment below this value. The ex-gratia payment must fall within the scope of being ex-gratia which, in itself, has specific requirements.

**Payment for goods or services to a trustee**

Trustees will be able to be paid for goods provided to a charity in certain circumstances (even if this is not expressly stated in the charity's governing documents). Prior to the Charities Bill becoming the Charities Act 2022, trustees could only be paid for supply of services. This change will allow charities the flexibility to access goods from trustees provided it is in the best interests of the charity (such as a cheaper price) without needing approval from the charity regulator.

**Simpler rules on failed appeals**

Charities can now take advantage of simpler and more proportionate rules on failed appeals. For example, if a charity raises insufficient funds through an appeal, the charity will be able to spend donations below £120 on similar charitable purposes without needing approval from the individual donors. Prior to the changes, a failed appeal would mean that the charity would not be able to use all (or any) of the money for the purpose it was raised.

**Legacies less likely to be lost**

In situations where a charity merges with another organisation, or becomes an incorporated charity, there is a risk that legacies to the old charity may be lost as it effectively no longer exists. It is for this reason that some old charities remain open as a 'shell' to receive legacies and this, of course, creates administrative burdens which leads to increased costs for the charity.

The new Act fixes this issue so that, provided the transaction is recorded in the 'register of mergers' as a gift, the legacy will go to the new charity even if it specifies that it will only take effect if the charity still exists.

**Incorrect trustee appointments**

If a mistake comes to light surrounding the appointment of a trustee, the Charity Commission is now given a new power which ratifies the appointment or election of a charity trustee where there is either:

- uncertainty as to whether the trustee was properly appointed or elected; or
- any defect in their appointment or election.

Charities need to keep in mind this should always be a last resort because trustees still have a duty to comply with the rules in their governing document.

# 4 Related parties (Lecture A785 – 21.49 minutes)

Related parties are dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 33 *Related Party Disclosures*. Small entities applying the presentation and disclosure requirements of Section 1A *Small Entities* must have regard to the requirements in paragraphs 1AC.34 to 1AC.36. However, small entities applying Section 1A must also have regard to the provisions in Section 33 as disclosures beyond those required by Section 1A may be needed to provide a true and fair view.

Related parties have long-since been a contentious issue, largely because of their subjective nature. In some cases entities are reluctant to disclose related party transactions in their financial statements because of commercially sensitive information or simply because management do not want to disclose such information. Where the entity is audited, this will invariably cause the audit opinion to be modified if the situation is not resolved adequately.

## 4.1 Identifying a related party

FRS 102, para 3.2(a) says:

> *A person or a* ***close member of that person's family*** *is related to a reporting entity if that person:*
>
> *(i) has* ***control*** *or* ***joint control*** *over the reporting entity;*
>
> *(ii) has* ***significant influence*** *over the reporting entity; or*
>
> *(iii) is a member of the* ***key management personnel*** *of the reporting entity or of a* ***parent*** *of the reporting entity.*

*FRS 102, para 33.2*

Terms which are shown in **bold type** mean that they are defined terms in the Glossary.

It should be borne in mind that the term 'close member of that person's family' is not a test as to whether a close family member can influence, or be influenced by, that person in their dealings with the entity. Instead, it is a test of whether the **users** of the financial statements would regard the close family members as having influence over that person. Keep in mind that the test is quite wide in its scope.

For the purposes of financial reporting, 'control' is usually obtained by virtue of an ownership interest of more than 50% of the voting rights of the entity. Numeric benchmarks are not, however, the only indicator that control exists and so regard must be had to the substance of the relationship (in some situations, control can be obtained even with an ownership interest of 50% or less).

'Significant influence' is usually obtained with an ownership interest of between 20 and 50%. As with control, numeric benchmarks are not always an indicator that significant influence exists – there may be other characteristics which could indicate an individual may have the ability to exert significant influence over the business despite having an ownership interest of less than 20%.

The term 'key management personnel' is also wide in scope. It is not confined to just the directors of a reporting entity. Managers and supervisors could, for example, be regarded as key management personnel if they have any authority or responsibility for planning, directing and controlling the activities of the entity (either directly or indirectly). Key management personnel of a group may also include directors of subsidiaries who are not on the board of the group.

If an entity has engaged the services of an individual under a temporary management contract, that individual may also fall within the scope of key management personnel depending on their level of authority within the business.

**Entities which are related parties**

FRS 102, para 33.2(b) then outlines the conditions which would give rise to an entity being related to a reporting entity. These conditions are as follows:

*FRS 102, para 33.2(b)*

- *(i) the entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).*
- *(ii) one entity is an **associate** or **joint venture** of the other entity (or an associate or joint venture of a member of a group of which the other is a member).*
- *(iii) both entities are joint ventures of the same party.*
- *(iv) one entity is a joint venture of a third party and the other entity is an associate of the third party.*
- *(v) the entity is a **post-employment benefit plan** for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.*
- *(vi) the entity is controlled or jointly controlled by a person identified in (a).*
- *(vii) a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).*
- *(viii) the entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.*

**Example – Identifying related parties**

Jeanette has an investment in Bamber Ltd and Clowes Ltd. Jeanette is the controlling party in Bamber and has significant influence over Clowes.

In Bamber's financial statements, Clowes will be a related party because Jeanette has significant influence over it. This would also be the case if Jeanette had control or joint control over Clowes.

In Clowes' financial statements, as Jeanette has control over Bamber, Bamber is related to Clowes because Jeanette has significant influence over Clowes.

If Jeanette had only significant influence over both Bamber and Clowes (but did not have control or joint control over either entity), this would not be enough to mean the entities were related.

FRS 102, para 33.3 outlines the importance of considering each possible related party relationship by assessing the **substance** of the relationship rather than the legal form. This would also apply to small companies as well (even those reporting under FRS 102, Section 1A).

**Example – Husband and wife investing in two separate companies**

Mr and Mrs Byrne are husband and wife. Mr Byrne has a controlling investment in Company A and Mrs Byrne has a controlling investment in Company B.

As they are spouses, Mr and Mrs Byrne are close members of the family of each other.

**If Company A is the reporting entity**

As Mr Byrne controls Company A, and is a close member of the family of Mrs Byrne, who controls Company B, Company and Company B are related parties (FRS 102, paras 33.2(b)(vi), (a)).

**If Company B is the reporting entity**

As Mrs Byrne controls Company B, and is a close member of the family of Mr Byrne, who controls Company A, Company B and Company A are related parties (FRS 102, paras 33.2(b)(vi), (a)).

**Disclosure requirements**

Transactions between Company A and Company B would require disclosure as related party transactions (unless they are small companies), as they are not part of the same group and so the 100% subsidiary exemption does not apply.

**If Mr and Mrs Byrne only had significant influence**

If Mr and Mrs Byrne only had significant influence over each of their respective companies (rather than control or joint control), the companies would not be related to each other.

## 4.2 Entities who are not related parties

FRS 102, para 33.4 states:

*In the context of this FRS, the following are not related parties:*

*FRS 102, para 33.4*

*(a) Two entities simply because they have a director or other key member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.*

*(b) Two **venturers** simply because they share joint control over a joint venture.*

*(c) Any of the following simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process):*

*(i) providers of finance;*

*(ii) trade unions;*

*(iii) public utilities; and*

*(iv) government departments and agencies.*

*(d) A customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of **business**, merely by virtue of the resulting economic dependence.*

FRS 102, para 33.4 restricts the circumstances in which the above entities are not related parties. For example, two entities because they '… have a director or other key member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.' There may be other reasons why two entities with key management personnel in common could be related and hence they could still be related parties once the substance of the relationship is established.

Careful scrutiny of the relationships needs to be carried out to ensure that there are no other circumstances or factors which result in any of the above entities becoming related parties of the entity and hence having to comply with the disclosure requirements.

**Example – One director in common**

Martyn is the sole director of Greaves Ltd and Ratchford Ltd. During the year to 31 May 2022, Greaves sold goods to Ratchford for £10,000 plus VAT.

Under FRS 102, Section 33, two companies are not related just because they have a director in common. Often, a director will be able to have a say over the running of the company, but this does not necessarily give rise to Greaves and Ratchford becoming related parties as both companies would be expected to go about their own business for the benefit of their respective shareholders.

## 4.3 Intra-group trading

FRS 102, para 33.1A clarifies that transactions entered into between two or more members of a group need not be made in the financial statements provided that any subsidiary which is a party to the transaction is wholly owned by such a member.

Companies Act 2006, s1159(2) defines a 'wholly owned subsidiary' as follows:

> *A company is a "wholly-owned subsidiary" of another company if it has no members except that other and that other's wholly-owned subsidiaries or persons acting on behalf of that other or its wholly-owned subsidiaries.*

*CA 2006, s1159(2)*

**Example – Intra-group trading**

The following illustrates the structure of the Sunnie Group Ltd:

Sunnie Limited

↓ 100%

Morley Limited

↓ 60%

Dexter Limited

During the year to 31 March 2022 all three entities trade with each other.

Morley Limited is a wholly owned subsidiary of Sunnie Ltd. Sunnie Ltd also has control over Dexter Ltd because it owns more than 50% of the subsidiary. However, Dexter Ltd is not a wholly owned group member and hence transactions with Dexter Ltd would be disclosed within Sunnie's and Morley's individual financial statements.

If, however, Sunnie Ltd owned the remaining 40% of Dexter Ltd, then Dexter would become a wholly owned subsidiary within the group and all three companies would be able to take advantage of the exemption from disclosing all trading among themselves.

FRS 102 is unclear as to what happens when a subsidiary is only partially owned at the date the transaction arises but is wholly owned at the balance sheet date as the parent has acquired the remaining non-controlling interest by th. It could be argued that disclosure is not necessary because the subsidiary is wholly owned at the balance sheet date, especially where there is no third-party interest. However, common practice is that if they were not wholly-owned at the date of the transaction, disclosure is still required,

## 4.4 Examples of related party transactions

FRS 102, para 33.12 provides a useful list of examples of related party transactions which may need disclosure as follows:

*FRS 102, para 33.12*

a) purchases or sales of goods (finished or unfinished);

b) purchases of sales of property and other **assets**;

c) rendering or receiving of services;

d) leases;

e) transfers of **research** and **development**;

f) transfers under licence agreements;

g) transfers under finance arrangements (including loans and equity contributions in **cash** or in kind);

h) provision of guarantees or collateral;

i) settlement of **liabilities** on behalf of the entity or by the entity on behalf of another party; and

j) participation by a parent or subsidiary in a **defined benefit plan** that shares risks between group entities.

## 4.5 Changes in related party relationships

There is no guidance in FRS 102 as to what happens when a party ceases to be a related party during the reporting period; i.e. whether any transaction(s) with the related party should be disclosed because they were a related party at some stage during the reporting period but were not a related party at the balance sheet date. Conversely, no guidance is provided where a party was unrelated up to a certain point during the reporting period but then became related and was a related party at the balance sheet date.

In such cases, it may be advisable to make the disclosures up to the point at which the related party ceased to be a related party. If the related party becomes a related party during the reporting period, disclosures should be made from at least the date when the party became related.

If a party becomes a related party after the balance sheet date, but before the financial statements are authorised for issue, the provisions in FRS 102, Section 32 *Events after the End of the Reporting Period* will apply. Where the event is a material non-adjusting event, disclosure of such will be needed in the financial statements, including an estimate of the financial effect (or a statement that such an estimate cannot be made). In respect of parties that become related parties after the reporting date, but before the financial statements are authorised for issue, the disclosures required by Section 33 may apply.

**Practical suggestion**

With respect to transactions, the amounts of such transactions and details regarding terms and conditions etc should be disclosed for those transactions if the parties were related at the time of the transaction.

With respect to outstanding balances, details should be disclosed in respect of parties that were related parties either at the end of the reporting period or at the time of the transaction that gave rise to the outstanding balance.

## 4.6 Disclosure requirements for non-small entities (FRS 102, Section 33)

It should be noted at the outset that FRS 102 (both Section 33 and Section 1A) does not require the names of the transacting related parties to be disclosed. Instead, the standard requires the entity to disclose the **nature** of the related party relationship. This applies to both small and non-small entities.

FRS 102, Section 33 requires the following to be disclosed:

**Parent-subsidiary relationships**

Relationships between a parent and a subsidiary are to be disclosed regardless of whether, or not, there have been any related party transactions as required by FRS 102, para 33.5.

The entity must disclose the name of its parent and, where different, the ultimate controlling party. When neither the parent nor the ultimate controlling party produce publicly available financial statements, the name of the next most senior parent that does so (if any) is to be disclosed.

The term 'publicly available' can mean the financial statements are available from Companies House, or copies can be obtained from a specific address (e.g. the registered office).

Generally, FRS 102, Section 33 does not require the names of transacting related parties to be disclosed. However, it does require the name of the entity's parent and, if different, the name of the ultimate controlling party to be disclosed.

Sch 4 to The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410), para 8 requires the following disclosures:

- the name of the undertaking;
- the address of the undertaking's registered office (whether in or outside of the UK); and
- if it is unincorporated, the address of its principal place of business.

Where group accounts are prepared, paragraph 8 also requires the entity to disclose the address where the consolidated financial statements can be obtained (if these are publicly available).

**Key management personnel compensation**

Key management personnel compensation is consideration of all forms paid, or payable, to key management personnel (KMP) in exchange for services rendered. Please note, this is not the same as the directors' emoluments and other benefits disclosure which is required under company law. For the purposes of KMP compensation, it includes all employee benefits (e.g. salaries, benefits in kind, paid leave, profit-sharing and bonuses) including share-based payments which are dealt with in FRS 102, Section 26 *Share-based Payment*. It is the cost of the compensation to the entity and must be disclosed in totality for all members of KMP (names need not be given nor does it need to be disaggregated into remuneration, pension contributions etc).

There is an exemption in FRS 102, para 33.7A from disclosing KMP in totality. This can be applied when the entity is required by law or regulation to disclose directors' remuneration (or equivalent) and KMP and the directors are the same body. Keep in mind that KMP is not confined to just the directors – it can involve anyone with authority for planning, directing and controlling the entity, hence supervisors and managers who are not directors may be included in KMP. Therefore, there are a lot of entities which will be unable to apply the exemption in FRS 102, para 33.7A.

**Example – Non-executive directors**

Catalan Ltd has four non-executive directors on its board. The finance director is proposing not to include the remuneration of these non-executive directors in the disclosure of remuneration for key management personnel in the financial statements. Her conclusion is drawn from the requirements of the UK Corporate Governance Code which requires a certain number of 'independent' non-executives whose role, among other things, involves scrutinising the performance of management.

The finance director has concluded that as they are independent, they are not part of management and hence need not be included in the key management personnel compensation disclosure.

The definition of 'key management personnel' is clear. It specifically says '… *including any director (executive or otherwise)*…'. Therefore, the finance director should include the non-executive directors' remuneration within the key management personnel compensation disclosure.

**Related party transactions**

Related party transactions do not have to have a price attached to them for them to need disclosure – they can be entered into at nil consideration and even then such transactions are disclosable. When the entity has entered into related party transactions it must disclose the nature of the related party relationship and provide further information about the transactions, outstanding balances and commitments which are necessary for an understanding of the (potential) effects of the relationship on the financial statements. Keep in mind that this is the whole purpose of related party disclosures – i.e. to inform the user that the financial statements may have been affected by the existence of related parties and transactions and balances with those related parties.

**As a minimum**, the disclosures must include:

*FRS 102, para 33.9*

*(a)* *The amount of the transactions.*

*(b)* *The amount of outstanding balances and:*

*(i)* *their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and*

*(ii)* *details of any guarantees given or received.*

*(c)* *Provisions for uncollectible receivables related to the amount of outstanding balances.*

*(d)* *The expense recognised during the period in respect of bad or doubtful debts due from related parties.*

FRS 102, para 33.9 clarifies that such transactions could include purchases, sales, or transfers of goods or services, leases, guarantees and settlements by the entity on behalf of the related party or vice versa.

Thes are the minimum required by FRS 102, Section 33. Other significant information must be disclosed if this is necessary for an understanding of the financial statements.

The above disclosures must be made for each of the following categories:

*FRS 102, para 33.10*

(a) *entities with control, joint control or significant influence over the entity;*

(b) *entities over which the entity has control, joint control or significant influence;*

(c) *key management personnel of the entity or its parent (in the aggregate);*

(d) *entities that provide key management personnel services to the entity; and*

(e) *other related parties.*

FRS 102, para 33.10 provides the minimum disaggregation but further disaggregation in addition to the above would be required by FRS 102, para 33.14 when such disaggregation is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

## 4.7 Arm's length related party transactions

A reporting entity cannot assert in the financial statements that related party transactions were made on terms equivalent to those which prevail in an arm's length transaction unless such terms can be substantiated. Auditors need to pay particular attention to this and ensure they obtain appropriate audit evidence where such a statement has been made in the financial statements.

The term 'arm's length transaction' is not defined in FRS 102, but is defined in ISA (UK) 550 *Related Parties* as:

*ISA (UK) 550, para 10(a)*

> *A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.*

FRS 102, para 33.13 prohibits entities from stating that transactions with related parties are carried out on terms equivalent to those prevailing in an arm's length transaction when, in fact, they have not, because such a statement would clearly be misleading. The whole point of making related party disclosures is to highlight that the financial statements may have been influenced by the presence of related party transactions which may have not been carried out on an arm's length basis.

The issue concerning arm's length transactions will usually apply when goods or services are provided to, or from, a related party and no price is charged. Similarly, in a group context, a parent, for example, may provide goods or services (or even loans) and charge favourable prices or reduced rates of interest. In such situations, the transactions cannot be said to have been carried out on an arm's length basis so must not be described as being carried out as such in the financial statements.

## 4.8 Small entities applying Section 1A

As noted above, FRS 102, para 1AC.35 does not require the names of transacting related parties to be disclosed – instead it follows the principles in Section 33 and requires the nature of the related party relationship to be disclosed.

The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409) state that an entity **may** disclose details of transactions which the company has entered into with related parties. However, both the Act and Section 1A do specifically require disclosure of material transactions which have not been undertaken under normal market conditions with:

(a) owners holding a participating interest in the company;

(b) companies in which the company has a participating interest; and

(c) the company's directors (or members of its governing body).

FRS 102, para 1AC.35 refers to transactions that have not been concluded **under normal market conditions**. The standard does not define the term 'normal market conditions' and hence this will be left to professional judgement. However, the term should be taken to mean on an arm's length basis.

In respect of such transactions, the small entity must disclose:

(a) *the amount of such transactions;*

(b) *the nature of the related party relationship; and*

(c) *other information about the transactions necessary for an understanding of the financial position of the small entity.*

*FRS 102, para 1AC.35*

When transactions have been entered into between related parties which are similar in nature, the entity may aggregate them. However, separate disclosure would be required when this is necessary for an understanding of the effects of the related party transactions on the financial position of the small entity.

**Important point**

The above disclosure requirements are the legally required minimum as per the Companies Act 2006. However, it must be borne in mind that directors of small entities have a legal duty to ensure the financial statements give a true and fair view and hence directors must consider whether additional related party disclosures need to be made to achieve this. Regard must therefore be had to Section 33 of FRS 102 in case any additional disclosures may be necessary to achieve a true and fair view.

**Example – Related party disclosures**

Ben Currie and Daniel Walker are both directors of C&W Trading Ltd. Ben owns 80% of the ordinary shares with the remaining 20% being owned by Ben's wife. Daniel is unrelated to Ben and is not a shareholder. Both directors live in houses provided by the company. Ben pays a peppercorn rent of £100 per annum and Daniel pays full market rent of £18,000 per annum. There are no amounts of rent outstanding or prepaid at the balance sheet date.

**Disclosure under full FRS 102**

During the year the company rented two properties to key management. One property attracted a peppercorn rent, and the other property a commercial rent. Total rents received in the year to 31 May 2022 were £18,100 (2021: £17,900). No amounts are outstanding (2021: £nil).

| |
|---|
| Note – technically FRS 102, para 33.5 only requires the ultimate controlling party disclosures in respect of a group (i.e. where the reporting entity has a parent entity). In this scenario, Ben Currie is the shareholder with ultimate control, but disclosing this is not strictly necessary. |
| **Disclosure under FRS 102, Section 1A**<br><br>During the year the company rented a property to a director. A peppercorn rent of £100 was charged (2021: £100). |
| Note – under FRS 102, Section 1A, only material transactions not concluded under normal market conditions need disclosure. If the small entity were to make all the related party disclosures, the standard notes that it would still be compliant with the law. |
| **Disclosure under FRS 105**<br><br>None. |

### 4.9 Audits of small entities

Auditors of small entities cannot simply ignore related party disclosures under FRS 102, Section 33 because the small entity has applied the presentation and disclosure requirements of Section 1A. Indeed, some related party transactions may not have been disclosed by the directors either through oversight or deliberately. The auditor must therefore still gather all of the normal information about who the related parties are, as set out in ISA (UK) 500 *Audit Evidence*, as otherwise they won't be able to ascertain if there are any transactions that need disclosing or if there are other impacts on the financial statements.

The auditor must then consider whether any such transactions have been concluded under normal market conditions because if they are material and have **not** been concluded under normal market conditions then they will be disclosable. If the auditor does not consider these issues, then audit risk (being the risk that the auditor will express an incorrect opinion on the financial statements) is increased. It is likely to lead to the auditor expressing an unmodified opinion when, in fact, a modified opinion is more appropriate in the circumstances.

# 5 Borrowing costs (Lecture A786 – 9.18 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with borrowing costs in Section 25 *Borrowing Costs*. The term 'borrowing costs' is defined in FRS 102 as:

> *Interest and other costs incurred by an entity in connection with the borrowing of funds.*

*FRS 102 Glossary* ***borrowing costs***

Borrowing costs include:

- interest charges calculated using the effective interest method in Section 11 *Basic Financial Instruments*;
- finance charges in respect of a finance lease accounted for under Section 20 *Leases*; and
- exchange differences that have arisen from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

## 5.1 Recognition and measurement

At the outset it is worth noting that for micro-entities choosing to report under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, all borrowing costs must be written off to profit or loss as they are incurred. There is no option under FRS 105 to capitalise such costs.

There is an accounting policy choice available under FRS 102 which allows an entity to capitalise borrowing costs as part of the cost of the qualifying asset. Where an entity elects to capitalise borrowing costs, then it must do so consistently for a class of qualifying assets.

The term 'qualifying asset' is defined as:

> *An* ***asset*** *that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the circumstances any of the following may be qualifying assets:*
>
> *(a)* ***inventories****;*
>
> *(b) manufacturing plants;*
>
> *(c) power generation facilities;*
>
> *(d)* ***intangible assets****; and*
>
> *(e)* ***investment properties****.*

*FRS 102 Glossary* ***qualifying asset***

> ***Financial assets****, and inventories that are produced over a short period of time, are not qualifying assets.*
>
> *Assets that are ready for their intended use or sale when acquired are not qualifying assets.*

The definition of a qualifying asset refers to an asset which '… takes a substantial period of time to get ready for its intended use or sale.' The term 'substantial period of time' is not a defined term in FRS 102 and will involve the exercise of professional judgement. In practice, a substantial period of time would not be a period shorter than 12 months. It would be unusual for an entity to capitalise borrowing costs where the period of construction is less than 12 months because of the work involved and the overall immaterial effect this may have on the financial statements.

In addition, management may wish to assess the impact of borrowing costs on the entity's corporation tax position as there may be restrictions on those which are allowable against tax.

## 5.2 Specific borrowings are used to construct an asset

FRS 102, para 25.2A states that borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset are those costs which the entity would have avoided had the expenditure on the qualifying asset not been made. In practice, where an entity is self-constructing an asset, it is commonplace to take out specific borrowings to undertake the project where the entity has not already got access to the finance in the form of disposable income.

**Important point**

Many clients take out a loan construct an asset which incurs a loan arrangement fee on inception of the loan of, say, £5,000. This £5,000 arrangement fee is NOT capitalised as part of the cost of developing a qualifying asset.

FRS 102 requires that any separately incurred transaction costs (such as loan arrangement fees) are debited to the loan account (i.e. the loan is initially recognised NET of the transaction cost).

The loan liability net of the arrangement fee is dealt with in accordance with FRS 102, Section 11 *Basic Financial Instruments* i.e. using the amortised cost method and effective interest rate.

It is the interest expense that is **calculated in accordance with FRS 102, Section 11** that is capitalised as opposed to written off to finance costs in profit or loss. Keep in mind that capitalisation can only occur during periods of active development of the

| |
|---|
| qualifying asset. |

Where specific borrowings are incurred on a project, management must determine the amount of borrowing costs which are eligible for capitalisation. This will be the actual borrowing costs incurred less any investment income (i.e. bank interest) received on the temporary investment of those borrowings.

**Example – Borrowing and interest received**

On 1 March 2021, Watson Ltd borrowed £5m from its bank to finance the construction of a new office next door to its manufacturing plant. The terms of the contract with the building company state that they will receive three equal instalments over the construction phase, with the final instalment being paid on successful completion and sign-off by the directors. The funds are being held in a deposit account which pays interest each month. Watson has a policy of capitalising borrowing costs as part of the cost of the new building.

The financial statements of Watson Ltd should reflect the actual borrowing costs in respect of the £5m bank loan received. Bank interest received is deducted from the borrowing costs capitalised, hence:

Dr Property, plant and equipment (asset under construction) X

Cr Bank loan X

*Being capitalised borrowing costs incurred during the period that would otherwise have been recorded in profit or loss*

Dr Bank deposit account X

Cr Property plant and equipment (asset under construction) X

*Being interest received on funds borrowed to finance the new building*

## 5.3 General borrowings are used to construct an asset

It may be the case that an entity which is constructing a qualifying asset will use general borrowings to fund the project rather than incur specific borrowings. FRS 102, para 25.2C states that to the extent that funds applied to obtain a qualifying asset form part of the entity's general borrowings, the amount of borrowing costs eligible for capitalisation are determined by applying a capitalisation rate to the expenditure on that asset. **The amount of borrowing costs which an entity capitalises during a period must not exceed the amount of borrowing costs it incurred during that period**.

Clearly, when an entity uses general borrowings to fund a qualifying asset, the amount of the borrowing costs which are eligible for capitalisation is not as clear-cut as it would be had specific borrowings been incurred. The use of general borrowings where an entity has a policy of capitalisation of borrowing costs will create inherent complexities in determining the amounts eligible for capitalisation.

**Capitalisation rate**

The capitalisation rate used during an accounting period is the weighted average of rates applicable to the entity's general borrowings which are outstanding during the period. The amount of borrowing costs which an entity capitalises during the reporting period cannot exceed the amount of borrowing costs incurred during that same period.

Please note that any borrowings which relate to the construction of other qualifying assets (i.e. specific borrowings) must not be included in the capitalisation rate.

**Example – Calculation of capitalisation rate and interest capitalised in the period**

During the year to 31 January 2022, Richardson Ltd commenced a property development, incurring the following expenses:

| | £ |
|---|---|
| September 2021 | 16,000 |
| November 2021 | 20,000 |
| December 2021 | 25,000 |

Richardson has a range of borrowings on which interest has been paid as follows:

| | Balance outstanding | Interest paid |
|---|---|---|
| | £ | £ |
| 7-year loan at 9% | 18,000 | 1,620 |
| 8-year loan at 8% | 32,000 | 2,560 |
| 1-year loan | 11,000 | 1,000 |
| Bank overdraft (average) | 9,000 | 950 |
| | 70,000 | 6,130 |

The capitalisation rate to be applied on the qualifying expenditure is calculated as follows:

$$\frac{\text{Total borrowing costs incurred in the period}}{\text{Weighted average total borrowings}} \quad \frac{6{,}130 \times 100}{70{,}000} = 8.76\%$$

The interest capitalised in the year is calculated as follows:

| | £ |
|---|---|
| £16,000 x 5/12 x 8.76% | 584 |
| £20,000 x 3/12 x 8.76% | 438 |
| £25,000 x 2/12 x 8.76% | 365 |
| Interest to capitalise | 1,387 |

The total interest paid in the year is £6,130 and the borrowing costs eligible for capitalisation are £1,387 and so the rule in paragraph 25.2C which prohibits the amount of capitalised interest exceeding the amount of borrowing costs incurred during the period is not breached. If the amount eligible for capitalisation were higher than the amount of borrowing costs incurred, the amount capitalised in the period would be capped at the total amount of borrowing costs incurred in the period.

The rule in FRS 102, para 25.2C which restricts the amount of borrowing costs capitalised if they exceed the amount of borrowing costs incurred may not pose a problem in an individual entity's financial statements. Problems may, however, arise at group level where individual subsidiaries correctly capitalise borrowing costs, but in the consolidated financial statements, the total amount of borrowing costs capitalised may exceed the borrowing costs incurred for the group as a whole. This will necessitate a consolidation adjustment to reduce the amount of borrowing costs capitalised at group level.

## 5.4 Period of capitalisation

The period of capitalisation is outlined in FRS 102, paras 25.2D(a) to (c). FRS 102, para 25.2D requires an entity that capitalises its borrowing costs to:

(a) capitalise borrowing costs from the point it first incurs expenditure on the qualifying asset and undertakes activities to prepare the asset for its intended use or sale;

(b) suspend capitalisation during periods where active development is paused;

(c) cease capitalisation when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

**Example – Construction is stopped**

Harper Ltd is constructing a new building for use in its operations. It has taken out a bank loan to fund the project and incurs interest each month. The company has adopted a policy of capitalising the interest incurred on the borrowings as part of the cost of the building.

In April, construction stopped because of an accident on the site. The period of suspension was four months and during that time the finance director continued to post the interest incurred on the borrowings to the cost of the new building.

The finance director is incorrect to continue capitalising borrowing costs during the period of suspension. FRS 102, para 25.2D(b) is specific that capitalisation must be suspended during extended periods where active development of the asset has paused.

**Example – Legislative issues outstanding**

On 10 June 2021, Revere Ltd completed the building of a new warehouse which it had funded by specific borrowings via five-year bank loan. The company has a policy of capitalising borrowing costs.

The company must receive clearance from the Health and Safety Directorate before it can be used due to the nature of the products being stored in the warehouse. This clearance cannot be obtained under September 2022 due to a backlog of cases being handled by Health and Safety. The finance director is unsure whether to continue capitalising the borrowing costs which the company will incur in the months of June to September 2022.

Ordinarily, capitalisation will cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are complete. However, when it is not possible to avoid a delay between physical completion and any consents required to use the asset, capitalisation of borrowing costs will continue to remain appropriate. This is because until the Health and Safety clearance is received, the asset cannot be regarded as ready for its intended use.

In the example above, the delay between physical completion of the asset and the point at which it is ready for intended use was due to formalities beyond the control of the company. Continued capitalisation of borrowing costs was therefore appropriate between the date of physical completion and clearance being received. If, on the other hand, the delay in physical completion is intentional rather than unavoidable, capitalisation of borrowing costs must cease.

### 5.5 Disclosure requirements

Where an entity does not have an accounting policy of capitalising borrowing costs, no additional disclosure requirements are needed.

Where the entity does have a policy of capitalising borrowing costs, it discloses:

(a) the amount of borrowing costs capitalised in the period; and

(b) the capitalisation rate used.

The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410), Sch 1, para 27(3) requires the amount of interest included in the cost of an asset to be disclosed in a note to the financial statements. This is different than the requirements of FRS 102 which require disclosure of the amount of borrowing costs capitalised in the period. The Companies Act 2006 requires the cumulative amount of interest included in the cost of the asset to be disclosed.

# 6 Accounting policies, estimates and errors

This specific area of the course will concentrate on **changes** in accounting policies and estimates as well as error correction because these are common areas which are often incorrectly treated in the financial statements.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with accounting policies, estimates and errors in Section 10 *Accounting Policies, Estimates and Errors*. FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* deals with them in Section 8 *Accounting Policies, Estimates and Errors*.

The term 'accounting policies' is defined as:

> *The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting **financial statements**.*

*FRS 102 Glossary **accounting policies***

An 'change in accounting estimate' is defined as:

> *An adjustment of the **carrying amount** of an **asset** or a **liability**, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of **errors**.*

## 6.1 Changes in accounting policy

FRS 102, para 10.8 only allows a change in accounting policy in two situations:

(a) the change is required by an FRS; or

(b) the change is effected by management of an entity so that the financial statements provide reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

Voluntary changes in accounting policy can only be undertaken if the change results in the financial statements providing reliable and more relevant information. For example, an entity may decide to present depreciation charges in administrative expenses rather than cost of sales (or vice versa). This is a change in presentation which is a change in accounting policy and hence must be applied retrospectively. If this presentational change was not applied retrospectively, the financial statements will not be comparable as the depreciation charges for the same assets would be in two different places in the profit and loss account

FRS 102, para 10.9 confirms the following are **not** changes in accounting policies:

*(a)* *the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring;*

*(b)* *the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were not material; and*

*FRS 102, para 10.9*

*(c)* *a change to the cost model when a reliable measure of **fair value** is no longer available (or vice versa) for an asset that an FRS would otherwise require or permit to be measured at fair value.*

**Example – Change in accounting policy: borrowing costs**

In the financial statements for the year ended 31 March 2021, Byrne Limited adopted an accounting policy of writing off borrowing costs to profit or loss when it self-constructs an asset. In the year to 31 March 2022, management decided to voluntarily change this policy to capitalising borrowing costs as management concluded that this would result in the financial statements providing reliable and more relevant information about such costs.

This voluntary change in accounting policy should be applied retrospectively for all borrowing costs to the extent that retrospective application is practicable.

**Example – Change in accounting policy: inventory**

Breary Ltd has always valued its inventory using the first-in first-out method. Due to changes within the industry, management decided to change the cost formula to that of the weighted average cost method.

This is a voluntary change in accounting policy and hence should be applied retrospectively for all inventory balances to the extent that retrospective application is practicable.

### 6.2 Changing an accounting policy

FRS 102, para 10.11 provides the guidance in changing an accounting policy as follows:

*(a)* *an entity shall account for a change in accounting policy resulting from a change in the requirements of an FRS in accordance with the transitional provisions, if any, specified in that amendment;*

*(b)* *when an entity has elected to follow IAS 39 Financial Instruments: Recognition and Measurement and/or IFRS 9 Financial Instruments instead*

*of following Section 11 Basic Financial Instruments and Section 12 Other Financial Instruments Issues as permitted by paragraph 11.2, and the requirements of IAS 39 and/or IFRS 9 change, the entity shall account for that change in accounting policy in accordance with the transitional provisions, if any, specified in the revised IAS 39 and/or IFRS 9; and*

*(c) when an entity is required or has elected to follow IAS 33, IFRS 8 or IFRS 6 and the requirements of those standards change, the entity shall account for that change in accounting policy in accordance with the transitional provisions, if any, specified in those standards as amended; and*

*(d) an entity shall account for all other changes in accounting policy retrospectively (see paragraph 10.12).*

Retrospective application requires the comparative year's/period's financial statements to be changed to reflect the revised accounting policy (i.e. as if the revised accounting policy had always been in force) and this is acknowledged in FRS 102, para 10.12. This means that all the primary financial statements (including the cash flow statement and notes to the financial statements) should be changed accordingly. The reporting entity is also required to disclose the effect(s) of the change in accounting policy on the current period, prior periods and in the aggregate for earlier periods (i.e. the impact on retained earnings brought forward).

A change in accounting policy should be applied as far back as is practicable and in practice this would mean applying the change in accounting policy to the opening comparative year's balance sheet, the closing comparative year's financial statements and the current period. Retrospective changes made to opening balances of each component of equity affected are usually made in retained earnings, although a separate component of equity can be used if management judge this to be appropriate. Separate components of equity to account for changes in accounting policy are less common in practice.

If it is impracticable to determine the individual period effects of a change in accounting policy on comparative information for one, or more, prior periods presented, the revised accounting policy is applied to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable per FRS 102, para 10.12.

**Example – Change in accounting policy for inventory**

Palmyra Ltd manufactures bedroom furniture and has an accounting reference date of 30 April. Due to changes within the business, the directors decided to change the method by which they value finished goods in inventory at the year end from the first-in first-out (FIFO) method to the average cost method. Extracts from the entity's financial statements are as follows:

| Value of finished goods | FIFO | Average cost |
|---|---|---|
| | £'000 | £'000 |
| 30.04.2022 | | 125 |
| 30.04.2021 | 98 | 112 |
| 30.04.2020 | 110 | 123 |

The change in accounting policy is recorded as follows:

At 30 April 2020 (opening balance sheet position of the comparative year)

| | £'000 |
|---|---|
| Dr Inventory | 13 |
| Cr Retained earnings | 13 |

*Being increase in finished goods as restated under the average cost method*

At 30 April 2021 (closing comparative year)

| | £'000 |
|---|---|
| Dr Inventory | 14 |
| Cr Cost of sales (closing stock) | 14 |

*Being increase in finished goods in comparative year as restated under average cost method*

At 30 April 2022 (current year)

| | £'000 |
|---|---|
| Dr Inventory | 125 |
| Cr Cost of sales (closing stock) | 125 |

*Being inventory valuation under average cost in current year*

Of course, there may also be tax effects to consider where retrospective restatement due to an accounting policy change has been effected in the financial statements (including deferred tax). It follows that when the adjustment is recognised in opening retained earnings, the tax effects should also be accounted for in that reserves.

**Disclosure requirements: changes in accounting policy**

The disclosure requirements in respect of changes in accounting policy are split into two categories:

- changes due to an amendment in an FRS; and
- voluntary changes.

**Changes due to an amendment in an FRS**

FRS 102, para 10.13 requires the following to be disclosed:

*(a) the nature of the change in accounting policy;*

*(b) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment for each financial statement line item affected;*

*FRS 102, para 10.13*

*(c) the amount of the adjustment relating to periods before those presented, to the extent practicable; and*

*(d) an explanation if it is impracticable to determine the amounts to be disclosed in (b) or (c) above.*

*Financial statements of subsequent periods need not repeat these disclosures.*

**Voluntary changes**

FRS 102, para 10.14 requires the following to be disclosed:

*(a) the nature of the change in accounting policy;*

*(b) the reasons why applying the new accounting policy provides reliable and more relevant information;*

*(c) to the extent practicable, the amount of the adjustment for each financial statement line item affected, shown separately:*

*(i) for the current period;*

*(ii) for each prior period presented; and*

*(iii) in the aggregate for periods before those presented; and*

*(d) an explanation if it is impracticable to determine the amounts to be disclosed in (c) above.*

*Financial statements of subsequent periods need not repeat these disclosures.*

When the financial statements of prior periods have been restated for the effects of accounting policy changes, it is good practice (although not a legal requirement) to head the comparative period up 'as restated'.

## 6.3 Revaluation of assets

FRS 102, para 10.10A states that the initial application of a policy to revalue assets in accordance with Section 17 *Property, Plant and Equipment* or Section 18 *Intangible Assets other than Goodwill* is a change in accounting policy to be dealt with as a revaluation in accordance with those sections, rather than in accordance with FRS 102, paras 10.11 and 10.12.

## 6.4 Changes in accounting estimates

A change in an accounting estimate is accounted for differently than a change in accounting policy. As noted above, changes in accounting policy are applied retrospectively, whereas a change in an accounting estimate is applied prospectively.

FRS 102, para 10.15 clarifies that in situations where it is difficult to distinguish a change in accounting policy from a change in accounting estimate, the change is treated as a change in accounting estimate. Examples of changes in accounting estimates include:

- a change in the useful economic life or residual value of a fixed asset;
- a change in depreciation method;
- a change in the expected outcome of a provision; and
- allowances for inventory obsolescence.

**Example – Change in depreciation method**

During the year to 31 March 2022, Wolves Ltd changed the method of depreciating its motor vehicles from a 25% reducing balance basis to four years on a straight-line basis as this revised method better reflects the entity's consumption of the motor vehicles over their useful lives and is consistent with the entity's replacement cycle.

The change in depreciation method is a change in accounting estimate and is accounted for in the period of the change (i.e. in the current year) and going forward.

When a change in an accounting estimate has the effect of changing assets and liabilities, or relates to an item of equity, the change is recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change. In other words, when an entity changes an accounting estimate that changes the carrying amount of an asset, liability, or equity it need not report that change in profit or loss when it is appropriately reflected in the carrying amount of other assets or liabilities, or taken directly to equity, in accordance with the requirements of the relevant section of FRS 102.

Conversely, when a change in an accounting estimate does affect the profit and loss account, it should be recognised in the same line item as the previous estimate.

**Example – Change in a provision for a liability**

In the financial statements for the year ended 30 April 2021, Jackson Ltd recognised a provision for damages of £25,000. This accounting estimate has been correctly recognised in cost of sales.

The solicitors acting for Jackson confirmed on 30 April 2022 that the damages have reduced to £15,000 due to new evidence presented.

The credit to the profit and loss account of £10,000 should be taken to cost of sales to ensure that the cumulative expense is correct.

**Disclosure requirements: changes in accounting estimates**

When an entity changes an accounting estimate, FRS 102, para 10.18 requires disclosure of the nature of the change in accounting estimate together with the effect the change has had on assets, liabilities, income and expense for the current period. When it is impracticable for the entity to estimate the effect of the change in one, or more, future periods, the entity must disclose those estimates.

## 6.5 Error correction

Errors are defined in the Glossary to FRS 102 as:

*Omissions from, and misstatements in, the entity's **financial statements** for one or more prior periods arising from a failure to use, or misuse of, reliable information that:*

*FRS 102 Glossary **errors***

*(a) was available when financial statements for those periods were authorised for issue; and*

*(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.*

FRS 102, para 10.20 then goes on to clarify that such errors include the effects of:

- mathematical mistakes;
- mistakes in applying accounting policies;
- oversights;
- misinterpretation of facts; and
- fraud.

Errors are distinct from the corrections of estimates. A typical estimate would be where a provision for a liability is concerned. The outcome may be higher or lower than previously estimated but the difference would not be regarded as an error because information was not available prior to the resolution of the issue giving rise to the provision. Similarly, the corporation tax charge for the year will have been estimated because this only becomes final once it is agreed with HMRC. Any over- or under-provision would be regarded as a change in accounting estimate.

Errors which are material must be corrected by way of a prior period adjustment (i.e. retrospectively) in the first financial statements authorised for issue after its discovery by:

*(a) restating the comparative amounts for the prior periods(s) presented in which the error occurred; or*

*FRS 102, para 10.21 (extract)*

*(b) if the error occurred before the earliest period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.*

FRS 102, para 10.22 then goes on to clarify that when it is impracticable to determine the period-specific effects of a material error on comparative information for one, or more, prior periods presented, the entity shall restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable and this may be in the current period.

In rare situations, it may be the case that management determine it necessary to issue revised financial statements (especially if the error is significantly material). Neither FRS 102, FRS 105 nor IAS 8 require revised financial statements to be issued as the disclosure requirements where error correction is concerned will often suffice.

However, if revised financial statements are issued, they replace the original financial statements for that year. In practice, Companies House would also be provided with the revised version of the financial statements for placing on the public record which are usually shown as 'Amended' financial statements where practicable to alert the user that they supersede any previous financial statements filed on the public record.

**Disclosure requirements: prior period errors**

FRS 102, para 10.23 requires the following disclosures where errors are corrected retrospectively:

*(a) the nature of the prior period error;*

*(b) for each prior period presented, to the extent practicable, the amount of the correction for each financial statement line item affected;*

*FRS 102, para 10.23 (extract)*

*(c) to the extent practicable, the amount of the correction at the beginning of the earliest prior period presented; and*

*(d) an explanation if it is impracticable to determine the amounts to be disclosed in (b) or (c) above.*

*Financial statements of subsequent periods need not repeat these disclosures.*

# 7 Companies House reforms (Lecture A787 – 17.17 minutes)

Plans to reform Companies House have gathered pace over the last couple of months. In the Queen's Speech, the government announced that it will legislate its plans for Companies House reforms through the Economic Crime and Corporate Transparency Bill during this parliamentary term.

It is currently uncertain how compliance will be enforced, but the new regulatory regime is expected to be more robust and potentially carry sanctions for breaches.

The idea of the Companies House reforms is to make the information placed on the public record more transparent and reduce fraudulent activities by criminals. There are a number of issues which will be of interest to accountants where these reforms are concerned.

## 7.1 Filing requirements for accounts

All company accounts will need to be filed digitally in iXBRL format and be fully tagged. In addition, small and micro-entities will be required to file a profit and loss account and there will be no ability to file abridged or 'filleted' accounts. Small companies will also need to file a directors' report, but micro-entities will not need to do this as the requirement to prepare a directors' report for a micro-entity preparing their financial statements under FRS 105 was repealed in 2016.

Dormant companies will also need to file eligibility statements which confirm the dormant status of the business.

## 7.2 Reporting shareholder information

All companies will be required to record the full names of shareholders in their registers.

Private companies and traded companies where shareholders hold at least 5% of issued shares of any class must provide a one-off shareholder list. Any subsequent changes to this list of shareholders are updated annually via the confirmation statement.

Companies which claim exemption from providing Persons with Significant Control details will need to provide further information in order to prove exemption.

## 7.3 ID verification

There will be ID verification needed for new and existing directors, Persons with Significant Control, members of LLPs and general partners of limited partnerships. There will also be a requirement for a verified account to be created. This can be set up directly with Companies House or via a third-party. No directors will be registered without a verified account and unverified directors and companies directed by such directors will commit a criminal offence for which sanctions are likely.

## 7.4 Incorporation agents

Incorporation agents will need to be registered in the UK and be registered with a UK supervisory body for anti-money laundering purposes. Any changes in supervisory body registration will need to be lodged at Companies House.

Incorporation agents will also be required to conduct customer due diligence checks under the anti-money laundering regulations and submit evidence of their ID checks undertaken on prospective directors.

## 7.5 New powers granted to the registrar

The overarching objective of the Companies House reforms is to improve the integrity of the information lodged at Companies House. To that end, the registrar is going to be provided with more querying and checking powers (currently, the registrar must generally accept information at face value). The new querying and checking powers will include:

- The power to query, reject and remove information provided to the register including new filings, existing information and, in some cases, company names and registered offices. These powers will be used on a discretionary basis using a risk-based approach and this is likely to be the case for information which is suspicious, fraudulent or likely to impact the integrity of the register.

- Additional checks for new filings which include ID verification checks and checking prior compliance for outstanding documents. Any rejected documents will be returned with a reason for rejection. The company will then have the opportunity to provide further information within 14 days.

- The registrar will have the power to punish non-compliance by imposing a sanction on the entity (further sanctions are being considered at the time of writing).

The registrar will also be given the power to share data and pass relevant information to certain public, regulatory and supervisory bodies including law enforcement. This will be the case where it:

- is required to allow the registrar to fulfil its statutory role and function.

- will assist other bodies prevent crime or in the interests of national security.

- will assist regulatory and supervisory bodies to fulfil their obligations and function.

The registrar will be able to cross-reference data which is held by public and some private bodies in order to verify its authenticity or accuracy.

Discrepancy reporting requirements will be expanded so as to include director information and registered office addresses. The registrar will also be given the powers to extend these provisions in the future as necessary.

## 7.6 Privacy of information

Information will not be available to the public where the applicant can provide evidence that they are at risk from harm. The application can be made prior to the information becoming public. However, such information will be available to certain groups (such as law enforcement). Information which may be suppressed may include:

- Signatures;
- Dates of birth;
- Residential and sensitive addresses.

Business occupations will no longer be required and will be removed from the register. In addition, the registrar will have the discretion to suppress further information as is considered necessary.

Where a company has been dissolved, historic records will be retained for 20 years. After 20 years, the records will be removed from the public record.

## 7.7 Corporate directors

There was a proposal in 2015 to place an outright ban on corporate directors. However, this was never legislated but the government now want to restrict the appointment of corporate directors as follows:

- All entities that are registered at Companies House must have at least one fully verified natural person directly associated with them on the register.
- The appointment of a corporate director must satisfy two conditions:
    - that all directors of the company seeking such appointment are themselves natural persons; and
    - those natural person directors are, prior to the corporate director appointment, subject to appropriate ID processes.
- Companies which fail to satisfy these conditions cannot be appointed as a corporate director.
- These rules will extend to all appointable entities, such as limited liability partnerships.
- Corporate directors will be restricted to only those entities that are registered in the UK.

## 7.8 Timetable for implementation

The timetable for implementation of the Companies House reforms have not yet been announced. Further details will be provided in future Audit and Accounting Quarterly Update courses as and when developments arise.

# 8 ISQM 1 – Part 4

As noted in previous updates, in July 2021, the FRC issued two new quality standards:

- ISQM (UK) 1 *Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements*; and
- ISQM (UK) 2 *Engagement quality reviews.*

As explained in previous quarters, it is important that firms start to consider the impact these two ISQMs (UK) will have. ISQM (UK) 1 requires the system of quality management to be designed and implemented by 15 December 2022, with an evaluation of this within one year following this date.

According to ISQM (UK) 1, there are eight components of a system of quality management as follows:

- The firm's risk assessment process (see quarter 3 2021 notes)
- Governance and leadership (see quarter 4 2021 notes)
- Relevant ethical requirements (see quarter 1 2022 notes)
- Acceptance and continuance of client relationships and specific engagements
- Engagement performance
- Resources
- Information and communication
- The monitoring and remediation process

In this quarter, we will examine acceptance and continuance of client relationships and specific engagements.

## 8.1 Acceptance and continuance of client relationships and specific engagements

ISQM (UK) 1, para 30 states:

*The firm shall establish the following quality objectives that address the acceptance and continuance of client relationships and specific engagements:* *ISQM (UK) 1, para 30*

*(a) Judgments by the firm about whether to accept or continue a client relationship or specific engagement are appropriate based on:*

*(i) Information obtained about the nature and circumstances of the engagement and the integrity and ethical values of the client (including management, and, when appropriate, those*

*charged with governance) that is sufficient to support such judgments; and*

(ii) *The firm's ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements.*

(b) *The financial and operational priorities of the firm do not lead to inappropriate judgments about whether to accept or continue a client relationship or specific engagement.*

This section of ISQM (UK) 1 includes principles-based requirements to establish quality objectives that address the acceptance and continuance of client relationships and specific engagements. The overarching focus is on the firm's judgements in determining whether, or not, to accept or continue the client relationship or specific engagement.

To that end, there is an enhanced requirement to ensure the firm obtains information concerning the nature and circumstances of the engagement as well as the integrity and ethical values of the client (including management and, where appropriate, those charged with governance). There is also a requirement addressing the financial and operational priorities of the firm in the context of making decisions about whether to accept or continue a client relationship or specific engagement.

**How should firms approach this requirement?**

Keep in mind that ISQM (UK) 1 is scalable so smaller audit firms are expected to have a less complex system of quality management than, say, a large audit firm. In any event, a firm might provide the information which needs to be gathered relating to the nature and circumstances of the engagement. The firm may also provide details of the information needed to verify the integrity and ethical values of the client (which would include management and, where appropriate, those charged with governance). ISQM (UK) 1 policies and procedures may also provide details as to the source of this information.

The policies and procedures may also outline the type of engagements the firm is willing to take on and those which it cannot. For example, an audit firm may not specialise in charities or pension funds and hence the ISQM (UK) 1 procedures may stipulate that the firm is not to take on clients of this nature because it lacks expertise.

When deciding whether or not to continue a client relationship, or accept a specific engagement, ISA (UK) 220 *Quality Management for an Audit of Financial Statements* requires the audit engagement partner to consider whether the firm's policies and procedures have been followed and that the conclusions reached by the firm are appropriate. This will require the audit engagement partner to document this process carefully on the file.

# 9 ISA (UK) 600 planned for change (Lecture A788 – 7.37 minutes)

The Financial Reporting Council (FRC) has recently issued an Exposure Draft of proposed changes to ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*. The changes reflect recent revisions to ISAs that are issued by the International Auditing and Assurance Standards Board (IAASB).

In December 2021, the IAASB issued a final version of a substantially revised edition of ISA 600 and the FRC are strongly supportive of the aim of the IAASB to address key public interest issues concerning group audits. The FRC believes the enhancements to ISA 600 support group auditors' efforts in achieving high quality audits (something which the FRC are working on improving to restore confidence in the audit profession).

## 9.1 What is planned for change?

The proposed changes in the Exposure Draft include the following key revisions:

- Clarification on the scope and applicability of the standard.
- Clarification and reinforcement of the fact that all ISAs are to be applied in group audits. This will be achieved by establishing stronger linkages to other ISAs (in particular ISA (UK) 220 (Revised) *Quality Management for an Audit of Financial Statements*; ISA (UK) 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement*; and ISA (UK) 330 *The Auditor's Responses to Assessed Risks*.
- Focussing the group engagement team's attention on the identification and risk assessment at the consolidated financial statements level and emphasising the importance of designing and performing appropriate procedures to respond to those risks.
- Reinforcing the need for robust communication and interactions between the group engagement team, group engagement partner and component auditors.

## 9.2 When are the proposed changes effective?

The proposed effective date of ISA (UK) 600 (Revised) is to be for audits of group financial statements for periods beginning on or after 15 December 2023. This is in line with the IAASB's effective date for ISA 600. The FRC believe that this is a reasonable timeframe to allow for effective implementation and provides sufficient time for firms to prepare after ISQMs (UK) 1 and 2 and ISA (UK) 220 (Revised) have been implemented, all of which have effective dates of 15 December 2022.

## 9.3 Comment period closing date

Invitations to comment on the proposed changes to ISA (UK) 600 close on 8 July 2022. Comments are invited in writing on all aspects of the consultation. Comments should be sent via email to aat@frc.org.uk.

# 10 Audit evidence (Lecture A789 – 13.59 minutes)

One of the most frequent criticisms from file reviewers and professional bodies on audit files is the lack of audit evidence. In addition, audit evidence which is not 'sufficient and appropriate' is also cited. Indeed, ICAEW's Audit Monitoring report which is issued on an annual basis usually cites audit evidence as being in the 'top five' list of problems noted on audit files.

ISA (UK) 500 *Audit Evidence* states:

> *The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.*

*ISA (UK) 500, para 4*

The objective refers to audit evidence being **sufficient** and **appropriate**:

- **Sufficiency** relates to the quantity of audit evidence
- **Appropriateness** relates to the quality or relevance and reliability of audit evidence

A key concept that auditors must bear in mind is that audit evidence is always **persuasive** rather than conclusive. This is one of the inherent limitations of an audit.

## 10.1 Sufficient audit evidence

The audit opinion in the auditor's report has to be based on the audit evidence on file. To that end there needs to be 'enough' audit evidence to support the auditor's conclusion and this will involve professional judgement. When determining whether audit evidence is sufficient, the auditor must consider:

- the risk of material misstatement;
- the materiality of the item;
- the client's internal control;
- whether tests of control have revealed operating weaknesses;
- the auditor's knowledge and experience of the client;
- the size of the population that is being tested;
- the size of the sample selected to test; and
- the reliability of the evidence obtained.

**Example – Auditing the bank balance**

The audit semi-senior is auditing the cash at bank figure in the balance sheet of Toulouse Limited for the year ended 30 April 2022. Due to the risk assessment, the audit manager concluded that a bank audit letter was necessary this year, which has been received. The balance on the bank audit letter has been agreed to the year end bank statement and the semi-senior has stated that in her opinion this is sufficient.

While a bank audit letter is a good source of audit evidence (because it is externally generated and sent directly to the auditor), it is insufficient to provide assurance regarding the **completeness** and final valuation of bank balances. There may well be timing differences resulting in a difference between the balance per the bank statement/bank audit letter and the cash book balance per the balance sheet.

The semi-senior should also obtain bank reconciliations for all bank accounts and review these by tracing reconciling items to after-date cash payments/receipts, checking casts on the bank reconciliation and reperforming the year end bank reconciliation.

In combination, this work (in addition to the bank audit letter) will provide sufficient audit evidence over the bank balances.

**Example – Related parties**

The draft financial statements of Catalan Ltd for the year ended 30 April 2022 show no disclosures in respect of related parties. The audit semi-senior has held a discussion with the finance director who has confirmed there were no related parties and has provided a written representation to this effect. The semi-senior has concluded that this is sufficient audit evidence.

These are weak forms of audit evidence which would not constitute sufficient audit evidence. Inquiry is a valid procedure under ISA (UK) 500, but on its own is weak audit evidence because it generates internal responses from the client.

ISA (UK) 580 *Written Representations* also confirms that written representations, on their own, are necessary audit evidence, but do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

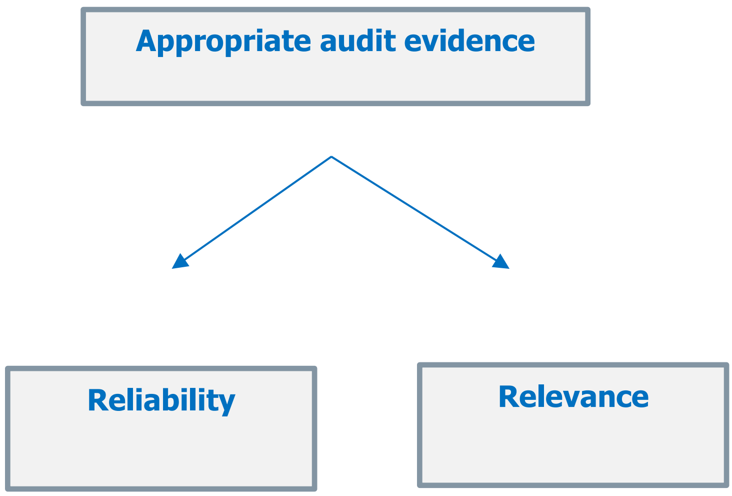
Both inquiry and written representations in respect of a subjective (and usually material) area such as related parties would be insufficient to conclude there have been no related party transactions during the year. The semi-senior would need to carry out further checks, such as:

- Reviewing accounting records for evidence of transactions with related parties
- Inspecting board minutes or evidence of any undisclosed related parties or transactions with those related parties
- Discussing the schedule of related parties with the finance director to ensure completeness
- Carrying out searches at Companies House on the directors to identify any other entities in which the directors have an interest and reviewing accounting records to identify any transactions with those companies
- Review the bank audit letter (if obtained) for evidence of any related parties
- Reviewing the prior year's audit file to identify any related parties and establishing whether there have been any transactions with those related parties this year

Keep in mind that in situations such as this (where a subjective area of the financial statements is concerned), audit risk (the risk that the auditor forms an incorrect opinion on the financial statements) is increased. This is because if sufficient appropriate audit evidence is not obtained the auditor may express an unmodified opinion when, in fact, a modified opinion may be necessary had further audit procedures been applied which may contradict the response by management or the written representation.

### 10.2 Appropriate audit evidence

Appropriateness of audit evidence is sub-divided into two concepts:



**Reliability**

Auditors should always try, wherever possible, to obtain audit evidence from the most trustworthy and dependable source possible. Audit evidence is generally considered to be more reliable when it is:

(a) Obtained from an independent and external source

(b) Generated internally by the client, but is subject to an effective system of internal control

(c) Obtained directly by the auditor

(d) Is provided in documentary form

(e) Is an original document (not a photocopy or scanned copy)

The more reliable the audit evidence which the auditor can collate as part of their audit procedures, the less of it they will need. However, keep in mind that if the audit evidence is unreliable, it will never be appropriate (no matter how much of it is gathered).

**Relevance**

To be relevant, audit evidence must address the objective or purpose of a procedure.

**Example – Attendance at stock count**

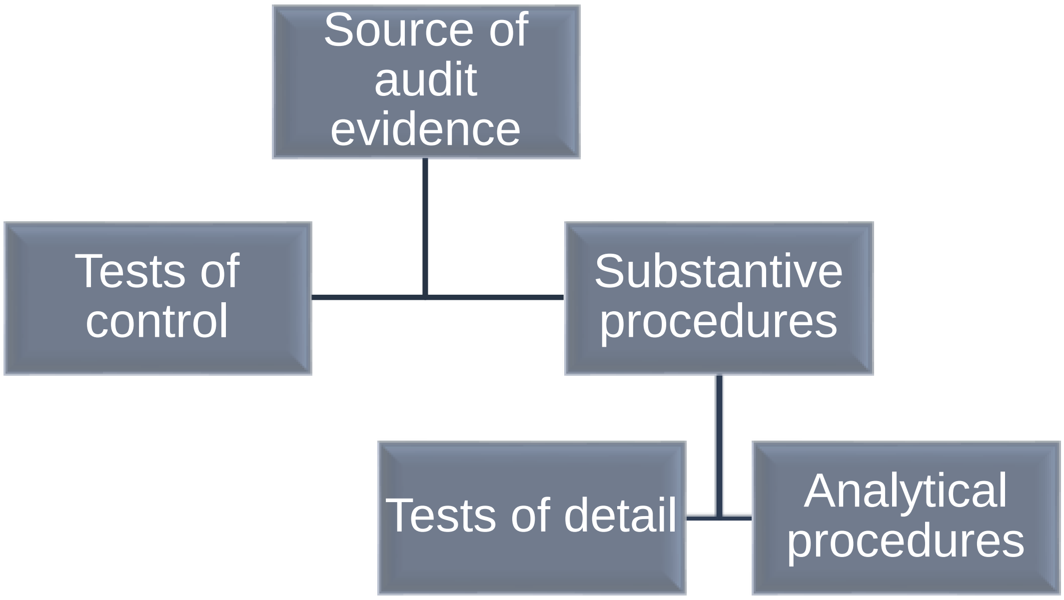
Three members of the audit engagement team have attended Revere Ltd's year end stock count. The procedures involve selecting items that have already been counted and tracing them from the count sheets to the physical stock and vice versa.

- Selecting items from the count sheets to the physical stock confirms the **existence** of the stock at the count date

- Selecting items from the physical stock to the count sheets confirms the **completeness** of the stock at the count date

While the procedures look, on the face of it, to be similar in nature, their purpose (and hence relevance) is to test different assertions concerning the stock valuation.

## 10.3 Sources of audit evidence




**Tests of control**

Tests of control are designed to evaluate the operating effectiveness of controls in preventing and detecting and correcting a material misstatement. Tests of control do not focus on monetary amounts in the financial statements and are defined as:

> *An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correctly, material misstatements at the assertion level.*

*ISA (UK) 330 para 4(b)*

'Control risk' is a function of the risk of material misstatement and is defined as:

> *The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.*

*ISA (UK) 200, para 13(n)(ii)*

All businesses will have some degree of internal control present. The stronger the client's system of internal control, the lower the control risk and hence there is a lower risk of material misstatement in the financial statements. However, in order to be able to rely on the client's internal control system, the auditor will need to:

- Ascertain how the system operates
- Document the system in the audit working papers
- Test the operation of the system
- Assess the design and operating effectiveness of the system of internal control

- Determine the impact on the audit approach for specific classes of transactions, account balances and disclosures

Examples of tests of control include:

- Reviewing purchase invoices for evidence of authorisation by a responsible official
- Reviewing payroll records for evidence that overtime payments have been authorised
- Inspecting board minutes for approval of capital expenditure requirements or a restructuring
- Attending the inventory count
- Reviewing the month end bank reconciliations to ensure they have been approved by the finance director and any reconciling items have been checked

**Example – Test of control**

During the audit of fixed assets, the audit senior reviewed a purchase invoice from a supplier amounting to £25,000. The audit senior was ensuring that items of capital expenditure have been appropriately authorised during the year.

The fact that the invoice being tested is for £25,000 is irrelevant because tests of control do not focus on the monetary amounts in the financial statements. It is the control that is being tested.

A test of control can, however, provide **indirect** evidence over the financial statements. This is because the auditor can assume that if the controls are operating effectively, there is less risk of material misstatement in the financial statements.

No internal control system can be said to be 100% effective; that is one of the main limitations of internal control. For example, management could deliberately override an internal control for personal financial gain and this risk must be factored into the auditor's risk assessment at the planning stage. In addition, management override of internal control is viewed as a significant risk per ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*. To that end, paragraph 32 of ISA (UK) 240 requires specific procedures to be carried out as follows:

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

(i) make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

(ii) select journal entries and other adjustments made at the end of a reporting period; and

(iii) consider the need to test journal entries and other adjustments throughout the period.

(b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:

(i) evaluate whether the judgments and decisions by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and

(ii) perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year.

(c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or lack thereof) of the transactions suggest that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

**Substantive procedures**

In contrast to tests of control, substantive procedures do test the figures in the financial statements for misstatements. Substantive procedures consist of two types of procedure:

(a) **Tests of detail** which are used to verify individual transactions and balances.

(b) **Substantive analytical procedures** which involve the evaluation of financial information through analysis of plausible relationships among both financial and non-financial data.

| **Test of detail versus analytical procedure** | |
|---|---|
| A test of detail looks at supporting | Analytical procedures could be used to |

| | |
|---|---|
| evidence for an individual transaction (e.g. inspecting a purchase invoice to check an item has been capitalised at the correct value or that invoice is in the name of the company for the rights and obligations assertion). | assess the reasonableness of the gross profit margin in the current year versus the prior year to see if it is consistent. This procedure is not looking in detail at any of the items making up gross profit and hence there is a possibility that there are a number of misstatements within the trading account which would only be discovered through tests of detail, thus this analytical procedure would provide a **source** of potential misstatement. |

Substantive analytical procedures involve the use of calculations, such as calculating a change in a specific revenue cycle to see if the change in the current year is in line with expectations. This type of procedure is not looking at the detail of any particular transaction, but at the total figure. This means that there could be other misstatements within the total sales population which may cancel each other out and hence substantive analytical procedures would not detect such misstatements.

Care should be taken when using substantive analytical procedures because they should only be used as the main source of substantive evidence where the entity's system of internal control is judged to be reliable as this would mean there is less chance of misstatements being present as the control system itself would have detected and corrected them on a timely basis. Additionally, it is vital that substantive analytical procedures properly follow the requirements in ISA (UK) 520 *Analytical Procedures*, with documentation to demonstrate this.

**Example – Proof in total test**

The audit senior is auditing the payroll cycle of Greaves Ltd for the year ended 31 December 2021 and has decided to use a proof in total test to assess the reasonableness of the payroll charge per the financial statements.

To carry out this test, the audit senior will take last year's payroll charge per the financial statements, inflate it for pay increases and any bonuses and take account of changes in staff numbers to arrive at an expected payroll cost for the year ended 31 December 2021. An important point to emphasise is that the factors used in developing the expectation for this year needs to be verifiable, such as staff numbers from human resources and pay increases have been agreed to standard award letters and/or contracts of employment.

Analytical procedures are a useful tool for auditors because they can be used to corroborate other audit evidence gathered through alternative procedures. They are useful when auditing a whole account balance or class of transaction as a means of assessing its reasonableness. Analytical procedures can also help with the identification of management fraud, where there is what appears to be an adequate paper trail of documentation, but where the figures just 'don't add up'.

During analytical procedures, the auditor may calculate various percentage movements in amounts to identify potential misstatements. For example, gross profit margins in some businesses are generally expected to remain fairly static from one reporting period to the next. Where gross margins have fluctuated beyond the auditor's expectations (i.e. they have increased or decreased significantly), the auditor will then further investigate the movement as this may give rise to a material misstatement or indicate weaknesses in areas such as cut-offs of sales and stock, or it could be indicative of a fraud risk factor.

To use analytical procedures effectively, the auditor must arrive at an expectation. Where the organisation has been subject to, say, a significant restructuring during the year, this may prove difficult; although if the changes were planned and the auditor had been made aware of the changes, they can factor this in when carrying out analytical procedures.

In addition, ratio analysis is meaningless unless the auditor has got something to compare the ratio to. In a new start-up business, for example, calculating the gross profit margin for one year does not inform the auditor unless it can be compared to something else; such as that of a competitor or a budget/forecast. Newer technology platforms are starting to become available which can provide benchmark figures on other similar companies. Such information could provide the auditor with useful insights for their analytical procedures.

**Wholly-substantive audit**

Substantive testing can be an arduous and costly exercise. However, there are occasions when the auditor may conclude that a wholly-substantive audit approach is necessary. This could arise when, for example, a wholly-substantive approach is considered to be a more efficient or effective way of obtaining audit evidence (this usually happens in a smaller audit). Conversely, the auditor may determine that the entity's internal control environment is weak or inefficient and hence may not place any reliance on control tests. In this situation it is likely the auditor will determine that a wholly-substantive approach to be more appropriate. However, if sufficient evidence cannot be gathered through substantive procedures alone, then controls must also be tested. This is more likely to arise in an organisation with automatic transaction processing, complex systems and/or very large numbers of transactions or adjustments.

The auditor must always carry out some substantive procedures on material items as well as carrying out substantive procedures as required by ISA (UK) 330 *The Auditor's Response to Assessed Risks* which requires the auditor to carry out the following:

- Agree the financial statements to the underlying accounting records
- Examine material journal entries
- Examine other adjustments made in preparing the financial statements

## 10.4 Use of sampling

It is usually impossible to test every single transaction that makes up an account balance and this is particularly the case in a larger entity. Auditors do not provide absolute (or maximum) assurance in their auditor's report. Audit procedures must be carried out in line with the risk of material misstatement and the procedures must be responsive to the assessed levels of risk. Where deficient audit work has been carried out and a material misstatement has not been detected, hence an inappropriate audit opinion has been formed, the auditor is open to a negligence claim and/or sanctions being imposed on them by their professional body or FRC.

The fact that one of the main inherent limitations of an audit is that audit procedures may not detect a material misstatement is not grounds to justify inadequate audit procedures or inadequate audit work.

ISA (UK) 530 *Audit Sampling* defines 'audit sampling (sampling)' as:

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

*ISA (UK) 530, para 5(a)*

When designing a sample, the auditor must consider four factors:

- The purpose of the procedure
- The combination of procedures being performed
- The nature of the evidence which the auditor requires
- The possible misstatements that may be found (or the risk of material misstatement)

There are generally five ways of selecting a sample:

- **Haphazard selection**: This is where the auditor does not follow any structured technique, but is conscious to avoid bias or predictability in their selection. Haphazard selection is a non-statistical method.

- **Block selection**: This involves the auditor selecting a block of contiguous (items adjacent to each other) from the population – for example all invoices in July. This method cannot ordinarily be used in audit sampling because block selection usually results in a sample which is not representative of the whole accounting period as the month or 'cluster' chosen may have unique characteristics. Block selection is a non-statistical method. It can provide useful evidence in certain situations, such as whether there is a particular worry about errors or deviations affecting the particular block of items (for example, because someone was on holiday during the period).

- **Random selection**: This involves the auditor simply choosing items subjectively whilst trying to avoid bias (i.e. avoiding those items which are easy to access or picking items because they appear unusual). Random number generators or tables are used as a basis of the sample. This method is acceptable for non-statistical sampling, but is not regarded as sufficiently rigorous for statistical sampling.

- **Systematic selection**: This is where the auditor will use a sampling interval, such as testing every 30th invoice or 50th balance with the first item being sampled randomly.

- **Monetary unit selection**: This method is sometimes referred to as the 'value weighted selection'. It is usually applied to large variance populations such as trade debtor balances or inventories where the individual members of the population are of varying degrees of size. In practice, monetary unit selection is suited to populations where errors are not expected and implicitly takes into account the auditor's assessment of materiality.

## 10.5 Evaluating deviations and misstatements in a sample

Deviations are issues which the auditor identifies when carrying out tests of control. For example, when the auditor is reviewing capital expenditure invoices for evidence of authorisation, any invoices which are not authorised would be deviating from the control process. Hence, if the auditor samples 100 invoices and ten of them are not authorised, the deviation rate is 10%. The auditor does not need to project this deviation rate across the population because it is a factual amount.

When the actual deviation rate exceeds the auditor's tolerable deviation rate, the risk of material misstatement becomes higher. In such situations, the auditor will place less reliance on the internal controls and carry out more substantive procedures to reduce the risk of material misstatement.

Misstatements arise when the auditor finds differences between the amounts actually recorded and the amounts that should have been recorded. Misstatements are found when the auditor is carrying out substantive procedures.

When the auditor discovers a misstatement, they first need to consider whether the error is a 'one-off' (sometimes called an 'anomalous error'). Where the auditor concludes that the misstatement is an isolated error, no further procedures will be necessary. In practice this is rare as it means utterly individual circumstances arose to cause this error and no others are expected.

If the auditor believes that the misstatement could be representative of further misstatements, the auditor projects the misstatements found in the sample to the entire population. They then evaluate the results of the sample by considering tolerable misstatement. The term 'tolerable misstatement' is defined as:

> *A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.*

*ISA (UK) 530, para 5(i)*

**Example – Tolerable misstatement**

The audit senior is testing sales invoices for a specific product. The procedure involves testing a sample of £50,000 out of a population of £900,000. Misstatements of £2,700 have been found and tolerable misstatement is set at £8,000.

The auditor will usually conclude that the misstatement is likely to be representative of further errors in the population, so the audit senior will need to extrapolate the effect of the misstatement across the whole population to assess whether the projected misstatement is greater than tolerable misstatement.

In this scenario, the audit senior may expect that there are misstatements of £48,600 (£2,700 / £50,000 x £900,000). In this case, the projected misstatement of £48,600 exceeds tolerable misstatement of £8,000 and further procedures will be needed.

# 11 Fraud in an audit of financial statements (Lecture a790 – 17.11 minutes)

ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* provides auditors with the guidance in dealing with fraud and fraud risk factors during the course of the audit.

This part of the course is not going to necessarily look at the technical detail of ISA (UK) 240 as this has been covered in previous updates, but is more of a reminder for auditors to carefully consider their obligations when it comes to fraud being discovered or suspected.

If the auditor suspects that fraud is being committed by a member of the entity's management (or a group of management), then the auditor should seek advice from either legal counsel or their relevant professional body as to the course of action that should be taken, but should also have regard to the provisions in ISA (UK) 240.

Anti-money laundering protocol must also be carefully considered. The auditor must keep in mind that they cannot 'tip off' the client if they suspect fraud and hence such situation must be handled in accordance with the provisions of ISA (UK) 240 and anti-money laundering regulations.

Auditors of charities must also consider whether they have a duty to report a Matter of Material Significance to the relevant charity regulator where they suspect fraudulent activity or discover fraud risk factors. Keep in mind that the guidance issued by the four charity regulators is *'If in doubt, report it.'* Reporting to a regulator may also be appropriate with other regulated clients.

In this section of the course, John Selwood considers some of the most common questions that are being asked in respect of the revised ISA (UK) 240 which becomes effective for audits of periods commencing on or after 15 December 2021.

## 11.1 Revisions to ISA (UK) 240 effective for December 2022 year ends

**The revisions to ISA (UK) 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, apply soon. What changes should I prepare for?**

The revised ISA (UK) 240 was issued by the Financial Reporting Council (FRC) in May 2021 and is effective for audits of periods beginning on or after 15 December 2021. In most cases this means that the changes will apply to December 2022 year ends, but do not forget about short accounting periods.

There are a number of detailed revisions in ISA (UK) 240, but in my view the ones that are most noteworthy are:

- a greater focus on the audit team discussion being 'an exchange of ideas' and the requirement to consider the need to have additional discussions during the audit (which sounds like a good idea to me);
- requirements to consider using forensic expertise;
- requirements relating to whistle-blowers; and perhaps most importantly;
- requirements that further encourage professional scepticism in audit teams.

However, above and beyond this, the implementation of ISA (UK) 240 (revised) is a good opportunity to remind audit teams about the difficult issues surrounding auditing for fraud. This is especially true of professional scepticism, which is both vitally important in detecting fraud and is often hard to properly encourage in audit teams.

Not for the first time, I recommend that firms use the ICAEW films *False Assurance* and *Without Question* as training tools.

**Why is there such a focus on auditing for fraud? I have read that the auditor is not responsible for detecting fraud.**

This is a common misconception and it's a dangerous one!

Hunting for fraud is not the auditor's primary role, when auditing historical financial statements. Auditors should, however, plan to detect all material misstatements including those arising from fraud.

When considering fraud, those who are relatively new to the profession, often think only about the misappropriation of assets, by which I mean theft. This is also, usually, what the general public immediately think of as fraud. However, in my experience, the most common fraud that auditors are exposed to is the fraudulent misstatement of the financial statements, with the intention of misleading the users of the financial statements.

Sometimes of course, fraud of both natures occurs simultaneously where assets are misappropriated and then the financial statements are misstated to conceal the theft.

So, to the extent explained above, it is the duty of the auditor to detect fraud and the reason that there is a particular focus on fraud in the ISAs (UK) is because doing this can be very challenging, for auditors. Frauds are unlike other misstatements. Errors in the financial statements are relatively easy to detect because nobody is trying to conceal them.

Detecting fraud requires more focus from auditors and a significant degree of professional scepticism, above and beyond that needed to detect errors. This is why fraud is given special treatment in the ISAs (UK).

**Because of the nature of fraud, isn't it inevitable that auditors will often fail to detect it? How can auditors be expected to detect falsified documentation if it comes from a credible source like management?**

This is a huge problem for auditors.

One thing that I need to challenge in your question, however, is your description of management as a credible source of information – which is not always the case. History tells us that when there is a fraud, management are often the perpetrators. It is for a very good reason that both ISA (UK) 240 (Revised) and the international version of the standard include the following requirement related to the audit team discussion:

> *The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity.*

*ISA (UK) 240, para 15*

I have heard auditors paraphrase this as 'Have the discussion assuming that management are crooks'. This sentiment goes too far, but not by much!

However, your central question is a valid one. How can auditors detect a falsified document? With modern IT, anyone with a cheap PC and a £29 printer can be a forger. But modern IT also provides tools to address such challenges. There are many software-based products available to assist with (and automate) digital and document forgery detection.

Deciding whether and how to deploy such tools is a decision based on the auditor's risk assessment, which is just one of the reasons why auditors need to be constantly vigilant and sceptical. Auditors need to remain alert for the tiniest detail that does not stack up and if they see it then they need to pursue the matter in a challenging way.

The revised ISA (UK) 240, includes a new requirement that the auditor shall be vigilant for conditions that indicate that a record or document may not be authentic and contains a useful list of indicators of things for auditors to look out for:

- Unexplained alterations to documents received from external sources.
- Serial numbers used out of sequence or duplicated.
- Addresses and company emblems not as expected.
- An absence of information that would be expected.
- Invoice references that differ from others.

- Unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms (for example, purchase costs that appear unreasonable for the goods or services being charged for).
- Information that appears implausible or inconsistent with the auditor's understanding and knowledge.
- A change from the authorised signatory.
- 'Copy' documents presented rather than originals.
- Electronic documents with a last edited date that is after the date they were represented as finalised.

Reading a revised auditing standard is always good practice and ISA (UK) 240 is no exception. It can be found on the FRC website along with all of the other current and past UK standards and guidance for audit and ethics (at https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance).

**I keep reading about revisions to the UK version of the International Standard on Auditing on fraud, but what's happening to the vanilla version? Has the International Auditing and Assurance Standards Board (IAASB) also revised the ISA?**

That's a good question.

In many cases, revisions to the UK versions of International Standards on Auditing (ISAs) follow or coincide with revisions to ISAs by the IAASB on which they are based. Occasionally, the FRC moves in advance of international standards to revise a UK version of a standard – as with the May 2021 revisions to ISA (UK) 240.

When the FRC issued its revised ISA (UK) 240 it explained that it was doing so 'to address urgent stakeholder concerns in the public interest' because of misunderstandings around the auditor's responsibilities in respect of fraud. The revised ISA (UK) aims to make auditors' obligations clearer, enhance the risk assessment they carry out, and set clearer requirements for what the auditor then does.

The IAASB has a project ongoing to revise ISA 240. It aims to:

- Clarify the role and responsibilities of the auditor for fraud in an audit of financial statements.
- Promote consistent behaviour and facilitate effective responses to identified risks of material misstatement due to fraud through strengthening ISA 240 to establish more robust requirements and enhance and clarify application material where necessary.
- Enhance ISA 240 to reinforce the importance, throughout the audit, of the appropriate exercise of professional scepticism in fraud-related audit procedures.
- Enhance transparency on fraud-related procedures where appropriate, including strengthening communications with those charged with governance and the reporting requirements in ISA 240 and other relevant ISAs.

The IAASB timeline suggests that we can expect an exposure draft and consultation for its revised ISA 240 during 2023, with final approval of the standard around the end of 2024. Meanwhile, you can follow developments and learn more about the project on the IAASB website at https://www.iaasb.org/consultations-projects/fraud

## 12 Gifts and hospitality (Lecture A791 – 15.39 minutes)

The FRC's Ethical Standard states:

> *A firm, its partners and any covered person, and persons closely associated with them, shall not offer or accept pecuniary and non-pecuniary gifts or favours, including hospitality, from an entity relevant to the engagement, or any other entity related to that entity, unless an objective, reasonable and informed third party would consider the value thereof as trivial or inconsequential.*

*FRC Ethical Standard, para 4.40*

The following examples below are for illustrative purposes only. Audit firms will need to develop their own policies and consult where necessary.

**Example – Trivial hospitality**

An audit team comprising of four staff attend an audit client's premises for two weeks to carry out the detailed audit fieldwork. During the course of that two-week period, the managing director's personal assistant regularly provided the team with tea, coffee and biscuits.

The provision of tea, coffee and biscuits (even on a daily basis) is unlikely to cause an ethical threat to integrity, independence and objectivity and hence it would be acceptable for the audit team to accept these refreshments.

**Example – Provision of a business lunch**

The financial statements of Naylor Ltd for the year ended 31 March 2022 have just been approved and the auditor's report thereon signed by the audit engagement partner. The CEO of Naylor Ltd has offered to take the audit engagement partner out for a business lunch at Naylor Ltd's expense.

Again, the provision of a business lunch in this scenario may not cause any ethical issues. This can also be supported by the fact that the business lunch takes places after the financial statements have been authorised for issue and the auditor's report signed.

**Example – Provision of gift vouchers**

The audit of Harper Ltd completed on 10 May 2022 after a number of problems were found in the entity's system of internal control which had caused some misstatements in the financial statements. These misstatements were all subsequently corrected by the finance department.

To thank the audit team for their efforts, the finance director has sent the audit engagement partner £300 worth of Amazon vouchers to be split among the four team members.

Each audit team member would receive £75 (£300 / 4) worth of vouchers. This is likely to cause an ethical problem and hence the audit engagement partner/team should politely decline the gift. Christmas gifts from an audit client are unlikely to cause any ethical threats where they are very small (e.g. gifts where the value is less than £25).

**Example – Attendance at regular social gatherings**

The audit engagement partner has attended a number of lunch/dinner engagements with the managing director of Tennyson Ltd. In addition, the managing director has invited the partner and his wife to his son's wedding in the summer of 2022.

Attending regular lunches/dinners would indicate a familiarity threat. This is accentuated by the fact that the engagement partner and his wife have both been invited to the managing director's son's wedding. Safeguards must be put in place to minimise this threat to an acceptably low level, or the audit engagement partner should be rotated off the audit.

Acceptance of gifts or hospitality would give rise to a self-interest and familiarity threat. The FRC's Ethical Standard requires a firm to establish policies and procedures on the nature and value of gifts, favours and hospitality that may be accepted from a client, or offered to a client.

Where team members are in any doubt as to whether, or not, to accept gifts or hospitality, the team must discuss the situation with the engagement partner. If further doubt still exists, the engagement partner reports the facts to the ethics partner/ethics function for further consideration regarding any action that is to be taken.

**Important point to note**

The firm's policy on gifts and hospitality will generally be more effective if it provides guidance on the types of situation where independence may be threatened rather than just being a rules-based limit based on specific monetary amounts. For instance, a policy that states no gifts or hospitality can be received is unlikely to be workable in practice, as it essentially means the audit team refusing an offer of tea or coffee and other items which are clearly trivial in nature. Conversely, a policy which states that everything under £25 is acceptable might miss the fact that either numerous gifts of this value are received, or that a friendship is developing that may impact independence.

If gifts or hospitality are accepted more than once, the **cumulative effect** must be considered in terms of its value. Even low value gifts and hospitality can threaten independence if they indicate a familiarity risk.

ICAEW's helpsheet on this subject suggests consideration of:

- The actual value of the gift or hospitality
- The perceived value of the gift or hospitality
- The frequency of gifts or hospitality
- The timing of gifts and hospitality
- Whether the gift or hospitality is targeted towards a single individual or spread amongst a larger team
- The intent of the person providing the gift or hospitality
- The circumstances surrounding the gift or hospitality
- Whether there is a clear business purpose to which the hospitality is ancillary
- The seniority of those involved

# 13 Long association with a client (Lecture A792 – 10.38 minutes)

The FRC Ethical Standard requires firms to establish policies and procedures to monitor the length of time that partners and staff in senior positions are involved on the audit engagement team. In addition, the Ethical Standard requires that the firm monitors the extent of the involvement of the partners and senior members of staff in the assignment.

Long association with a client can give rise to a familiarity threat which, if not reduced to an acceptable level, can impede on independence and objectivity. To that end, the Ethical Standard requires that where there is long association with a client, the firm and covered person must:

(a) apply safeguards that reduce the threats to independence and objectivity to a level where independence is not compromised; and

(b) disclose the engagements the firm has previously undertaken for an entity relevant to the engagement to those charged with governance and, if applicable, other persons or entities which the firm is instructed to advise.

In situations where the firm is unable to apply appropriate safeguards, the firm cannot accept the engagement and must resign or not stand for re-appointment, whichever is the most appropriate. Where legislation or regulation assigns responsibility for the engagement and the firm cannot resign, it must consider alternative safeguards that can be put in place.

## 13.1 Appropriate safeguards

To manage the threat to independence and objectivity where long association is concerned the firm can apply appropriate safeguards, such as:

- Appointing an engagement partner that has had no previous involvement with the entity in the capacity of engagement partner.
- Removing (rotating) partners and senior members of the engagement team after a pre-determined number of years.
- Having another partner that has not recently been a member of the engagement team review the work done by the partners and the engagement team.
- Arranging an engagement quality control review (i.e. a 'hot' or 'cold' review).

Where the audit engagement partner has been in the position for a continuous period of ten years, the firm must give careful consideration as to whether it is probable (i.e. more likely than not) that an objective, reasonable and informed third party would conclude that the integrity, objectivity or independence of the firm or covered persons are compromised. If the conclusion is that integrity, objectivity or independence are not compromised, then it is important that:

- safeguards, other than rotation, are applied (see above);
- the reasons why the individual continues to be involved in the audit are documented;
- the facts are communicated to those charged with governance.

**Example – Long association**

Ivan Sou is a partner in a two-partner audit firm. He has been the audit engagement partner of Parello Industries Limited for a period of 11 years.

To minimise the threat to independence and objectivity caused by the long association, the firm should have specific procedures outlined in their ISQC (UK) 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements*[1] to handle the threat. This could include a hot (pre-issuance) review or cold (post-issuance) review on a cyclical basis. Alternatively, the other partner may be engaged as the audit engagement partner if that is appropriate.

If Ivan Sou continues to act as audit engagement partner, the firm's ISQC (UK) 1 procedures must outline the reasons why he continues to be involved in the audit. The client must also be informed accordingly.

### 13.2 Public interest entities (PIE)

Companies Act 2006, ss491 and 491A state the relevant period that key audit partners can act for an audit client. Where a PIE is concerned, key audit partners who are responsible for carrying out the statutory audit must not act for more than five years. The firm must ensure that it does not accept or continue an audit engagement which would breach those requirements.

Key audit partners responsible for a statutory audit of a PIE must cease their participation in the audit not later than five years from the date of their appointment. Following the partner's removal from the audit, they are not permitted to participate in the statutory audit of the PIE until a period of five years has elapsed from their cessation.

In the case of a listed entity, the firm must implement policies and procedures to ensure in respect of a recurring engagement that:

[1] To be replaced by ISQM (UK) 1 *Quality Management for Firms that Perform Audits and Reviews of Financial Statements, or other Assurance or Related Services Engagements* from 15 December 2022.

- nobody shall act as engagement partner in excess of five years. This includes time spent participating in an engagement where an audit engagement has moved between firms;

- anyone that has acted as the engagement partner for a particular entity for five years must not subsequently participate in the engagement until a further period of five years has elapsed; and

- on completion of the rotation, the engagement partner must not continue to have significant or frequent interaction with senior management, or those charged with governance of the entity they have previously audited until the cooling-off period has elapsed.

When an audit client becomes a public interest or other listed entity, the length of time that the audit engagement partner has served the entity in the capacity as engagement partner is taken into account when calculating the period before the engagement partner is rotated off the audit. When the audit engagement partner has already served for four years or more, that partner can continue to serve as the engagement partner for not more than two years after the entity becomes a public interest or other listed entity. Where this is the case, and the audit engagement partner continues to act for no more than two years, this fact and the reasons for it are to be disclosed to the entity's shareholders as soon as possible and in each of the additional years the engagement partner continues to be involved in the audit. In the rare situation that the audit firm is not prepared to make this disclosure, the engagement partner is not permitted to be involved in the audit of the public interest or other listed entity.

If there are circumstances where the audit committee of a PIE or other listed entity decide that a degree of flexibility over the timing of rotation is necessary to safeguard the quality of the audit and the firm agrees, the engagement partner may continue in position for a maximum of two further years, so that no longer than seven years is spent in the position of engagement partner. As above, this information must be disclosed to the shareholders.

## 13.3 Engagement quality reviewers and other key partners involved in the engagement (PIEs)

The Ethical Standard at paragraph 3.18 requires an audit firm to establish an appropriate gradual rotational mechanism with regard to the most senior personnel involved in the audit. This includes at least those who are registered as statutory auditors. This gradual rotation method must be applied in phases on the basis of individuals as opposed to the entire engagement team. It is also to be proportionate taking into account the scale and complexity of the activity of the audit firm.

For audits of PIEs, the audit firm must be able to demonstrate to the FRC (being the Competent Authority in the UK) that such a mechanism has been effectively applied and adapted to suit the scale and complexity of the activity of the audit firm.

In respect of PIEs and listed entities, no one is permitted to act in the capacity of engagement quality control reviewer or a key partner in the engagement for a period longer than seven years. In addition, where an engagement quality control reviewer or a key partner involved in the engagement becomes the engagement partner, the **combined** period of service in these positions must not exceed seven years.

Where the engagement quality control/management reviewer has acted for a period of seven years, whether continuously or in totality, they are not permitted to participate in the engagement until a further five years have elapsed.

If a key partner has been involved in the audit of a public interest or listed entity for a period of seven years, whether continuously or in totality, they are not permitted to participate in the engagement until a further period of two years have elapsed.

Where roles have been combined, anyone who has acted in the capacity of quality reviewer, key partner or the engagement partner for a PIE or a listed entity for a period of seven years, whether continuously or in totality, they are not permitted to be involved in the audit until a period of five years have elapsed.

These policies and procedures must include any time spent participating in an engagement where an audit engagement has moved between firms.

Where PIEs and listed entities are concerned, it is the responsibility of the engagement partner to review the safeguards the firm has put in place to address threats to independence and objectivity where partners and staff have been involved in the audit in a senior capacity for a continuous period of longer than seven years and must discuss those situations with the quality reviewer. Where any problems or issues remain unresolved, they must be referred to the ethics function or partner.