Audit and Accounting Update – October 2024

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1 Changes to lease accounting (Lecture A867 – 28.05 minutes)

On 27 March 2024, the Financial Reporting Council (FRC) issued its final amendments to UK and Ireland accounting standards arising from the periodic review.

The amendments primarily affect FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, but there are consequential amendments to the other standards in the suite of UK and Ireland GAAP such as FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*.

The FRC estimate that some 3.4 million businesses will be affected by the changes which are designed to enhance the quality of financial reporting in the UK and Republic of Ireland.

Two of the most notable changes relate to lease accounting and revenue recognition. In this quarter, our focus will be on lease accounting and next quarter we will examine changes relating to revenue recognition.

At the outset, it is worth emphasising that the new lease accounting treatments affect FRS 102 only. FRS 105 is unaffected by the new changes and hence micro-entities preparing financial statements under FRS 105 will continue to recognise finance leases on-balance sheet and operating leases off-balance sheet using the risks and rewards approach to lease classification.

The amendments arising from the FRC's periodic review apply mandatorily for accounting periods commencing on or after 1 January 2026.

Early adoption is permissible provided that all the periodic review amendments are applied at the same time (i.e. an 'all or nothing' approach to early adoption).

The FRC has given a long lead time into mandatory implementation to enable preparers and entities to fully understand the impact that the new lease accounting treatments will have on entities' financial statements.

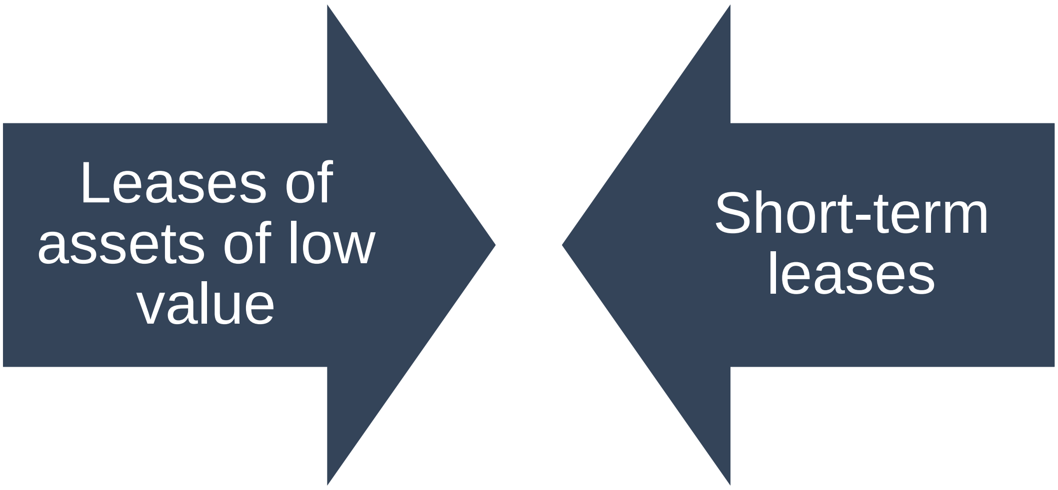
It is advisable to gain a sound understanding of the technical accounting requirements in advance to enable advice to be provided to entities in good time – particularly where the entity may have, for example, debt covenants in place which may need to be renegotiated.

1.1 On-balance sheet lease accounting

As was widely predicted, the FRC has aligned FRS 102, Section 20 *Leases* to IFRS® 16 *Leases*, albeit with additional simplifications and practical expedients to allow the new treatments to be proportionate to private entities.

Under the new recognition and measurement principles, a lessee will no longer distinguish between a finance lease and an operating lease.

Most leases will be recognised on-balance sheet with two exceptions which apply to:



Leases of assets of low value

In the Exposure Draft, the FRC included examples of assets that would be considered to be of low value (such as tablets and personal computers). Following stakeholder feedback, it has removed such examples and has only retained examples of underlying assets that would **not** be low value (FRS 102, para 20.11) such as:

- Cars, vans, buses, coaches, trams, trucks and lorries;
- Cranes, excavators, loaders and bulldozers;
- Telehandlers and forklifts;
- Tractors, harvesters and related attachments;
- Boats and ships;
- Railway rolling stock;
- Aircraft and aero engines;
- Land and buildings; and
- Production line equipment.

It should be noted that this is not a comprehensive list and professional judgement will, of course, be needed to assess what is, and what is not, low value.

The FRC has taken a more permissive approach to defining low-value assets. The term ‘low value’ is not specifically defined in the revised FRS 102, but paragraph 20.9 clarifies that the assessment of the value of an underlying asset is performed on an absolute basis. Leases of low-value assets qualify for off-balance sheet recognition regardless of whether those leases are material to the lessee. In addition, paragraph 20.9 clarifies that the value of lease payments has no bearing on the assessment of whether an underlying asset is of low value.

FRS 102, para 20.10 then states that an underlying asset can be of low value only if:

(a) *the lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee; and*

(b) *the underlying asset is not highly dependent on, or highly interrelated with, other assets.*

FRS 102, para 20.10 (a) and (b)

There is a restriction in paragraph 20.12 whereby if a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset.

The FRC are keen to emphasise that the assessment of low value is entity specific. It has chosen not to quantify a value for low value on the grounds of the permissive approach it has taken in contrast to IFRS 16 given the size of the task that the FRC has asked entities to take on in this respect.

Short-term leases

The FRC has included a new definition of 'short-term lease' which is:

*A **lease** that, at the **commencement date** has a **lease term** of 12 months or less. A lease that contains a purchase option is not a short-term lease.*

*FRS 102 Glossary **short-term lease***

1.2 Accounting treatment

Effectively, the new lease accounting treatments will mean more leases will be recognised on-balance sheet. The principal difference is that, for lessees, there will no longer be a requirement to distinguish between an operating lease and a finance lease.

As noted earlier, the new lease accounting treatments apply mandatorily for accounting periods commencing on or after 1 January 2026 (with early adoption permissible).

Paragraph 1.47 of FRS 102 states:

A lessee shall not restate comparative information. Instead, it shall recognise the cumulative effect of initially applying the Periodic Review 2024 amendments to Section 20 as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

Amendments to FRS 102 and other FRSs (March 2024), para 1.47

Therefore, prior year adjustments will not be carried out. Paragraph 1.51(a) states that the lessee shall recognise a lease liability at the date of initial application at the **present value** of the remaining lease payments, discounted using:

- The lessee’s incremental borrowing rate; or
- The lessee’s obtainable borrowing rate.

The 'lessee's incremental borrowing rate' is defined as:

> *The rate of interest a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.*

*Amendments to FRS 102 and other FRSs (March 2024), Glossary **lessee's incremental borrowing rate***

The lessee's 'obtainable borrowing rate is defined as:

> *The rate of interest a lessee would have to pay to borrow, over a similar term, an amount similar to the total undiscounted value of **lease payments** to be included in the measurement of the lease liability.*

Example – Lease previously treated as an operating lease

Sunnie Ltd signed a five-year lease on 29 December 2024 to lease a bonded warehouse facility and offices. Lease rentals are £137,500 per annum payable on a monthly basis. The lease previously met the operating lease criteria in FRS 102 (January 2022). Sunnie Ltd has an accounting reference date of 31 March. No upfront fees were payable on inception of the lease and no lease incentives were granted. On 1 April 2026, the company could borrow money from a reputable high street lender at a rate of 7% per annum (see Transition to FRS 102 (2024) later in the example). The lease payments are profiled as follows:

	£	
Lease rentals in the agreement	687,500	
Lease rentals payable per year	137,500	
Lease rentals payable per month	11,458	(rounded)

VAT/equivalent sales taxes have been ignored for the purposes of this example.

In the years to 31 March 2026

The following lease payments have been recognised in profit or loss as the lease was previously accounted for as an operating lease under FRS 102 (January 2022):

	£	
Year to 31 March 2025:	34,375	(£137,500 x 3/12)

Year to 31 March 2026: 137,500

Lease rentals not paid at each reporting date are as follows:

	£
Year to 31 March 2025	653,125
Year to 31 March 2026	515,625
Year to 31 March 2027	378,125
Year to 31 March 2028	240,625
Period to 31 December 2029	103,125

Transition to FRS 102 (2024)

The date of initial application of the new lease accounting rules is 1 April 2026. On this date, the committed lease rentals (i.e. unpaid lease rentals) amount to £515,625.

Sunnie Ltd can borrow money at 7% on 1 April 2026, hence on initial application:

Year/period to	Calculation	Present value
	£	£
31.03.2027	137,500 x $1/1.07^1$	128,505
31.03.2028	137,500 x $1/1.07^2$	120,098
31.03.2029	137,500 x $1/1.07^3$	112,241

31.12.2029	$103,125 \times 1/1.07^3$	84,181
Present value of committed lease payments		**445,025**

Note – there is no retrospective restatement where a lease was previously classified as an operating lease (FRS 102, para 1.47).

Keep in mind that paragraph 1.51(a) states that the lessee recognises a lease liability at the date of initial application at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate or the obtainable borrowing rate.

Sunnie Ltd recognises the right-of-use asset at the amount of the lease liability (as calculated above) adjusted for any prepaid or accrued lease payments (although there are no prepaid or accrued lease payments in this example):

Journal 1

	£
Dr Property, plant and equipment	445,025
Cr Lease liability	445,025
Being recognition of lease at date of initial application	

Sunnie Ltd could choose to present this as a right-of-use asset rather than within property, plant and equipment. It could also recognise the asset within property, plant and equipment and disclose which line items include right-of-use assets.

If the lease rentals have been posted to profit or loss during the year of transition to the new lease accounting requirements (which in many cases they will have been, hence in this case in the year to 31 March 2027), a journal to reallocate these will need to be made as follows:

Journal 2	£
Dr Lease liability	137,500

Cr Operating lease expense	137,500
Being reallocation of the lease payments	

A further journal will also need to be recorded to include the year-end finance cost (interest) for the lease liability as at 31 March 2027 which will be calculated in the next step (see Journal 4).

Subsequent measurement of right-of-use asset

The right-of-use asset is then depreciated in accordance with FRS 102, Section 17 *Property, Plant and Equipment*. Where there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset is fully depreciated over the shorter of the lease term and its useful economic life.

In addition, the lessee must carry out an assessment at each reporting date as to whether the right-of-use asset is impaired in accordance with FRS 102, Section 27 *Impairment of Assets*.

For the purposes of this example, assuming a four-year useful economic life, the right-of-use asset is depreciated at an amount of £111,256 (£445,025 / 4):

Journal 3

	£
Dr Depreciation charges (profit and loss)	111,256
Cr Accumulated depreciation	111,256
Being depreciation of right-of-use asset	

Subsequent measurement of the lease liability

The lease liability is subsequently measured using the amortised cost method in accordance with FRS 102, Section 11 *Basic Financial Instruments*.

This uses an effective interest rate and is accounted for as follows:

Year/period	Opening balance	Cash flow	Interest @ 7%	Closing balance

	£	£	£	£
31.03.2027	445,025	(137,500)	28,607	336,132
31.03.2028	336,132	(137,500)	21,607	220,239
31.03.2029	220,239	(137,500)	14,157	96,896
31.12.2029	96,896	(103,125)	6,229	-

The above calculation results in a slightly lower effective interest rate (of 6.43% rather than 7%) as the payments have been apportioned over three years plus the final ending balance of nine months to ensure each period has an effective interest charge in profit or loss.

At 31 March 2027, a journal will be required to allocate the finance cost of £28,607 as follows:

<u>Journal 4</u>

	£
Dr Finance cost (profit and loss)	28,607
Cr Lease liability	28,607
Being interest charge on lease liability	

Summary of impact of journals 1 to 4

	Asset	Liability	P&L	Journal
Property, plant and equipment	333,769			1 and 3
Lease liability		336,132		1 and 2
Impact on profit and loss account			2,363	2, 3 and 4

Presentation of the lease liability at 31 March 2027

At 31 March 2027, the lease liability is split between the portion falling due within one year of £115,893 (£336,132 - £220,239) and the portion falling due after more than one year of £220,239 to comply with the statutory formats of the balance sheet.

Impact on the financial statements

The impact on the financial statements of moving the lease on-balance sheet is:

Impact on profit and loss FRS 102 (2024)	***Impact on profit and loss FRS 102 (2022)***
• Depreciation charge £111,256 • Finance cost £28,607 • Total impact £139,863 *Overall impact is a reduction in profit of £2,363*	• Lease rental expense £137,500

Impact on balance sheet FRS 102 (2024)	**Impact on balance sheet FRS 102 (2022)**
• Reduction in cash (£137,500) • Right-of-use asset £333,769 • Lease liability (£336,132) *Additional asset is recognised of £333,769 with a current lease liability of £115,893 and a non-current lease liability of £220,239.*	• Reduction in cash (£137,500)

If there are issues such as lease incentives (e.g. a rent-free period) then the calculations above may become a little more complex. For clarity, under FRS 102, lease incentives are amortised over the period of the lease.

In the year of initial application, there will be additional work involved in bringing leases on-balance sheet. However, once this has been completed, the subsequent accounting treatments should generally be straightforward.

1.3 Tax implications

HM Revenue and Customs will be issuing guidance on the corporation tax implications of the new lease accounting treatments in due course, so it is advisable to keep abreast of developments on the Gov.uk website in this respect.

2 ICAEW practice monitoring (Lecture A868 – 15.18 minutes)

In 2023, ICAEW Quality Assurance Department (QAD) carried out more than 1,300 practice assurance reviews of member firms. These reviews include an assessment of a firm's compliance with the framework as well as relevant laws and regulations. In 2023, QAD's focus was on anti-money laundering (AML) procedures. QAD held more detailed discussions with some of the larger firms to explore AML-related themes, such as:

The role of the money laundering reporting officer (MLRO)	Firm-wide risk assessments	Sanctions
Prohibition of accountancy services to Russia	Suspicious Activity Reports	Customer Due Diligence

54% of the reviews were carried out on site with 18% being carried out by desktop review and 28% by telephone interview. Most firms had addressed matters requiring attention with no need for follow-up; and 99% of other desk-based reviews, including new firm reviews, achieved no matters requiring action.

6% of onsite visits were referred to the Practice Assurance Committee for further action with 1% being referred for desktop reviews, other desk-based reviews and telephone reviews.

In total, the Practice Assurance Committee considered 56 reports (2022: 45 reports). Some of the reasons are outlined below:

Money laundering

14 firms had significant weaknesses in complying with Money Laundering Regulations. Some of them had failed to fulfil assurances at previous reviews to improve their procedures. In some cases, they had also failed to fully comply with Clients' Money Laundering Regulations.

Use of description

Ten firms were using the description 'Chartered Accountants' when they were ineligible to do so.

Practising certificate

Four cases related to ICAEW members being in public practice without holding a practising certificate.

Professional Indemnity Insurance (PII)

Five firms had significant gaps in their PII.

Failure to submit an annual return

Three firms had failed to submit their annual returns.

The Practice Assurance Committee issued penalties of between £200 and £5,700 to 36 firms (2022: 19 firms). 22 were referred to the Conduct Department for further investigation.

ICAEW recommendations

ICAEW recommends the following:

- Review the points raised at your last Practice Assurance review and ensure that you have taken action to address all the issues. Failure to address issues raised at the previous review is a common reason for firms being reported to the Practice Assurance Committee.
- Check whether you need a practising certificate by reviewing the updated *Statement on Members Engaging in Public Practice – Practising Certificates*.
- Utilise the wide range of resources available for AML supervised firms on the ICAEW website to help ensure that you are fully compliant with the MLR.
- If you hold clients' money, ensure you are familiar with the Clients' Money Regulations and have robust procedures to comply with them.
- Review the eligibility of your firm to use the description 'Chartered Accountants', especially if your principals and/or shareholders have changed.
- View the Practice Assurance compliance review helpsheet.

2.1 Analysis of findings

The table below shows firms with at least one finding that relates to non-compliance with regulations:

Finding	Number of firms	% firms	2023 ranking	2022 ranking
Money Laundering Regulations	615	47%	1	1
Clients' Money Regulations	214	16%	2	2
ICAEW records and annual return	163	12%	3	3

Basis of fees and complaints, and engagement letters	159	12%	4	4
Referrals and commissions	109	8%	5	5
Data protection	69	5%	6	8
Eligibility	65	5%	7	6
DPB (Investment Business) boundary issues	55	4%	8	9
Professional Indemnity Insurance	52	4%	9	7
Objectivity	11	1%	10	N/A
Other isolated findings	26	2%	-	-

Money Laundering Regulations

ICAEW publishes an annual report on anti-money laundering (AML) which explains the findings from its monitoring reviews, together with information on its regulatory role and how it fulfils it. ICAEW recommends reading the report for a breakdown of AML compliance issues and relevant available resources.

Clients' Money Regulations

Non-compliance with Clients' Money Regulations remains one of the top areas of concern. ICAEW has identified that:

- 127 firms did not have a bank trust letter to acknowledge the status of clients' money bank accounts.
- 72 firms had not carried out and documented an annual clients' money compliance review.
- 40 firms were not using designated clients' money accounts when holding £10,000+ for more than 30 days.
- 33 firms had not obtained their clients' consent, or waited for at least 30 days after issuing an invoice, before taking their fee from a client money balance.
- 28 firms had not reconciled their clients' money accounts at least once every five weeks.

Eligibility issues, ICAEW records, annual return and notifying ICAEW of changes

This is the third highest area of concern according to ICAEW.

When completing the firm's annual return, ICAEW asks firms to be careful and check all standing data. If you find an error, let ICAEW know what it needs to do to correct it. Firms should take care to ensure that they complete their annual return correctly.

In addition, ICAEW requires firms to notify it of any changes to the structure of a firm within **ten business days**. The annual return is **not** to be used for this purpose as the firm will be in breach of the Practice Assurance Regulations.

Firms should visit ICAEW's page on maintaining your firm's records to check if they:

- can use the term 'Chartered Accountant';
- is a member firm under the Practice Assurance Regulations and therefore is automatically supervised by ICAEW for money laundering; or
- to check other eligibility matters.

Basis of fees and complaints, and engagement letters

ICAEW found 159 firms had not informed clients of the basis on which fees are charged or the firm's complaints procedure, including the client's right to complain to ICAEW.

Firms do not have to issue engagement letters, but the above two matters **must** be communicated to all clients in writing.

If a firm does not wish to issue an engagement letter, you could communicate these matters to clients in any one of the following ways:

- a standard terms of business letter;
- a brochure given to the client; or
- a paragraph in the body of initial correspondence.

ICAEW have also found issues where firms are not keeping their engagement letters up to date; or did not cover specialist services; and/or were incorrectly informing clients that they were able to carry out work requiring a DPB (Investment Business) licence when this was not the case.

Code of Ethics: referral fees and commissions

ICAEW have identified gaps in accounting for unregulated commission and/or referral fees at 69 firms. Typically, this is where firms have not told their clients in writing how much they have received and/or obtained their consent to retain it.

ICAEW Code of Ethics, sections 330.12 A1 to 33.14 A1 sets out your requirements to:

- notify all relevant clients in writing of the amounts received;

- obtain their written consent to retain it; and
- treat the amounts received as clients' money and bank them in a client account until you have permission to retain the money.

For unregulated activities, firms can obtain advanced informed consent by including an appropriate paragraph in the letter of engagement that includes examples of likely commissions and amounts. However, the firm will still need to notify the client of the amount once received.

Professional Indemnity Insurance (PII)

ICAEW's main findings in this area are related to firms being inadequately insured and/or having a policy that does not comply with the ICAEW PII Regulations. Firms must ensure that their PII meets the minimum requirements:

- The cover should be at least two and a half times your gross income fee for the accounting year preceding the start of the policy (subject to a minimum requirement of £100,000 and a maximum of £1.5 million).
- The policy needs to be with a participating insurer who has agreed to meet the requirements of ICAEW's minimum policy wording. You can view a current list of approved insurers at www.icaew.com/pii.
- A review of ICAEW's PII requirements has taken place which included a public consultation that closed in December 2023. Wide-ranging proposals were presented and some of these are now being taken forward. Changes will come into effect from 1 September 2024.

The main changes that will come into effect from 1 September 2024 are as follows:

- The minimum limit of indemnity will increase from £1.5 million to £2 million.
- For firms with a gross fee income which is below £800,000, the limit will be two and a half times the firm's gross fee income, subject to a minimum of £250,000 (this is an increase from £100,000).
- Larger firms with gross fee income over £50 million will not be required to put in place 'qualifying insurance' but must have in place appropriate arrangements which will be monitored. (Currently this approach is available to firms with 50+ principals).
- For firms that will be required to put qualifying insurance in place, the maximum aggregate excess should not exceed the higher of £3,000 or 3% of a firm's gross fee income.

These new arrangements will apply to policies taken out or renewed from 1 September 2024. ICAEW recommends checking with your broker whether any of the changes will impact your policy and to ensure you leave sufficient time to prepare for your renewal this year.

There were also a number of findings relating to notifications not being made to the insurers and errors on proposal forms. Both could result in problems in the event of a complaint.

Data protection

ICAEW found 56 firms that had not registered with the Information Commissioner's Office. In addition, it found 14 firms that had still not put adequate procedures in place to meet the requirements of GDPR.

DPB boundary issues and referrals to financial advisers

ICAEW reminds firms of the importance to review the requirements outlined in its Code of Ethics (section R331.17) when considering making referrals to financial advisers. ICAEW have identified issues at 51 firms in respect of referrals to restricted advisers.

Firms will need to know whether a chosen financial adviser is independent or restricted by the Financial Conduct Authority. To make a referral to a restricted adviser, you will need to ensure that your client's needs will be addressed appropriately by making an assessment of whether the restricted adviser places business with product providers who account for a large majority of the relevant market, or offer the sector of the market which is most suitable for your client's needs. If you are not confident that you have the knowledge to make this assessment, you should only refer to independent financial advisers. Some types of referral to financial advisers may require a DPB (Investment Business) licence.

Objectivity

Not too many issues have been identified by ICAEW in this respect. The findings tend to be specific to individual clients hence ICAEW finds it difficult to highlight particular themes.

Threats to objectivity may result from having interests in, or relationships with, a client or its directors, officers or employees. It is best to consider these matters prior to undertaking any new work and during the course of an appointment because threats can arise at any time.

Threats to objectivity may include the following considerations:

Actual – are there relationships that are so significant that they could detract the firm's judgement away from that which would be the professional objective, right thing to do? Or

Perceived – are the relationships such that a reasonable and informed third party would consider that objectivity is impaired?

When evaluating the significance of the threats, firms should consider both the nature of the service provided and the nature of the relationship.

Examples of safeguards may include:

- Where the firm has staff, changing the personnel on the engagement team (for example using staff who do not have significant personal relationships with the client).

- Discussing the matter with the board or other affected parties.

- Disclosure of the relationship to affected parties (for example, a firm of chartered accountants' name is shown on a set of unaudited financial statements, the reader is likely to assume that the firm does not have any connection with the client other than a professional relationship. If there is a significant connection that could be perceived to impact on objectivity, ensure the firm of chartered accountants is not shown as being the preparer or disclose the relationship).

- Undertaking reviews (internal or external) of the work performed.

2.2 Future areas of focus

For 2024, ICAEW have chosen two areas of focus:

AI

Tools such as ChatGPT and AI-driven copilots' are powerful tools, but they come with risks. Reviewers will be discussing procedures that firms have in place, including how they are protecting confidential client data and what kind of processes they have established to check the accuracy of outputs from AI models. Many firms may not be actively using AI, but that does not mean it will not have an impact. ICAEW reviewers are keen to help firms navigate this evolving area by sharing best practice and signposting to relevant ICAEW resources.

Eligibility

Consolidation in the accountancy sector, alongside increased equity investment, is resulting in more complex firm structures. When firms are restructuring, it is important that they continue to meet ICAEW's eligibility requirements and consider the implications for AML supervision as well as the eligibility use the designation 'chartered accountants'. ICAEW wants to understand how member firms keep on top of this area and who in the organisation takes overall responsibility.

ICAEW acknowledge that they still see firms falling foul of the rules, hence it is important that firms have appropriate procedures in place to liaise with ICAEW early in the process.

3 Goodwill: Part 2 (Lecture A869 – 9.16 minutes)

In quarter 1, we examined some key technical concepts associated with goodwill, notably:

- Identifying goodwill
- Basic accounting requirements for goodwill in a business combination
- Subsequent measurement (rules on amortisation)
- Negative goodwill
- Impairment of goodwill

In this quarter, we will examine the accounting issues concerning:

- Revaluation of goodwill
- Changing amortisation rates or methods
- Acquisition of further shares in a subsidiary
- Disclosure requirements for goodwill

3.1 Revaluation of goodwill

Under FRS 102, Section 19 *Business Combinations and Goodwill*, it is not possible to revalue goodwill. FRS 102, para 19.23 states:

*After initial recognition, the acquirer shall measure goodwill acquired in a business combination at cost less accumulated **amortisation** and accumulated **impairment losses**:*

FRS 102, para 19.23

*(a) An entity shall follow the principles in paragraphs 18.19 to 18.24 for amortisation of goodwill. Goodwill shall be considered to have a finite **useful life**, and shall be amortised on a systematic basis over its life. If, in exceptional cases, an entity is unable to make a reliable estimate of the useful life of goodwill, the life shall not exceed 10 years.*

(b) An entity shall follow Section 27 Impairment of Assets for recognising and measuring the impairment of goodwill.

A commonly asked question where the revaluation of goodwill is concerned and the approach taken by FRS 102 in prohibiting it being revalued is *'… but why?'*

If we look at the revaluation model in FRS 102, Section 18 *Intangible Assets other than Goodwill*, paragraph 18.18B requires that the fair value of an intangible asset be determined by reference to an 'active market'. An 'active market' is defined as:

FRS 102 Glossary ***active market***

A market in which all the following conditions exist:

(a) the items traded in the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

An active market from which a reliable measure of fair value can be derived does not exist for goodwill and hence it cannot be revalued.

It is not uncommon for the directors of a business to obtain a valuation of the business and to arrive at the (misguided) conclusion that an excess of the valuation over the net assets of the business should be recognised as goodwill. This is incorrect because any excess that may be 'goodwill' would be internally generated and internally generated goodwill is specifically prohibited from recognition in FRS 102, para 18.8C(f).

3.2 Changing amortisation rates or methods

An entity is able to change its amortisation rate or method for goodwill and it does this in accordance with FRS 102, Section 10 *Accounting Policies, Estimates and Errors*. A change in amortisation rate or method would be classed as a change in an accounting estimation and hence would be applied prospectively (i.e. in the year of the change and going forward). No retrospective restatement is applied because there has been no change to the accounting policy (the entity is still amortising goodwill over its useful life); it is the useful life or the amortisation method (which is an estimate used in the application of the entity's accounting policy for goodwill) that has changed.

3.3 Acquisition of further shares in a subsidiary

Goodwill generally arises in the consolidated financial statements of a group (although it can be recognised in the individual financial statements of a reporting entity where goodwill has been acquired for valuable consideration – e.g. when a sole trader sells the business to a limited company).

A parent-subsidiary relationship is created when the parent obtains control of that subsidiary (i.e. it can direct the financial and operating policies of the subsidiary). This is usually achieved with an ownership interest of more than 50% of the net assets or voting rights; although there can be other indicators that a control relationship has been achieved even with an ownership interest of less than 50.01%.

When a parent entity acquires further shares in a pre-existing subsidiary, non-controlling interest will decrease. There is no impact on goodwill (i.e. no additional goodwill is recognised, and no fair value exercise is carried out at the date the additional ownership interest is acquired). Instead, FRS 102 requires the transaction be treated as one between equity holders in their capacity as equity holders, hence assuming a cash acquisition of further ownership interest, the journals will be:

Dr Non-controlling interest (NCI)	With the value of the reduction to NCI
Dr Equity attributable to the parent (typically retained earnings)	With the difference between the adjustment to NCI and the consideration paid to acquire the additional ownership interest
Cr Cash at bank	With the value of the consideration paid to acquire the additional ownership interest in the subsidiary

3.4 Disclosure requirements

The disclosure requirements for business combinations and goodwill are dealt with in FRS 102, paras 19.25 to 19.26A. Included within these disclosures are specific disclosure requirements for goodwill. For clarity, the paragraphs are reproduced as follows with underlined text where the disclosure requirement concerns goodwill. In addition, certain additional disclosures will be required when the periodic review amendments are applied and these have been highlighted separately, where applicable:

For business combinations effected during the reporting period

For each business combination, excluding any group reconstructions, that was effected during the period, the acquirer shall disclose the following:

FRS 102, para 19.25

(a) *the names and descriptions of the combining entities or businesses;*

(b) *the acquisition date;*

(c) *the percentage of voting equity instruments acquired;*

(d) *the cost of the combination and a description of the components of that cost (such as cash, equity instruments and debt instruments);*

(e) *the amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, including goodwill;*

(f) *[Deleted]*

(g) *the useful life of goodwill, and if this cannot be reliably estimated, supporting reasons for the period chosen*; and

(h) *the periods in which the excess[1] recognised in accordance with paragraph 19.24 will be recognised in profit or loss.*

The acquirer shall disclose, separately for each material business combination that occurred during the reporting period, the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period. The disclosure may be provided in aggregate for business combinations that occurred during the reporting period which, individually, are not material. *FRS 102, para 19.25A*

Periodic review amendments (disclosable for accounting periods commencing on or after 1 January 2026 if not early adopted)

The following disclosures are **in addition to** the above disclosures in paragraph 19.25:

(aA) *the primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree;*

(cA) *the amount of any non-controlling interest in the acquiree recognised at the acquisition date;*

(dA) *for contingent consideration arrangements:*

(i) *the amount recognised as of the acquisition date;*

(ii) *a description of the arrangement and the basis for determining the amount of the payment; and*

(iii) *an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.*

(i) *for each contingent liability that is not recognised in accordance with paragraph 19.15F because its fair value cannot be measured reliably, the acquirer shall disclose the information required by paragraph 21.15.*

New paragraph 19.25B is inserted as follows:

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, and the acquirer has recognised in its financial statements provisional amounts for the items for which the accounting is incomplete in line with paragraph 19.19, the acquirer shall disclose that fact and the line items for which provisional amounts have been recognised.

[1] This refers to negative goodwill.

For all business combinations

*An acquirer shall disclose a reconciliation of the **carrying amount** of goodwill at the beginning and end of the reporting period, showing separately:*

FRS 102, para 19.26

(a) changes arising from new business combinations;

(b) amortisation;

(c) impairment losses;

(d) disposals of previously acquired businesses; and

(e) other changes.

This reconciliation need not be presented for prior periods.

Periodic review amendments (applicable for accounting periods commencing on or after 1 January 2026 if not early adopted)

The periodic review made amendments to FRS 102, para 19.26 as follows (note additional wording is highlighted:

(a) ~~changes~~ additional goodwill recognised during the reporting period arising from new business combinations;

(b) amortisation;

(c) impairment losses recognised during the reporting period in accordance with Section 27;

(d) ~~disposals of~~ goodwill derecognised during the reporting period in relation to previously acquired businesses; and

(e) other changes.

This reconciliation need not be presented for prior periods.

An acquirer shall disclose a reconciliation of the carrying amount of the excess recognised in accordance with paragraph 19.24 at the beginning and end of the reporting period, showing separately:

FRS 102, para 19.26A

(a) changes arising from new business combinations;

(b) amounts recognised in profit or loss in accordance with paragraph 19.24(c);

(c) disposals of previously acquired businesses; and

(d) other changes.

This reconciliation need not be presented for prior periods.

Periodic review amendments (disclosable for accounting periods commencing on or after 1 January 2026 if not early adopted)

The periodic review gave rise to an additional 19.26B being inserted as follows:

If, in exceptional cases, an entity was unable to make a reliable estimate of the useful life of goodwill arising on a business combination in a previous reporting period, it shall disclose for each such business combination the period over which the goodwill is being amortised, and supporting reasons for the period chosen.

4 FRC consultation on going concern (Lecture A870 – 14.27 minutes)

On 5 August 2024, the FRC issued a consultation on revisions to its *Guidance on the Going Concern Basis of Accounting and Related Reporting, including Solvency and Liquidity Risks.* Once finalised, this will replace the existing guidance issued in 2016.

The guidance is non-mandatory and serves as a proportionate and practical guide to all UK companies within its scope, including those that apply the UK Corporate Governance Code. It excludes small companies and micro-entities, although some of the principles may still be relevant.

4.1 What has changed?

The draft guidance updates the existing guidance issued in 2016 to:

- include companies applying the UK Corporate Governance Code within the scope of the guidance;
- reflect changes in accounting and auditing standards;
- provide additional guidance on overarching disclosure requirements, particularly in situations when significant judgement was involved in the assessment of the appropriateness of the going concern basis of accounting or the conclusion that there are no material uncertainties; and
- provide additional guidance on techniques that could support the assessment process.

4.2 Structure of the guidance

The guidance is structured to include good practice guidance and other suggestions explaining how the requirements might be applied as follows:

Summary of requirements	This information is intended to summarise important aspects of law, accounting standards, The UK Corporate Governance Code or other regulation that underpin the guidance. It is not intended to be a comprehensive analysis of those requirements.
Example	Practical examples are included. These examples are intended to be illustrative only and may not be appropriate for all

	companies and circumstances.
Terminology	• 'Must' or 'required to' are used to refer to mandatory requirements or provisions derived from law, accounting standards, listing rules, The UK Corporate Governance Code or other regulatory requirements for entities within their scope. Such requirements might be mandatory as a result of the combined effect of different sources of requirements or only when resulting disclosures would be material. • 'Should' is used throughout this document to refer to good practice guidance and recommended ways of achieving the requirements in law, accounting standards or other regulatory requirements. • 'Could' or 'may' is generally used when preparers may wish to consider alternative ways to perform assessments and present information, or when providing examples of issues, techniques or disclosures which may be applicable depending on the company's specific circumstances.

4.3 Invitation to comment

The FRC is requesting comments on the draft guidance by 28 October 2024. Comments should be sent by email to narrative@frc.org.uk.

5 Disclosure issues in financial statements (Lecture A871 – 14.23 minutes)

Financial statements are prepared using sophisticated accounts production software systems which are capable of producing various disclosures. However, care needs to be taken with such systems because the disclosures that are produced are often basic policies/disclosures that may not be specifically tailored to the entity's individual circumstances.

Frequently, reviewers of financial statements will criticise them for disclosure issues with the main reasons usually being:

- Accounting policies are 'boilerplate', irrelevant or missing.
- Disclosures required by accounting standards are missing or incomplete.
- Certain disclosures are inconsistent with the information in the primary financial statements (e.g. depreciation policies are not consistent with the way in which depreciation has been calculated).
- Certain disclosures required by company law are missing (for example, historical cost comparatives for assets subject to the revaluation model).

5.1 Revenue

Revenue is usually the largest and most material number in the financial statements. Reviewers will often criticise an entity's accounting policy for revenue recognition simply because it is incomplete. For example:

Turnover is stated net of VAT and trade discounts.

Some automated accounts production software systems will usually generate such a policy on the basis that the user must input additional narrative to cover issues such as:

- How is turnover recognised? (Usually at the fair value of the consideration received or receivable).
- At what point is turnover recognised? For example, does the entity recognise revenue at the point goods are dispatched; or when the customer receives the goods?
- Is there deferred revenue in the financial statements; and, if so, is it material? If so, the accounting policy should describe the treatment of deferred revenue and the point at which it is released to profit or loss.
- Are there multiple revenue streams? If so, the accounting policy should describe how such revenue is recognised and at what point in time revenue is recognised.

Such policies will require user-input as the software will not be able to determine these issues.

The periodic review amendments have resulted in new revenue recognition sections in both FRS 102 and FRS 105. There will be additional disclosure requirements that an entity preparing financial statements under FRS 102 will be required to provide and so it is important that preparers have a good understanding of what is disclosable once the periodic review amendments take effect.

5.2 Inventory (stock)

It is not uncommon to see the following accounting policy in relation to stock:

> *Stock is valued at the lower of cost and estimated selling price less costs to complete and sell.*

While this accounting policy describes the valuation methodology for stock, it would be viewed as boilerplate. The policy should describe:

- What constitutes cost (purchase price plus directly attributable costs in bringing the stock to its present location and condition).
- How estimated selling price less costs to complete and sell is derived.

The following example provides a non-comprehensive example of how a stock policy might be worded for a company in the manufacturing sector:

Example – Accounting policy for stock

Stocks are stated at the lower of cost and estimated selling price less costs to complete and sell. Costs, which comprise direct production costs, are based on the method most appropriate to the type of inventory class, but usually on a weighted average cost basis. Overheads are charged to profit and loss as incurred. Estimated selling price less costs to complete and sell is based on the estimated selling price of the goods less any estimated completion or selling costs likely to be incurred on sale.

When stocks are sold, the carrying amount of those stocks is recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of stocks to estimated selling price less costs to complete and sell and all losses of stocks are recognised as an expense in the period in which the write-down or loss occurs. The amount of any reversal of any write-down of stocks is recognised as a reduction in the amount of stocks recognised as an expense in the period in which the reversal occurs.

5.3 Related parties

FRS 102, Section 33 *Related Party Disclosures* provides the guidance preparers need to ensure the related party disclosures comply with the standard. Micro-entities choosing to prepare financial statements under FRS 105 need not make any related party disclosures (other than information concerning directors' advances, credits and guarantees as required by s413, Companies Act 2006).

Small entities applying the presentation and disclosure requirements of FRS 102, Section 1A *Small Entities* are currently required to make only limited related party disclosures. However, the periodic review amendments which become mandatory for accounting periods commencing on or after 1 January 2026 will extend those related party disclosures for small entities based in the UK.

One of the questions frequently asked is whether an entity may disclose the names of the transacting related parties. FRS 102 does not require the names of the transacting related parties to be disclosed. Instead, it requires the nature of the related party relationship to be disclosed. The entity must do this **separately** for each of the following categories:

(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;*

FRS 102, para 33.10 (extract)

(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.*

5.4 Secured debt

Companies often raise finance to provide them with resources. Financing can be obtained using a variety of means such as bank loans, invoice discounting, invoice factoring, shareholder loans, share issues, directors' loans etc. Company directors may also make personal guarantees to the financier (often the bank) so that if the company is unable to pay its debts, the directors will have to make good any loans from the bank from their personal assets.

When a company raises finance, the party providing the finance may require some form of security if the company is unable to discharge its obligations. Security can range from personal guarantees to fixed and floating charges.

Companies are required to disclose the value of secured debt that it is included within creditors. In addition, the company should also provide details of the nature of the security over those debts to comply with The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409) Sch 1, para 55(2) and The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008410), para 61(4)(a) which require the aggregate amount of any debts included within creditors to be disclosed together with an indication of the nature and form of such security.

5.5 Directors' advances, credit and guarantees

Section 413 of Companies Act 2006 requires an entity (regardless of size) to comply with the disclosure requirements in respect of directors' advances, credits and guarantees.

This is often an area that poses a lot of questions and the disclosure requirements in both FRS 102 and FRS 105 derive from the requirements of company law.

A director's advance is effectively a payment to the director that creates, or increases, a debit balance on their current (loan) account. An advance arises when the director becomes indebted to the company as can be seen in the following example.

Example – Director's advance

Joe is a director of Philbin Ltd. Details of his loan account for the year ended 31 March 2024 are as follows:

	£
Opening balance at 1 April 2023	(10,000)
Withdrawal 1	6,000
Withdrawal 2	3,000
Withdrawal 3	2,000
Withdrawal 4	5,000
Dividend declared 30 March 2024	(10,000)
Closing balance at 31 March 2024	(4,000)

Up to withdrawal 2, Joe is merely withdrawing from his credit balance, so these withdrawals do not constitute an advance because his current account remains in credit. At withdrawal 3, the current account becomes £1,000 overdrawn (which is an advance) and at withdrawal 4, the current account is £6,000 overdrawn. The overdrawn balance is repaid following payment of the dividend of £10,000 returning his current account to £4,000 in hand.

Advances are interest-free and become repayable on demand.

Section 413, Companies Act 2006 would require disclosure as follows:

Director's advances, credit and guarantees

During the year, the company made interest-free advances to a director amounting to £6,000 (2023: £X). These were repayable on demand.

The company received repayments of £6,000 (2023: £X).

Section 413, Companies Act 2006 requires the following to be disclosed in respect of an advance or credit:

a) The amount

b) Indication of the interest rate

c) Main conditions

d) Amounts repaid

e) Amounts written off

f) Amounts waived

Monetary amounts are required to be disclosed in respect of a), d), e) and f) above.

A key point to bear in mind is that it does not matter if the opening and closing balances of the director's current account were either £nil or in credit at the start and end of the year. If the current account becomes overdrawn at any point during the year (hence giving rise to an advance), the s413 disclosure requirements are triggered.

It should also be emphasised that these disclosure requirements apply to anyone that was a director during the year. Therefore, even if a director resigns part-way through the year, advances and credits in their director's current accounts would still need disclosure up to the point at which they cease to be a director.

There is no requirement in company law to disclose the maximum amounts outstanding during the year. Some entities choose to do this and would be required if the directors consider that making such disclosure is necessary for the purpose of a true and fair view being presented in the financial statements. However, the vast majority of companies choose not to disclose this information.

5.6 Ensuring disclosures are as complete as possible

The key 'tip' in striving for complete and accurate disclosures is not to place full reliance on accounts production software systems. Such systems will usually only disclose the basics and will require user-input to enable the disclosure requirements to be concise and entity specific.

It should also be borne in mind that many accounts production systems include standard accounting policy notes by default (e.g. deferred tax disclosures and assets obtained under hire purchase and finance leases). If these policies do not apply to the entity, remove them. Superfluous accounting policies and disclosures are not required to be presented even if they are generated automatically by the software.

In addition, ensuring that material accounting policy information is as concise and entity specific as possible will usually result in good disclosures being made.

Disclosure checklists (particularly for audited financial statements) are a key tool in ensuring that disclosures are as technically accurate as possible.

The other ‘tip’ would be to ensure you ‘stand back’ and review the disclosure notes for appropriateness. In particular, keeping an eye out for disclosures which may not have been updated, such as related party transactions and balances. Sometimes, these are overlooked resulting in the prior year disclosure note just simply being rolled forward into the current year.

Where the entity is required to prepare a strategic report, ensuring that the amounts are consistent with the financial statements is a key issue. The strategic report may have been drafted prior to the financial statements being finalised. Various adjustments (including audit errors) may have been incorporated into the financial statements. If the strategic report is not reviewed again for consistency immediately prior to finalisation, the amounts will be inconsistent with the financial statements and this could have implications for the auditor’s report if the inconsistencies are not adequately resolved.

6 Audit Regulations Consultation (lecture A872 – 6.10 minutes)

ICAEW proposes to make changes to the UK Audit Regulations and Guidance to increase the transparency of the movement of certain audits between audit firms. To that end, ICAEW is seeking feedback from stakeholders on the potential impact of these proposals.

The consultation opened on 6 June 2024 and will close on 6 September 2024. Following the consultation, the revised regulations are expected to come into effect in early 2025.

6.1 Key proposed change

ICAEW plan to change the Audit Regulations to require audit registered firms to notify ICAEW within 21 business days of being appointed as auditors to certain entities, and to entities where the audit fees are significantly higher than fees in the firm's existing audit portfolio.

The change will apply to the following audits:

Criteria A

A listed non-retained audit[2];

Criteria B**

A non-retained audit that:

- has turnover greater than £750 million; or
- is an Other Entity of Public Interest under the FRC Ethical Standard;

Criteria C***

Expected first-year audit fee for an entity, group or collection of entities with the same beneficial owner or controlling party that is:

- More than two times the firm's existing highest audit fee as notified on the firm's last annual return for an entity, group or collection of entities with the same beneficial owner or controlling party.

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[2] A non-retained audit is:

- not a PIE audit
- not one that has otherwise been retained by the FRC (for example a Lloyds Syndicate or certain AIM-listed entities).

Criteria D****

The registered auditor has three or fewer responsible individuals and the audited entity or group, or a collection of audited entities under common beneficial ownership or controlling party, have combined turnover greater than £750 million.

**The threshold of £750 million of turnover aligns with the previously proposed new criteria for a company that would be treated as a PIE under the potential changes to the PIE definition, although without the additional 750 employee threshold.

It may be that the Other Entity of Public Interest category would be removed from the Ethical Standard if a revised PIE definition is introduced. Given the uncertainty of the actions of a future government, it is unknown if, and when, the FRC would receive notifications of audit appointments to these categories of entity.

***The rationale for the requirement in Criteria C applying to an entity, group or collection of entities with the same beneficial owner or controlling party, is to align with recent changes made to the FRC Ethical Standard.

****The rationale for the requirement in Criteria D applying to an entity, group or collection of entities with the same beneficial owner or controlling party, is to align with recent changes made to the FRC Ethical Standard. The firm threshold in Criteria D of three or fewer responsible individuals is the level at which a registered auditor is not required to have an ethics partner.

The notification would also be required where the auditor remained in post when the audited entity began to meet the criteria in A or B, or the firm and audited entity(ies) began to meet the combined criteria in D. This is currently the case for the Audit Registration Committee (ARC) reporting requirement under regulation 3.15 of the Audit Regulations. For example, where firms have to notify the ARC if they remain in post when the audited entity becomes a PIE.

7 Analytical procedures (Lecture A873 – 15.09 minutes)

Analytical procedures are a vital tool for an auditor and **must** be applied at the planning stage of the audit (as required by ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement*) as risk assessment procedures. In addition, analytical procedures must be applied towards the end of the audit to enable the auditor to form an overall conclusion on the financial statements. An auditor may use analytical procedures during the fieldwork stage, if appropriate.

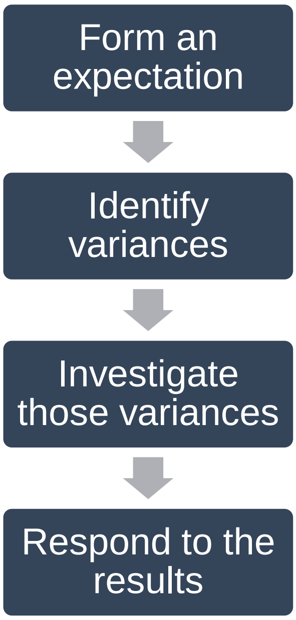
7.1 Analytical procedures at the planning stage

At the planning stage of the audit, analytical procedures are used as risk assessment procedures. This enables the auditor to obtain an understanding of the business and its environment to help reduce the risk of material misstatement in the financial statements. This then enables the auditor to devise the nature, timing and extent of audit procedures which then feeds into the development of the audit strategy and subsequent audit plan.

Put simply, the objective of analytical procedures is to assess if there are plausible and expected relationships between financial and non-financial data. 'Financial data' will, of course, be the financial statements. 'Non-financial data' could involve considering how the company goes about achieving its objectives, such as marketing, staffing requirements, opening branches in new locations and the client's overall position in the industry in which it operates.

Analytical procedures can indicate potential sources of misstatement at the planning stage of the audit, for which the auditor will then devise specific audit procedures to see what is going on. The reliability of the data should also be carefully considered by the auditor.

The general process involved in performing analytical procedures is as follows:



Step 1: Form an expectation

An expectation is a prediction of a recorded amount or ratio and can be a specific number, a percentage, a direction or an approximation.

Keep in mind that when the auditor uses substantive analytical procedures, they must always have an expectation to work with in order to identify plausible relationships.

Step 2: Identify variances

The auditor should always consider the amount of difference from the expectation they are willing to accept without having to perform further audit procedures. This is often referred to as 'tolerable error' or a 'threshold' and may be defined as a numerical value or as a percentage of the items being tested.

Establishing a threshold is important to ensure effective use of substantive analytical procedures. It is also particularly important that the threshold does not exceed performance materiality.

Step 3: Investigate those variances

This is where the auditor compares the expected value with the recorded amounts and identifies the difference (if any). The calculation of the difference should be done after consideration of an expectation and a threshold.

Step 4: Respond to the results

This is the investigation of significant differences and the auditor's conclusion thereon. Differences indicate an increased likelihood of misstatements and should be investigated.

Keep in mind that the auditor must obtain explanations/corroboratory reasons for the **full** difference, not just the amount of the difference exceeding the tolerable threshold.

Remember, any unexplained difference may indicate an increased risk of material misstatement.

A key point to bear in mind is that at the planning stage, the auditor is not obtaining audit evidence. Analytical procedures at the planning stage will assist the auditor in identifying inconsistencies, unusual transactions or events and unusual or unexpected relationships which may point to risks of material misstatement. The results of the planning analytical review will then feed into the development of the audit strategy and audit plan.

7.2 Types of analytical procedure commonly used at the planning stage

There are three common types of analytical procedures the auditor may carry out during the risk assessment stage of the audit:

Trend analysis	The auditor will compare a current year figure to the prior year to see if the two figures are consistent; or if one is significantly higher than the other. In addition, the auditor may also compare actual figures to budgeted figures or compare the client's figures to another company in the same industry to see if they are comparable. Where there are significant fluctuations, the auditor will devise procedures to investigate why those fluctuations have occurred.
Ratio analysis	This is probably the most well-known type of analytical procedure used in practice. The auditor will calculate various ratios (e.g. gross profit margin) to identify potential sources of misstatement. Keep in mind, however, that a ratio on its own is meaningless – the auditor will need at least the current year and prior year ratios for comparability purposes.
Reasonableness	This is where the auditor is asking themselves *'Does what I am seeing make sense based on other facts?'* For example, carrying out a reasonableness test on depreciation by calculating expected amounts and comparing that figure to the draft financial statements.

Example – Disproportionate increase in gross profit margin

The draft financial statements of Dudson Enterprises Ltd for the year ended 31 March 2024 show gross profit margins have increased to 40% (2023: 29%).

It may well be the case that gross profit margins have increased by 11 percentage points from the prior year, but the auditor cannot just take this at face value. Such an increase in gross profit margins could be due to:

- Cut-off errors on sales – i.e. sales for the succeeding financial year have been recognised in the current year due to a cut-off error.
- Cut-off errors on cost of sales – i.e. direct costs for the current year have been recognised in the succeeding year due to a cut-off error or under-accrual.
- Stock valuation – closing stock or work in progress may be overstated due to errors in the stock valuation or cut-off issues.
- Posting errors – sales invoices could have been duplicated or input into the system at an overstated value.

Example – Interaction of ratio analysis with the financial statement assertions

The audit senior of Summer & Co Accountants and Auditors is carrying out the planning of an existing client, Dwyer Enterprises Ltd. Planning analytical review procedures indicate that trade debtor days have increased from 35 days in 2023 to 62 days in 2024.

An increase in trade debtor days to this extent indicates that they may be overvalued. A key assertion over trade debtors is the **valuation** assertion (i.e. trade debtors are carried in the balance sheet at an appropriate amount). This means that the auditor will be primarily concerned with the recoverability of trade debtors – particularly those which are overdue for payment and will focus on testing trade debtors for overstatement. It may be that some debtors are irrecoverable and may need writing down to recoverable amount to avoid trade debtors being overstated.

7.3 Analytical procedures used as audit evidence

Where analytical procedures are used as audit evidence, ISA (UK) 520 *Analytical Procedures* will apply.

Caution is advised where the auditor plans to use analytical procedures as audit evidence because, all too often, firms are criticised for over-reliance on substantive analytical procedures that are effectively irrelevant because they are based on information that would not give rise to analytical procedures being appropriate.

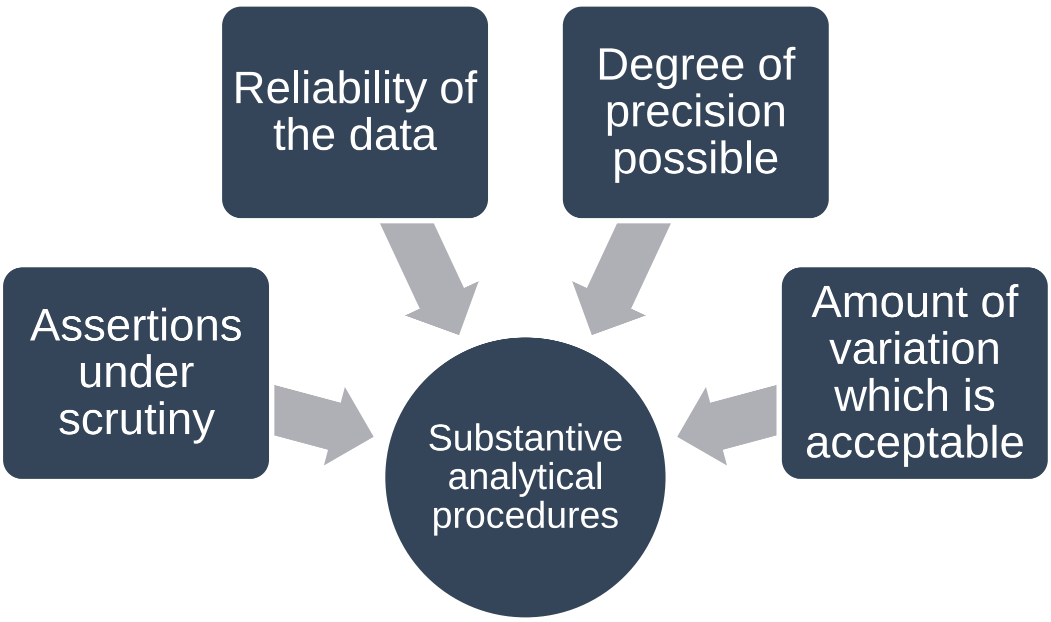
In addition, analytical procedures will not necessarily detect specific misstatements (this is what tests of detail are used for). To that end, analytical procedures cannot be used on their own to generate sufficient appropriate audit evidence; they should be used in conjunction with other forms of audit procedures (such as inquiry, recalculation and reperformance).

Example – High level of staff turnover

A 'proof in total test' is a reasonableness test that is a substantive analytical procedure which is often used when auditing payroll. The auditor will create an expectation of payroll costs during the year by taking last year's payroll expense from profit or loss, inflating this number for pay increases during the year and bonuses and changes in staff numbers.

If there are high levels of staff turnover, or inconsistent staff numbers or pay rates during the year, a proof in total test is unlikely to be reliable because it will invariably determine an expected figure that bears little resemblance to the figure in profit or loss. Hence, a more effective **substantive procedure**, such as recalculation or reperformance of the payroll expense may be more effective.

When using substantive analytical procedures, there are four issues that must be considered:



Assertions under scrutiny

The assertions under scrutiny should be suitable for the assertions which are being tested. For example, analytical procedures would be unsuitable for testing the existence of work in progress. However, they would be suitable for assessing whether any write-down to estimated selling price less costs to complete and sell for stock may be required by using the stock holding period ratio.

The use of analytical procedures is appropriate for those balances which are likely to be predictable over time because the auditor will need to analyse the relationships between those sets of data. This is the reason why it is important to only use substantive analytical procedures in specific situations because they are not always appropriate. Audit firms are frequently criticised for using substantive analytical procedures inappropriately (particularly where other forms of audit evidence are weak).

Reliability of the data

In a business where controls over the financial information are weak, the risk of material misstatement is higher. In this situation, the use of analytical procedures is generally not a suitable basis for assessment.

Degree of precision possible

Analytical procedures are viewed as being a high-level approach when testing a balance. If the auditor needs to test a balance (or multiple balances) with a high level of precision, analytical procedures are unlikely to detect misstatements.

A degree of precision will be involved if the auditor is to disaggregate the balance being tested. For example, if the auditor were to disaggregate turnover into products/divisions/regions. By disaggregating a balance, the auditor will be applying analytical procedures over a smaller balance and hence the procedures are likely to be more effective.

Amount of variation which is acceptable

The auditor must create an expectation to compare against the actual amount recorded in the financial statements. If the level of variation from actual is higher than the level of variation the auditor is willing to accept, the auditor will need to carry out further audit procedures to ensure the balance in the financial statements is not materially misstated.

7.4 Common problems with analytical review identified during file reviews

Common problems identified during file reviews where analytical procedures are concerned include the following:

- A 'crude' analytical review carried out only on profit and loss items (e.g. merely calculating movements without thorough investigation of the difference)
- A deduction for analytical procedures when there has been no substantive analytical procedures carried out
- No indication of a threshold
- No apparent questioning as to the reliability of the data and how the auditor is satisfied the data is accurate (indicating a lack of professional scepticism and challenge of source data)

7.5 Analytical procedures at the completion phase of the audit

ISA (UK) 520 requires the auditor to carry out analytical procedures at the completion phase of the audit in order to form an overall conclusion as to whether the financial statements are consistent with the auditor's knowledge and understanding of the client and the environment in which it operates as well as evaluating whether the financial statements are free from material misstatement. Remember, analytical procedures may also be used during the audit as a substantive procedure to obtain audit evidence, but this is not mandatory.

To all intents and purposes, the analytical procedures carried out at the final stage of the audit will not differ too greatly from those carried out at the planning stage (e.g. carrying out ratio analysis and comparing current year figures to the prior year).

The principal difference at the completion stage of the audit is that the auditor should have sufficient appropriate audit evidence to explain the issues that have been flagged up by analytical procedures. Hence, the auditor should be in a position to conclude as to the overall reasonableness of the financial statements. For example, if the client's gross profit margin was expected to be similar to the prior year, but has, in fact, declined, the auditor should have sufficient appropriate audit evidence to explain the reason(s) for the decline.

If the auditor finds any previously unidentified risks of material misstatement at the completion stage, then further audit evidence will need to be obtained.

8 ISA (UK) 600 (Revised) (Lecture A874 – 31.09 minutes)

On 26 September 2022, the FRC issued ISA (UK) 600 (Revised September 2022) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*.

This ISA (UK) (Revised) comes into mandatory effect for audits of group financial statements for periods beginning on or after 15 December 2023 (i.e. for 31 December 2024 year ends or short periods).

At the outset, it is worth noting that the changes brought about by this revised ISA (UK) are significant in some key areas and audit firms that are involved in group audits should not under-estimate the changes.

The amendments to ISA (UK) 600 (Revised) ensure that the standard is more aligned to the new quality management 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 well as ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement*.

8.1 Definition of 'component'

Group auditors must appreciate that the definition of a 'component' has been revised; in particular, the definition of 'significant component' has been removed. Instead, emphasis has been given to the consideration of risks of material misstatement at the assertion level of the group financial statements which are associated with components.

The revised definition of 'component' is as follows:

> *An entity, business unit, function or business activity, or some combination thereof, determined by the group auditor for purposes of planning and performing audit procedures in a group audit.*

ISA (UK) 600 (Revised), para 14(b)

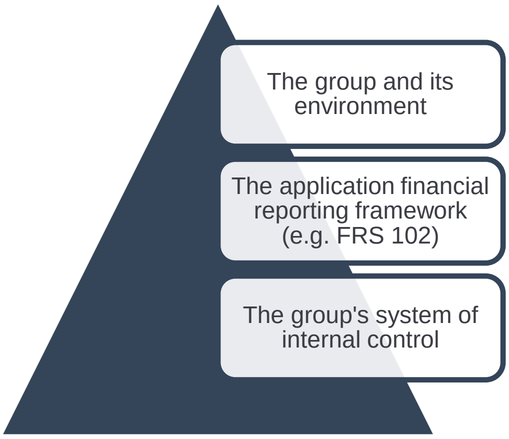
8.2 Proactive risk-based approach

One of the key changes is the introduction of a proactive and risk-based approach to the audit of groups.

There is more focus on identifying and assessing the risks of material misstatement, planning the approach to the audit and performing engagement procedures which specifically respond to the assessed risks.

Risk is dominant in ISA (UK) 315 and ISA (UK) 600 requires the group auditor to take responsibility for the identification and assessment of the risks of material misstatement of the group financial statements (including the consolidation process).

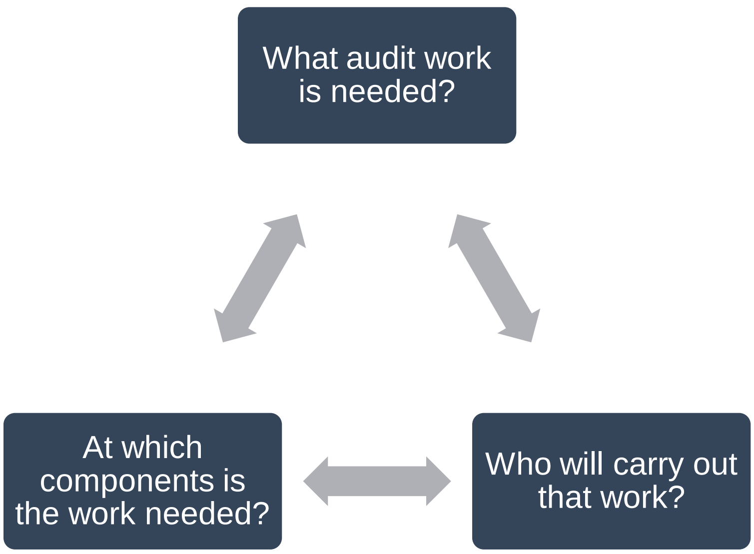
In practice, this would involve the group engagement team developing initial expectations concerning the potential risks of material misstatement and an initial identification of the significant classes of transactions, account balances and disclosures of the group financial statements, based on an understanding of:



This will then lead the group audit engagement team in considering whether to involve component auditors in risk assessment procedures. This is likely to be helpful at group level because component auditors will have obtained an understanding of the activities and related risks associated with the group's subsidiaries/entities and will also help the group audit engagement team to understand where the risks of material misstatement lie **within the group itself** and hence how the group financial statements may be materially misstated as a result of those risks.

The new 'top-down' approach to risk assessment requires the group engagement team to perform a group-wide risk assessment. This means there is more focus on identifying and assessing the risks of material misstatement for the group **as a whole**, planning the approach to the group audit and performing audit procedures that respond to the group engagement team's risk assessment (where these risks are located in the group).

To summarise, three questions that are now the key 'thrust' for group audits are:



8.3 Planning the group audit

It is difficult to prescribe a definitive list of group audit planning points to consider as every group audit will be different. Planning should be specifically tailored to the client and reflect the client's individual risk assessment and ISA (UK) 600 (Revised) essentially requires more in the way of risk assessment to be carried out.

Typical procedures which may be carried out at the planning stage might include the following (note, the list below is **not** comprehensive):

- Determine the size of the group and its components.
- Consider group-wide internal controls, such as:
    - the group's use of an internal audit function;
    - whether there is adequate segregation of duties (e.g. in payroll);
    - the frequency of meetings between the group and component management;
    - risk assessment procedures;
    - whether there is a centralised financial reporting function; and
    - the existence of any group-wide fraud prevention strategies.
- Whether there are any issues which could give rise to a limitation of scope leading to a modified opinion (e.g. prevention of access to component auditor working papers for which alternative procedures cannot be performed).
- Whether components have their own finance function.
- Group accounting issues, such as:
    - the effectiveness of the process of eliminating intra-group transactions and balances;
    - uniformity of accounting policies or the need for adjustments where group entities adopt different accounting policies to those of the parent; and
    - uniformity of accounting reference dates.

Direct controls will need to be documented at the planning stage. For example, flowcharts may be used whereby lines demonstrate the sequence of events and symbols are used to signify controls or documents.

The group audit engagement team should also consider the results of the previous year's audit and determine whether there were any problems encountered, such as inefficient internal controls or scope limitations. The group audit engagement team should also review the auditor's reports for individual components to establish whether the component auditor has encountered any difficulties during the previous year's audit which could impact on the current year.

8.4 Materiality considerations

ISA (UK) 600 (Revised) contains the definition of 'component performance materiality' as follows:

> *An amount set by the group auditor to reduce aggregation risk to an appropriately low level for purposes of planning and performing audit procedures in relation to a component.*

ISA (UK) 600 (Revised), para 14(e)

The definition refers to 'aggregation risk'. Aggregation risk is the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. ISA (UK) 600 (Revised), para A19 goes into more detail where this is concerned, specifically stating:

> *Aggregation risk exists in all audits of financial statements, but is particularly important to understand and address in a group audit because there is a greater likelihood that audit procedures will be performed on classes of transactions, account balances or disclosures that are disaggregated across components. Generally, aggregation risk increases as the number of components increases at which audit procedures are performed separately, whether by component auditors or other members of the engagement team.*

ISA (UK) 600 (Revised), para A19

In practice, aggregation risk can increase for many other reasons (not just due to the number of components). For example, aggregation risk could also increase due to the extent of disaggregation of the financial information across components of the group as well as the nature, frequency and magnitude of misstatements in the component's financial statements. Ordinarily, the auditor would respond to aggregation risk by reducing component performance materiality to an appropriate level to enable audit procedures to be performed separately on the financial information of components across the group. Hence, ISA (UK) 600, para A19 may be somewhat limited in comparison to practical application, which is something auditors in practice need to bear in mind.

What is important to bear in mind is that the group audit planning documentation must include the basis of how component materiality has been determined and the rationale for conclusions drawn in this area. Remembers, reviewers must understand the reasons **why** conclusions have been drawn in areas that involve professional judgement.

ISA (UK) 600 (Revised), para 35(a) requires the group auditor to determine component performance materiality for each of the components where audit procedures are performed on financial information that is disaggregated. Keep in mind that component performance materiality is likely to be different for each component. In addition, the component performance materiality for an individual component need not be an arithmetical portion of the group performance materiality. Consequently, the aggregate of component performance materiality amounts may exceed group performance materiality (although individual component performance materiality levels need to be lower than group performance materiality).

ISA (UK) 600 (Revised) does not require component performance materiality to be determined for each class of transaction, account balance or disclosure for components at which audit procedures are performed.

However, if, in the group's specific circumstances, there are one, or more, classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the group financial statements as a whole could reasonably be expected to influence the decision-making process of the users, this should be considered by applying the principles in ISA (UK) 320 *Materiality in Planning and Performing an Audit*.

8.5 Relying on the work of component auditors

ISA (UK) 600 (Revised) includes additional wording within paragraph 25(b) which makes it clear that the group engagement partner must confirm with the component auditor that they are able to comply with the FRC's Ethical Standard. For UK-based components, this is unlikely to be a problem; however, for overseas components, there may be issues with compliance that need to be handled carefully.

It is down to the group auditor's professional judgement in determining the components at which audit procedures will be performed. Matters which may influence the group auditor's decision to carry out additional audit procedures at components may include:

- The nature of events or conditions that could result in a risk of material misstatement, such as:
  - in-year acquisitions or newly formed entities;
  - subsidiaries in which significant changes have taken place;
  - significant transactions with related parties;
  - significant transactions have arisen that are outside the ordinary course of business; or
  - abnormal fluctuations have been identified through analytical procedures performed at group level.
- The disaggregation of significant transactions, account balances and disclosures in the group financial statements across components, considering the size and

nature of assets, liabilities and transactions in the component relative to the group financial statements.

- Whether sufficient appropriate audit evidence is expected to be obtained for all significant classes of transactions, account balances and disclosures in the group financial statements from audit work of identified components.

- The nature and extent of misstatements or control deficiencies that have been noted in components in prior years.

- The nature and extent of common controls across the group and whether the group centralises activities that are relevant to financial reporting.

Whether reliance can be placed on component auditors' work will, of course, be driven by the risk assessment. In practice, technical competence should not usually be a major factor because audit firms are prohibited from taking on work which they are neither competent to perform; or do not have adequate resources available to carry the work out in accordance with the ISAs (UK) or other professional standards.

The issues in a group audit which usually cause problems are:

- The size of the component auditor and the materiality of the component to the group.

- The availability of audit staff (particularly in busy times).

- Short reporting deadlines.

8.6 Restrictions on accessing component auditor working papers

When components are located in countries other than the group auditor's, it is important to consider the complexities in obtaining sufficient appropriate audit evidence due to cultural and language differences as well as different laws and regulations. Questions that should be asked are:

- Does law or regulation restrict the component auditor from providing documentation outside of their jurisdiction?

- Has there been war, civil unrest or outbreaks of disease that may restrict access to relevant component auditor audit documentation?

Where restrictions exist, there are other options which may be viable, such as:

- Visiting the location of the component auditor, or meeting with the component auditor in a location different from where the component auditor is located to review the component auditor's audit documentation.

- Reviewing the relevant audit documentation remotely through use of technology, when not prohibited by law or regulation.

- Requesting the component auditor to prepare and provide a memorandum that addresses the relevant information and holding discussions with the component auditor, if necessary, to discuss the contents of the memorandum.

- Discussing with the component auditor the procedures performed, the evidence obtained and the conclusions reached by the component auditor.

If access to component management or those charged with governance of a component is restricted, consider requesting group management or those charged with governance of the group to assist with removing the restriction. Alternatively, request information directly from group management or those charged with governance of the group.

When the group auditor is unable to obtain sufficient appropriate audit evidence due to restrictions on access to information or people, the group auditor may:

- Communicate with group management about the restrictions and encourage group management to communicate with regulators. This may be useful when restrictions affect multiple audits in the jurisdiction or by the same firm, for example, because of civil war, civil unrest or outbreaks of disease in a major economy.

- Communicate (as may be required by law or regulation) with regulators, listing authorities or others about the restrictions.

Restrictions on access may have other implications for the group audit. For example, if group management imposes restrictions, the group auditor may need to reconsider the reliability of group management's responses to the group auditor's inquiries and whether the restrictions call into question group management's integrity.

If restrictions are imposed after acceptance of the group audit engagement that may affect the ability to obtain sufficient appropriate audit evidence, this could result in a modified audit opinion to which the group auditor must refer to ISA (UK) 705 *Modifications to the Opinion in the Independent Auditor's Report* for further guidance.

8.7 Summary of major changes and practical points to consider

While these notes do not consider every change to ISA (UK) 600, we have summarised below the key major changes that group auditors must be aware of where ISA (UK) 600 (Revised) is concerned:

- A more proactive risk-based approach.

- More focus on identifying and assessing risks of material misstatement **within the group**.

- Definition of 'engagement team' includes component auditors.
- New definition of component has been included (see **8.1** above).
- Strengthened two-way communication requirements between group and component auditor.
- Enhanced requirements for professional scepticism.
- Enhanced documentation requirements.
- Clarifications on restrictions to access to people or information that may exist.

Effectively, where group auditors were doing a reasonable job in applying the outgoing ISA (UK) 600, it may be the case that they do not experience much in the way of change where the overall audit strategy and resulting audit plan is concerned under ISA (UK) 600 (Revised). However, key practical points which we are expecting firms to take away are:

- Reviews of component working papers will be risk-based. This is not a 'line by line' review, but it will involve professional judgement.
- Regulators tend to increase the volume of a revised ISA (UK) to 'pull out' those points that auditors should have been doing under the outgoing standard and either were not doing them; or were doing them wrong or inadequately. This is often why a standard significantly increases in volume.
- Group auditors cannot just send out questionnaires to components as this will not work under ISA (UK) 600 (Revised).
- There are likely to be challenges in implementing the new ISA (UK) 600, particularly in revising audit methodologies.
- The group auditor may identify local risks that could impact the group audit opinion – this will need factoring into the audit strategy at the planning stage of the group audit.
- Firms must consider acceptance and continuance protocol at an early stage in the audit. It may no longer be appropriate for the group auditor to continue to act for the group (e.g. because of issues in the prior year).
- Audit firms cannot just roll forward audit working papers from the prior year. You must ask yourself '*what is the audit strategy going to be?*' As mentioned above, if you were doing a good job under the outgoing ISA (UK) 600, you may find your audit strategy does not change very much.
- For components located overseas, consider whether they are technically competent (and capable) of doing the job. Should the group auditor carry out

research on the component audit firm – such as whether they have been subjected to regulatory sanctions for poor audit work. If so, the group auditor must question the technical competency of the component and this may involve the group engagement team carrying out further procedures on the component. Group audit firms should evidence any research carried out on their group audit working papers.

- Consider more open questions where questionnaires are being used. For example, 'Have you acted for the client for more than five years?' could be worded as 'How long have you acted for the client?'

- The group audit engagement partner should consider attending the planning meeting with component management or those charged with governance and the group auditor to understand the risks. Consider whether the Engagement Quality Reviewer (EQR) is in discussions with the component auditor as well.

- There will need to be more time allocated in the budget for the group engagement partner and EQR and this is likely to impact on fees, which may need to be increased.

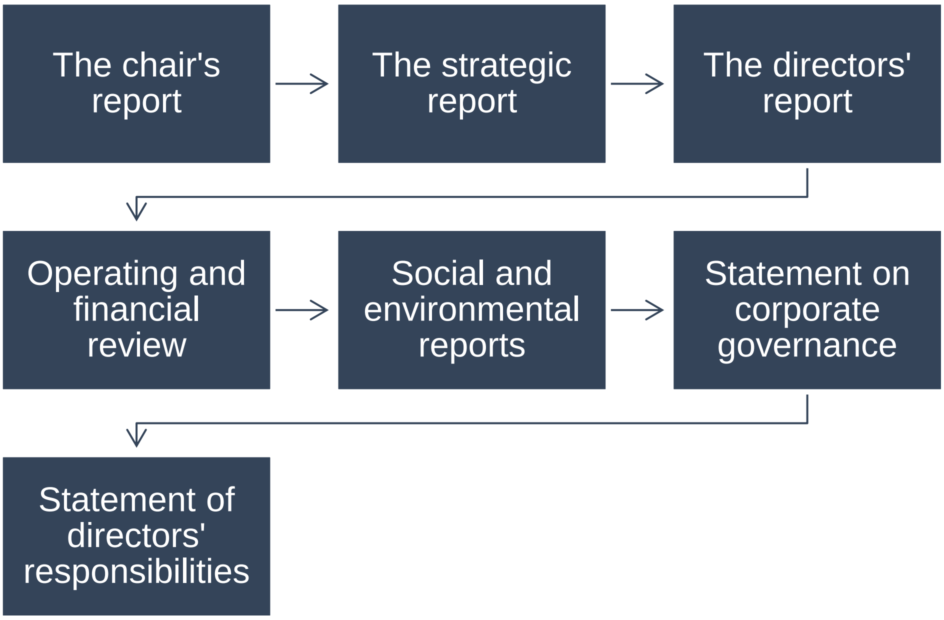
The key is to start the group audit planning as early as possible because there is more work needed to be carried out at group level under ISA (UK) 600 (Revised).

9 Other information in the annual report (Lecture A875 – 6.31 minutes)

ISA (UK) 720 *The Auditor's Responsibilities Relating to Other Information* states that 'other information' is information that relates to financial or non-financial information, but it does **not** relate to the financial statements and the auditor's report thereon, which is included in the annual report.

Financial statements will often contain lots of additional information which the organisation needs to include, not only because company law or regulation may dictate that such information must be included, but also because users will need to have the information to hand to make informed decisions.

Examples of other information contained in the entity's annual report includes:



9.1 Auditor's responsibilities

It is obvious that the auditor's overall responsibility where the audit is concerned is to express an opinion on whether the financial statements give a true and fair view and have been properly prepared in accordance with the financial reporting framework and other regulation. In terms of 'other information', this is not audited but is referred to in the auditor's report. Instead, the auditor is required to read the other information which the client has included in the annual report with a view to identifying any material inconsistencies in that other information when compared to the financial statements.

Section 496, Companies Act 2006 requires that the auditor must state whether, in their opinion, based on the work undertaken during the audit, the information provided in the strategic report (if any) and the directors' report for the financial year for which accounts are prepared is consistent. In addition, the auditor must also consider whether the strategic report and the directors' report have been prepared in accordance with the applicable legal requirements and if any material misstatements have been identified in those reports. Where material misstatements have been identified in the strategic report and directors' report, the auditor must provide an indication of the nature of each of the misstatements.

Keep in mind that any material misstatements or inconsistencies in other information are likely to undermine the credibility of the financial statements and auditor's report.

In addition, the auditor cannot be associated with any information that is misleading. Hence, the requirement for the auditor to carefully consider the other information included in the annual report in terms of its accuracy and consistency with the financial statements. Any misstatement of the other information exists when the other information is incorrectly stated or otherwise misleading because it omits or obscures information which is necessary for a proper understanding of a matter.

Example – Inconsistency identified

Olive is the audit senior working on the audit of Bauer Industries Ltd for the year ended 31 March 2024.

Olive has reviewed the directors' report which states that the company's operating profit has increased by 25% from the prior year and that gross profit margins have remained consistent.

During Olive's analytical review, she noted that the company's operating profit had, in fact, only increased by 6.2% and gross profit margins for the current year had declined by some 3% because of an increase in raw material prices.

This inconsistency between what the directors are reporting in the directors' report and what is being reported in the company's profit and loss account is likely to be materially inconsistent. It may be that the directors' report had been drafted some time ago and the financial statements may have been adjusted to take account of misstatements identified during the audit, and the directors' report has simply not been updated. On the other hand, it may also be an attempt by the directors to mislead the users.

In any case, if the directors do not correct this inconsistency, the auditor must make reference to it in the auditor's report.

When the auditor discovers a material inconsistency, it must be discussed with management with a view to them correcting the misstatement. ISA (UK) 720 requires the auditor to:

- Perform audit procedures to evaluate the inconsistency (i.e. to ascertain whether it is the accounts or other information that requires adjustment).

- If management refuse to correct the inconsistency, discuss it with those charged with governance (although management and those charged with governance may be the same body of people).

- If the matter remains unresolved, the auditor must describe the issue in the auditor's report.

- The auditor may decide to withdraw from the engagement if permitted under law or regulation because the inconsistency would cast doubt over the integrity of management.

The auditor must exercise professional scepticism where inconsistencies are concerned because, as mentioned in the previous example, there may be an attempt by management to deliberately mislead the users of the financial statements – particularly if other issues that bring into question the integrity of management and/or those charged with governance have been identified during the audit. It may also be the case that the inconsistency identified is so serious that the auditor feels they have no alternative but to resign.

9.2 Placement of the Other Information section in the auditor's report

Ordinarily, the 'Other Information' section is included after the 'Conclusions relating to going concern" section and before the 'Opinions on other matters prescribed by the Companies Act 2006 section. It will confirm that the responsibility for the other information rests with the directors and that the auditor's opinion does not cover such information. Where the auditor does not identify any material misstatement of the other information, they are required to state this fact.

Example – Other Information section

Other Information

The other information comprises the information in the annual report other than the financial statements and our auditor's report thereon. The directors are responsible for the other information contained within the annual report. Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon. Our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the course of the audit, or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether this gives rise to a material misstatement in the financial statements themselves. If, based on the work we have performed, we conclude there is a material misstatement of this

other information, we are required to report that fact. We have nothing to report in this regard.

10 FRC Tier 1 audit firm inspection results (Lecture A876 – 7.45 minutes)

On 30 July 2024, the FRC published its Annual Review of Audit Quality in respect of:

- BDO LLP
- Deloitte LLP
- EY LLP
- Forvis Mazars LLP
- KPMG LLP
- PwC LLP

A 'Tier 1' firm is defined by the FRC as those with the largest share of the UK Public Interest Entity (PIE) market.

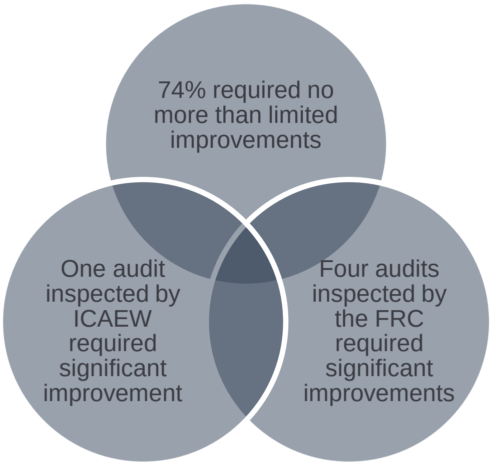
The FRC has a regulatory 'toolkit' whereby it adopts a risk-based, assertive and proportionate approach to selecting and inspecting audits. It focusses on areas with significant potential impact on financial statements and investor reliance.

The findings from these reports are useful because they can be used by all audit firms to understand where things often go wrong during an audit. Findings from the FRC are often broadly consistent with the findings from professional body inspections (such as those carried out by ACCA or ICAEW). The FRC's Annual Review expands on the points raised by expanding on the deficiencies noted and also provides details of good practice identified during the inspection to balance out the findings.

10.1 FRC findings

The FRC comment that while the overall audit quality of the leading four firms is good, the other two Tier 1 firms have not yet delivered sufficient audit quality improvements.

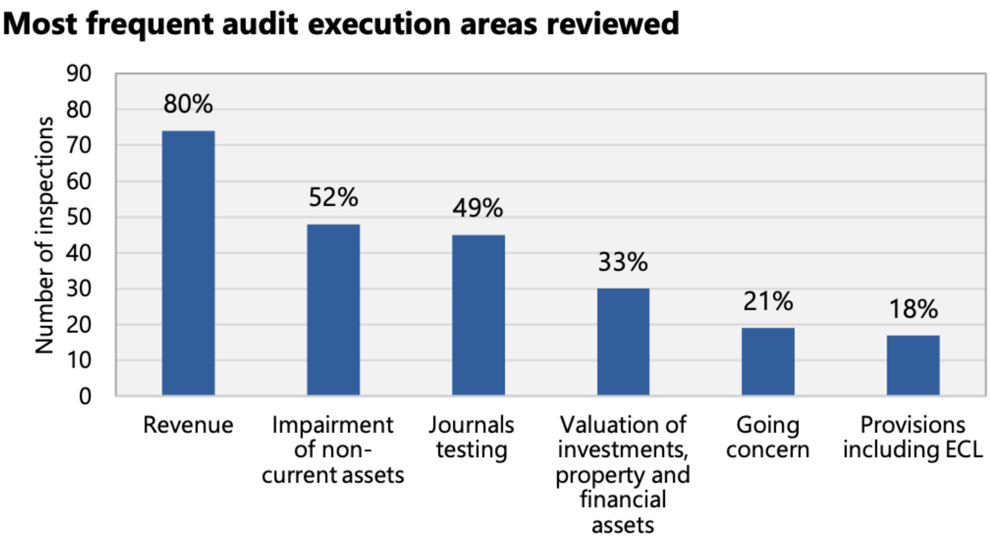
92 individual audits (2022/23: 100) across the six Tier 1 firms were inspected. Of the audits inspected:



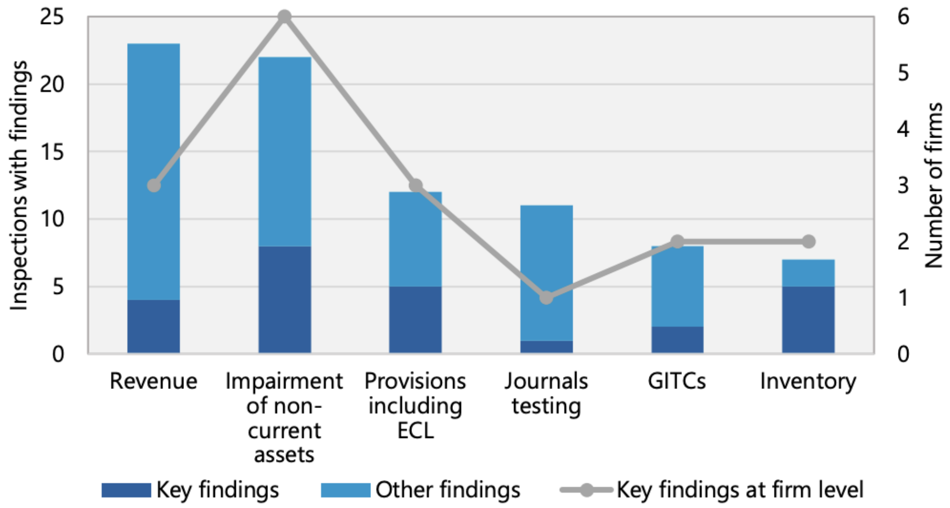
BDO and Forvis Mazars result in 2023/24 show a decline in their inspection results (in fact, the gap between the performance in audit quality for these two firms and that of their peers in Tier 1 has widened significantly). The FRC has commented that they must address these reasons and continue to commit to their investment in audit quality.

While BDO and Forvis Mazars have taken action in recent years to address inspection findings and to strengthen related firm-wide systems and audit quality functions, these actions have not yet had the desired impact on the front-line audit teams to improve audit quality.

The FRC will continue to apply more intensive supervision to BDO and Forvis Mazars. This could result in stronger action being taken by the FRC (including using its PIE Auditor Registration powers) if it does not see improvements in 2025.



Common inspection findings[4,5]



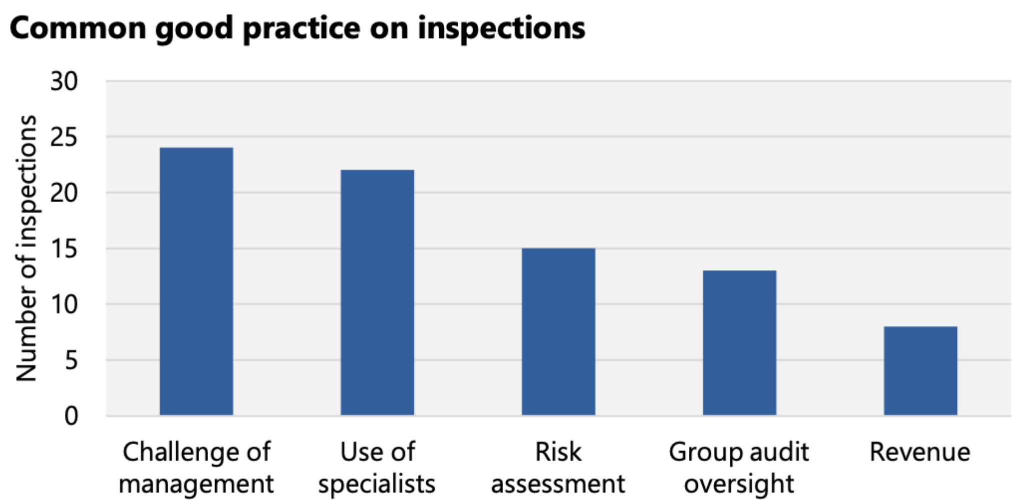
The FRC found the most common inspection findings in the areas of estimation and judgement and the audit of revenue.

Findings for revenue included:

- Issues with contract testing
- Data analytics
- Data input testing

In respect of estimation and judgement, the FRC found they were most often linked to weaknesses in the evaluation of key assumptions and judgements together with the challenge of management. The FRC also identified common findings relating to journals testing, general IT controls and inventory.

At firm level, the FRC identified key findings for impairment at all six firms and for revenue and provisions at three firms. All of the firms had recurring key findings in at least one of these areas, demonstrating that the actions previously taken by the firms have not been sufficient. The FRC comment that more must be done by the firms to understand why previous actions have been insufficient in addressing previous inspection findings and to improve the quality and consistency of audit work in these areas.



The most common areas where the FRC identified good practice on inspections in 2023/24 are largely consistent with those identified in previous inspection cycles.

When the FRC refer to ‘good practice’, it typically reflects an innovative or effective way that an auditor or audit firm has found to address a requirement, or to respond to the specific circumstances robustly.

All firms had good practice relating to the challenge of management for the audit of accounting estimates and judgements, with several examples in the areas of impairment and provisions.

10.2 ISQM (UK) 1

The FRC have identified that all firms inspected have areas to improve in their new systems of quality management.

As a reminder, there are eight components to a system of quality management identified by ISQM (UK) 1.

Key areas for improvement identified by the FRC include:

- Strengthening the monitoring process to ensure that responses to quality risks are designed and operating effectively.
- Assess other relevant sources of information relating to the extent of mitigation of quality risks.
- Enhance the evidencing of the annual evaluation process (including assessing if any findings indicator potential deficiencies to the system of quality management individually or in the aggregate).

The FRC acknowledges that this is the first year of implementation of ISQM (UK) 1 subject to inspection, so it is supporting firms in their development of effective and proportionate systems of quality management and will continue to challenge their conclusions in future inspections.

10.3 BDO

13 individual audits were inspected. The FRC has instructed BDO to significantly improve its audit quality. 38% of audits inspected by the FRC require no more than limited improvements. However, two audits inspected required significant improvements.

These results are worse than the prior year and the FRC comments that this is unacceptable. Over a number of years, the FRC has highlighted recurring findings related to the challenge and testing of estimates and assumptions, audit of revenue and quality control procedures.

In 2023/24, the FRC has identified key findings in other areas including the audit of inventory and impairment of goodwill and intangible assets.

The FRC has commented that the firm must urgently re-assess its recurring findings to understand why its previous quality actions have not had the impact on audit quality expected. In addition, the firm must also rigorously assess all other areas where key findings have been identified in 2023/24.

Firm's system of quality management

BDO reported that it was unable to fully implement a system of quality management as required by ISQM (UK) 1. Consequently, the firm devised a remediation plan to redesign its system and has been in discussions with the FRC on the progress of this project.

FRC actions

In response to the findings in 2023/24, the FRC will take the following action:

- Increase by one the number of audits to be inspected to 14.
- Undertake a number of targeted follow-up reviews.
- Maintain a level of intensive supervision in relation to the firm's audit quality transformation, quality monitoring and implementation of an effective system of quality management.
- Hold the firm to account for setting appropriate actions and monitor its effectiveness through the Single Quality Plan process.

Key findings

The key findings for BDO are as follows:

- Urgently assess the actions required to improve the audit team's challenge and testing of estimates and assumptions in key areas of judgement.

- Urgently improve the firm's audit quality control procedures.

- Improve the audit of impairment of goodwill and non-current assets.

- Reassess the audit quality plan to reduce the occurrence of issues over the audit of revenue.

- Improve the audit of inventory.

- Improve the evidence supporting the audit of groups, including the oversight of component audit work.

10.4 Deloitte

17 individual audits were inspected. Deloitte has shown an improvement across the audit inspections. 94% of audits inspected by the FRC required no more than limited improvements. However, one audit required significant improvements. 100% of audits inspected by the ICAEW were classified as good or generally acceptable.

Key findings

The key findings for Deloitte were:

- Improve the audit of impairment assessments and other valuations supported by discounted cash flow forecasts.

- Strengthen testing of the completeness and accuracy of data that is relied upon for audit purposes.

10.5 EY LLP

17 individual audits were inspected.

The FRC found that 76% of audits inspected required no more than limited improvements.

No audits inspected were found to require significant improvements.

Key findings

The key findings for EY were:

- Continue to improve the testing of revenue and journals.

- Improve aspects of the audit of impairment an deferred tax assets, in particular relating to forecasts.

- Improve the audit of the carrying value of investments in subsidiary undertakings (parent companies).

10.6 Forvis Mazars LLP (formerly Mazars LLP)

The FRC has commented that Forvis Mazars must improve its audit quality.

While the firm has taken actions over recent years, especially in relation to strengthening firm-wide systems and quality functions, it is evident that more focus on front-line audit delivery was needed to impact the results quickly.

Nine audits were inspected and only 44% required no more than limited improvement. One audit required significant improvement.

Firm's system of quality management

The FRC found that Forvis Mazars had implemented a system of quality management, including monitoring and remediation processes and had completed its first annual evaluation of this system.

The FRC identified that within the process of iterative improvement, the firm needs to significantly enhance the evidencing and monitoring of its system of quality management, and the extent of support for its annual evaluation process.

FRC actions

In response to the 2023/24 inspections, the FRC will take the following action:

- Increase by one the number of audits to be inspected to ten.

- Maintain its review of the AQTP and SQP using them to monitor the actions taken to improve audit quality, their effectiveness (over the short- and long-term) and their use in complying with ISQM (UK) 1.

- Maintain a level of intensive supervision in relation to the continuing changes to ethics, conduct and culture, and of specific actions within the AQTP. This includes increased discussions on areas such as strategy and resource capacity in certain audit sectors, roundtable technical discussions and quarterly progress discussions on the AQTP, holding the firm to account on effectiveness and monitoring and revising or setting new actions.

Key findings

The key findings for Forvis Mazars were as follows:

- Urgently strengthen the quality of audit work relating to areas of estimation and judgement.

- Improve the audit of revenue relating to long-term contracts.
- Improve the audit of general IT controls and the quality of audit responses to identified deficiencies.

10.7 KPMG

19 individual audits were inspected and 89% of those required no more than limited improvements.

No audits inspected required significant improvement. The FRC has commented that this shows significant progress compared to the prior year.

Key findings

The key findings for KPMG were as follows:

- Improve the quality and consistency of the audit of estimates, particularly for impairment assessments and expected credit loss provisions.
- Improve the quality and consistency of risk assessment and response to internal control deficiencies.

10.8 PwC

17 individual audits were inspected and 76% of those required no more than limited improvements. No audits inspected required significant improvement.

Key findings

The key findings for PwC were as follows:

- Improve the audit of inventory.
- Improve aspects of the audit of impairment and valuations of non-current assets, in particular relating to forecasts.
- Improve the audit of the carrying value of investments in subsidiary undertakings (parent company).

10.9 General findings

When you look at the reports, there is a consistent theme running through them where deficiencies are concerned. Most appear to relate to estimates, judgements, revenue recognition, impairment and inventory. All these areas require some element of professional judgement and the findings from these inspection reports can be used by private entities as a means of identifying where larger firms are struggling.

The general findings also show key areas that are frequently flagged up in monitoring reports issued by ICAEW and ACCA so lessons can be learnt by audit firms across the board from the FRC's findings.

Audit quality will continue to be the focus of the FRC and the professional bodies. In turn, this means that firms will be under increasing scrutiny where audit work is concerned. It is also important that firms continue to evaluate their system of quality management as required under ISQM (UK) 1 as there is a strong likelihood this will be asked for during the course of any routine monitoring inspection by a professional body or regulator.