Audit and Accounting Quarterly Update – October 2023

Contents

Publication date: **October 2023**

1 Amendments to FRS 102 (Lecture A828 – 3.26 minutes)

In July 2023, the Financial Reporting Council (FRC) issued *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 101 Reduced Disclosure Framework – International tax reform – Pillar Two model rules*. This followed the Organisation for Economic Co-operation and Development's (OECD) publication of its Pillar Two model rules.

The OECD's Pillar Two model rules:

(a) aim to ensure that large multinational groups pay a minimum amount of tax on income arising in each country in which they operate; and

(b) would achieve that aim by applying a system of 'top-up taxes' that results in the total amount of tax payable on profit in each country representing at least a minimum rate of 15%.

The FRC's amendments to FRS 102 introduce a temporary exception to the accounting for deferred tax that arises from the implementation of the Pillar Two model rules, alongside targeted disclosure requirements. The amendments exempt qualifying entities from certain disclosures which relate to the consolidated financial statements of a group, provided that equivalent disclosures are made in the group accounts in which the qualifying entity is included.

The temporary exception applies immediately and retrospectively. The effective date for other amendments is for accounting periods commencing on or after 1 January 2023, with early application permitted.

1.1 FRS 101 amendments

FRS 101 has also seen consequential amendments as a result of the Pillar Two model rules as IAS® 12 *Income Taxes* introduced a temporary exception to the accounting for deferred tax arising from the same rules (alongside targeted disclosure requirements). Essentially, the FRC's amendments are consistent with those of the International Accounting Standards Board's® changes to IAS 12.

FRS 101 has been amended to provide an exemption from certain disclosures that are primarily relevant to the consolidated financial statements of a group. The proviso is that equivalent disclosures must be included in the group accounts in which the qualifying entity is consolidated.

It is not expected that the Pillar Two model rules are going to affect FRS 102 reporters extensively, hence many entities will be unaffected by the changes.

2 CCAB proposes changes to the LLP SORP (Lecture A829 – 5.26 minutes)

On 4 August 2023, the CCAB issued *Draft Statement of Recommended Practice – Accounting by Limited Liability Partnerships*. The amended LLP SORP is intended to become effective for accounting periods commencing on or after 1 January 2024 with early adoption permissible.

Responding to stakeholder feedback, CCAB propose to update the LLP SORP in the following areas:

- Amounts payable to former members of the LLP
- Sharing of group profits – interests in subsidiaries
- Automatic division of profits to members who provide no services to the LLP
- Climate change disclosures

It should be emphasised that the proposed changes do not cater for any amendments arising from the FRC's ongoing periodic review of UK and Ireland GAAP, notably FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. At the time of writing, the FRC were currently analysing feedback received from the recent comment period of the Exposure Draft. The amendments to UK and Ireland GAAP arising from the periodic review may be published towards the end of 2023 or early 2024. They are currently expected to take mandatory effect for accounting periods commencing on or after 1 January 2025.

The majority of the changes proposed by CCAB are essentially clarifications and are not expected to significantly impact the way in which LLPs prepare their financial statements.

A summary of the notable amendments are as follows (references to para numbers are to the draft LLP SORP):

Amendment	Proposal
Amounts payable to former members	Additional guidance on scenarios which may be less common to LLPs – for example, where FRS 102, Section 26 *Share-based Payment* may apply. See paras 76 and 76A.
Group profits – interests in subsidiaries	Additional guidance on how an LLP which is a parent should account for a subsidiary that is also an LLP in its group accounts. The additional guidance specifically covers the treatment of members' debt and equity interests in the subsidiary

	when determining whether there is a non-controlling interest in the net assets of the group that should be recognised in the group accounts. See paras 119A to 119G.
Automatic division of profits to members who provide no services to the LLP	Additional guidance is included in the draft SORP on the treatment of profits which are automatically divided between members who do not provide any services to the LLP. See para 34D and Appendix 2, para 6.
Climate change disclosures	The draft SORP includes new requirements for certain (larger) LLPs to provide climate-related financial disclosures in the strategic report (if one is prepared) or in the energy and carbon report. See para 25D.

2.1 Comment deadline

If you wish to comment on the proposed changes to the LLP SORP, they should be submitted to executive.office@ccab.org.uk by 27 October 2023.

If you wish to send hard copy comments, these should be posted to:

CCAB – LLP SORP

Moorgate Place

London

EC2P 2BJ

3 New sustainability standards issued (A830 – 7.05 minutes)

In June 2023, the International Sustainability Standards Board (ISSB) issued its first two IFRS® Sustainability Disclosure Standards in the form of:

- IFRS S1 *General Requirements for disclosure of Sustainability-related Financial Information*; and
- IFRS S2 *Climate-related Disclosures*.

These two new standards are designed to be applied together and are geared at all companies (not just very large entities). They support companies to identify and report information that investors require for informed decision-making (i.e. information that affects the assessments investors make about companies' future cash flows).

IFRS S1 provides a framework for companies to report on all relevant sustainability-related issues across the areas of:

- Governance
- Strategy
- Risk management
- Metrics
- Targets

IFRS S1 is then supported by more detailed guidance on how to report climate-related risks and opportunities in the current climate environment. Additional standards covering other topics are expected to be issued in the future, but in the meantime companies will use guidance highlighted in IFRS S1 to report on other topics.

3.1 Effective date

The standards are effective from 1 January 2024. However, it will be down to individual jurisdictions to decide whether (and when) to adopt. It is expected that a number of jurisdictions will fully adopt the standards given that they have received widespread support.

It is expected that some public and private entities may choose to adopt the standard voluntarily (e.g. due to investor or societal pressure).

3.2 Development of the new standards

The ISSB's starting point for the development of IFRS S1 and IFRS S2 were existing frameworks and standards, including the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB). The ISSB have also confirmed that they are committed to working with the Global Reporting Initiative (GRI) to ensure its standards are complementary and compatible with existing GRI standards (note, the GRI standards have a different objective of meeting wider stakeholders' information needs).

It is expected that connected financial and sustainability reporting will be a requirement, rather than a feature, of best practice reporting. The ISSB refers to the information disclosed as 'sustainability-related financial disclosures' which confirms that disclosures must be connected with information in the financial statements, rather than as a separate issue entirely.

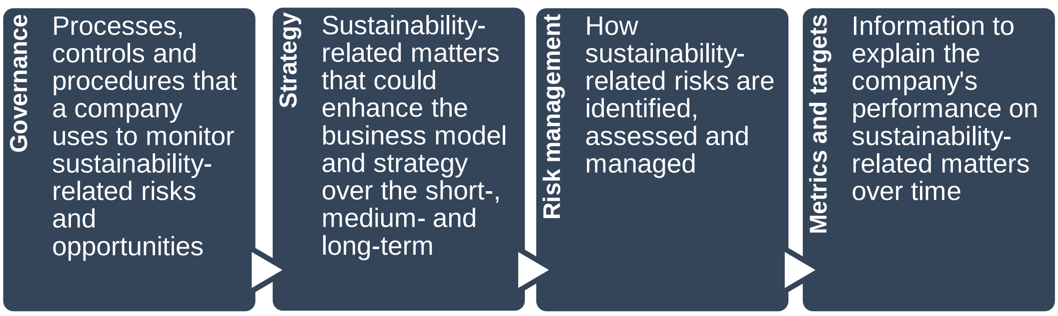
3.3 What companies need to do now

For those entities that will be applying the new standards from 2024, finance and sustainability teams will need to work closely together to ensure the information disclosed is complementary and based on the same facts and circumstances. Sustainability-related information may differ in nature from information that is presented in the financial statements; however, there should be as much consistency as possible. This is required regardless of whether the financial statements are prepared in accordance with IFRS Accounting Standards or other GAAPs.

Companies will also need to ensure that their systems of internal control can capture information effectively to enable concise sustainability-related information to be included in the financial statements.

3.4 What will need to be disclosed?

The general disclosure requirements standard sets out the following framework:



The following information will need to be disclosed:

Material information

- Providing a complete and balanced explanation of sustainability-related risks and opportunities.
- Covering governance, strategy, risk management and metrics and targets.

- Focussing on the needs of investors and creditors.
- Reflecting consistent, comparable and connected disclosures.
- Presented across time horizons (short-, medium- and long-term).
- Relevant to the sector and industry.

Material metrics

- Based on measurement requirements specified in the climate standard (or in future standards).
- Identified from other guidance, such as SASB.
- Reflecting other metrics used by the company.

3.5 Transitional issues

Companies will not be required to provide comparative information for any period prior to the date of initial application. In addition, there will not be a requirement to disclose Scope 3 emissions metrics or information on topics other than climate until the second period of reporting.

3.6 Presentation in the financial statements

The Standards do not stipulate a specific location where the information is to be disclosed. They do allow for cross-referencing to information presented elsewhere, but only if that information is released at the same time as the general purpose financial statements.

Examples of the 'ideal' place to present the disclosures would be in the management commentary or in the management discussion and analysis.

3.7 Assurance requirements

Assurance requirements are not within the remit of the ISSB. However, regulators may choose to require assurance is obtained on the disclosures.

Regardless of any local assurance requirements, companies will need to make sure they have processes and controls in place to produce robust and timely information.

4 Investments and equity accounting

There are two situations where equity accounting is to be used under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*:

1. An investor which holds significant influence over an investee is a parent and prepares consolidated financial statements.

2. A venturer, which is a parent that prepares consolidated financial statements, has an interest in a jointly-controlled entity.

The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980) made amendments to company law to allow the option to use the equity method of accounting in the individual financial statements of an investor. However, the FRC decided **not** to introduce this option into FRS 102 on the basis that there are already enough accounting policy options available in the standard to measure investments in associates.

4.1 Group issues

When an entity is a parent (i.e. it has ownership interests in a subsidiary(ies) and prepares consolidated financial statements), investments in associates are accounted for using the equity method of accounting. The exception to the use of the equity method of accounting would be where the investments are held as part of an investment portfolio. The term 'held as part of an investment portfolio' is defined in FRS 102 as follows:

> *An interest is held as part of an investment portfolio if its value to the investor is through **fair value** as part of a directly or indirectly held basket of investments rather than as media through which the investor carries out **business**. A basket of investments is indirectly held if an investment fund holds a single investment in a second investment fund which, in turn, holds a basket of investments. In some circumstances, it may be appropriate for a single investment to be considered an investment portfolio, for example when an investment fund is first being established and is expected to acquire additional investments.*

*FRS 102 Glossary **held as part of an investment portfolio***

Entities which are not parents, but have investments in associates, are required to measure investments in associates using an accounting policy choice of:

- cost;

- fair value through other comprehensive income; or

- fair value through profit or loss.

4.2 Associate versus subsidiary

It is important to distinguish between an associate and a subsidiary because a parent-subsidiary relationship is created when the parent acquires **control** over the subsidiary. In such cases, consolidated financial statements are required if any exceptions or exemptions from preparing consolidated financial statements cannot be claimed.

In contrast, an investor has an investment in an associate when the investor has **significant influence** over the associate.

The terms 'associate' and 'significant influence' are defined as follows:

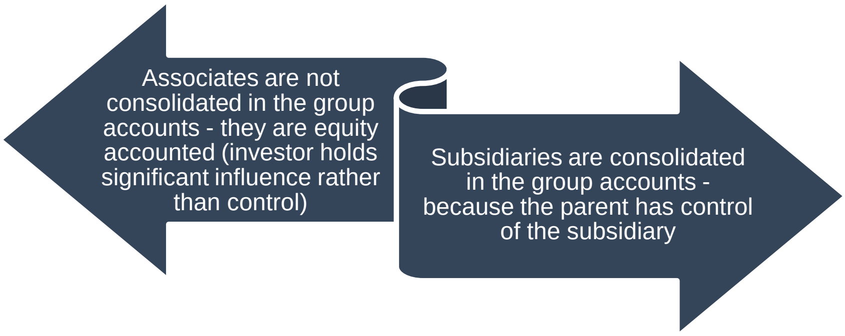
> *An entity, including an unincorporated entity such as a partnership, over which the investor has **significant influence** and that is neither a **subsidiary** not an interest in a **joint venture**.*

*FRS 102 Glossary **associate***

> *Significant influence is the power to participate in the financial and operating policy decisions of the associate but is not **control** or **joint control** over those policies.*

*FRS 102 Glossary **significant influence***

Therefore, the principal differences between an associate and a subsidiary are as follows:



Significant influence is usually (but not always) achieved by an ownership interest of between 20% and 50% of the net assets of the investee. Such numeric benchmarks are not absolute, because there can be other indicators that significant influence has been acquired by the investor, such as:

- Representation on the board of directors or equivalent governing body of the investee.
- A participation in the policy-making processes, including dividend policies and other distributions.
- Interchange of managerial personnel.
- Provision of essential technical information.
- Material transactions taking place between the investor and the investee.

Where an ownership interest is below 20%, careful scrutiny of the relationship between the investor and the investee will be required to ensure that *de facto* significant influence has been created.

Conversely, it may be the case that an investor holds, directly or indirectly, 20% or more of the voting power of the associate but it can be clearly demonstrated that significant influence has not, in fact, been created. This may be the case where:

- Severe long-term restrictions prevent the investor from receiving investee funds.
- The investor rescinds all significant influence through an agreement with other investors.
- Law or regulation prevent significant influence from being exercised by the investor (for example, in a foreign country).
- It is probable (i.e. more likely than not) that the investee will issue additional shares to third parties which, in turn, dilutes the ownership interest of the investor.
- There are adverse political or economic conditions in the foreign country in which the investee is situated.

The list above is not designed to be comprehensive, and it is important to carefully scrutinise the substance of the relationship between the investor and the investee because significant influence may be achieved by other means (for example, by participation in the policy-making process).

4.3 Initial measurement

FRS 102, para 14.4 provides three accounting policy options to investors to initially recognise an investment in an associate in the individual financial statements of the investor:

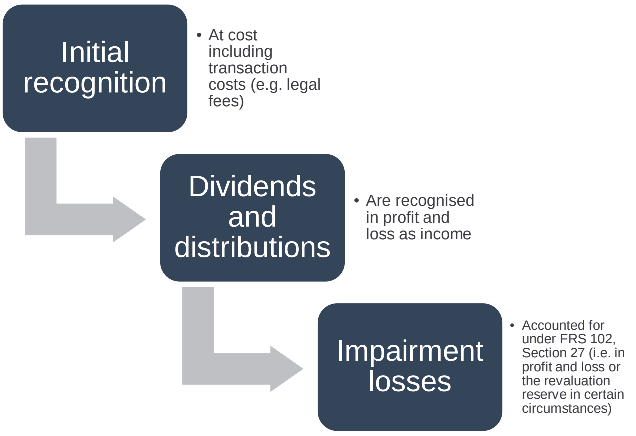
- Cost model
- Fair value through other comprehensive income
- Fair value through profit or loss

You may notice that FRS 102, para 14.4(b) is shown as 'Deleted' in the Standard. In the *IFRS for SMEs Accounting Standard*, this paragraph permits the equity method of accounting to be used in the individual financial statements. As noted earlier, this is not possible under FRS 102. Under UK and Ireland GAAP, the equity method of accounting is only possible in the consolidated financial statements.

Cost model

An investor which is not a parent and which chooses to measure an investment in an associate under the cost model measures its investment at cost less accumulated impairment losses. Impairment issues are dealt with in FRS 102, Section 27 *Impairment of Assets*.

Dividends and other distributions received from the investee are recognised as income regardless of whether the distributions are received from accumulated profits of the associate arising before, or after, the acquisition date. Therefore, under the cost model:



Fair value models

These are straightforward to understand. The investment is remeasured to fair value at each reporting date and changes in fair value are recognised in other comprehensive income or profit or loss in accordance with FRS 102, paras 17.15E and 17.15F.

4.4 Equity accounting

FRS 102, para 14.8 states:

> *Under the equity method of accounting, an equity investment is initially recognised at the transaction price (including **transaction costs**) and is subsequently adjusted to reflect the investor's share of the profit or loss, **other comprehensive income** and **equity** of the associate.*

FRS 102, para 14.8

You will note that this paragraph refers to an 'equity investment'. FRS 102 does not define this term, but it should broadly be taken to mean investments in shares of another entity.

As noted earlier, the equity method of accounting is only relevant to the group accounts under UK and Ireland GAAP. It is not relevant to the individual financial statements of the investor. The diagram below provides a high-level summary of how the method works:

Initially recognise the investment at cost

Increase the investment for share of profit or decrease it for share of loss

Decrease the investment for share of dividend or other distributions from the associate

The important point to remember where equity accounting is concerned is that dividends and other distributions from the associate are **not** taken to profit or loss. This is because they reduce the value of the investment in the consolidated balance sheet. A review of some financial statements indicates that this accounting treatment has been incorrectly applied in the past, with some dividends and distributions being credited to group profit or loss. This is incorrect under equity accounting principles and can cause the group accounts to be materially misstated.

Example – Equity accounting

On 3 January 2022, Harper Ltd acquires a 35% ownership interest in Evan Ltd for a consideration of £475,000 in cash. On this date, the book value of Evan's assets was £900,000. During the year to 31 December 2022, Evan made a profit of £80,000 and paid a dividend of £120,000. Harper is a parent entity that prepares consolidated financial statements as a medium-sized group.

Under the equity method of accounting, The Harper Group would account for its associate as shown overleaf:

Acquisition of Evan Ltd	£	£
Share of Evan's net assets (£900,000 x 35%)	315,000	
Goodwill* (£475,000 less £315,000)	160,000	
		475,000
Share of profit (£80,000 x 35%)		28,000
Dividend received (£120,000 x 35%)		(42,000)
Carrying amount of associate per group balance sheet		461,000

Reconciled as:

Share in book value of Evan's net assets:

£315,000 - 35% (£80,000 - £120,000)	301,000	
Goodwill	160,000	
		461,000

Journals to record the above transactions following acquisition of the investment are as follows:

Recognition of the Harper's share of the profit:

	£
Dr Investment in associate	28,000
Cr Income from associate (P&L)	28,000

Recognition of share of dividend received:

	£
Dr Bank/Debtors	42,000
Cr Investment in associate	42,000

*The goodwill element is shown here for clarity purposes. Goodwill may 'arise' where an investment in an associate is made, but it is not shown separately in the consolidated balance sheet because the associate is equity accounted, not consolidated.

General points

There are some general points outlined in FRS 102, para 14.8 which relate to the equity method as follows:

Distributions from the associate

Distributions received from the associate reduce the carrying amount of the investment (as they are a return on the investment); they are not taken to the group profit and loss account. Adjustments to the carrying amount of the investment may also be required due to changes in the associate's equity arising from items of other comprehensive income.

When the interest in the associate is reduced to zero, any further losses are only recognised to the extent that the investor has a legal or constructive obligation, or has made payments on behalf of the associate.

FRS 102 provides no guidance on what happens in the event that dividends are received following reduction of the investment in associate to £nil. In such situations, provided that the distributions are not refundable by the investor, and the investor is not liable for the investor's liabilities, then any dividends or distributions recognised in excess of the carrying amount of the investor should be recognised as income. It would be inappropriate to have a negative balance as an investment in associate in the consolidated balance sheet.

Potential voting rights

While potential voting rights are brought into consideration when establishing whether significant influence exists, the investor must measure its share of profit or loss and other comprehensive income (and its share of changes in the associate's equity) on the basis of actual ownership interest at the balance sheet date and these measurements must not reflect the potential exercise, or conversion, of potential voting rights (e.g. through convertible debt).

Implicit goodwill and fair value adjustments

As you can see from the example of Harper and Evans above, goodwill is the difference between the cost of the acquisition and the investor's share of the fair value of the net identifiable assets. The goodwill arising is not shown separately on the face of the consolidated balance sheet as would be the case where a subsidiary is concerned. The investor must adjust its share of the associate's profit or losses post-acquisition to account for additional depreciation or amortisation of the depreciable/amortisable assets in the associate. This is because, at the date of acquisition, the associate's identifiable assets and liabilities are fair valued and the fair values may be different than the associate's book values at the time of acquisition. This will give rise to a fair value adjustment being made in the group accounts.

Impairment

Where there is evidence that an associate is impaired, the investor must test the entire carrying amount of the investment for impairment using the provisions in FRS 102, Section 27 *Impairment of Assets*. The test for impairment is as a **single asset**. Goodwill arising on the acquisition of the associate is **not** tested separately, but is part of the test for impairment on the entire investment.

Investor's transactions with associates

It is not uncommon for an investor to trade with its associates and vice versa. Where such trading takes place, the investor must eliminate all unrealised profits and losses in a two-way direction (i.e. 'upstream' which refers to trading between the associate and the investor; and 'downstream' which refers to trading between the investor and associate).

Care must be taken here because this is not the same thing as eliminating intra-group transactions in a consolidation. In the case of an associate, the investor will only eliminate unrealised profits and losses to the extent of the investor's interest in the associate. It must also be borne in mind that unrealised losses on such transactions may indicate that an asset transferred is showing indicators of impairment.

Normal trading balances which are unsettled at the balance sheet date are recognised as current assets or current liabilities as appropriate where investments in associates are concerned (do not eliminate them). In addition, any long-term loans to the associate are disclosed as due after more than one year and this will also require consideration as to whether such balances are shown as fixed assets or debtors due after more than one year in the consolidated balance sheet.

Period ends

The equity method of accounting requires the associate to use the same accounting reference date as that of its investor, unless this is impracticable to do so. The term 'impracticable' is defined as follows:

> *Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.*

FRS 102 Glossary ***impracticable***

In practice, such impracticalities are likely to be rare. However, where it does prove to be impracticable, the investor should use the most recent available financial statements of the associate and make adjustments for the effects of any significant transactions or events that have taken place between the two accounting periods.

Accounting policies

Where the associate uses accounting policies which differ from those used by the investor, the investor must adjust the associate's financial statements so that they reflect the accounting policies for the purposes of applying the equity method, unless it is impracticable (see above) to do so. Again, it is likely to be rare for such impracticalities to exist in practice.

Losses in excess of the investment

As noted earlier, when the investor's interest becomes zero, any additional losses are recognised as a provision only to the extent that the investor has incurred a legal or constructive obligation which will necessitate the recognition of a provision under FRS 102, Section 21 *Provisions and Contingencies*. In addition, the investor recognises a provision where it has made payments on behalf of the associate.

When the associate subsequently reports a profit, the investor can then resume recognising its share of those profits, but only where its share of the profits is equivalent to the share of losses not recognised.

Discontinuing the equity method

The equity method of accounting ceases from the date that the investor no longer has significant influence over the investment. The equity method will no longer apply where the investor becomes a subsidiary. Where control is achieved, the investor applies the provisions in FRS 102, Section 19 *Business Combinations and Goodwill*. Conversely, if the associate becomes a joint venture, the investor will also cease to use the equity method (except in the case of a jointly-controlled entity).

Where the equity method of accounting is discontinued, the accounting treatment is as follows:

(a) where significant influence is lost as a result of a full or partial disposal, the associate is derecognised and the difference between the disposal proceeds and the carrying amount of the investment at the date of disposal is recognised in profit or loss. Any interest which the investor continues to retain following the disposal is accounted for using FRS 102, Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues* as appropriate. The carrying amount of the associate at the date of disposal becomes 'cost' for initial recognition of the financial asset; or

(b) if other reasons apply for the loss of significant influence, other than a partial disposal of the investment, the investor regards the carrying amount of the investment at that date as the new cost and the investment is accounted for under FRS 102, Section 11 or Section 12 as appropriate.

The gain or loss recognised on disposal should include all amounts that have been recognised in other comprehensive income which relate to the associate subject to the disposal and where such amounts must be reclassified to profit or loss on disposal. Where amounts cannot be recycled through profit or loss, they are transferred directly to retained earnings as a movement on reserves.

In practice, the only items which may need to be reclassified on disposal of an associate under FRS 102 are those amounts relating to cash flow hedges that had been recognised in other comprehensive income.

5 Dilapidation provisions (Lecture A831 – 16.34 minutes)

Provisions are contingencies are dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 21 *Provisions and Contingencies*. While not specifically covered by FRS 102, dilapidation provisions would be within the scope of this section.

The Glossary to FRS 102 defines a 'provision' as:

> *A **liability** of uncertain timing or amount.*

FRS 102 Glossary **provision**

5.1 Background to provisions for liabilities

A provision for a liability is recognised when an entity has a present obligation (legal or constructive) as a result of a past event, it is probable (i.e. more likely than not) that a transfer of economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Unless these conditions are met by the balance sheet date, no provision is recognised and a contingent liability is disclosed instead, if material.

Where it is not clear whether a present obligation exists, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date.

For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This will be the case only where the settlement of the obligation can be enforced by law or, in the case of a constructive obligation, the event (which may be an action of the entity) creates valid expectations in the mindsets of other parties that the entity will discharge the obligation. The only liabilities recognised in an entity's balance sheet are those that exist at the balance sheet date. Where an entity can avoid future expenditure by its future actions, for example by changing its method of operation, it has no present liability for that future expenditure and no provision is recognised.

For a liability to qualify for recognition there must not only be a present obligation, but also the probability of a *transfer of economic benefits* to settle that obligation (generally an outflow of cash). A transfer of economic benefits in settlement of an obligation is regarded as probable if the outflow is more likely than not to occur.

An entity will normally be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is therefore disclosed as a contingent liability.

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The provision is measured before tax and will take account of risks and the time value of money (if material).

5.2 Reimbursement assets

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party (such as an insurance company), the reimbursement asset must be recognised only when it is *virtually certain* that reimbursement will be received if the entity settles the obligation. Care needs to be taken here because the 'virtually certain' test is a higher hurdle to get over than the probability test and the asset will usually qualify for recognition when the third party has agreed in writing to reimburse the entity. The reimbursement asset must be treated as a separate asset and must not be offset in the balance sheet against the related liability. However, the income can be offset against the expense in the profit and loss account (i.e. the expense can be reported net of the reimbursement in profit or loss).

5.3 Review of provisions

Provisions must be reviewed at each balance sheet date and adjusted, where appropriate, to reflect the current best estimate. If it is no longer probable that a transfer of economic benefits will be required to settle the obligation, the provision must be reversed.

Where discounting is used, the size of a provision will change in each period to reflect the passage of time. This change is recognised as interest expense and disclosed separately from other interest on the face of the profit and loss account.

FRS 102, paragraph 21.10 sates that an entity must charge against a provision only those expenditure for which the provision was originally recognised.

5.4 Dilapidation provisions

As noted above, a provision can only be recognised in the financial statements if there is a present obligation as a result of a past event.

With respect to general dilapidations, the tenant will normally maintain the property in good order in the early stage of the lease. Since there is no damage to the property, there is no obligation, and no provision is required hence there is often no need to make provision for dilapidation.

More generally, a dilapidation provision should only be made when damage is caused to the property. This will typically arise towards the end of the lease term when the tenant has ceased to maintain the property to the highest standard.

Some accountants have been known to estimate a final dilapidation provision and then average it out over the life of the lease. A provision will then be built up over the entire lease term. This sort of general provision is not permitted under FRS 102 because there is no past event giving rise to an obligation. A provision can only be made once the damage has been caused because it is the cause of the damage that creates the obligating event.

Example – Replacement roof

Harper Ltd took out a 20-year lease on a property on 1 January 2006. The lease contains general dilapidation provisions that the property should be made good.

At 31 December 2022 (the company's year end), the condition of the roof had deteriorated to such an extent that it will need replacing imminently. The directors have received quotes from contractors to replace the roof.

In addition, it was also discovered that there is some corrosion of the steel walls that could indicate the possible need for the walls to be reskinned in the next ten years.

The replacement of the roof is a current obligation as a result of a past event and should be provided for by way of a provision. This would not be the case if the roof was not in need of repair at the year end.

If the walls are not in need of repair or a full reskin at the year end, then a provision is not required. However, if the terms of the lease would require the corrosion on the walls to be made good then this would give rise to a provision being recognised in the financial statements for the year ended 31 December 2022.

The question that is then asked is whether Harper Ltd should have been making a provision for this at the outset of the lease.

This sort of general provision is not permitted under FRS 102. This is because there must be an obligation at the time the provision is made.

Example – Dilapidation provision

Tennyson Ltd took out a 25-year lease on a property on 1 January 2022. The terms of the lease require all damage caused to the property to be rectified. Tennyson Ltd made alterations to the property during the first year of the lease which cost £180,000. The best estimate of the cost to reinstate the property to its original condition at the end of the lease is £120,000.

How should the financial statements for the year ended 31 December 2022 reflect these matters?

Treatment of improvement costs - £180,000

Provided this satisfies the definition of property, plant and equipment (and meets the recognition criteria in FRS 102, Section 17 *Property, Plant and Equipment*), then the costs can be capitalised and depreciated over their useful lives.

In the 31 December 2022 financial statements, the carrying amount will be £172,800.

Treatment of re-instatement costs - £120,000

A provision should be made for the present value of the cost of the re-instatement work at the time of the original damage. If the provision had been made at the start of the lease term (i.e. 1 January 2022) then the cost of £120,000 would have been discounted for 25 years. Assuming a risk-free discount rate of 5% we obtain a discount factor of 0.295.

Therefore, the original entry in the 2022 accounts would have been:

Dr Fixed assets (£120,000 x 0.295)	£35,400	
Cr Provisions		£35,400

This would be depreciated over 25 years at a charge of £1,416 (£35,400 / 25) per annum.

In the 31 December 2022 financial statements, fixed asset will appear as £33,984.

For the first full year and each year thereafter, the provision will be increased by 5% giving the following:

	Interest charge	**Year end provision**
Y/e 31/12/22	£1,770	£37,170
Y/e 31/12/23	£1,859	£39,029
Y/e 31/12/24	£1,951	£40,980

and so on…

5.5 Disclosure of judgements and estimation uncertainty

FRS 102, paragraphs 8.6 and 8.7 require an entity to make disclosures about judgements and key sources of estimation uncertainty. Small entities are encouraged to disclose information about judgements.

The FRC's own financial statements contain a very good example of this type of disclosure:

> *The FRC has an obligation to make good the conditions of the premises at 125 London Wall, in accordance with the lease agreement at the end of the lease term. Provisions for dilapidations is the area involving estimates and judgements where there is the greatest potential risk of a material adjustment in future years. The provision is expected to be utilised at the end of the lease.*
>
> *Accounting estimate – The current provision is based on management's current best estimate of the future obligation. This year the estimate draws upon a current year valuation report provided by a third-party surveyor. The provision is expected to be utilised at the end of the lease.*
>
> *Accounting judgement – In making the estimate management has exercised judgement about the likely future outcomes, including factors such as building and material costs. However various factors and changes in circumstances could affect any amount payable in the future.*

FRC financial statements 31 March 2021

5.6 Tax treatment

Like most issues relating to provisions, the tax treatment tends to follow the accounting treatment.

6 Accounting policies, estimates and errors (Lecture A832 – 20.36 minutes)

The issue of accounting policies is one that crops up frequently during file reviews – particularly the disclosure of accounting policies. Inadequate disclosures, or absent disclosures, are some of the main reasons why financial statements are often viewed as containing deficiencies. The main 'culprit' is boilerplate accounting policies which tend to be software-generated without any tailoring to the client's specific circumstances.

The danger with over-reliance on automated accounts production software systems is that it inevitably leads to accounting policies which are either too long, too short or missed out completely. Superfluous accounting policies should be removed along with immaterial accounting policies and those which are significant (or material) should be tailored so they are entity specific.

6.1 FRS 102 requirements

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

'Accounting policies' are defined as:

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

*FRS 102 Glossary **accounting policies***

It follows that accounting policies are the choices which an entity makes about which facts it will present and how and where it will present them in the financial statements.

Interestingly, the definition makes references to the 'principles, bases, conventions, rules and practices applied by an entity', but does not include accounting estimates which are, in fact, a relevant part of applying an accounting policy and which are usually included in the accounting policy disclosures.

FRS 102, para 10.1 states that Section 10 sets out the requirements for:

FRS 102, para 10.1(a) to (c)

(a) *selecting and applying the **accounting policies** used in preparing **financial statements**;*

(b) *accounting for **changes in accounting estimates**; and*

(c) *accounting for corrections of **errors** in prior period financial statements.*

FRS 102 does not set out the areas to be covered by accounting policies disclosure because these are dealt with in each specific section of the standard. In terms of restatements, FRS 102, Section 10 distinguishes the situations where an entity restates prior period financial statements for either:

(a) the correction of a prior period error;

(b) a change in accounting policy (for which retrospective restatement is necessary);

(c) restatements due to changes to an accounting estimate (for which no retrospective restatement is necessary).

6.2 Accounting policies and materiality

Accounting standards only deal with material items in the financial statements. The term 'material' is defined as:

> *Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the **financial statements**. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.*

*FRS 102 Glossary **material***

It is generally accepted that materiality has both qualitative and quantitative aspects. FRS 102, para 8.5 states that an entity must disclose its 'significant' accounting policies.

The term 'significant' is not defined in the standard but should be taken to mean material. Hence, only an entity's **material** accounting policies should be included in the notes to the financial statements. The FRC are proposing to change the term 'significant' to 'material' during the current periodic review of FRS 102 which will add clarity.

As noted above, the disclosure of accounting policy information is an issue which is frequently criticised by file reviewers. Often, accounting policies are too lengthy or are irrelevant. This is usually because the user relies too heavily on automated accounts production software systems without tailoring the policies, so they are entity specific. Accounting policies which are required to be disclosed should be concise and relevant to the reporting entity. Just because the accounts production software system may include an accounting policy by default, does not mean it is appropriate or even relevant.

Conversely, accounting policies which are not included by default may need to be included where they are relevant to the entity. Hence, the message here is to not rely too much on accounts production software systems, but to tailor accounting policies so they are entity specific and relevant.

Example – Goodwill written down to £nil

Spring Ltd has included a lengthy accounting policy disclosure concerning goodwill which was fully amortised two years ago.

There is no need to make a lengthy accounting policy disclosure for an intangible asset which has been fully amortised. This can be removed from the accounting policies section of the notes.

Example – Asset under construction

Four years ago, Summer Ltd completed the building of its new head office. The current year's financial statements include a lengthy accounting policy about the way 'Assets under construction' are accounted for in the entity's accounts.

Provided there are no other assets in the course of construction at the reporting date, there is little to be achieved by having a lengthy accounting policy concerning assets under construction. This accounting policy can be removed.

Example – Financial instruments

Autumn Ltd has a number of financial instruments accounted for as both basic and other financial instruments under FRS 102. The accounting policy for financial instruments is shown below:

Financial instruments

A financial asset or a financial liability is recognised when the entity becomes a party to the instrument. Financial liabilities are recognised where there is a contractual obligation to pay cash or transfer other assets to the holder of the instrument and equity is recognised where there is no obligation to transfer cash or other assets.

This accounting policy is inadequate. The accounting policy should describe which instruments are accounted for as basic instruments under FRS 102, Section 11 *Basic Financial Instruments* (e.g. trade debtors, trade creditors, straightforward bank loans etc). It should also describe those instruments which are accounted for as other financial instruments, if appropriate, (such as derivative financial instruments), how transaction costs are accounted for and how fair value gains and losses on non-basic instruments are recognised (e.g. through profit or loss).

While the accounting policy itself need not be excessively lengthy (indeed it is more about quality than quantity), it should be more succinct and entity specific than it currently is.

6.3 Issues that are not dealt with in an FRS

In the rare situation that an FRS does not specifically address a transaction, event or condition, management must use their judgement to develop and apply an accounting policy. This is not as straightforward as it may first seem because FRS 102, paragraph

10.4 states that the policy developed by management must result in information which is:

(a) *relevant to the economic decision-making needs of users; and*

FRS 102 para 10.4

(b) *reliable, in that the financial statements:*

(i) *represent faithfully the* ***financial position****, financial* ***performance*** *and* ***cash flows*** *of the entity;*

(ii) *reflect the economic substance of transactions, other events and conditions, and not merely the legal form;*

(iii) *are neutral, ie free from bias;*

(iv) *are prudent; and*

(v) *are complete in all material respects.*

It should be noted that under FRS 102, emphasis is placed on relevance and reliability. The term 'relevance' is defined as:

The quality of information that allows it to influence the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

FRS 102 Glossary ***relevance***

The term 'reliability' is defined as:

The quality of information that makes it free from ***material error*** *and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent.*

FRS 102 Glossary ***reliability***

For an accounting policy to be reliable, it must reflect the substance of the transaction and not merely legal form. The term 'substance' is essentially the commercial reality of the transaction. For example, currently an asset acquired through a finance lease is capitalised on the balance sheet with a corresponding finance lease creditor because the entity has acquired an asset for use in the business which has been financed through a leasing transaction. In a finance lease, the risks and rewards incidental to ownership of the asset pass to the lessee. If only the legal form of this transaction were considered, the lease would be treated as an operating lease and hence would not be reported on the balance sheet. This accounting treatment is likely to change once the FRC's periodic review is completed as it is expected that most leases will be reported on-balance sheet for accounting periods commencing on or after 1 January 2025.

FRS 102, para 10.4(b)(iii) and (iv) refers to 'neutrality' and 'prudence'. The term 'neutrality' is confirmed as meaning 'free from bias'. In other words, management cannot simply choose a policy because it will achieve a desired outcome, such as a favourable tax treatment.

The term 'prudence' is defined as:

> *The inclusion of a degree of caution in the exercise of judgements needed in making the estimates required under conditions of uncertainty, such that **assets** or **income** are not overstated and **liabilities** or **expenses** are not understated.*

*FRS 102 Glossary **prudence***

Prudence is therefore the exercise of caution when making judgements for various uncertainties to avoid overstating assets or income and understating liabilities or expenses. It does not, however, permit management to deliberately understate assets or income or overstate liabilities or expenses, for example because it improves results or is tax efficient.

The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) at paragraph 13 brings prudence into the equation, but from a different angle.

Paragraph 13 of Sch 1 to SI 2008/410 states:

> *The amount of any item must be determined on a prudent basis, and in particular—*
>
> *(a) only profits realised at the balance sheet date are to be included in the profit and loss account, and*
>
> *(b) all liabilities which have arisen in respect of the financial year to which the accounts relate or a previous financial year must be taken into account, including those which only become apparent between the balance sheet date and the date on which it is signed on behalf of the board of directors in accordance with section 414 of the 2006 Act (approval and signing of accounts), and*
>
> *(c) all provisions for diminution in value must be recognised, whether the result of the financial year is a profit or loss.*

SI 2008/410 para 13

(c) above was included as part of the amendments to the Companies Act 2006 by The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980) and requires a provision for diminution of value to be recognised regardless of whether the result of the financial year is a profit or loss.

GAAP hierarchy

When developing an accounting policy, management must refer to, and consider the applicability of, the following sources in **descending order**:

(a) the requirements and guidance in an FRS which deals with similar and related issues;

(b) if the entity is within the scope of a SORP, the requirements and guidance in that SORP which deals with similar and related issues; and

(c) the definitions, recognition criteria and measurement concepts in respect of assets, liabilities, income and expenses together with the *Concepts and Pervasive Principles* in Section 2 of FRS 102.

Some commentators suggest referring to IFRSs® if FRS 102 does not deal with a specific transaction, event or condition. This would be permissible (indeed paragraph 10.6 of FRS 102 does state that management could consider the requirements and guidance in adopted IFRS). However, as IFRS is not mentioned in the mandatory sources in the GAAP hierarchy, the entity would not be required to follow the provisions in IFRS, if it felt this would be inappropriate to its particular circumstances.

Example – Entity has regard to IAS® 16 *Property, Plant and Equipment*

Wanderers Ltd has an accounting policy of measuring its five owner-occupied buildings under the revaluation model per FRS 102, Section 17 *Property, Plant and Equipment*.

FRS 102 does not deal specifically with the treatment of accumulated depreciation when the buildings have been revalued again. However, IAS 16 does specify two permissible methods in paragraph 35 and hence it would be acceptable to use either one of these methods from IAS 16 when reporting under FRS 102.

When an entity is subject to the requirements of a SORP, it should consider the requirements of that SORP to determine whether it addresses an accounting treatment for a transaction, event or condition that is not dealt with in FRS 102. In situations that a SORP does provide guidance on a specific treatment, but the entity chooses not to apply the SORP's requirements on the grounds that an alternative treatment would be more appropriate, the entity will need to demonstrate that its chosen policy is more appropriate than the SORP's treatment.

In addition, FRS 100 *Application of Financial Reporting Requirements*, para 6 requires that where a non-small entity departs from the provisions of a SORP to which it is subject, it must provide a description of how the financial statements depart from the recommended practice which must include:

(a) for any treatment that is not in accordance with the SORP, the reasons why the treatment adopted is judged more appropriate to the entity's particular circumstances; and

(b) brief details of any disclosures recommended by the SORP that have not been provided, and the reasons why they have not been provided.

Small entities are encouraged, but not required, to provide the above disclosures.

6.4 Consistency of accounting policies

In practice, it is rare for an entity to change accounting policies on a regular basis. Indeed, regular changes in an accounting policy would raise the question of why management consider it appropriate to keep changing their policies as retrospective restatement is needed each time a change in an accounting policy is actioned. Frequent changes in accounting policy are not only costly but may also impede on the relevance and reliability of the financial statements.

When management are considering changing a policy, they must consider this carefully. This is because they will have significant difficulty in changing it back in the subsequent year. For example, if a reporting entity had a policy of writing off borrowing costs immediately to profit and loss and then decided to capitalise them, management could not then switch back to a policy of expensing them.

Accounting policies must be consistently applied for similar transactions, other events and conditions. The exception to this rule would be where an FRS specifically requires, or permits, categorisation of items for which different policies may be appropriate.

Consistency is important so that the financial statements can be compared to the prior year and with financial information of other entities. While there is no 'hard and fast' rule which stipulates that accounting policies for all entities in the same industry must be uniform, management may have justifiable reasons for developing entity specific policies which may not necessarily be consistent with the industry in which the entity operates.

The Companies Act 2006 (Sch 1, paras 10(2) and 12) also specifies that accounting policies should be applied consistently within the same accounts and from one financial year to the next, unless there are 'special reasons' for departing from this principle. The Act does not define the term 'special reasons' but such reasons could, for example, be due to the issuance of a new FRS or section in an FRS which triggers the requirement to change an accounting policy.

6.5 Changing an accounting policy

There are two situations when an entity can (or must) change an accounting policy:

1) If the change is required by an FRS. This could be as a result of a change to FRS 102 by the FRC which then triggers the entity to action a mandatory change in an accounting policy, or multiple accounting policies. This may be the case following the finalisation of this current periodic review by the FRC in areas such as revenue recognition.

2) If the change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. This would effectively be a voluntary change in accounting policy and hence accentuates why it would be difficult for management to justify a switch back to the previous policy if things do not go according to plan.

FRS 102, para 10.9 outlines three issues which are **NOT** changes in accounting policies as follows:

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

FRS 102 para 10.9(a) to (c)

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

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

Applying a change in accounting policy

FRS 102, para 10.11 outlines certain principles which must be followed when an entity changes an accounting policy or when it elects to follow certain provisions in adopted IFRS as permitted by FRS 102.

A change in accounting policy is applied retrospectively. In other words, the financial statements of previous periods are restated to reflect the revised accounting policy as if the revised policy had always been applied. This is to ensure that the financial statements are comparable (keep in mind that 'comparability' is one of the qualitative characteristics that financial statements must contain according to FRS 102, Section 2 *Concepts and Pervasive Principles*). If a change in accounting policy is not applied retrospectively, the financial statements will not be comparable as the prior year will reflect the old policy, whereas the current year will reflect the new.

If the FRC change FRS 102, any consequential change in an accounting policy is accounted for in accordance with the transitional provisions, if any, which will be specified in the amendment. This is likely to be the case once the FRC complete their current periodic review and issue new versions of UK and Ireland GAAP. Areas such as leasing in FRS 102 are expected to contain significant changes and hence transitional provisions will be included in the new standard to allow entities to reflect the revised accounting treatments.

Changes to an accounting policy are applied retrospectively to comparative information for prior periods to the **earliest date** for which it is practicable. If it is deemed impracticable to determine the individual-period effects of a change on comparative information for the prior period presented, the entity applies the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable (this may be the current period). A corresponding adjustment is made to the opening balance of each affected component of equity for that period.

Change in accounting policy: borrowing costs

In the financial statements for the year ended 31 March 2021, Frankie Ltd adopted an accounting policy of writing off borrowing costs when it self-constructs an asset to the profit and loss account. In the year to 31 March 2023, management decide to voluntarily change this policy to capitalising borrowing costs as management have concluded that this would result in the financial statements providing reliable and more relevant information about such costs.

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

Change in accounting policy for inventory

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

Value of finished goods	FIFO	AVCO
	£	£
At 30 April 2023		125,000
At 30 April 2022	98,000	112,000
At 30 April 2021	110,000	123,000

The change in accounting policy will be recorded in the financial statements as follows:

At 30 April 2021 (opening balance sheet position of the comparative year)

£

Dr Inventory	13,000
Cr Retained earnings (P&L reserves)	13,000

Being increase in finished goods as restated under AVCO

At 30 April 2022 (closing comparative year)

	£
Dr Inventory	14,000
Cr Cost of sales (closing stock)	14,000

Being increase in finished goods in prior year as restated

At 30 April 2023 (current year)

	£
Dr Inventory	125,000
Cr Cost of sales (closing stock)	125,000

Being year-end inventory calculated at AVCO

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

Revaluation of assets

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

Therefore, when an entity first adopts the revaluation model for an asset, it need not obtain a retrospective revaluation for the prior year.

Disclosure of a change in accounting policy

FRS 102 requires disclosure of a change in accounting depending on whether the change arises from a mandatory change (i.e. because the FRC have amended an FRS) or a voluntary change.

Mandatory change due to a change in an FRS

Disclose:

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

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

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

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

The financial statements of subsequent periods do not need to repeat the above disclosures.

Voluntary changes to an accounting policy

Disclose:

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

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

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

(i) for the current period;

(ii) for each prior period presented; and

(iii) in the aggregate for periods prior to those presented; and

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

As with mandatory changes to an accounting policy, the financial statements for subsequent accounting periods need not repeat these disclosures.

Note also that the statement of changes in equity will also show the effects of retrospective application as an adjustment to retained earnings. Small entities choosing to apply the presentation and disclosure requirements of FRS 102, Section 1A *Small Entities* are encouraged to provide a statement of changes in equity.

When the financial statements of prior periods have been restated for the effects of accounting policy changes, it is good practice (although not a legal requirement) to head the comparative year up 'as restated' so it is clear that there has been a change to the comparative year since those financial statements were originally authorised for issue. Only columns in which figures have changed should be headed up in this way though.

6.6 Changing an accounting estimate

A change in an accounting estimate is an adjustment of the carrying amount of an asset or a liability which results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. A change in an accounting estimate does not result from new information or new developments, hence they are not regarded as a correction of a prior period error.

A 'change in accounting estimate' is defined as follows:

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

*FRS 102 Glossary **change in accounting estimate***

In situations when management may be uncertain as to whether a change is an accounting policy change, or an accounting estimate change, the change is treated as a change in accounting estimate.

A change in an accounting estimate is accounted for on a prospective basis (i.e. no retrospective restatement is required – it is accounted for in the current and subsequent accounting periods). The most common types of accounting estimates include:

- the useful lives of fixed assets;
- residual values of fixed assets;
- provisions for inventory obsolescence; and
- expected outcome of provisions (such as litigation provisions or warranty provisions).

It must be emphasised that the revision of an estimate will be required if circumstances in which the estimate were originally based change. Such a change is not applied retrospectively as it does not relate to prior periods and is not the same as the correction of an error.

Example – Change in a legal provision

In the financial statements for the year ended 30 April 2022, Dexter Ltd recognised a provision for damages of £25,000. This accounting estimate has been correctly recorded in cost of sales.

The solicitors acting for Dexter confirmed on 30 April 2023 that the damages have reduced to £15,000 due to new evidence presented.

The credit to the profit and loss account of £10,000 (£25,000 less £15,000) should be taken to cost of sales to ensure that the cumulative expense is correctly stated.

Example – Change in depreciation method

During the year to 31 March 2023, Morley Ltd changed the method of depreciating its motor vehicles from 25% reducing balance to four years on a straight-line basis as this revised method better reflects the entity's consumption of the motor vehicles over their useful lives and is consistent with the entity's replacement cycle.

The change in depreciation method is a change in accounting estimate and is accounted for prospectively in the period of the change (i.e. in the current year) and continues in subsequent periods.

Disclosures for a change in accounting estimate

Where the entity changes an accounting estimate, it should provide disclosure of the nature of the change and the effect the change has had on assets, liabilities, income and expense for the current period. If it is practicable for the entity to estimate the effect of the change in one, or more, future periods, the entity is to disclose those estimates.

In addition, Sch 1 to *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410), para 69(1) states:

> *Where any amount relating to any preceding financial year is included in any item in the profit and loss account, the effect must be stated.*

SI 2008/410, Sch 1. para 69(1)

6.7 Error correction

Under FRS 102 (and FRS 105) **material** errors are corrected by way of a prior period adjustment.

The term 'errors' is defined in the Glossary to FRS 102 as:

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

*FRS 102 Glossary **errors***

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

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

FRS 102 identifies the following types of errors (the list below is non-exhaustive):

- effects of mathematical mistakes;
- mistakes in applying the entity's accounting policies;
- oversights or misinterpretation of facts; and
- fraud.

While material prior period errors are corrected retrospectively, FRS 102 does not restrict this requirement to *only* material errors. In practice, an immaterial error would be corrected in the current period.

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

The correction of a material prior period error is carried out by:

(a) restating the comparative amount for the prior period(s) presented in which the error occurred; or

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

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

As with changes in accounting policy discussed above, when comparative financial statements have been restated (whether due to error correction or retrospective application of a change in accounting policy), it is best practice to head up the comparative year 'as restated' on each page of the financial statements that have been affected, so the user is aware that the comparative year has been subject to change since those financial statements were originally authorised for issue. Disclosures should also be made where comparative financial statements have been changed.

Disclosures concerning prior period errors

Where material prior period errors have been corrected, disclose:

(a) the nature of the prior period error;

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

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

(d) an explanation where it is not practicable to determine the amounts to be disclosed in (b) or (c) above.

The financial statements of subsequent periods do not need to repeat the disclosures above.

When the prior period figures have been restated, it is good practice to head up the comparative period 'As restated' on each page to notify the reader that there has been an adjustment to the comparative period. There is, however, no specific requirement to do this.

7 Changes to the Ethical Standard proposed (Lecture A833 – 14.05 minutes)

On 8 August 2023, the FRC issued a consultation on revisions to the Ethical Standard (ES) which aim to enhance and clarify the principles of integrity, objectivity and independence. Comments on the proposed amendments will close on 31 October 2023 and the revised ES will become effective on 15 December 2024.

In addition, changes to the ES are necessary in light of the new quality management standards in the form of:

- ISQM (UK) 1 *Quality Management for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*; and

- ISQM (UK) 2 *Engagement Quality Reviews.*

The revisions to the ES remove references to the old ISQC (UK) 1 and update certain terminology to be consistent with the new standards (such as changing 'quality control' to 'quality review').

7.1 Headline changes

Some of the headline changes to the ES include:

Withdrawal of the OEPI category

In 2022, the FRC issued a position paper on audit market reform which confirmed that the FRC is committed to revising the ES and to consult at the same time concerning the withdrawal of the *Other Entities of Public Interest* (OEPI) category which was brought into the ES in 2019 when it was last issued. The reason the FRC are looking at withdrawing the OEPI category is because of the government's proposed changes to the statutory definition of 'Public Interest Entity'.

Breach reporting

PIE audit firms are required to report breaches of the ES to the FRC on (at least) a biannual basis. The revisions to the ES will:

(a) Introduce a specific requirement for firms to design controls which are effective in identifying reportable breaches. This revision has been driven by concerns about potential inconsistencies in reporting between firms.

(b) Include a specific requirement for firms to consider the perspective of an Objective Reasonable and Informed Third Party (ORITP) when assessing the implications of a breach of the ES.

(c) Align the ES with the FRC's formal policy for reporting breaches by highlighting instances when firms ought to report to the FRC on a more timely basis.

(d) Include the concept of 'inadvertent' breaches of the ES which do 'not necessarily call into question the firm's ability to give an audit or other public interest assurance opinion.' Additional material will be added to explain which breaches of the ES cannot be considered to be 'inadvertent'.

Application of prohibitions to different categories of entity

Section 2 of the ES sets out the prohibitions and requirements in respect of personal financial independence for engagement teams and other staff in audit firms. These are combined requirements of the ES and those set in law. The dual source of these prohibitions has made the material in the ES hard to understand and hence difficult to implement. The FRC have therefore redrafted paragraphs 2.3 and 2.4 to make the requirements more succinct.

Partner and staff rotation

A table has been included setting out the rotation rules for various partners on an audit engagement. In addition, further guidance has been included (from previously published material) setting out circumstances such as maternity/paternity leave and sickness absence which may be relevant to those rotation rules.

Fees

Changes are proposed to enhance prohibitions where an audit firm's independence could be threatened by an economic over reliance on fees from entities that are connected in substance, if not in legal form.

Non-audit and additional services

Changes to Section 5 of the ES are aimed to align more closely with changes to the IESBA Code. This is in line with the FRC's commitment to have an ES which is as stringent as the IESBA's. This also helps UK firms who comply with the IESBA Code as part of their membership commitment to the international Forum of Firms, or because the Code forms the basis for the Ethical Code of UK Professional Accountancy Bodies. Additional changes have been made to reflect FRC inspection or enforcement findings as follows:

- IT services to reflect stricter IESBA Code restrictions on audit firms providing hosting services to audited entities.

- Enhanced tax service prohibitions that can be provided to the majority shareholders of unlisted entities, in response to supervision and inspection findings.

- Recruitment and remuneration services, reflecting more explicit IESBA Code prohibitions where audit firms provide more related services.

- Corporate finance services where IESBA have introduced extended prohibitions relating to the provision of advice on audited entities on debt and financial instruments.

8 Audit sampling (Lecture A834 – 10.48 minutes)

Audit sampling is dealt with in ISA (UK) 530 *Audit Sampling*. The definition of 'audit sampling' is:

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

ISA (UK) 530, para 5(a)

The term 'population' refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

It is usually impracticable for the auditor to test every item in an accounting population because of time and cost constraints. This is recognised as one of the inherent limitations of auditing.

Remember, that the auditor only provides **reasonable** assurance (not absolute assurance) that the financial statements are free from material misstatement, whether caused by fraud or error. Hence, the auditor is not certifying that the financial statements are 100% accurate as they are not verifying 100% of the transactions which are included in the financial statements.

8.1 Sampling risk

Sampling risk is a component of detection risk. Detection risk is the risk that the auditor will not detect a misstatement which exists in an assertion that could be material, either individually or when aggregated with other misstatements. In the audit risk model, detection risk is the only risk that is under the control of the auditor.

The term 'sampling risk' is defined as:

> *The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to types of erroneous conclusions:*
>
> *(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.*
>
> *(ii) In the case of a test of controls, that controls are less effective than they actually are or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.*

ISA (UK) 530, para 5(c)

The term 'non-sampling risk' is defined as:

> *The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.*

ISA (UK) 530, para 5(d)

Auditors are faced with sampling risk in both tests of controls and in substantive procedures. Essentially, sampling risk is the risk that the auditor's sample from a population will not be representative (in other words, the sample is too small).

Sampling risk within tests of control

Tests of control are designed to evaluate the operating effectiveness of controls in preventing or detecting and correcting material misstatement.

The risk to auditors where tests of controls is concerned is that control are either more or less effective than they actually are because the rate of errors in the sample is not the same as the actual rate of errors in the population.

Sampling risk affects tests of controls because the wrong conclusion over the operating effectiveness of controls could lead the auditor to relying too heavily on controls, hence failing to detect a material misstatement and therefore expressing an incorrect audit opinion. Or, the auditor could place less reliance on internal controls which results in more substantive procedures having to be applied, which results in audit inefficiencies due to more work having to be performed which increases the cost of the audit.

Example – Attendance at the year-end inventory count

During the initial audit planning meeting with the finance director of Minikin Enterprises Ltd, the audit senior was informed that all staff involved in the year-end inventory count are provided with detailed instructions drawn up by her and the company's production director, Joshua Johnson. The audit senior confirmed that at each warehouse there will be a number of teams counting the inventory in different numbered sections of each warehouse which has been mapped out on a floor plan. Each team will comprise two individuals: one will count the inventory and another will record the inventory on the sequentially numbered inventory count sheets.

The audit engagement team will be attending each warehouse on 31 August 2023 to carry out a sample of test counts in a two-way direction: from inventory count sheets to inventory (testing the existence assertion) and from the physical inventory to the inventory counting sheets (testing the completeness assertion). As each section of a warehouse has been counted, it will be crossed out on the floor plan to indicate that counting is complete in that area.

In this example, the sampling risk is the risk that the auditor's sample from the entire inventory count is not representative of the population (the population being the entire inventory). This can arise because the auditor's sample is inadequate (i.e. it is too small). In order to reduce sampling risk, the auditor must increase the size of the sample selected.

However, the auditor may consider that increasing the sample size need not be necessary on the grounds that Minikin Enterprises has a number of controls in place over the inventory counting process as follows:

- Detailed instructions are provided to counting staff by management.
- Each section of the warehouse has been numbered on the warehouse floor plan.
- Teams are comprised of two individuals – one counting and one recording.
- Sequentially numbered inventory counting sheets are being used.

Sampling risk can lead the auditor to incorrectly concluding that the above controls are more effective than they actually are. This means that the auditor's sample of inventory counts will be lower than would otherwise be the case (as they are placing reliance on the effectiveness of controls) and is more likely to lead to an inappropriate audit opinion being expressed because those items of inventory which have not been sampled may contain material misstatement due to the incorrect conclusion over the controls over the inventory count.

Conversely, sampling risk can lead the auditor to incorrectly concluding that the above controls are less effective than they actually area. This results in the auditor increasing sample sizes than would otherwise have been the case which creates additional work (and costs) and hence reduces audit efficiency.

Sampling risk within substantive procedures

Substantive procedures are aimed at detecting material misstatement at the assertion level. Tests of details, which are one type of substantive procedure, are often performed on a sampling basis.

Remember that sampling risk is the risk that the auditor's sample from a population is not representative. If the sample is too small, the sampling risk is that the auditor fails to detect a material misstatement (detection risk). On the flip side, if the auditor has concluded that a material misstatement exists and hence requires a large sample to be tested, the auditor is carrying out more substantive procedures than is necessary which increases time spent on the audit.

Example – Insufficient sample size

During the audit of trade debtors, the audit senior picks a sample of 20 debtors. The population size is 330.

Here, the sample size is too low because it only represents 6.1% (20/330 x 100) of total trade debtors. There is a risk that those trade debtor balances which remain untested if the sample is not increased will contain a material misstatement. This increases detection and audit risk and hence the auditor should increase their sample accordingly so that it is representative of the population.

Non-sampling risk

Non-sampling risk is the risk that the auditor's conclusion is inappropriate for any other reason, such as the application of inappropriate audit procedures or the failure to recognise a misstatement or deviation. Non-sampling risk can also arise by the auditor misinterpreting the audit evidence obtained.

Example – Non-sampling risk

Martyn Greaves is the audit supervisor of ABC & Co Accountants who is attending the inventory count of Ratchford Enterprises Ltd with a team of four other audit engagement team members. The inventory count is being carried out as at the year end 31 August 2023.

During August 2023, a significant problem arose in the company's inventory control system. A junior member of the warehouse team incorrectly inputted the selling prices of goods as opposed to their cost prices into the stock control system. This resulted in overstated inventory valuations for approximately 20% of the company's products. The issue only came to light due to complaints from customers who had been overcharged for goods they had purchased from the company.

Daniel Westhead (the production director) carries out monthly reviews of the prices input into the stock valuation system to ensure they are cost prices to ensure that stock is valued at the lower of cost and estimated selling price less costs to complete and sell. However, in August 2023, Daniel was absent due to illness and hence could not carry out the checks – nor did any other responsible official. Martyn Greaves has fully documented the controls over the inventory cycle, including the checks carried out by Daniel Westhead, but has not been made aware of this control deviation; nor has Martyn inquired of the finance director about any problems arising in the system during the year.

The issue here is that further inputting errors could have been made by the junior member of staff. A failure to recognise a misstatement or deviation is a non-sampling risk. Hence, Martyn Greaves could conclude that controls over the inventory cycle have been operating effectively enough during the year to reduce the risk of material misstatement, when, in fact, there has been a deviation from the internal control which should result in more substantive procedures being performed.

8.2 Statistical versus non-statistical sampling

ISA (UK) 530, para 5 defines 'statistical sampling' as:

An approach to sampling that has the following characteristics:

(i) random selection of the sample items; and

(ii) the use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.

ISA (UK) 530, para 5(g)

While statistical sampling requires the use of mathematical procedures, it still requires the auditor to exercise professional judgement – for example, in determining what constitutes a misstatement or deviation and what the performance materiality level is. In practice, a certain level of mathematical competence is required if valid conclusions are to be drawn from the sample evidence.

The table below outlines the advantages and disadvantages of statistical sampling:

Advantages	Disadvantages
It can be used by all levels of audit staff.	It can result in complex mathematical processes which need to be understood.
It is an efficient use of audit time because excessive sample sizes are not taken.	The principles of testing have to be properly applied in order for the tests to be valid.
It can result in a standard programme of testing.	

Non-statistical sampling means selecting an appropriate sample size based on the auditor's judgement of what is desirable. In contrast to statistical sampling, no time is spent on complex mathematical procedures and no specialist knowledge of statistics is required.

8.3 Sampling techniques

There are a variety of sampling techniques (both statistical and non-statistical) which the auditor can use in devising a sample of a population to perform audit procedures over. The technique used will ultimately be at the discretion of the auditor's professional judgement and there are various factors that need to be carefully considered by the auditor because not every technique will be appropriate in the circumstances.

ISA (UK) 530 recognises that there are many methods of selecting samples and states that the principle methods are as follows:

Random selection

This can be achieved through the use of random number generators or tables.

Systematic selection

Where the number of sampling units in the population is divided by the sample size to give a sampling interval. For example, every 20th sales invoice. While the starting point may be determined on a haphazard basis, the sample is more likely to be truly random if it is determined by the use of a computerised random number generator or by way of random number tables. It is important when auditors use this sampling technique that they ensure that the sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

Monetary unit sampling

This is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts. This technique selects items based on monetary values (usually focussing on higher value items).

Haphazard selection

When the auditor adopts a haphazard technique it is not a structure technique. When no structured technique is followed, the auditor would nonetheless avoid any conscious bias or predictability (e.g. by avoiding difficult to locate items or always avoiding items on the first or last page of the nominal ledger account). This ensures that all items in the population stand a chance of selection. ISA (UK) 530 acknowledges that haphazard selection is inappropriate when using statistical sampling.

Block selection

This involves selecting a block of contiguous (i.e. items next to each other) items from from the population and is often used when testing cut-offs. ISA (UK) 530 clarifies that such a technique would rarely be appropriate where the auditor intends to draw valid inferences about the entire population based on the sample.

Stratification

Stratification is the process of breaking down a population into smaller sub-populations. Each sub-population is a group of sampling units which have similar characteristics.

Example – Stratification

The draft financial statements of Hall Industries Ltd for the year ended 31 August 2023 shows total revenue of £38.6 million. The company's revenue streams are not the same and so to ensure complete coverage of all revenue streams (and to ensure that no material revenue stream is missed out), the auditor divides the population into strata's (layers) as follows:

	Number of sales invoices in the stratum	Value of the stratum	Test size
Manufacturing	1,625	£22.6m	80
Storage	2,113	£8.2m	30
Distribution	1,009	£5.1m	20
Repairs	998	£2.7m	20

The sample chosen is weighted towards the higher value items because they are most material. The important issue that the auditor considers where different revenue streams are concerned is that they should break the revenue figure down into sub-populations to ensure appropriate coverage.

8.4 Attribute sampling

Attribute sampling is a technique used by the auditor to test controls. It provides results based on two possible attributes: correct (compliant) or not correct (non-compliant). Attribute sampling means that an item being sampled either will, or will not, possess certain qualities (or attributes). The auditor selects a certain number of records to estimate how many times a certain feature will present itself in a population.

Example – Attribute sampling

Heaton Enterprises Ltd has a policy that every purchase invoice over £10,000 must be authorised by a member of the board of directors. In this situation, every purchase over £10,000 either will or will not be authorised by a director.

The audit senior has extracted a sample from the purchases day book report showing all supplier invoices over £10,000. There are 150 invoices in the sample and she notes that six of the 150 invoices are not authorised by a director. This gives a population error rate of 4% (6 / 150 x 100).

The audit file contains the following details:

- Tolerable error is 7%
- Expected error is 5%
- Sampling risk is 2%
- Confidence level is 98% (confidence level plus sampling risk should always equal 100%)
- Population error rate is 4%

Keep in mind that the audit senior is only looking at a sample of invoices – not the entire population. Notwithstanding the fact that the 4% population error rate is less than the tolerable error of 7%, the auditor cannot conclude that the sample is sufficient. When using attribute sampling the auditor must add the sampling risk of 2% to the population error of 4%. These two figures added together are referred to as the 'upper deviation rate'.

The upper deviation rate is 6% which is below tolerable error of 7% and the auditor can place reliance on the control.

8.5 Factors to consider when selecting a sample

There are various factors that must be considered by the auditor when selecting a sample. Some of these are as follows (note, the list below is not designed to be comprehensive):

The purpose of the procedure

What is the overall objective of the test? What contribution does the test make to the overall assessment of the financial statements presenting a true and fair view?

The combination of procedures that are being performed

Are tests of control being carried out and can they contribute towards audit evidence? What other audit procedures are being carried out over the area being audited?

The nature of the audit evidence sought

Is external, third-party audit evidence available? Can auditor-generated audit evidence be obtained?

The possible misstatement conditions

Is the area being audited at a higher risk of material misstatement or are controls over the area weak or non-existent?

Example – Factors when deciding on a sample

Dwyer Industries Ltd operates approximately 400 sales ledger accounts and the majority of these accounts are expected to owe the company money at the year end 31 August 2023. The audit engagement partner has decided that a trade debtors' circularisation will not be carried out this year due to the low response rate received in the previous year's audit and the fact that they are generally viewed as a weak form of audit evidence.

The audit engagement partner has, instead, requested extended post-year-end cash receipts testing be performed to corroborate the valuation and existence assertions.

Given the number of sales ledger accounts in existence, it is highly likely that year-end trade debtors will be material. The audit engagement partner has requested **extended** post-year-end cash receipts testing as a trade debtors' circularisation is not being carried out. When designing the sample, the auditor must consider:

- **The purpose of the procedure** – which is to provide reasonable assurance that the trade debtors amount in the balance sheet does not contain material misstatement and the valuation of debtors is appropriate.

- **The combination of the procedures that are being performed** – extended post-year-end cash receipts testing will be **in addition** to other audit procedures to support the trade debtors amount (such as agreeing the sales ledger control account to the list of balances and selecting a sample of year-end balances and agreeing back to goods dispatched notes and sales order).

- **The nature of the audit evidence sought** – the extended post-year-end cash receipts testing will confirm (or otherwise) that trade debtors exist at the year end and that they are appropriately valued as they will be traced to monies received post-year end.

- **Possible misstatement conditions** – the auditor must consider the possibility that some debtor balances may not be recoverable (especially if they cannot be trade to post-year-end cash receipts) and hence a provision for bad debts may be necessary to avoid overstate trade debtors and profit.

8.6 Factors that influence the sample size

There are various sampling techniques and various factors which the auditor must consider and not all techniques and factors will apply in every audit. Sample sizes must be representative of the population because if they are too small there is a greater risk that the auditor will form an incorrect opinion on the financial statements (i.e. audit risk is increased). Conversely, if they are too large, there will be a resulting increase in audit inefficiencies (i.e. increased costs).

The most important factor that must be considered when determining the sample size is the risk of material misstatement. The higher the auditor's assessment of the risk of material misstatement, the larger the sample size must be. The auditor's assessment of the risk of material misstatement is affected by inherent and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Hence, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.

Conversely, the more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.

9 Materiality (Lecture A835 – 12.25 minutes)

ISA (UK) 320 *Materiality in Planning and Performing an Audit* provides guidance to auditors on both financial statement materiality and performance materiality.

Materiality calculations are often challenged during audit file reviews – particularly where the 'averaging method' is used and so it is worthwhile recapping on some of the issues so that audit firms can ensure their materiality calculations are appropriate in the client's circumstances.

ISA (UK) 320 refers to materiality in the following way:

> *Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.*

ISA (UK) 320, para 2 (extract)

In this way, you can think of materiality as a way for the auditor to prioritise the elements of the financial statements which need more attention. Essentially, it is a way of managing audit risk – the more material an element of the financial statements, the more audit attention it is likely to require, to ensure that the appropriate audit opinion is provided.

Materiality is a wholly judgemental issue and can be revised during the course of an audit. It is set at the planning stage based on the draft financial statements or other sources of financial information. If matters come to light during the audit which the auditor was not previously aware of, the auditor may choose to increase or decrease materiality levels as appropriate.

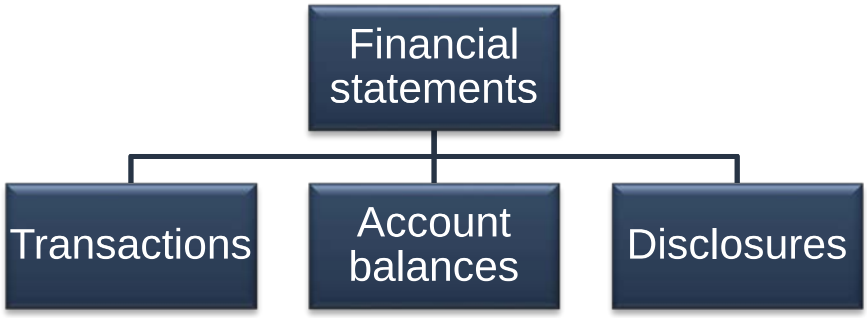
9.1 Material classes of transactions, account balances and disclosures

ISA (UK) 320 contains the fundamental requirement relating to materiality as follows:

> *When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.*

ISA (UK) 320, para 10

Financial statements are split into transactions: items in profit and loss and other comprehensive income; account balances: items in the balance sheet and disclosures.



Transactions include turnover, purchases, payroll and other expenses, income received from financial investments, interest payable and similar expenses and tax.

Account balances include assets, liabilities and equity.

Disclosures are information in the notes to the financial statements, including material accounting policy information and other notes required by UK and Ireland GAAP, legislation and regulation.

The auditor is concerned with material classes of transactions, account balances and disclosures to ensure there is no material misstatement. Immaterial account balances and disclosures will not be a major concern on the grounds of their immateriality, but that is not to say they can be forgotten about entirely during the course of the audit – immaterial transactions, balances and disclosures may become material if there are any revisions to materiality levels during the course of the audit. It is clear during some file reviews that immaterial items are completely ignored at the completion phase even though there is a risk they may become material when combined.

An item in the financial statements should be considered from different viewpoints in order to determine its materiality. An item could be material from one point of view, but immaterial from another point of view. The important thing to remember is that materiality should be judged from the perspective of the users of the financial statements.

9.2 Applying materiality

When considering materiality, there is no 'set method' for deciding whether something is material or not – the auditor uses their professional judgement to make this decision, using the framework set out in ISA (UK) 320.

ISA (UK) 320 confirms the importance of professional judgement when determining materiality by stating:

> *Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and*

ISA (UK) 320, para 2 (extract)

Judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

The auditor's objective is to obtain sufficient appropriate audit evidence over the figures that appear in the financial statements and that the auditor is also concerned with ensuring that the narrative information relevant to the financial performance, financial position and cash flows is complete and accurate. The auditor must also consider the overall impact that immaterial misstatements may have on the financial statements when they are combined, for example, could they turn a reported profit into a loss?

There are two important factors to consider where materiality is concerned: whether an item is material by **size** or whether it is material by **nature** – in other words, there are both qualitative and quantitative factors in respect of materiality.

ISA (UK) 320 does not specify a calculation for materiality because it recognises that it is down to the auditor's professional judgement. However, percentage 'benchmarks' can be a useful starting point, such as, depending on the circumstances:

- ½ to 1% of turnover
- 5% to 10% of profit before tax
- 1% to 2% of total assets

These benchmarks are common, but are not definitive. Different audit firms may use different benchmarks or different thresholds for each client. For a profit-orientated entity, a benchmark based on profit before tax is commonly applied. However, materiality should be assessed each year and the method may need to change in response to new circumstances. For example, if profit before tax becomes volatile, the auditor may no longer conclude that it is an appropriate benchmark, so could decide to use a different benchmark, such as gross profit, total revenue or a normalised profit figure.

Increasingly, professional bodies are advising that the auditor documents their thought process when it comes to establishing materiality levels as ISA (UK) 320 requires the auditor to document the factors considered in the determination of materiality. This is so that the rationale behind the determination of materiality can be understood. This is important because the calculation of materiality cannot just be viewed as a 'mechanical' part of planning; the financial statement and performance materiality levels should be justified as to their appropriateness to the audit.

Some audit firms use the 'averaging method' which use the benchmark figures above and then divide the sum of these by three to arrive at an average financial statement materiality level. While there is nothing in ISA (UK) 320 that suggests this is wrong, regulators have indicated that this is not an appropriate method as a basis of calculating materiality. This is on the grounds that the averaging method does not focus appropriately on where the risks arise.

Performance materiality

ISA (UK) 320 defines 'performance materiality' as:

> *The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality levels for particular classes of transactions, account balances or disclosures.*

ISA (UK) 320, para 9

Performance materiality is therefore a level of materiality which is set **lower** than financial statement materiality. It is this lower level of materiality that is used when designing and performing audit procedures (i.e. it is the level used in testing). For example, if performance materiality for trade debtors is £40,000 then all individual trade debtor balances exceeding £40,000 are included in the sample.

9.3 FRC Thematic Review on materiality

In their 2017 Thematic Review on Materiality, the FRC found that the most common way to determine a materiality threshold (in their survey of the eight largest audit firms) is based on 5% of profit before tax.

The FRC commented that:

> *It may be appropriate to use a profit-based measure for some sectors, such as construction, general retailing and support services; in others, such as mining and equity investment instruments, however, earnings before interest, tax depreciation and amortisation (EBITDA) and net asset values may be more appropriate.*

FRC Thematic Review on Materiality

This highlights the fact that auditors need to use their judgement when determining how to apply materiality – the same approach will not be suitable for all audit clients. This is why it is important to document the rationale behind the materiality calculation as noted earlier.

In addition, the Thematic Review noted that some firms use materiality benchmarks based on a rolling average, which should work to eliminate volatility in profits and therefore in the materiality benchmark applied in audits of clients in industries where profit volatility is also prevalent.

One of the significant findings of the Thematic Review was that there is a considerable difference in how audit firms determine materiality, with some audit firms using considerably lower materiality levels than others on their audits. Perhaps this is not too surprising given the extent of professional judgement that needs to be used when setting a level of materiality for audit clients. In the Thematic Review, the FRC comments that it is possible that the materiality levels set by some firms could be around 100% higher than that of the more prudent firms. These different approaches to materiality could lead to significantly different audits being conducted, impacting on the scope and detail of audit work performed and possibly on the conclusions reached by the audit firm.

The Thematic Review also encourages audit committees to engage with their audit provider to discuss and, where necessary, challenge the auditor's determination of materiality. The Thematic Review reported that only 17% of audit committees have engaged with their auditor regarding materiality which goes against the principle that the audit committee should monitor the quality and effectiveness of the external audit.

9.4 Materiality and audit risk

Audit risk is the risk that the auditor expresses an incorrect opinion on the financial statements. The auditor must try to reduce audit risk to the lowest possible level, although the reality is that they cannot remove audit risk entirely.

There is an inverse relationship between materiality and the level of audit risk. Hence, the higher the assessed level of audit risk, the lower the level of materiality and vice versa. Another way of thinking of this is that if the auditor wishes to reduce audit risk, they should reduce the materiality level – this means that more balances, transactions and disclosures will become material (based on quantitative materiality) and larger sample sizes will be used to obtain audit evidence.

Example – Inverse relationship between audit risk and materiality

During the audit of Howard Enterprises Ltd, the auditor discovers significant weaknesses in the controls over the payroll cycle.

The payroll department has weak segregation of duties and a lack of authorisation controls in place. During the last four months of the financial year, there had to be significant revisions made to the company's payroll due to mistakes made in the processing.

In this situation, there is a high audit risk relating to payroll transactions. The auditor reduces audit risk by reducing materiality levels hence there is a higher likelihood that the auditor will detect more misstatements by performing more audit procedures on payroll. In this example, the auditor is using materiality as a way of reducing their audit risk exposure.

The example above also demonstrates that materiality does not remain 'fixed' during the course of the audit. Matters may come to light during the audit fieldwork process that may cause the auditor to revise materiality levels either upwards or downwards depending on the issues identified. Where misstatements, fraud risks or weaknesses/override of internal controls are identified, the auditor is likely to increase materiality levels and carry out a more substantive approach to testing.

In fact, this is a requirement of ISA (UK) 320 which requires the auditor to revise the level of materiality during the audit in the event of becoming aware of information that would have caused the auditor to have determined a different amount(s) initially. This can happen, for example, if the initial assessment of materiality is based on projected financial information, and the actual financial results for the period turn out to be quite different to the projections.

10 Common audit issues (Lecture A836 – 18.54 minutes)

There are many issues that get flagged up during the course of file reviews – some more than others. In this quarter's update, we will examine some of the more common deficiencies that are found during audit file reviews to help firms avoid the many pitfalls that exist where audit work is concerned.

10.1 Income completeness

Revenue (turnover/sales) is tested primarily for **understatement**. Remember, from a directional testing methodology, liabilities and income are tested for understatement; whereas assets and expenses are tested primarily for overstatement.

When testing revenue for completeness, the objective of the substantive income completeness test is to identify whether there are any goods and/or services that have been dispatched/rendered that have not been invoiced. The starting point, therefore, for substantive procedures over income completeness must be from 'outside' of the accounting system. For example, a customer's order will often trigger the transaction and income completeness testing should start from this order, through to goods dispatched notes, through to the sales invoice and then through to the various ledgers.

It is not uncommon to see the starting point for income completeness testing being from the sales invoice. Effectively, this renders the test meaningless because the whole point of the procedure is to test income for understatement. If the auditor starts from the sales invoice, then clearly the good and/or service has been invoiced and revenue has been recognised.

It is not just understatement that the auditor is concerned about where revenue is concerned. Another principal audit risk is that revenue is **overstated**. This could happen because the entity has recognised sales in the current year's financial statements that should be recognised in the next accounting period and could have arisen because cut-off's have been applied incorrectly or because of deliberate manipulation. The entity could also overstate its revenue figure by recognising fictitious revenue (i.e. sales that have not occurred).

Overstated revenue distorts the financial statements by falsely improving the financial performance of the business for the year and could lead to a user believing the entity is more successful than it really is. Deliberate overstatement of revenue also affects the balance sheet because the trade debtors figure will be inflated by the value of the overstatement.

The Tesco scandal
In 2014, Tesco was found to have overstated its profits by some £263m due to aggressive revenue recognition policies. This scandal resulted in the involvement of

the Financial Conduct Authority and the Serious Fraud Office.

Tesco had once dominated the grocery industry but increasing amounts of competition meant that it saw a decline in the value of its reported profits.

A decline in profits leads to questions being asked by the shareholders as to why this is happening and can call into question the ability of the directors.

Rather than try to remedy the situation ethically, management decided to falsify the information in its financial statements by increasing revenue and delaying the recognition of costs to make the financial statements look more healthier than they actually were. Quite often, this can appease the shareholders who assume that the company is still in a highly profitable position and the directors are ensuring shareholder wealth is maintained.

Tesco recognised revenue in the form of supplier rebates that were dependent on the company hitting certain sales targets. Some employees became aware that the sales targets would not be met and struck deals with the suppliers concerned. The 'deal' was that the supplier would still make the payment on the condition that they would receive benefits in the next accounting period.

Once the issue was in the public domain, Tesco's management asked one of the 'Big Four' accountancy firms to carry out an independent and comprehensive review which is said involved the accelerated recognition of commercial income and delayed accrual of costs. The firm involved in carrying out this review was not the official auditor of Tesco.

The conclusion reached was that Tesco had overstated its profits by £118m in the first half of 2015; by £75m in the 2013/14 financial year and by £75m prior to that. This sent shockwaves around the business community and the general public. Questions were also asked of the audit firm who had not (on the face of it) challenged these aggressive accounting policies.

Unorthodox practices such as manipulating the financial statements to achieve a desired outcome can lead to serious punishment, including lengthy prison sentences because it is fraud. Tesco, itself, was find £129m by the Serious Fraud Office for overstating its profits.

As you can see from the Tesco scenario above, it is important that revenue is adequately covered by audit work and sufficient appropriate audit evidence is obtained to provide the auditor with reasonable assurance that revenue is fairly stated. Inappropriate or incorrect audit procedures can lead the auditor to missing key issues (and fraud risk factors).

Situations which could give rise to fraud risk factors include the client wishing to raise finance. Remember, a 'fraud risk factor' does not mean a fraud has taken place – it means that the risk of fraud is effectively higher. The principal audit risk here is that revenue may be overstated so that the entity presents a health set of financial statements to the bank/financier to secure the finance. Conversely, the entity may wish to suppress revenue to influence the tax liability.

Another issue that seems to crop up is the rebuttal of the presumption of fraud in respect of revenue recognition. ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* singles out revenue as containing a fraud risk.

Only in very rare situations should the auditor rebut this presumption. Hence, the auditor must ensure they devise procedures which address this risk and must not simply state that they do not believe a fraud has arisen during the year as this also fails to demonstrate professional scepticism.

Auditors can be reprimanded by the professional body or regulator for inappropriately rebutting such presumptions that are in the ISAs (UK). Remember, if such presumptions are in the ISAs (UK) it means they are viewed as significant risks.

Simply stating that the risk of fraud due to revenue recognition is 'not applicable because we have not detected fraud in previous audits' demonstrates a fundamental lack of professional scepticism and contravenes ISA (UK) 240 which requires previous experience of management's integrity and honesty to be set aside by the auditor.

10.2 Audit evidence

Audit evidence crops up a lot in terms of deficiencies. ISA (UK) 500 *Audit Evidence* requires the auditor to obtain **sufficient** and **appropriate** audit evidence. ISA (UK) 500 defines 'audit evidence' as:

> *Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and information obtained from other sources.*

ISA (UK) 500, para 5(c)

Audit evidence is made up of information that supports and corroborates management's assertions and also information that contradicts management's assertions. Both types of information can provide evidence that will help the auditor to form an opinion on the financial statements.

It is not unusual to see material areas of the financial statements that have not been properly corroborated through sufficient appropriate audit evidence.

Sufficient audit evidence means there is the right amount (quantity of evidence). Sufficiency will be determined by factors such as the level of risk associated with the item in question, by the quality of evidence obtained and the links to materiality. The auditor must use judgement to decide when sufficient evidence has been obtained, and in reaching this decision the type of procedures that have been used to obtain that evidence must be considered. For example, it is important to appreciate that inquiry alone does not usually provide sufficient audit evidence on the operating effectiveness of controls, or on the absence of a material misstatement.

Appropriate audit evidence means that the evidence is both **relevant** and **reliable**. Relevance means that evidence should be pertinent to the assertions inherent in the item in question. For example, when gathering evidence about a property, a physical verification will provide evidence of existence, but not of the right to recognise the property on the balance sheet. So further audit procedures would be necessary to obtain evidence on the client's right to recognise the property on the balance sheet.

Reliability means that the auditor can trust the audit evidence. If the information used as the basis of an audit procedure is not auditor-generated, i.e. has been provided by the client or by an auditor's expert, the auditor must carefully evaluate the accuracy and completeness of the information and whether it is detailed enough to support the planned audit procedure.

The reliability of audit evidence is influenced by factors, such as:

- The source of the evidence (e.g. client-generated or auditor-generated).
- The nature of the evidence (e.g. whether it is documentary or based on inquiry).
- The circumstances under which it is obtained (e.g. whether there were effective controls over the preparation of the audit evidence).

ISA (UK) 500, para A31 provides a guideline as to the reliability of evidence summarised:

Type of reliable evidence	Examples
Generated by third parties independent of the client	• Confirmation of a trade debtor balance by a customer • A letter from the bank confirming an overdraft limit, rates of interest, etc • Evidence obtained by an auditor's expert, for example, a specialist property valuer
Generated by the auditor rather than by the entity	• Financial performance measures such as trends and ratios prepared by audit software • Recalculations of complex computations such as foreign exchange gains or losses

Documented in a written form rather than an oral representation	• Written management representations • Written confirmation of matters discussed with people outside the audited entity such as lawyers and finance providers
Gathered from original documentation rather than photocopies or scanned documents	• Original signed documents such as lease agreements, loan covenants, contracts with suppliers and customers • Original version of board minutes and meetings with shareholders
Produced by the entity when controls are deemed to be effective	• Evidence obtained from a well-organised and well-controlled inventory count • Evidence based on the audited entity's accounting records when controls are effective

Sufficiency and appropriateness should not be considered in isolation. For example, the more reliable the source of evidence, a lesser quantity of it may be needed.

For example, consider an auditor is obtaining evidence in relation to a lease that has been entered into. If the audit client can present the auditor with the original signed copy of the lease, which is a reliable source of audit evidence, then limited further procedures need to be performed. However, if the client presents the auditor with a photocopy of the lease, or cannot produce the document in any form at all, further procedures will be necessary.

Risk and audit evidence

Remember, audit evidence is always persuasive in nature – not conclusive. ISA (UK) 330 *The Auditor's Responses to Assessed Risks* indicates a link between the auditor's assessment of risk and the persuasiveness of the audit evidence obtained. The correlation is that the higher the assessment of risk, the more persuasive the evidence will need to be. To obtain more persuasive audit evidence, the auditor can:

- Increase the quantity of evidence obtained
- Obtain evidence that is more relevant
- Obtain evidence that is more reliable

Quite often, it is clear from audit file reviews that there is little consideration of the overlapping risk.

For example, a circularisation of trade debtor balances has indicated a higher risk than previously identified during the audit planning. The auditor could respond in a few ways to improve the persuasiveness of evidence, such as:

- Extending the sample of trade debtors that were circularised.
- Extend other audit procedures which are relevant and reliable, such as after-date cash receipts testing.

10.3 Related parties

Related parties can be a tricky area to audit. A key problem for the auditor is that unless management tells the auditor about the existence of related parties, they can be hard to identify. Even where management are willing to inform the auditor about related parties, management may not themselves understand the complex definition contained in FRS 102, Section 33 *Related Party Disclosures* which can lead to incomplete or inadequate related party disclosures. This is particularly the case in smaller audits which may lack informed management.

Internal controls are often not set up to specifically deal with related parties and transactions with them. So, for example, if two companies under common control trade with each other, these transactions may not be separately identified within the accounting system as related party transactions, so again there is a risk of incomplete disclosure.

Management may also deliberately conceal related parties and transactions with them. This is because related parties are sometimes used as a vehicle for fraud, and this type of fraud often involves senior management.

Care must be taken with related parties due to their subjectivity and it is an area that frequently crops up in file reviews as one of the most deficient. In some, more serious, cases, the only audit evidence on file concerning the completeness of related party disclosures is a written representation letter.

Example – Fraud and related parties

One of the most famous frauds involving related parties involves the US company, Tyco. This is an old case, dating back to 2002, but it demonstrates how related party transactions can be used to carry out significant frauds by senior management. Remember, that 'key management personnel' are, by definition, related parties according to ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of*

Financial Statements.

In the Tyco case, the company's CEO, Dennis Kozlowski and CFO, Mark Swartz, were found to have given themselves loans amounting to $120m, often disguised as bonuses, which were interest-free or had very low rates of interest. The company had a legitimate Key Employee Loan Programme, which was set up to help senior management to acquire loan stock in the company. However, Kozlowski and Swartz abused this policy, making loans without appropriate authorisation leading to significant theft from the company as the loans were never intended to be repaid.

In addition to the unapproved loans, the company's funds were misused by Kozlowski for extravagant personal expenses, famously including a $6,000 shower curtain, works of art and houses worth many millions of dollars, and a $2m birthday party for his wife. Kozlowski clearly believed that the company's assets were 'his money' – a concept known as 'commingling'.

Both Kozlowski and Swartz were found guilty of grand larceny, falsifying business records, securities fraud and conspiracy in 2005. They both received lengthy prison sentences and ordered to pay fines totalling over $230m.

In addition to the misappropriation of assets, on investigation it was discovered that Tyco's financial statements were misstated by a $5.8bn overstatement of profit.

The company's auditor, PwC, was investigated by the Securities and Exchange Commission. The audit engagement partner was found guilty of recklessly violating the anti-fraud provisions of federal law and of engaging in improper conduct, and was barred from acting as an accountant. PwC ultimately paid $225m in settlement of legal claims against the audit firm.

There is a separate ISA (UK) which deals with related parties, that of ISA (UK) 550 *Related Parties*. ISA (UK) 550 recognises that transactions with related parties may carry no more risk than other transactions with non-related parties. However, a fraud between related parties is something that the auditor must consider because it is relatively easy for individuals, especially senior management, to collude with a related party of the entity in order to commit fraud.

Reviews of audit files often find weak procedures in the area of related parties. Remember, the principal audit risk is that of inadequate or incomplete disclosures. Auditors must keep in mind that some disclosures are material in nature.

Management may not want to make certain disclosures because they could be considered to be too sensitive, for example details of salaries, bonuses and pension contributions. Just because a transaction, or a series of transactions, may be considered sensitive, it does not preclude the directors from disclosing them as related party transactions.

Quite often, it is also unclear whether there has been a discussion among the engagement team at the planning stage of the audit as to the susceptibility of the financial statements to fraud because of transactions with related parties. This is a specific requirement of ISA (UK) 550.

Management representation

While there is a requirement for the auditor to obtain a written representation in respect of related parties (ISA (UK) 550, para 26), this representation cannot be used as sole audit evidence. ISA (UK) 580 *Written Representations* acknowledges that written representations, on their own, are insufficient audit evidence, primarily because they are internally generated (see **10.4** below). If the auditor is unable to obtain sufficient appropriate audit evidence through other procedures, it is likely the audit opinion will have to be modified (qualified).

10.4 Written representations

ISA (UK) 580 *Written Representations* provides guidance to auditors on the requirement to obtain written representations from management and, where appropriate, those charged with governance.

During file reviews, the content of the written representation frequently gives rise to review points. For example, incomplete representations or missing representations. Also, as noted above, reliance on written representations as sole audit evidence is also sometimes noted during reviews which contravenes the requirements of ISA (UK) 580 because written representations must complement other forms of audit evidence – on their own they are insufficient forms of evidence because they are internally generated.

The Appendix to ISA (UK) 580 contains a list of paragraphs in other ISAs (UK) which must be included in the written representation letter. This list is reproduced below:

ISA (UK)	Paragraph number
ISA (UK) 240 (Revised May 2021) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	40
ISA (UK) 250 (Revised November 2019) Section A – *Consideration of Laws and Regulations in an Audit of Financial Statements*	17
ISA (UK) 450 (Revised June 2016) *Evaluation of Misstatements Identified during the Audit*	14

ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items*	12
ISA (UK) 540 (Revised December 2018) *Auditing Accounting Estimates and Related Disclosures*	37
ISA (UK) 550 *Related Parties*	26
ISA (UK) 560 *Subsequent Events*	9
ISA (UK) 570 *Going Concern*	12-2(f)
ISA (UK) 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements*	9
ISA (UK) 720 (Revised November 2019) *The Auditor's Responsibilities Relating to Other Information*	13(c)

10.5 Opening balances

ISA (UK) 510 *Initial Audit Engagements – Opening Balances* provides guidance to auditors on opening balances which are those account balances in existence at the start of a new accounting period.

For new audit clients, company law makes provision for the auditor to be provided with access to the predecessor auditor's working papers file in order to obtain audit evidence concerning opening balances. However, certain audit clients are not covered by such a requirement (e.g. pension funds) and so additional audit work will need to be carried out to determine if the opening balances have been correctly brought forward into the current period and whether audit evidence can be obtained to support those opening balances. In some situations, this can result in a modified audit opinion being expressed due to a limitation of scope.

Incoming auditors should remember that just because the prior year's financial statements may have been audited, this does not mean that they can just assume that the opening balances are correct. This is often evident during file reviews and the conclusion reached is that insufficient audit work has been carried out on opening balances.

The incoming auditor must be satisfied, through obtaining sufficient appropriate audit evidence that opening balances are free from misstatement and have been correctly brought forward into the current year from the prior year.

Where the previous auditor has expressed a modified (qualified) audit opinion on the previous year's financial statements and that modification remains relevant and material to the current year's financial statements (e.g. non-attendance at the inventory count), the incoming auditor must modify the auditor's opinion as well.

Client requires an audit for the first time

It may be the case that an existing client breaches the audit exemption thresholds and requires an audit for the first time. If the comparative financial statements have not been audited (e.g. because the client was able to take advantage of audit exemption in the prior year), the auditor must ensure that the auditor's report discloses the fact that the comparatives are not audited.

However, the auditor must also ensure that they are not aware of any possible material misstatement in those opening figures. If the auditor is unable to obtain sufficient appropriate audit evidence that the opening balances are free from material misstatement, the audit opinion must be modified on the basis that the comparative financial statements may not be comparable.

Only auditors of listed entities are mandatorily required to include a Key Audit Matters (KAM) section in the auditor's report in accordance with ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report*. Where the auditor encounters difficulty in obtaining sufficient appropriate audit evidence that the opening balances do not contain material misstatement, this is likely to be a KAM and should be referred to as such in the auditor's report.

Regardless of any potential modification to the auditor's report in respect of opening balances, where the comparative financial statements were not audited, the auditor must include an 'Other Matter' paragraph in the auditor's report which states that the comparative figures are unaudited. This is often forgotten about and an illustration is set out below:

Example – Other Matter paragraph

Other matters which we are required to address

Without qualifying our opinion, we draw attention to note 2 'Basis of preparing the financial statements' and the fact that the company's comparative financial statements were unaudited. For the year ended 31 December 2022, the company qualified as small and the directors took advantage of the exemption in section 477 of Companies Act 2006 and did not require the company to have its financial statements for the year then ended audited.

10.6 Ethical requirements

Often, it is apparent that auditors forget about their obligations under the FRC's Ethical Standard (ES) as they are wholly focussed on ensuring compliance with the ISAs (UK). Compliance with the ES is as important as compliance with the ISAs (UK). Any breaches of the ES must be notified to the competent authority (being the FRC). However, auditors of private entities (i.e. non-PIE audits) are required to notify their relevant professional body of breaches of the ES. This is an issue that is often either forgotten about, or audit firms are unaware of it.

Long association

There are strict rules in place in respect of PIE audits and these must be clearly understood. For non-PIE audits, the long association rules are often overlooked; or, where they are considered, the safeguards applied are often clearly documented.

Where there is a long association threat, the typical safeguards that are implemented are cyclical pre- and post-issuance reviews (or 'hot' and 'cold' reviews as they are commonly referred to). These can provide suitable safeguards to reduce the threat to objectivity, independence and objectivity to an acceptable level, but it is not necessarily the case that such reviews will always reduce the long association threat.

Where there is long association with an audit client, the audit file must include the relevant safeguards that have been applied. In addition, the file should also document the reasons why those safeguards are considered appropriate (it is not enough just to document the safeguard). Reviews of files often indicate neither safeguard nor rationale have been documented adequately.

Non-audit services

The provision of non-audit services is common among non-PIE audit clients. For example, it is not uncommon for the audit firm to be involved in areas such as preparing the statutory financial statements from a trial balance or dealing with the tax computation.

For smaller audits, Section 6 of the ES contains the Provisions Available for Audits of Small Entities. Where there is informed management, the auditor can rely on these provisions provided reference is made to such in the auditor's report. It is often the reference in the auditor's report that is missing.

The primary threat where non-audit services are performed for the client is a self-review threat. This is where the auditor may, for example, be involved in a non-audit activity that involves including an amount or disclosure in the financial statements and then auditing that area. As with all threats, the self-review threat must be mitigated to an acceptable level.

One of the main ways of minimising self-review threats is to have two (or even three) separate teams. For example, where the audit firm is involved in calculating the corporation tax liability, someone from the tax department could calculate the liability; a member of the accounts preparation team could include the liability in the financial statements; and a member of the audit engagement team could audit that area. This reduces the self-review threat because the auditor is not auditing their own work.

Again, it is important that the safeguards applied are clearly documented on the audit file, together with the reasons why those safeguards are appropriate.

For PIE audits, there are strict rules which essentially prohibit most non-audit services being performed. Where a client is a PIE, a sound understanding of these rules is crucial to avoid breaching the ES.

Another issue which crops up every now again and is the performance of due diligence work when an existing client acquires a new business, particularly valuation services. Remember, there are prohibitions on auditors carrying out valuation services where the valuation involves a significant degree of subjective judgement and has a material effect on the financial statements.

Where a client asks the audit firm to carry out due diligence work (particularly that which may involve the provision of valuation services), there must be a clear understanding of the rules. Remember, the ES strictly prohibits the provision of valuation services on the grounds that the self-review threat is considered too high where the valuation involves amounts with a significant degree of subjectivity and which have a material effect on the financial statements.

11 External confirmations (Lecture A837 – 7.59 minutes)

ISA (UK) 505 *External Confirmations* provides guidance to auditors on obtaining external confirmations for use as audit evidence.

An external confirmation is audit evidence obtained in written form by the auditor in response to a request from the auditor. ISA (UK) 505 acknowledges that the response can be in paper form or by electronic or other medium.

There are a couple of points that are worthy of consideration where ISA (UK) 505 is concerned.

11.1 Proposed revisions to ISA (UK) 505

The FRC has recently carried out a consultation to revise ISA (UK) 505 to reflect recent enforcement findings and to ensure that the ISA (UK) is reflective of modern approaches to obtaining confirmations. Comments on this consultation closed on 1 September 2023. A summary of the proposed changes are as follows:

Additional clarification on electronic external confirmations

ISA (UK) 505 currently acknowledges that external confirmations can be obtained electronically. However, the FRC is proposing to include additional wording that clarifies that external confirmations can be obtained through directly accessing information held by third parties through web portals or software interfaces.

Prohibition of negative confirmations

A 'negative confirmation request' is a request where the confirming party responds to the auditor only if the confirming party disagrees with the information provided in the request. The FRC is proposing to prohibit the use of negative confirmation requests.

The FRC has come across instances where auditors have inappropriately relied on negative confirmations, for example where a response was unlikely ever to be received even if there were relevant matters. This calls into question the suitability of negative confirmation requests. In addition, the FRC considers them a less persuasive form of audit evidence compared to positive confirmation requests.

Designing confirmation requests to provide assertion-based audit evidence

Additional material is proposed to be included in ISA (UK) 505 to ensure that auditors design confirmations to obtain sufficient appropriate audit evidence in relation to all assertions identified in respect of ISA (UK) 330 *The Auditor's Responses to Assessed Risks*.

Enhanced requirements to investigating exceptions

The FRC is proposing to include enhanced requirements to the auditor's responsibilities when investigating exceptions. The FRC have come across instances where auditors are not appropriately considering risk when confirmations are not as expected.

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

Effective date

The proposed effective date of the revised ISA (UK) 505 will be for audits of financial statements for periods beginning on or after 15 December 2024.

11.2 Bank confirmation requests

An issue that has seemingly come to the surface relates to obtaining sufficient appropriate audit evidence over the **completeness** of bank balances at the year end.

ISA (UK) 505 does not make it mandatory for an auditor to obtain a bank confirmation letter (often referred to as a 'bank audit letter' or 'bank certificate'). This is now based on the auditor's risk assessment.

Nowadays, clients will often keep a copy of the year-end bank statement that has been downloaded from the online banking system on file and many auditors take a copy of this bank statement and use it as audit evidence to support the balance per the bank statement on the client's year-end bank reconciliation.

Many banks tend not to send out paper bank statements in the post anymore and so an original bank statement may not be available. Where the auditor has not obtained a bank confirmation letter, the completeness of the year-end bank balances still needs to be adequately verified.

There is a risk that the copy of the bank statement downloaded from the online banking system may have been 'doctored' (remember, original documents are more reliable audit evidence than copies). To address this risk, it is advisable to ask the audit client to logon to the online banking system to prove the balances of each bank account at the year end. The auditor should then document that they have done this on the audit file so that the reviewer can see that the completeness assertion has been adequately covered.

While ISA (UK) 505 does not mandate the auditor to obtain a bank confirmation letter, they can still provide the necessary audit evidence, particularly where the auditor may consider the risk of material misstatement of the year-end bank balances to be higher.