

## **Audit implications of the periodic review (Lecture A866 – 16.22 minutes)**

### **FRS 102 periodic review**

After considering the feedback from FRED 82 *Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs – Periodic Review*, the final amendments were published by the FRC on 27 March 2024.

### **Effective date**

Application is for periods commencing 1 January 2026. Early adoption is permissible provided all the amendments are adopted at the same time.

### **Changes**

The amendments include:

- a new model for revenue recognition in FRS 102 and FRS 105;
- a new model for lease accounting in FRS 102; and
- numerous other incremental improvements and clarifications.

### **Why is this an audit issue?**

*Complexity* – the revised FRS 102 takes a more sophisticated approach to leasing and revenue. This will result in there being more areas where audit evidence needs to be obtained, particularly on transition to the revised standard.

*Independence* – transition to the revised FRS 102 approach in respect of leasing and particularly revenue will not be easy. Management in SME audited entities will often not have the necessary knowledge and skills to do this unassisted. To what extent could the auditor help in providing a non-audit service?

### **Leasing**

#### **Changes to the standard**

The aim of these amendments is for FRS 102 to be aligned more closely to IFRS® 16 *Leases*, with most leases (except leases of low-value assets and short-term leases) coming on-balance sheet. There were several simplifications when compared with the international standard, including (but not limited to):

- The ability to use the interest rate implicit in the lease or, if not readily determinable, the lessee's incremental borrowing rate or the lessee's obtainable borrowing rate.
- A few simplifications to lease modifications which mean fewer modifications will require a revised discount rate to be used.

- Simplifications to variable lease payment recognition (the impact of which is taken to profit and loss rather than adjusting the right-of-use asset and lease liability).

There are transitional exemptions available with the use of the modified retrospective approach, which applies the impact cumulatively at the start of the first period of adopting the amendments. There is no option available to restate comparatives. There are also a number of practical expedients available (such as using a single discount rate for a whole portfolio of leases with reasonably similar characteristics).

Where the low-value asset and short-term lease exemptions are taken, disclosure will be required similar to what we currently see for operating leases.

### **Key audit issues?**

Management will be required to make judgments concerning:

- low values assets and short-term leases;
- lease terms; and
- discount rates.

Auditors will need to evaluate these judgments and obtain audit evidence to support management's assertions.

### **Independence issues**

The biggest issue arises from determining discount rates to calculate the net present value of lease liabilities. Where management does not have the ability to do this themselves, the consequential management and self-review threats could be very significant.

Could management simply ask the auditor to determine this figure for them (as a non-audit service)? Assuming that the issue is material, the answer is almost certainly, 'no'. The issue requires judgement and the threats to independence could not be appropriately addressed with safeguards.

The auditor, however, might be able to assist to some lesser extent, by providing guidance. Safeguards would be needed in this respect, which should also be documented on the audit file, together with the reason *why* those safeguards reduce threats to independence and objectivity to an acceptably low level.

### **Revenue**

#### **Changes to the standard**

The revisions to UK and Ireland GAAP (in this case both FRS 102 and FRS 105) see an aligning of the revenue recognition principles to IFRS 15 *Revenue from*

*Contracts with Customers*. These five steps (as discussed earlier in the course) are:

Step 1: Identify the contract(s) with a customer.

Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract.

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation.

There are a few simplifications compared to the international standard, such as not having to consider the time value of money if payment is within six months of transferring the goods/services (although this is unlikely to be a significant issue when applying the concept of materiality in any case).

While many of the requirements in the amended FRS 102, Section 23 are consistent with the IASB's Exposure Draft of the third edition of the *IFRS for SMEs Accounting Standard*, there are some specific amendments which permit entities to use an accounting policy for revenue and which meets the requirements of both FRS 102 and IFRS 15 as follows:

- The amendments require an entity to account for a warranty as a separate promise when the warranty provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. This applies even if the warranty is insignificant to the contract.
- The amendments allow an entity to account for an option to provide a customer with a material right as a separate promise when the effect of doing so is insignificant to the accounting of the individual contract.
- There is a requirement for refund liabilities to be measured at the amount of consideration received (or receivable) to which the entity does not expect to be entitled (i.e., amounts not included in the transaction price).

### Key audit issues?

The key issues to carefully consider are as follows:

- Does management do the work to establish the appropriate accounting policy to comply with the five-step approach?
- Do they do it properly?
- Do they document their work?

- If necessary, is there corroborating audit evidence to support any relevant management assertions?

### **Independence issues**

Carrying out the above to ensure the entity's revenue recognition practices comply with the five-step model may be completely beyond the management of many audited entities.

Establishing accounting policies is the role of management and the auditor is very limited in terms of how much assistance they can provide.

### **Other issues**

#### **Transition**

There are many requirements relating to transition for lease accounting and revenue. Auditors will need to watch for compliance with these and appropriate presentation and disclosure.

#### **Small company disclosures**

Whilst most small companies are not subject to audit, some are. There are extensive additions to the disclosure requirements for small entities in the UK, some of which management might be reluctant to make (e.g. dividends paid or payable).

Auditors will need to be aware of these changes.

### **Documentation**

As always, auditors will need to document their work to include:

- An evaluation of management's approach.
- Sufficient appropriate audit evidence.
- Basis for the auditor's conclusions.
- Consideration of independence issues.