In a previous edition of audit news we looked at the impact of FRS 102 and potential audit issues arising on transition. During recent monitoring visits, there have been some common issues raised on files reviewed by the monitoring team, and we have prepared a follow up article summarising some of these issues. This edition also includes further information on the FRCs new compendium of audit reports, and guidance on Responsible Individual (RI) status and signing audit reports.

Auditing FRS 102 – an audit monitoring update

In a June 2016 Audit News article, we looked at the impact of FRS 102 and potential audit issues arising on transition.

During recent monitoring visits, there have been some initial common issues raised and, whilst most firms appear to have taken steps to prepare for the new standard, some firms have been surprised by the degree of preparation needed. This includes underestimating the transition workload, including time taken in reformatting information and determining what information is required to be disclosed, particularly in relation to transition adjustments.

The following article summarises some of the key issues raised on monitoring visits so far in 2016.

As with all changes in accounting framework, the move to FRS 102 has not been straightforward. From discussion with firms during recent monitoring visits, it is clear that FRS 102 has posed a number of challenges, not least unanticipated increases in the time taken to prepare financial statements. There have been further challenges in engaging with clients who perhaps don't appreciate the complexity of the changes or the time commitment involved, and all of this compounded by accounting software issues.

Technical issues
A large number of recent FRS 102 financial statements reviewed by ICAS Audit Monitoring (ICAS AM) have required no transition adjustments. While this is not unusual or unexpected, firms are reminded that there are still several technical issues to work through on the audit file, and the auditor's consideration of these areas should be clearly documented.

The most common issue raised on initial reviews relate to FRS 102 considerations not being clearly documented, and ICAS AM have been unable to determine how the firm has concluded over certain technical areas. There have been further issues where firms have concluded that transition adjustments would not be material, but have not quantified an unadjusted error, documented the auditor's conclusion or evidence that these matters have been discussed with the client.

Some of the better documented files have included a schedule at planning. clearly setting out technical issues under the new standard, the potential impact on the financial statements, and a clear conclusion (i.e. that there is no impact; or, if there is an impact whether this will result in a transition adjustment or unadjusted error).

The **five most common** issues highlighted on file reviews to date are set out below –

1. **Holiday pay accrual**

   It is now mandatory to accrue for holiday pay in the financial statements, particularly if it is a material amount. This will generally be the case where the accounting year end does not coincide with the holiday year end.

2. **Deferred tax for all property revaluations, including investment properties**

   Deferred tax must now be provided on all revaluations of property. Previously there was no requirement to provide deferred tax where there was no intention to sell those properties. Assuming property values have risen resulting in an increased deferred tax liability, the debit entry in the financial statements will either be reported in retained profit (investment property) or in revaluation reserves (heritable property).

Firms are reminded that, under FRS 102, all gains and losses on investment properties must be reported directly in profit and loss despite the fact that the properties have not yet been sold. On transition, this requires reclassification of the investment property revaluation reserve to retained earnings.

The presentation of capital and reserves will be different on application of FRS 102, as amounts that would previously have been shown in a revaluation reserve will be part of the accumulated profit and loss account. An entity choosing not to show a separate revaluation reserve may wish to transfer fair value movements on investment properties out of retained earnings into a separate non-distributable reserve.

3. Reassessment of the depreciable amount of property, plant and equipment

Under FRS 102 the residual value of property, plant and equipment must be regularly re-estimated. Auditors will have to look carefully at very large assets of property, plant and equipment to ascertain whether the residual value used in calculating the annual depreciation charge is appropriate at transition and the risk that current prices at each reporting date will have changed such that depreciation is materially misstated.

The auditor will also need to consider how best to obtain evidence that establishes what a current price for an asset at the reporting date should be. A common issue has been raised on visits where the audit file documents that depreciation policies are consistent with prior years, however does not address whether the residual value used in calculating depreciation is still appropriate.

4. One off revaluation of property at the date of transition

Under Section 35 of FRS 102, companies can avail of the option to carry out a one-off valuation of property even if they have never revalued previously. This valuation is adopted as deemed cost going forward. Companies that are currently revaluing under old UK GAAP can also elect not to continue to revalue but adopt their last valuation as their deemed cost going forward.

Firms are reminded that this has an impact on deferred tax, as a liability will have to be created for the potential tax due on sale of these properties.

5. Financial transactions

FRS 102 introduces the concept of financing transactions, which occur if payment is deferred beyond what might be considered normal terms or is financed at below a typical market rate of interest (i.e. an intercompany or related party loan).

The standard requires that these transactions be measured at the present value of future cash flows, discounted using the market rate for an equivalent arm's length loan at the date of the transaction. This will result in a difference from the nominal value.

Using a simplified example:
On 1 January 20X1 a company obtains an interest -free loan of £1,000. The loan is repayable in full in two years' time, on 31 December 20X2. The market rate of interest for similar loans is 5.4%per annum. The net present value of the loan is approximately £900 ($1{,}000/1.054^2$). The accounting for the £100 difference will depend on who the transacting parties are and the nature of the transaction.

For example, where a loan is made from an owner (a holding company or principal shareholder), the gift element can potentially be shown as a capital contribution added directly to the reserves of the borrowing entity. In other cases, the amount would have to be shown in interest.

Loans between subsidiaries are more complicated – if the loan was made on the instructions of the parent this could be a capital contribution. If not, the shortfall should be treated as interest. Similarly, in the case of interest-free loans between a company and its directors and/or shareholders, a loan with a shareholder may be accounted for as a capital contribution. On the other hand, on a loan with a director who is not a shareholder, the shortfall should be accounted for as interest.

> If a loan is stated to be repayable on demand, or there are no clear repayment terms, notional interest does not arise. A loan would be regarded as repayable on demand so long as the lender retains the right to demand payment, whether or not the entity has the resources to pay.

Further guidance regarding financing transactions can be found in the FRC Staff Education Note 16 (SEN 16) which is available on the FRC website.

Disclosure issues

All new standards require a degree of interpretation and some elements of FRS 102 are more complex than others. Consequently, there are areas of more detailed disclosure under the new FRS, particularly in the case of accounting policy notes, and a number of issues have been raised due to omitted policies or where the policy wording in a certain area reflects old UK GAAP. Common issues are as follows:

- No transition note disclosures when adjustments have been made;
- An accounting policy note which states that adjustments have been made on transition, when in fact there have been no adjustments;
- Insufficient revenue recognition polices – remember that FRS 102 requires revenue to be recognised on the transfer of risks (sale of goods) or percentage completion (provision of services or construction);
- Property plant and equipment policies omitting any reference to residual values or impairment;
- Omission of a current tax policy; and
- Omission of a financial instruments policy.

Firms are also reminded that:

- Operating lease commitments should disclose the total (rather than the annual) commitment due AND the lease payments made in the year as an expense;
- Key management personnel compensation should be disclosed in total. It is further recommended that where KMPs are restricted to directors' that this fact be disclosed;
- The legal form of the entity, it's country of incorporation and the address of the registered office should be clearly disclosed; and
- The nature of the entity's operations and its principal activities should be clearly disclosed, unless already in the business review or similar statement.

Accounting software

With accounts preparation software becoming more important to practitioners, the reliance on such software has come under the spotlight.

Some firms have been disappointed with the content and quality of disclosures produced by some software systems, and the amount of time needed to resolve issues arising during the audit and accounts preparation has, in some cases, been considerable. Firms have encountered quite fundamental issues with their accounts preparation software, such as figures not agreeing, comparative figures disappearing, and updates not being compliant in all respects.

We would encourage firms to provide any such feedback to their software providers. That being said, there is an overriding requirement to ensure the disclosures in audited financial statements are correct, and the responsibility rests with the firm to review these in detail.

In this regard, firms are encouraged to maintain staff and RI training in the requirements of the new standard, and expand the firms technical resource and reference material to include a robust and detailed disclosure checklist or model FRS 102 financial statements.

Going forward

It is clear that we are at the beginning of a long and steep learning curve and, next year, smaller entities will fall under the standard for the first time. FRS 102 section 1A includes a section for small entities (now for turnover of up to £10.2m; balance sheet total of up to £5.1m; and 50 or fewer employees).

While section 1A sets out the different presentation and disclosure requirements, there are **no** recognition or measurement simplifications available.

FRC publishes a new compendium of illustrative audit reports

The Financial Reporting Council (FRC) has published a Compendium of illustrative auditor's reports on United Kingdom private sector financial statements for periods commencing on or after 17 June 2016. The Compendium contains examples of auditor's reports illustrating the reporting requirements of the recently revised International Standards on Auditing (UK) (ISAs (UK)) effective for audits of financial statements for periods commencing on or after 17 June 2016.

The recent revisions to the ISAs affect both the auditor's duties and the wording of auditor's reports on the financial statements of companies. This new compendium of reports provides a useful reference source for practitioners, and is designed to be persuasive rather than prescriptive.

The FRC has also published on its website the description of the auditor's responsibilities for the audit of the financial statements which auditors are permitted to cross-refer to in their auditor's report.

The Compendium replaces the guidance in:

- Bulletin 2010/2 Compendium of Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements for periods ended on or after 15 December 2010 (Revised) (Updated March 2012); and
- Bulletin 4 Recent Developments in Company Law, The Listing Rules and Auditing Standards that affect United Kingdom Auditor's Reports (Revised) (Updated June 2015),

accordingly, these Bulletins are withdrawn.

Responsible Individuals and signing audit reports

The granting of a practising certificate, admission to partnership, becoming an Affiliate of ICAS, or even just writing to ICAS, does not automatically approve someone to sign audit reports.

Anyone who intends to sign an audit report must first need to ensure that they have applied to become a Responsible Individual (RI), and this application requires approval by ICAS before an individual can commence acting as an RI.

All audit reports, therefore, which are signed on behalf of a firm registered with ICAS to conduct audit work, are required to be signed by an individual who can demonstrate that they have met the necessary criteria and is suitably qualified and experienced to sign such a report. The individual must not undertake the role of an RI or any activities of an RI until they have received notice from ICAS that the RI application has been successful.

It is important to note the distinction between 'audit qualified' status and 'RI' status. 'Audit qualification' is obtained from an RQB (Recognised Qualifying Body). This is awarded where an individual has achieved sufficient knowledge and supervisory experience in audit, through examination and work experience gained within an Authorised Training Office. Note, however, that audit qualification alone is not sufficient to authorise an individual to sign audit reports, and this can only be done by those who have also then been approved as an RI by the Recognised Supervisory Body (RSB) which regulates the audit firm.

The Committee has required to consider a number of cases recently in relation to ACCA principals where firms have mistaken the "PC AQ" (Practising Certificate Audit Qualified) status held by those principals as being RI status. All ACCA principals holding PCAQ must still apply for RI status with the RSB which registers their audit firm (e.g. an ACCA member working in an ICAS audit registered firm must still apply to ICAS to become an RI).

In addition, where an RI moves firm they must also reapply to become an RI of the new firm – the status does not automatically move with the individual.

Guidance to those applying for RI status

In applying for RI status an individual must demonstrate that they have met the necessary criteria and that they are suitably qualified and experienced to act in this capacity. The following are the considerations that the Authorisation Committee takes into account:

The requirements under the Audit Regulations

Audit Regulation 4.01 states that a firm's audit compliance principal may designate as a RI any of the firm's principals or employees who:

- has an appropriate qualification i.e. the 'audit qualification';
- is competent to conduct audit work; and
- is allowed to sign audit reports in their name on behalf of the firm.

When completing the application to become an RI, each applicant is asked to provide details of their skill set and audit experience in the previous 24 months. If the applicant's recent audit experience is not considered to be sufficient by the Authorisation Committee, there are two courses of action that may be adopted:

<u>1) Conditions</u>
Conditions may be placed on the granting of the RI status, such as:

- initial assignments as an RI are to be subject to a hot file review, and/or
- further audit training specified by the Authorisation Committee is undertaken during the forthcoming year.

<u>2) Gain further experience before reapplying</u>
The applicant may be asked to withdraw their application and to gain further experience before reapplying. Further experience may be gained by:

- Attendance at relevant audit training courses; and/or
- Mentoring with an auditor/RI.

Further guidance can be found by searching 'audit registration' on icas.com

Failure to apply for RI status could result in the Authorisation Committee taking regulatory action against the firm. Firms are, therefore, urged to ensure that sufficient time is given to succession planning, and to planning for new RIs joining the firm or being promoted within the firm.