Audit News – Spring 2022/23

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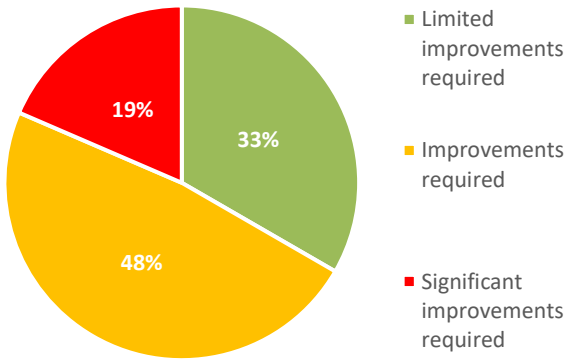
Audit Monitoring: Our 2022 findings

Michael Lavender, ICAS Audit Monitoring's Senior Regulatory Reviewer, shares some key insights on what we found during our 2022 monitoring visits, to help give some food for thought when firms are establishing their Systems of Quality Management under ISQM (UK) 1.

2022 was an unusual year for ICAS Audit Monitoring, which saw a significant degree of change in the review team. As a result, there were fewer audit monitoring visits conducted with the 14 visits undertaken focusing on firms that had not been visited for six years. As the visit schedule was somewhat different to a 'typical' year, we expect that the visit findings might not be readily comparable to previous years. However, there are still key themes and common findings that all audit registered firms should take in to account and can learn from.

Every file reviewed in 2022 was considered to require some degree of improvement, with no files being considered a grade 1, or "satisfactory", standard. This was a concerning result, with 77% of the files requiring more than limited improvements. While a small number of 2022 visits are awaiting consideration by the ICAS Authorisation Committee, and as such have not yet been formally completed, initial findings are provided below for reference.

Audit file quality 2022



Most common International Standards on Auditing (ISAs) (UK) breaches

1. ISA (UK) 230 – Documentation (79% of visits)
Weaknesses in audit documentation remain extremely common in the files reviewed. Typical examples include working papers that do not clearly set out the nature and extent of audit testing conducted, or where the audit work had not been documented in sufficient detail to allow the audit monitoring reviewer to understand the results of the audit procedures performed, the conclusions reached, and the significant professional judgments made in reaching those conclusions. There were also instances where audit work, or supporting evidence, was held by the auditor but had not been added to the audit file.

2. ISA (UK) 500 – Audit evidence (71% of visits)
Obtaining sufficient appropriate audit evidence over all material transactions, balances, and disclosures is one of the fundamental requirements of the ISAs, and absolutely essential in conducting a quality audit. However, the monitoring team found weaknesses in audit evidence in the majority of visits conducted in the year. Common issues included:

- Material transaction streams, balances, and/or disclosures not being subject to dedicated substantive audit testing. Firms should be aware that, irrespective of the assessed risks of material misstatement, the ISAs require substantive audit procedures over each material class of transactions, account balance, and disclosures.
- Substantive testing being conducted in a way that does not properly address the audit risk identified. This included testing being conducted against the wrong assertion – such as sample testing designed to test the completeness of revenue being selected from the accounting records (and as a result testing the occurrence assertion).
- Areas of significant estimates and judgements not being adequately considered (e.g. the work of a management expert not being subject to sufficient consideration; or significant accounting estimates, such as those over construction contracts, not being considered under the full requirements of ISA (UK) 540).

3. ISA (UK) 315 – Risk assessment (57% of visits)
Reviewers regularly found areas where risk assessment procedures have not been adequate, with related breaches being raised in the majority of reviews. The most common driver for a breach of ISA (UK) 315 was insufficient audit work being conducted at the planning stage in order to understand, and document, the internal control environment relevant to the audit. This is often as a result of systems work not being documented over all relevant transactions streams (e.g. no system notes being held over payroll), or where the auditor has not determined whether the relevant controls identified have been implemented (e.g. a 'walkthrough' test has not been conducted, or has relied solely on inquiry of client).

4. ISA (UK) 240 – Fraud (50% of visits)
Half of the monitoring reviews conducted in 2022 found weaknesses in fraud considerations. These fell broadly under two categories:

1. Management's assessment of fraud risk had not been sufficiently considered and documented at the planning stage. Firms should ensure that, in addition to asking the client about known or suspected frauds, all audit files record:
    a. Management's assessment of the risk of material misstatement due to fraud;
    b. Management's process for identifying and responding to the risks of fraud;
    c. Management's communication, if any, to those charged with governance (TCWG) regarding its processes; and
    d. Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.
2. Insufficient consideration of presumed significant risks relating to fraud in revenue recognition and from management override, due to one or both of these risks being omitted from audit planning, or the planned testing being insufficient in order to address the risk. In particular, reviewers regularly found that insufficient substantive testing had

being conducted over journals and other adjustments in response to the significant audit risk from management override. Firms are reminded that every audit file should demonstrate:

a. Inquiry of relevant individuals about inappropriate or unusual activity;
b. Substantive testing of specific journals and other adjustments at the end of a reporting period;
c. Consideration of the need to test journals and other adjustments throughout the period;
d. A review accounting estimates for biases; and
e. An evaluation of the rationale for significant transactions outside the normal course of business.

5. ISA (UK) 550 – Related parties (43% of visits)
A significant number of monitoring reviews identified non-compliance with the ISA requirements in relation to related parties. This typically reflected cases where audit planning had not sufficiently considered the completeness of potential related parties (e.g. where other interests of directors, or their close family members, had not been identified); where audit testing had not been conducted to ensure the completeness of related party disclosures; or where audit evidence had not been obtained in response to a management assertion that related party transactions were conducted on an 'arm's length' basis.

Common breaches of the Audit Regulations

1. Audit Regulation 3.10 - Compliance with the ISAs (UK)
See commentary above for common weaknesses in ISA (UK) compliance.

2. Audit Regulation 3.20 - Audit Compliance Review (50% of visits)
The Audit Compliance Review process is a key part of a firm's approach to audit quality. This internal monitoring becomes even more important under the new ISQM (UK) 1, so it is vital that firms invest time and effort to identify and improve on any deficiencies,

The findings during 2022 related to the old ISQC (UK) 1 and common issues identified in the year included:

- A formal Audit Compliance Review not being conducted, or the findings of a firm's review of compliance with the audit regulations not being consistent with that of the monitoring team (e.g. where the monitoring team had identified an issue with the firm's eligibility that was not identified in the firm's own compliance review process).
- A process of Cold File Reviews not being conducted in order to inform the firm's Audit Compliance Review, or weaknesses being identified in the firm's process. The most common issue in this regard was firms not conducting a Cold File Review process at all, which reflects a clear breach of the requirement. The monitoring team also noted instances where the findings of an internal Cold File Review process were not consistent with the findings of the monitoring team; and where firms had not sufficiently remediated issues identified by Cold File Reviews on subsequent audit files.

3. Audit Regulation 3.03 – Acceptance and reappointment (43% of visits)
Reviewers found breaches related to acceptance procedures in almost half of the reviews undertaken in 2022, with the majority of these relating to firms' consideration of ethical compliance at the outset of an audit. The FRC's Revised Ethical Standard 2019 sets out specific requirements relevant to ethical considerations that may arise in audit engagements, and compliance with the requirements of the Standard forms an integral part of every file review conducted by the monitoring team. Any breach of the Ethical Standard has the clear potential for the ICAS Authorisation Committee to take regulatory action. The most common weaknesses identified in 2022 were:

- Insufficient documentation being held at the outset of the audit demonstrating that Ethical Threats (such as the management, self-interest and self-review threats that

commonly arise from the provision of non-audit service) had been identified, and that appropriate safeguards had been implemented in response; and

- Insufficient safeguarding of the threat from long association, where the additional safeguarding required by the FRC's Revised Ethical Standard 2019 had not been implemented. Firms are reminded that under the revised standard, a specific safeguard needs to be applied to the threat (in addition to communication of the matter to the client). Appropriate safeguards may include:
    - Appointing another Responsible Individual ('RI') to lead the audit (*something that may not be possible in some smaller audit firms*);
    - involving an additional partner, who is not and has not recently been a member of the engagement team, to review the work done by the partners and the other senior members of the engagement team and to advise as necessary (*some smaller firms may not have another partner, independent of the audit team, with sufficient recent audit experience to conduct a review of this nature*); or
    - arranging an Engagement Quality Review ('EQR' as its known under ISQM (UK)1 – this was previously known as EQCR under the previous ISQC (UK) 1) of the engagement in question (*which may require an external reviewer to be engaged if a firm only has one RI*).

4. Audit Regulation 3.08 – Statutory requirements (43% of visits)
These breaches reflect areas where disclosures made in the financial statements; or other areas of reporting, were found to be significantly deficient and/or where an accounting policy was found to be non-compliant which had not been identified through the audit process.

5. Audit Regulation 2.03 - Audit eligibility (14% of visits)
While less common, there have been a number of cases where firms have been found to have breached the eligibility requirements of the Audit Regulations as a result of principals not being appropriately notified to ICAS and/or affiliate applications not being submitted for principals that are not members of ICAS, ICAEW, ICAI, or ACCA.

Breaching the eligibility requirements is a significant matter, which will be reported to the ICAS Authorisation Committee, with the clear potential for regulatory action, such as a Regulatory Penalty, being proposed depending on the circumstances surrounding the breach. Firms are reminded of the importance that:

- ICAS is notified of all changes in principals on a timely basis (within 10 business days);
- Any principals of an audit firm who are not members of ICAS, ICAEW, ICAI, or ACCA will likely require an Audit Affiliate application to be submitted;
- Principals with the audit qualification must hold sufficient rights to direct the firm's overall policy or alter its constitution, i.e. at least a majority control (NB. If the firm is an LLP or an Unincorporated Partnership and has no formal partnership agreement, all members/partners will be considered to have equal voting rights).

Author: Michael Lavender, Senior Regulatory Reviewer

ISQM (UK) 1: What does this mean for ICAS audit monitoring visits?

As explained in the last edition of Audit News, effective from 15 December 2022 all audit firms are required to have designed and implemented a System of Quality Management (SOQM) which complies with the new International Standard on Quality Management (ISQM) (UK) 1.

This means that for all audit monitoring visits conducted from 1 January 2023 onwards each firm's quality performance will be monitored against this new standard as well as the other new quality management standards, ISQM (UK) 2 and ISA 220 (UK) Revised.

What are the main changes?

- *Duration:* The scope of the Audit Monitoring visit has expanded significantly meaning that the visit will, at least in the short to medium term, take longer in duration – expected to be at least one additional day on the shortest visits. The anticipated time for the visit will continue to be notified to your firm on your visit notification letter.

- *What you need to get ready*: The Visit Questionnaire & Documents List has been updated to reflect the increased scope of the visit. Given the new information requirements, you should ensure that your firm gives enough time to prepare for the visit.

- *New areas covered on the visit*: much of the visit format will be the same as before i.e. there will be an opening meeting, followed by file selection, file reviews, and discussion with each Responsible Individual (RI) on the findings from our file reviews. The big difference now is that for our 'firm-wide' work instead of just reviewing your audit quality policies and procedures we will focussing on your full SOQM, and particularly:
    - *Roles:* how your firm has allocated the roles of ultimate responsibility and operational responsibility for the SOQM;
    - *SOQM*: whether you have implemented an effective SOQM, including:
        - identifying Quality Objectives (i.e. that your firm has documentation setting out 'what you are trying to achieve');
        - identifying and assessing Quality Risks (i.e. that your firm has documentation where you have identified 'what could go wrong' and then your firm has risk assessed the likelihood and impact of each risk): we will be reviewing your quality risk assessments in detail;
        - implementing Quality Responses (i.e. that you have documented policies and procedures that address 'how do we deal with these risks'): we will be reviewing your quality policies and procedures in details– this is similar to what we used to do previously under ISQC (UK)1 but now:
            - we will be considering whether these policies and procedures are effective at mitigating the quality risks you have identified;
            - your quality risk assessment may have identified the need to introduce additional policies and procedures that we will not have reviewed before, and we will have to review these during the monitoring visit.

      During our assessment of your SOQM, we will be considering how well you understand your firm and its quality risks and whether your policies and procedures are adequate to mitigate these risks. Every firm is different, and we are looking to ensure that you have a thorough understanding of the unique nature, circumstances, events and conditions that impact your firm's quality management. So, we are likely to have to spend more time in discussions with you during the visit. If, for example, we identify risks during the visit that your firm has not identified, this will indicate that there are weaknesses in your SOQM.

    - *Monitoring and remediation:* Similar to before, we will be reviewing your own internal monitoring (i.e. what we called the audit compliance review) whether you conduct it yourselves or contract this to an external organisation. However, now, for any monitoring reviews conducted after 15 December 2022, we will be reviewing:
        - how you analysed the monitoring findings and identified the most serious issues (called deficiencies);
        - we will ask to see your root cause analysis ('RCA') work, as you should be conducting an RCA for every deficiency identified;
        - we will be asking you for your action plans and will assess how you are tracking progress in remediating (a) your monitoring findings and (b) the causes identified during the RCA.

So they key thing to remember now is that its not just about conducting effective internal monitoring, which has been a challenge for some firms (as can be seen from our annual monitoring findings, on page 1) but the actions you take to improve the issues you have identified.

We would advise you to invest time now in an effective monitoring and remediation process, even if this means engaging with an external service provider, given the significant changes requires under ISQM (UK) 1.

Will the outcome of the visit change?

Whilst we understand there is a very steep learning curve for firms on top of all the other pressures, the FRC has made it clear to the RSBs (Recognised Supervisory Bodies) that they expect us to take robust action where there are shortfalls in implementing an effective SOQM, particularly given the time periods between monitoring visits. We therefore expect that more firms are likely to be placed on follow up submissions by the Authorisation Committee, but we hope that most firms will be able to turnaround improvements quickly.

Alongside the typical follow up action conditions that the Authorisation Committee currently set for firms following monitoring visits, such as hot and cold file reviews or training plans, we expect that there will be additional requirements, such as submission of:

- Root Cause Analysis as part of report responses;
- SOQM documentation to evidence improvements made; and
- Action plans, and progress tracking against action plans.

As we stated before in our recent implementation videos, firms will receive much more favourable outcomes if they have tried their best to implement their SOQM, even if there are some shortcomings, than not having started the process at all. So, we urge firms to invest the time and effort now.

Author: Lesley Byrne, Director, Regulatory Monitoring

ISQM (UK) 1: FRC Releases new guidance on audit firm eligibility

ICAS recently asked the Financial Reporting Council ('FRC') for clarification in relation to a specific UK requirement in ISQM (UK) 1. The FRC has now issued updated guidance on audit firm eligibility which addresses this issue, as is explained below.

The issue

Paragraph 20 of ISQM (UK) 1, which derives from the original IAASB standard, requires that the firm allocates both ultimate responsibility and operational responsibility for the System of Quality Management ('SOQM'). This paragraph requires that the person with ultimate responsibility is the CEO, managing partner or managing board. As explained in our video 'ISQM (UK)1 Unwrapped' the intention was to ensure that the person at the very top of the firm holds responsibility and those with operational responsibility have accountability and support from that person.

However, the UK additions to the international standard, at paragraph 21-2, additionally require that the persons with ultimate and operational responsibility are 'eligible for appointment as a statutory auditor' (this is because of statutory requirements in UK legislation called 'SATCAR' The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019 (2019 No. 177) Part 4 Regulation 83(a)), which in this context means 'holds an audit qualification'.

Whilst this means that the person with operational responsibility must hold an audit qualification, we would anticipate that in most firms the person with operational responsibility will be the Audit Compliance Principal, who holds the audit qualification and RI status, or at least another audit professional with an audit qualification.

However, this begged the question, what happens when a managing partner or CEO, who is meant to hold ultimate responsibility, isn't audit qualified? This was the question we asked the FRC.

The clarification

The FRC has updated its staff guidance note on 'Guidance Eligibility for Appointment as Statutory Auditor'. One of the matters this guidance covers is the eligibility requirements for the persons with ultimate and operational responsibility for the system of quality management.

It clarifies that in the situation where an audit firm's CEO or managing partner is not eligible for appointment as a statutory auditor i.e. doesn't hold an audit qualification, ultimate responsibility and accountability for the system of quality management needs to be assigned to the firm's managing board of partners, of which at least one of those individuals would need to hold the audit qualification. This means that the person with operational responsibility (such as the ACP) should report to a managing board where at least one of the board holds the audit qualification.

Our current understanding is that, in practical terms, within a small firm (for example a firm with two or three partners), the ISQM (UK) 1 requirements would be satisfied by SOQM matters, such as the results of monitoring, being considered at normal partner meetings which is attended by managing partner/CEO, and where at least one of the partners holds the audit qualification.

The guidance also covers the following:

- key audit partners
- engagement quality reviewers
- public sector considerations
- local audit considerations

Authors: Lesley Byrne, Director Regulatory Monitoring & James Barbour, Director, Policy Leadership

ISQM (UK) 1: A reminder of key resources

Firms are reminded of the ISQM (UK) 1 resources available as follows:

Links to ICAS guidance and videos

- **ISQM(UK)1 implementation guidance:** Highlights certain key elements of ISQM (UK) 1 and provides tips on how to implement the standard, including useful examples. Read it here.
- **Video: 'ISQM (UK) 1 unwrapped'**: A short summary of the main changes from ISQC (UK) 1 and the main requirements in the new standard. Find it here.
- **Video 'ISQM (UK) 1: How to get started':** Shares practical tips on setting up a System of Quality Management and can be accessed here.

Further videos and implementation guidance can be found on the quality management page of icas.com here and an ICAS webinar sharing the tips from two ICAS firms on how to go about implementing ISQM (UK) 1 is available here.

Links to the new and revised UK quality management standards

ISQM (UK) 1

ISQM (UK) 2

ISA (UK) 220 (Revised July 2021)

Conforming amendments to other ISAs and related materials (as introduced by the IAASB)

FRC Feedback Statement and Impact Assessment

IAASB resources

The IAASB has created a suite of resources and material to support audit firms in the transition to the new quality management approach.

First time implementation guides:

ISQM 1

ISQM 2

ISA 220 (revised)

Webinar series

Article by IAASB Chair, Tom Seidenstein

Quality management videos

Author: Lesley Byrne, Director, Regulatory Monitoring

Reporting breaches of the FRC Ethical Standard

Firms are reminded of Section 1.21 of the FRC Revised Ethical Standard 2019 (ES) which requires firms to report all identified breaches of the Ethical Standard to its competent authority for audit in the UK on a biannual basis. For firms that audit public interest entities (PIEs), the notifications should be made to the FRC. All other firms should notify their Recognised Supervisory Body (e.g. ICAS). Additionally, the ES requires TCWG of the relevant entity to be informed.

The ES recognised that an inadvertent breach would not necessarily call into question the firm's ability to give an audit opinion, provided that:

- the firm has established policies and procedures that require all identified breaches to be promptly reported to the engagement partner or to the Ethics Partner, as appropriate;
- the engagement partner or ethics partner promptly notifies the team that any breach is to be addressed as soon as possible and ensures that such action is taken;
- safeguards, where appropriate, are applied;
- the actions taken and the rationale for them are documented; and
- where the breach relates to the provision of non-permitted non-audit services to a public interest entity, the engagement partner reports as required in the audit report.

Prompts designed to ensure compliance with the ES will be a fundamental component of any ISA (UK) compliant set of audit procedures, and potential threats under the ES, and resulting safeguards applied, should be clearly recorded at the outset of each audit. However, there remains the risk that a breach of the ES is not identified during the audit process, and only comes to light through subsequent quality management procedures (such as internal or external cold file review) or through other means. Firms must ensure that any breaches identified, either during an audit, or afterwards, must be reported.

The most common examples of ethical breaches we see in ICAS Audit Monitoring are (but are not limited to):

- long association without implementing appropriate safeguards;
- fee dependence (i.e. fees regularly exceeding 10% without the required independent engagement quality review).

What should be submitted?

Details that should be sent to ICAS at regulatoryauthorisations@icas.com include:

- Firm information – firm name, number and the RI responsible for the audit client.
- Audit client information – name and year end.
- Information about the breach - full details of the breach, enclosing supporting documents if appropriate.
- Which requirement of the ES has been breached (please identify the relevant section of the ES – the standards can be found **here**).
- Details of any safeguards which the firm had in place that may have mitigated the breach.
- A breakdown of the fees charged to the relevant client(s) during the period of the breach (this should include the audit fees charged, any non-audit services charged and a total of the full fees charged to the client).
- Timeline of events – date of the breach, when and how it was identified, when the client was informed, date of remedial action taken.
- Details of remedial actions taken by the firm (e.g. whether management and TCWG have been informed; whether the firm's own governance has been informed (e.g. Ethics Partner, persons with ultimate responsibility for the SOQM, and Management Boards/ Committees etc), sanctions taken by the firm against the RI, any safeguards taken such as second partner review, resignation as auditor etc).
- Any other relevant information.

What happens next?

These breaches will be considered by the Regulatory Authorisations team. The outcome of this review will depend on the nature and circumstances of the ethical breach. Possible outcomes include:

- No action is considered necessary.
- The firm is referred to the Authorisation Committee, for consideration.
- The Authorisation Committee proposes a regulatory penalty.
- The firm is referred to the Investigations Committee, for an investigation to be initiated.
- The firm is referred to audit monitoring, to conduct a monitoring review if there are indications that the firm's SOQM is not operating effectively.

Firms which have failed to report identified ethical breaches which are then identified on monitoring visits or during investigations are likely to attract more punitive regulatory action than those which have self-reported and rectified the issue early on.

Author: Charlotte Barbour, Director, Regulatory Authorisations

Frequently Asked Questions

In this new section we share with you typical FAQs and our responses to firms.

FAQ 1*: I do not have audit experience in the previous two years across 10 audits – can I still apply to be an RI?*

Answer

The short answer is that yes, that such RI applications can still be submitted but the application may require in depth consideration by the Authorisation Committee and a decision will be taken based on the application's unique circumstances. The bigger the shortfall the less likely the application is to be approved and applicants should provide as much relevant information as possible in support of their application. The committee may, because of the shortfall, either reject the application or may approve the RI application subject to strict conditions and restrictions. Approval is likely to only happen where the RI has other support mechanisms in place such as from other RIs in their firm.

Please read below for the detailed answer:

The experience requirements are detailed on the ICAS website - an applicant should have recent, relevant and sufficient experience in order to be competent to conduct audit work. All decision making is overseen by the FRC.

ICAS staff conduct a number of checks over RI applications – this includes checking whether applicants have experience across at least 10 audits in a 24-month period and whether this experience extends across the IES 8 requirements. Where all the checks have been passed, and the application process is straight forward, the ICAS staff have delegated authority to approve the application.

Where these conditions are not met, then applications may be taken to the Authorisation Committee, which is responsible for approving audit firm and RI applications.

If the application is considered by ICAS's Authorisation Committee and the committee has any concerns regarding the sufficiency of the audit experience, the application may only be approved subject to conditions and/or restrictions. This could include:

- external/internal hot or cold file reviews
- notifying the committee when audit appointments are accepted, and/or
- providing future completed CPD details.

This course of action is more likely if the applicant works in a firm that has an audit registration and where there are already other RIs.

Alternatively, if the committee rejects the application due to inexperience, then the applicant may be asked to gain further relevant audit experience before reapplying.

Where firms have decided to submit an RI application with an experience shortfall, we advise your firm to provide the following details:

- a detailed explanation of the audit experience the applicant has obtained in the past and how they have still been able to stay up to date if they have not been involved in audit practice work recently;
- records of current audit experience, mentoring, or other training that supports the application; and
- the ways in which the ACP/firm would plan to mitigate any risks with the applicant not having had recent experience e.g. hot file reviews, mentoring, training etc.

FAQ 2*: To what extent is it possible for me to be directly involved in the audit work and also be the RI signing the audit report?*

Answer
It is suggested that you seek guidance from the ACP in your firm in the first instance to ensure the firm's own policies and procedures are adhered to. However, in general terms there would be no specific rule or regulation precluding an RI from being directly involved in some, most or all audit work on a file. That said, you would likely want to consider how to best address any potential audit risks that could arise as a result of a lack of segregation of duties in the planned audit work (e.g. risks arising from self-review) on such an audit and document your consideration of that on file.

Author: Charlotte Barbour, Director, Regulatory Authorisations

Consideration of climate related risks in an audit of financial statements

Considerably greater focus is now being placed by audit regulators, on the implications of climate change. In recognition of this in October 2020 the International Auditing and Assurance Standards Board (IAASB) produced a Staff Audit Practice Alert 'The Consideration of climate related risks in an audit of financial statement.'

The FRC expects all RSBs to consider whether audit firms are appropriately addressing climate related risks during audit engagements. This article providers a reminder of the audit requirements, and alerts firms to the fact that ICAS Audit Monitoring will consider how the firm has addressed these requirements during audit monitoring visits.

The purpose of this alert was to help auditors understand what is already contained in the ISAs and how that material relates to the auditor's consideration of climate-related risks in an audit of financial statements. The guidance looks at various ISAs and highlights matters that auditors should consider. Given that the FRC's ISAs (UK) are substantively based on the ISAs, this guidance is equally applicable in the UK context.

The following is a summary of the IAASB guidance, but members are advised that they should refer to the document in full.

The ISAs (UK) require that the auditor:

- identifies and assesses the risks of material misstatement of the financial statements, whether due to fraud or error;
- designs and performs audit procedures responsive to those risks, and obtains audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion.

Climate-related events and conditions may result in a risk of material misstatement of an entity's financial statements. Entities might be impacted by climate change; directly or indirectly e.g. through energy usage or their supply chains. Ultimately, all entities need to consider what type of climate-related risks their businesses could be exposed to in the long-run. This is becoming ever more important. Such risks will be unique to each entity and vary in impact, but can affect many aspects of a company's financial statements.

Accordingly, audit teams need to ensure that consideration of the impact of climate change is taken into account in their risk assessment process and their planned audit work. Potential specific audit areas where there may be an impact include valuation of assets; assumptions used in impairment testing; depreciation rates; decommissioning provisions and other similar liabilities; as well as financial risk disclosures.

The directors are responsible for preparing the financial statements of the entity in accordance with the applicable financial reporting framework. The auditor's objective is to obtain reasonable

assurance as to whether the financial statements, as a whole, are free from material misstatement to enable the auditor to report on whether the financial statements show a true and fair view and are prepared in accordance with the applicable financial reporting framework.

If climate change impacts the entity, the auditor needs to consider whether the financial statements appropriately reflect this in accordance with the applicable financial reporting framework (i.e., in the context of risks of material misstatement related to amounts and disclosures that may be affected, depending on the fact and circumstances of the entity). Auditors also need to understand how climate-related risks relate to their responsibilities under professional standards, and applicable law and regulation.

ISAs that may be most relevant in relation to climate-related risks are discussed below:

ISA 315 (Revised 2019): Identifying and assessing the risks of material misstatement

The auditor may consider the implications of climate-related risks when obtaining an understanding of the entity and its environment. Matters to be considered might include:

- **The entity's business model**. Whether climate-related risks including physical and transition risk to which the entity might be exposed, influence, or will influence, the entity's business model, including the entity's customer base and supply chain. Additionally, the auditor may obtain an understanding of how management and TCWG consider the effects of climate-related risks.
- **Industry factors**. These include the competitive environment, supplier and customer relationships, and technological developments. Whilst climate change is entity dependent, industry factors are still an important consideration e.g., new technological developments to address climate change may have a significant impact on the industry and in turn, the entity subject to audit. The car industry is an example as more people switch to electric vehicles.
- **Regulatory factors**. New or revised climate-related laws and regulations could affect taxation or the entity's business model through increased environmental requirements.
- **Other external factors**. These include general economic conditions, including interest rates, availability of financing, and inflation. The ability to access external finance could be impacted by financial institutions' consideration of increased regulatory risk or changing consumer preferences in making lending decisions.

With respect to the entity's system of internal control, the auditor is required to obtain an understanding of, among other components of the system, the entity's risk assessment process relevant to the preparation of the financial statements. Climate change may factor into understanding the entity's process for identifying climate-related business risks relevant to its financial reporting objectives, assessing the significance of such risks (including the likelihood of their occurrence) and addressing the risks.

Based on the risk assessment procedures, the auditor is required to identify and assess the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures. Climate-related risks may give rise to risks of material misstatement in respect of one or more relevant assertions, for example, accuracy, valuation and allocation, rights and obligations, and presentation for a class of transaction, account balance or disclosures.

ISA 320: Materiality in planning and performing an audit

Depending on the nature of a business and the facts and circumstance the auditor's determination of materiality and performance materiality may be affected by climate-related risks. Of course, the auditor's determination of materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements. Where, for example, climate related disclosures are important to the users

of the financial statements, such as related to impairment assessments, or valuations of assets, these factors will require to be taken into account when setting materiality and particularly performance materiality for those affected areas.

ISA 330: The auditor's responses to assessed risks

If the effects of climate-related risks form part of the reasons for the assessment given to the risk of material misstatement at the assertion level, the auditor's further audit procedures are required to be responsive to these risks. The auditor is required to obtain more persuasive audit evidence the higher the assessment of risk.

ISA 250 (Revised): Consideration of laws and regulations in an audit of financial statements

As part of this consideration the auditor is required to perform audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements. For climate-related risks, other laws and regulations may include environmental regulations. A breach of such regulations could have a material effect on the financial statements, e.g. a breach may result in a contingent liability for potential litigation and fines or penalties resulting from those regulations.

ISA 450: Evaluation of misstatements identified during the audit

Circumstances that may affect this evaluation include the extent to which the misstatement:

- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to users' understanding of the financial position, financial performance or cash flows of the entity. For example, disclosures of sources of estimation uncertainty that fail to include climate-related risks in cases when it impacts the carrying amount of assets or liabilities. This may be the case for climate-related information, given investor statements on the importance of climate-related risks to their decision-making; or
- Affects other information to be included in the entity's annual report that may reasonably be expected to influence the economic decisions of the users of the financial statements. This may be the case for climate-related information, given that the majority of climate-related information is currently disclosed outside the financial statements.

ISA 540 (Revised): Auditing accounting estimates and related disclosures

Climate-related risks might impact an entity's accounting estimates in various ways e.g.:

- Impairment of property, plant and equipment, intangible assets and goodwill;
- Fair value of financial assets (investments and receivables);
- Fair value of financial liabilities;
- Certain provisions and contingent liabilities; and
- Mineral resources and reserves.

The level of estimation uncertainty may be impacted because of climate change e.g.

- Making it more difficult to determine reliable predictions about the future realisation of a past transaction or about the likelihood and impact of future events or conditions (e.g., the frequency of extreme droughts or extreme rainfalls on harvests).
- Laws or regulations requiring entities to reduce their carbon dioxide emissions or encouraging the use of sustainable energy sources. The introduction of new low emission zones in city centres might require certain businesses to renew their vehicle fleets earlier than originally anticipated.

The degree to which the accounting estimate is subject to complexity may be affected by climate change because:

- To capture the effects of the changing climate, new models may need to be designed requiring the use of specialised skills or knowledge by management.
- It may be more complex to derive data on which the accounting estimate is based due to the need to incorporate data from outside of the traditional accounting system. For example, a pension fund investing in a portfolio may rely on information disclosed by its investees. If those investees do not make adequate climate-related disclosures, it may be more complex to derive other data on which to base the accounting estimate.

The degree to which the accounting estimate is subject to subjectivity may be affected by climate change. This may particularly be the case for:

- Assumptions with long forecast periods.
- Assumptions based on data that is currently unobservable.
- Balances where it is difficult to make reliable forecasts about the future.

The IASB's publication 'IFRS Standards and climate-related disclosures' also includes examples of accounting estimates that could be affected by climate change.

ISA 570 (Revised): Going Concern

A climate-related risk could potentially give rise to an event or condition that may cast significant doubt on an entity's ability to continue as a going concern e.g. extreme weather events may be more frequent than before and may be relevant to the appropriateness of management's going concern assumption.

ISA 620: Using the work of an auditor's expert

If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor is required to determine whether to use the work of an auditor's expert e.g. to help calculate the provision recognised for decommissioning a plant or rehabilitating environmental damage due to regulatory changes or shortened project lives.

ISA 700 (Revised): Forming an opinion and reporting on financial statements

In forming an opinion, the auditor is required to conclude whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, taking into account, among other matters, the auditor's conclusion, in accordance with ISA 450, whether uncorrected misstatements are material, individually or in aggregate.

Climate-related risks that could give rise to material misstatements (if uncorrected), may relate to:

- Appropriateness or adequacy of disclosures e.g. the entity may not have appropriately disclosed the effect of climate-related risks in the financial statements while the decisions of users of the financial statements are likely to be affected by such disclosures.
- Application of the entity's accounting policies e.g. inappropriate recognition and measurement of assets because the related impairment calculations do not appropriately account for the effect of climate-related risks.

If the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement, the auditor is required to modify the opinion in the auditor's report in accordance with ISA 705 (Revised).

ISA 720 (Revised): The auditor's responsibilities relating to other information

The majority of climate-related information is currently disclosed in other information. In reading the annual report, the auditor is required to consider whether there is a material inconsistency between:

- The other information, including any climate-related information contained therein, and the financial statements; and
- The other information, including any climate-related information contained therein, and the auditor's knowledge obtained in the audit.

Material inconsistencies between the other information and the financial statements may indicate that there is a material misstatement of the financial statements or that a material misstatement of the other information exists.

When climate-related information is presented in a document outside a document titled "annual report," it may be important to determine whether the document containing the climate-related information nevertheless forms part of the annual report as defined for purposes of ISA 720 (Revised). An example of a document which is not always part of the annual report is a sustainability report, which some jurisdictions are seeing an increase in entities issuing.

The FRC has also published the following:

- Staff guidance note: Auditor responsibilities under ISA (UK) 720 in respect of climate related reporting by companies required by the Financial Conduct Authority.

  This staff guidance note sets out information for auditors that may assist them in determining their responsibilities under ISA (UK) 720 in their audits of financial statements of companies that are required to include climate-related disclosures consistent with the Taskforce on Climate-related Financial Disclosures (TCFD) Recommendations and Recommended Disclosures.

  This staff guidance also includes a brief reminder of auditor's responsibilities under ISA (UK) 720 in respect of the company's Streamlined Energy and Carbon Reporting (SECR) disclosures.

- FRC Climate Thematic: Audit – How are auditors taking account of climate-related challenges?

  This was published in November 2020 and looked at how a sample of audit teams, predominately taken from the four largest audit firms, had responded to climate risks in practice when performing their audit procedures to determine if an entity's financial statements present a true and fair view. The paper looks as this in relation to the following stages of an audit.

  1. Risk assessment: Identifying the climate-related risks to which the business is exposed that could affect the audit approach and annual report.
  2. Controls: Understanding how management identifies and responds to climate-related issues.
  3. Audit procedures: Performing audit work to test the financial statement balances with regard for climate-related risks.
  4. Specialists: Using specialists to support the audit work over climate-related issues.
  5. Disclosures: Testing management's financial statement disclosures and reviewing the other information included in the front half of the annual report.
  6. Reporting: Communicating findings to TCWG.

  Whilst there have been developments since, this still provides a useful overview.

Author: James Barbour, Director- Policy Leadership

Proposed Revisions to FRS 102 and FRS 105

In December 2022, the Financial Reporting Council (FRC) published its proposed revisions to Financial Reporting Standard (FRS) 102.'The Financial Reporting Standard applicable in the UK

and Republic of Ireland' and FRS 105 'The Financial Reporting Standard applicable to the Micro-entities Regime'.

These are contained in Financial Reporting Exposure Draft (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 main proposals resulting from this second periodic review of FRS 102 and other UK Financial Reporting Standards are as follows:

FRS 102

(i) **Revenue recognition:** Introducing a new five step model of revenue recognition in FRS 102 based on that in International Financial Reporting Standard (IFRS) 15 'Revenue from Contracts with Customers' with appropriate simplifications. The extent to which this will change an entity's revenue recognition in practice will depend on the form of its contracts with customers.

This model is as follows:
(a) Step 1: Identify the contract(s) with a customer;
(b) Step 2: Identify the promises in the contract;
(c) Step 3: Determine the transaction price;
(d) Step 4: Allocate the transaction price to the promises in the contract; and
(e) Step 5: Recognise revenue when (or as) the entity satisfies a promise.

Detailed considerations relate to each of the above steps. Indeed, this is a far more detailed and structured approach to revenue recognition than is currently to be found in section 23 of FRS 102.

An entity recognises revenue when (or as) it satisfies a promise to transfer a good or service or bundle of goods or services to a customer. A good or service is transferred when (or as) the customer obtains control of that good or service. For each promise identified an entity determines at contract inception whether the promise is satisfied over time or satisfied at a point in time. Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining economic benefits that may flow from, the asset.

(ii) **Lease accounting:** Introducing a new model of lease accounting based on the on-balance sheet model from IFRS 16 'Leases', with appropriate simplifications. This is expected to impact the financial statements of many entities that are lessees under one or more operating leases. In contrast to current operating leases where lessees expense the rentals charged, they will be required to bring on the lease liability and the related right of use asset. There are exceptions for short term leases (12 months or less at commencement date) and low value leases.

Additionally, other incremental improvements and clarifications are proposed to FRS 102 which include.

- Greater clarity for small entities in the UK applying Section 1A regarding which disclosures need to be provided in order to give a true and fair view.
- A revised Section 2 Concepts and Pervasive Principles, updated to reflect the International Accounting Standards Board's Conceptual Framework for Financial Reporting, issued in 2018.
- A new Section 2A Fair Value Measurement, replacing the appendix to Section 2 and updated to reflect the principles of IFRS 13 'Fair Value Measurement'.
- Removal of the option to newly adopt the recognition and measurement requirements of IAS 39 under paragraphs 11.2(b) and 12.2(b), in preparation for the eventual removal of this option, but permitting entities already applying the option to continue to do so in the meantime.

FRS 105

For micro-entities, the FRC is proposing to include the 5 step IFRS 15 revenue recognition model but not the on-balance sheet lease requirements of IFRS 16 in FRS 105. It is also proposing to align section 2 concepts and pervasive principles to that in the 2018 IASB conceptual framework. There are also a number of more minor changes.

The consultation closes on 30 April 2023 and the proposed effective date of the amendments set out in the FRED is 1 January 2025. This will be subject to the FRC finalising its revisions prior to the end of this year. On 23 February we held a webinar at which Jenny Carter, the FRC's Director of Accounting Policy outlined the key proposed changes.

Author: James Barbour, Director- Policy Leadership

Survey on the audit market for audit partners

An independent survey is being carried out by Touchstone Renard (TR) on behalf of the Financial Reporting Council (FRC) to help inform the FRC's future work.

As an ICAS member your experience, views and insights on the audit market would be invaluable. This is a timely opportunity to have your say and we encourage you to participate. The survey takes 7 minutes to complete. To access the survey please click on the following link: https://www.surveymonkey.co.uk/r/ZLBJRXH

The deadline for completing is 21 April 2023.

The survey is completely confidential and TR will not reveal your identity, or that of your firm, to the FRC or to anyone else.

TR hope that as many audit partners as possible will participate in the survey and would like to express their thanks to ICAS and all involved with facilitating the survey launch.

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