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Audit News- Summer / Autumn 2024



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New Look Audit News

We have launched a new look digital Audit News but are also retaining the PDF versions in our Audit News library, which is located [here](#), to enable you to share copies within your teams.

Changes to the Audit Regulations

On 1 October, revised Audit Regulations were published on ICAS.com. There have been several amendments made, and firms should ensure that the revised regulations are reviewed and adhered to going forward. While there have been various changes, revisions to the following three areas are considered to have the most significant effect on ICAS audit firms:

- Audit eligibility;
- Maintaining competence / Continuing Professional Development; and
- Audit compliance review.

Changes to the Eligibility Requirements

When do the changes below take effect?

While the revised Audit Regulations are effective from 1 October 2024, given the potential impact on firm eligibility, the FRC has agreed that changes discussed here will be subject to a six-month transition period with the new eligibility requirements coming in to effect from 1 April 2025.

Summary of change

This is a change to the eligibility requirements to make it clear that where a firm's constitution, however comprised, includes certain decisions that need more than a simple majority-vote for approval, that audit-qualified persons must be able to control any such 'super-majorities'. Firms will have until 1 April 2025 to comply.

The eligibility change explained in more detail

Audit firms will be aware that the previous Audit Regulation 2.03 required individuals who have an appropriate qualification (which in practice equates to the Audit Qualification in the majority of cases), and Registered Auditors (e.g. another registered audit firm) to hold:

- 2.03b - at least a majority of the voting rights (or hold such rights under the firm's constitution) as enable them to direct its overall policy or alter its constitution;

- 2.03c - at least a majority of the voting rights in the management board (or hold such rights under the firm's constitution) as enable them to direct its overall policy or alter its constitution.

While the above elements of the regulations have not changed, the most recent revisions to the supporting guidance notes and definitions used in the Regulations have brought renewed focus on what constitutes authority/control, and in particular seeks to address situations where a firm's constitution requires a 'supermajority' for some decision making. The updates included:

- clarifications to the guidance given on what constitutes a 'majority', to more clearly reflect that the 'majority' of rights required to be held by individuals with the Audit Qualification will be whatever 'majority'/'supermajority' a firm's constitution requires to amend the firm's overall policy / allow alterations to the constitution; and
- clarifications to the guidance given on 'voting rights' to more clearly apply to all matters that direct the firm's overall policy / allow alterations to the constitution.

What is a 'majority'?

A new definition of 'majority' has been added to the Regulations:

"In the context of regulation 2.03 'majority' of the voting rights means more than 50% unless the firm's constitution specifies a higher percentage of these rights is required for decision making, in which case, 'majority' shall be taken to mean that specified percentage or more."

This clarifies that where a supermajority is required to affect changes to the firm's overall policy / allow alterations to the constitution then rights sufficient to meet whatever that supermajority is must be held by individuals with the Audit Qualification (and/or Registered Auditors).

What are 'voting rights'?

The definition of Voting Rights used in the Regulations has been changed:

FROM: *"The rights to vote on all or substantially all matters at meetings of principals or shareholders of the body in question..."*

TO: *"The rights to vote at meetings of principals or shareholders of a firm on all matters that direct the firm's overall policy or alter its constitution..."*

This change removes the 'substantially all' terminology and focusses more clearly on the relevant areas for decision making. The guidance notes to Regulation 2.03 go on to clarify that while a 'majority' normally means greater than 50%, where a firm's constitution requires a higher percentage of voting rights for decision-making, "majority" shall mean the specified higher percentage. It also clarifies that in this context 'decision-making' relates to all management or ownership decisions which direct the firm's overall policy or alter its constitution.

When considering this matter, firms should be aware that a positive authority to affect change is required. In that context, a fallback power of veto over some decisions would not be expected to constitute sufficient 'authority', and the Audit Qualified individuals (and/or Registered Auditors) must hold the authority to pass a vote if one were ever to arise.

Impact on ICAS audit firms

Firms will need to ensure that enough voting rights are held by qualified persons to meet any approval percentages stipulated in the firms' governance documents. It is not enough that qualified persons can veto a decision; the qualified persons must be capable of passing the vote on all matters that direct the firm's overall policy or alter its constitution.

It is not expected that these clarifications and amendments will have an impact on many ICAS audit firms, given the majority of our firm are small firms, or firms with simple governance structures. The changes are likely to impact larger firms and those which have more complex governance arrangements (e.g. where there are different voting arrangements for different policies/areas). However, for the small number of firms that are affected these changes could impact those firms in a fundamental way with regards their audit registration and eligibility.

All firms must carefully consider their own specific circumstances to ensure the eligibility requirements are, and continue to be, met. Given the fundamental nature of Audit Regulation 2.03 with regards a firm's eligibility for audit registration, any instances of non-compliance would be considered significant matters. Cases of non-compliance would be expected to result in reporting to the ICAS Authorisation Committee and consideration of regulatory action (such as a regulatory penalty accompanied by public notice).

Firms should be aware that considerations may well become more complex where there are multiple legal entries / registered firms within a group structure, and/or where legal entities (rather than natural persons) are principals in a firm (e.g. where corporate entities hold a director / LLP member role). If firms are in any doubt of whether principals and/or those with voting authority hold the Audit Qualification, they should look in to this as a matter of urgency – which may require contacting individuals' membership bodies. Careful consideration should also take place when succession planning to ensure that individuals with the Audit Qualification, or Registered Auditors, always hold such rights under the firm's constitution as enable them to direct its overall policy or alter its constitution.

Other relevant regulations: notification of changes in eligibility

The transition period to 1 April 2025 should allow firms time to make any governance changes required.

Firms should also be aware that Audit Regulation 2.11 requires audit registered firms to inform ICAS in writing, as soon as practicable, of any changes which might affect a firm's eligibility. Notification of such changes should be timely and not later than ten business days after the event.

It is recognised that some unforeseen or unavoidable circumstances may result in a firm ceasing to meet the eligibility requirements. Under Audit Regulation 2.17 a firm must notify the Authorisation Committee if it ceases to meet one or more of the eligibility requirements. Notification must take place in writing within ten business days of the situation arising and should set out the circumstances and what action the Registered Auditor proposes to take. On considering such a notification, the Authorisation Committee has the power to grant dispensation from the eligibility requirements in cases where continued registration would not adversely affect an audit client or any other person. Dispensation would be temporary, to enable the firm to address any eligibility issues, and would not last for more than 90 days.

Audit monitoring visits

While breaches of eligibility are relatively rare (in 2023 this was identified in only 8% of visits), they are among the most significant issues identified on audit monitoring visits.

From the monitoring team's experience, issues with eligibility most often arise where there have been changes in the structure of a firm, or where principals have changed, without sufficient notification being made to ICAS and / or consideration of the potential impact of the changes with regards to compliance with the Audit Regulations.

Firms should be aware that not all CAs have the Audit Qualification, so care should be taken to keep track of changes in Audit Qualified principals and voting rights. Partnerships are reminded that all members / partners of such practices will be considered to have equal voting rights unless there is a formal agreement setting out otherwise.

There have also been a small number of other issues relating to eligibility noted in recent years, which are shared here again for reference:

- Non-qualified principals in an audit firm not completing the required Audit Affiliate application. Firms are reminded that under Audit Regulation 2.03a, any principal that is not a member of ICAS, ICAEW, ICAI, or ACCA will likely require an Audit Affiliate application to be submitted.
- Audit firms constituted as a corporate practice (i.e. a limited company), which have not sufficiently tailored their Articles of Association. Audit Regulation 2.03d sets out various requirements that must be met in such a firm's articles of association. These include a requirement for shareholders to notify the firm of any changes in shareholding, and a requirement that the firm's directors must approve any transfer of shares resulting in a shareholder holding more than 3% of the firm's share capital.
- A case where an Audit Compliance Principal (ACP) was not a principal in the firm. In such cases, the regulations require the ACP to be a member of a management board which administers or manages the firm, but this was not the case.

Authors: Michael Lavender, Lesley Byrne, Regulatory Monitoring

Changes to the regulations relating to maintaining competence

Audit Regulation 3.17 – Maintaining Competence (which is seen to relate to a firm's overall processes for training and ongoing development) has been expanded to set out to more clearly cross refer to Audit Regulation 3.17A (which relates more directly to the requirement for each RI to maintain competence), and to clarify the importance of retaining evidence of training / CPD undertaken.

Maintaining competence

The additional references now included are shown in **bold** below

3.17 – “A Registered Auditor must make arrangements so that all principals and employees doing audit work are, and continue to be, competent to carry out the audits for which they are responsible or employed. **The Registered Auditor's arrangements in this regard facilitate compliance with regulation 3.17A by the responsible individuals. A Registered Auditor must make arrangements for the retention of the records of continuing professional development ('CPD') undertaken by principals and employees engaged in audit work including the CPD undertaken by responsible individuals to comply with regulation 3.17A. A Registered Auditor must ensure that CPD records are made available to the registering Institute for inspection and review when requested.**”

Audit Regulation 3.17A has also been amended and expanded to clarify requirements on an RI level, and to more clearly refer to the learning outcomes in Table A of International Education Standard 8 (IES8), which sets out the core competencies that all RIs are required to develop and maintain.

FROM: 3.17A – “A responsible individual must take part in appropriate programmes of continuing education in order to maintain their theoretical knowledge, professional skills and values, including, in particular, in relation to auditing, with content that is relevant to their role and responsibilities.”

TO: 3.17A “A Responsible individual is required to:

- (a) take part in appropriate programmes of continuing education in order to maintain their theoretical knowledge, professional skills and values, in relation to auditing, at a sufficiently high level. A responsible individual must undertake CPD to:**
 - **achieve the learning outcomes in Table A of IES 8; and**

- **maintain professional knowledge in (i) the UK auditing framework and (ii) financial reporting standards in use in the UK relevant to the preparation of financial statements and to statutory audit;**

(b) ensure that appropriate records are retained to demonstrate compliance with the responsible individual's CPD obligations.”

While the underlying requirements are nothing new, ICAS Audit Monitoring regularly finds that firms (in considering a firm-wide approach to CPD) and RIs (in considering their own approach) have not explicitly considered IES8 as part of the CPD process. There is also a correlation between non-compliance with Audit Regulation 3.17 & 3.17A and poor audit quality. Firms should ensure that sufficient appropriate CPD is conducted by all auditors, and that RIs are explicitly considering the requirements of IES 8 when planning, conducting and recording CPD. To aid in the latter, worked examples of a CPD record for an experienced RI are available on ICAS.com for reference.

Audit Monitoring findings

Looking back at 2023, the monitoring team found breaches against Audit Regulation 3.17 and/or 3.17A on 16% of visits, resulting from weaknesses in a firm or RIs arrangements for training and continuing professional development (CPD). While this was in a relatively small proportion of visits, it should be recognised that breaches of these regulations are often closely linked to other significant, or widespread, issues with audit quality or compliance:

- Half of these visits related to cases where insufficient or ineffective CPD was considered to have been an underlying factor in poor audit quality (where the RIs files were found to require significant improvement).
- The other half of the cases related to instances where RI's CPD records were poor, and did not demonstrate sufficient consideration of the requirements of IES8.

Authors: Michael Lavender, Lesley Byrne, Regulatory Monitoring

Changes to the regulation relating to the audit compliance review process

The guidance notes to Audit Regulation 3.20 have been expanded and updated to more clearly cross refer to the requirements brought in by the International Standard on Quality Management (UK) 1 (ISQM1).

Audit Compliance Review (including Cold File Review)

Given the guidance and commentary available elsewhere on ISQM1, and the monitoring and evaluation processes it requires, this update will not go into detail on those changes. However, we do want to signpost an amendment to the commentary on cold file review processes.

Firms should already be aware that the regulations require a process of cold file review(s) to be conducted annually. Previously the de minimis required by the Audit Regulations was for at least one cold file review to be conducted per year. The updates to the regulations give additional guidance:

“ISQM1 requires firms to select at least one completed engagement for each responsible individual on a cyclical basis determined by the firm. It also prohibits and engagement team members or the engagement quality reviewer from performing any inspection of that engagement.

However, to comply with these regulations the firm's procedures for review of completed engagements must also meet the following two criteria:

- 1. The cycle of inspection of completed engagements for each responsible individual must not exceed three years.**
- 2. Monitoring must include at least one inspection of a completed engagement, each year.**

Where the additional reviews required by '2' above exceed those that would be required for the firm to comply with ISQM1, the firm may relax the requirement for the inspection to be conducted by an individual independent from the engagement team providing it considers that the selected individual is able to conduct the review with a sufficiently independent and objective mindset.

A firm that does not have a suitable internal reviewer meeting the criteria set out in ISQM1 should engage an external reviewer at least once every three years."

The latter two paragraphs here recognise that a small, sole RI firm may well have challenges in conducting an independent cold file review process. As in the previous Audit Regulations, a sole RI can conduct a cold file review of one of their own files (so long as they are able to conduct the review with a sufficiently independent and objective mindset) on the proviso that an external cold file review process is engaged at least once every three years.

Firm Quality Management processes in the year of a monitoring visit

One other minor amendment flagged in the revised regulations, is that:

"A firm should conduct monitoring each year, even when the firm has had a quality inspection from the Institute during the year."

While this has always been the case, as ICAS Audit Monitoring do not form part of a firm's quality management (or control, as was) processes, this is a welcome opportunity to remind firms that they must continue to conduct their own quality management reviews, including 'whole firm' monitoring and cold file reviews, even in years when a monitoring visit is expected, planned, or has taken place.

ICAS Audit Monitoring findings

Looking back at the 2023 ICAS Audit Monitoring visits, 32% of visits identified a breach of AR 3.20. The most common underlying issue being the lack of an effective cold file review process. In most cases, this resulted from a complete lack of a cold file review process in the year of the monitoring visit, and that preceding it.

Our 2023 Monitoring Report noted that an effective cold file review process is an essential component of a firm's SOQM, and firms with good quality audit files tend to have an effective cold file review process in place more often than not. Most cases where a cold file review process had not been conducted at all involved smaller firms, and it is acknowledged that sole RI practices can find it especially challenging. As above, it is recognised that a sole RI can still conduct their own cold file review so long as an external reviewer is engaged at least once every three years. Smaller firms may also want to consider whether there is any other individual in the firm who, although not a responsible individual, is very experienced in current auditing requirements and might be able to undertake an effective review. If so, assuming that the individual did not take part in the audit, the firm may decide this individual would be a suitable person to conduct the required cold file review.

In 2023, reviewers also came across some instances where a cold file review had been conducted as required, but where the findings of the process were inconsistent with the findings of ICAS Audit Monitoring. This is most often the case where an internal review did not raise many queries, or did not identify significant issues that were identified in the monitoring visit. Firms should ensure that any cold file review process is robust and conducted by individuals with sufficient capability and experience.

More latterly, the monitoring team has anecdotally considered there to be a correlation between firms (including even larger firms) that choose to engage an external cold file review process and better levels of audit quality, even when such reviews are only engaged on a periodic basis (e.g. every second or third year). This may not be unexpected where internal reviews tend towards considering compliance with firm procedures and 'the way we do things', while external reviews give a different perspective. While external reviews are not certainly required under the regulations (other than as previously stated) firm's may want to consider what options are available to them to ensure their monitoring procedures are as affective and robust as possible.

Authors: Michael Lavender, Lesley Byrne, Regulatory Monitoring

ISQM (UK) 1 – annual evaluations

International Standard on Quality Management (ISQM) (UK) 1 has now been in place for almost two years. Effective monitoring and evaluation arrangements are a key component of a functioning System of Quality Management (SoQM), and firms should have conducted at least one annual monitoring and evaluation cycle by now, with the second due before the end of 2024. The monitoring team thought this would be a good time to remind firms of some of the key monitoring and evaluation requirements.

Monitoring

Firm's need to establish monitoring processes that will provide relevant, reliable and timely information about the design, implementation and operation of the full SoQM. While the likes of a cold file review process will be one key (and mandatory) element of that, it is not the only monitoring process required. Firms should ensure monitoring activities cover all elements of the SoQM, and the nature and timing of such activities will depend on:

- (a) The reasons for the assessments given to the quality risks;
- (b) The design of the responses;
- (c) The design of the firm's risk assessment process and monitoring and remediation process;
- (d) Changes in the system of quality management;
- (e) The results of previous monitoring activities, whether previous monitoring activities continue to be relevant in evaluating the firm's system of quality management and whether remedial actions to address previously identified deficiencies were effective; and
- (f) Other relevant information, including complaints and allegations about failures to perform work in accordance with professional standards and applicable legal and regulatory requirements or non-compliance with the firm's policies or procedures established in accordance with ISQM (UK) 1, information from external inspections and information from service providers.

Each firm's monitoring processes will depend on how the firm's risk assessment process is designed. The standard recognises approaches will differ, and scale, given the size and complexity of each audit firm:

“In a less complex firm, the monitoring activities may be simple, since information about the monitoring and remediation process may be readily available in the form of leadership's knowledge, based on their frequent interaction with the system of quality management, of the nature, timing and extent of the monitoring activities undertaken, the results of the monitoring activities, and the firm's actions to address the results.

In a more complex firm, the monitoring activities for the monitoring and remediation process may be specifically designed to determine that the monitoring and

remediation process is providing relevant, reliable and timely information about the system of quality management, and responding appropriately to identified deficiencies.”

Evaluating the system of quality management

Firms are expected to identify whether any ‘deficiencies’ exist in the SoQM by evaluating any findings from their monitoring processes. The standard recognises that a deficiency may arise from a single finding or a combination of findings. Professional judgement needs to be applied in determining whether findings, individually or in combination, give rise to a ‘deficiency’ in the system of quality management. The application material provided in the standard itself provides a number of helpful examples which firms may find useful when conducting evaluation processes and forming judgements on the nature of any findings and their pervasiveness.

The standard requires the individual(s) assigned ultimate responsibility and accountability to evaluate the SoQM at least annually. Typically, in the firms we monitor the evaluation process is conducted by the Audit Compliance Principle, being the individual with ultimate responsibility. The standard recognises that other individuals may assist in performing the evaluation, but firms should be clear that whoever is assigned ultimate responsibility for the SoQM is responsible for the overall evaluation.

Concluding on the evaluation

Based on the evaluation, the individual(s) assigned ultimate responsibility for the SoQM needs to conclude using one of the following three statements:

- (a) The system of quality management provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved;**
- (b) Except for matters related to identified deficiencies that have a severe but not pervasive effect on the design, implementation and operation of the system of quality management, the system of quality management provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved;**
or
- (c) The system of quality management does not provide the firm with reasonable assurance that the objectives of the system of quality management are being achieved.**

Conclusion (a) indicates there may have been no deficiencies identified by the firm's monitoring processes. Where deficiencies have been identified in the SoQM then conclusions (b) or (c) would appear to be more appropriate, depending on how significant those deficiencies were.

Root Cause Analysis

In any case where conclusions (b) or (c) were appropriate, it is expected that root cause analysis would be required over the deficiencies driving that conclusion. Once root causes have been identified the firm would also need to set a remedial action plan. Firms should be clear that a (b) or (c) conclusion to the overall evaluation will require the firm to:

- (a) Take prompt and appropriate action to address the deficiencies identified; and
- (b) Communicate matters to:
 - i. Engagement teams, to the extent that it is relevant to their responsibilities; and
 - ii. External parties, if required under the firm's policies or procedures.

Monitoring reviewers would expect to see a clear record of a firm's root cause analysis and remedial action plan on any monitoring visit that followed a (b) or (c) conclusion to the annual SoQM evaluation.

Periodic performance evaluations of individuals with responsibility for the SoQM

It's also worth noting that in addition to the annual evaluation of the SoQM, ISQM (UK) 1 requires firms to undertake periodic performance evaluations of:

- the individual(s) assigned ultimate responsibility and accountability for the SoQM, and
- the individual(s) assigned operational responsibility for the SoQM.

It is expected that the outcome of the annual evaluation of the SoQM would form a key element of these periodic performance evaluations.

Annual reporting of the firm's evaluation

Going forward, firms will be asked to report their conclusion on the annual evaluation of the SoQM through the Firm's Annual Return process.

Importance of a compliant approach

The Financial Reporting Council (FRC) has been very clear on the importance of ISQM (UK) 1's implementation and compliance as part of all audit firms' registrations, and this will remain an area of focus during 2025. In terms of monitoring compliance, there is a clear expectation that any the firms that have not conducted and evidenced the required ISQM (UK) 1 evaluation by 15 December 2023, would be breaching Audit Regulation 3.10 (Compliance with auditing standards and the quality management standards). Where such a breach is identified, any failure to remediate the issue on an expedited basis will result in consideration by the ICAS Authorisation Committee, which could include the consideration of regulatory actions.

Additionally, the FRC has requested ICAS notify it directly of any firms failing to remediate such non-evaluation of ISQM (UK) 1 on an expedited basis. This reporting requirement is a significant step, and should leave all parties in no uncertain terms as to the importance of compliance in this area.

Authors: Michael Lavender, Regulatory Monitoring

ISA (UK) 600 Revised

International Standard on Auditing (ISA) (UK) 600 (Revised September 2022), '**Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)**' becomes effective for audits of group financial statements for periods beginning on or after December 15, 2023, so effectively for years ending on or after 31 December 2024. This revised standard deals with the special considerations that apply to a group audit, including in those circumstances when component auditors are involved and is intended for all group audits, regardless of size or complexity, and to be applied in the context of the nature and circumstances of each group.

Key Changes - Summary

This is a substantially revised standard, and contains the following key revisions:

- The definition of a component has been revised with the definition of 'significant components' removed. This provides clarification on the scope and applicability of the standard, including in relation to branches and divisions, shared service centres and non-controlled entities. Emphasis has been given to the consideration of risks of material misstatement at the assertion level of the group financial statements that are associated with components.

- Clarification and reinforcement of that fact that all ISAs (UK) are to be applied in group audits, by establishing stronger links with other ISAs (UK) to ensure that ISA (UK) 600 revised better aligns to other recently revised standards, in particular ISA 220 (UK) (Revised) 'Quality management for an audit of financial statement', ISA 315 (Revised) 'Identifying and Assessing the Risks of Material Misstatement' and ISA (UK) 330 'The Auditor's Responses to Assessed Risks; doing so encourages proactive management of quality.
- Focusing the group engagement team's identification and assessment of risk at the group financial statement level and emphasising the importance of designing and performing appropriate procedures to respond to those risks. The introduction of this proactive risk-based approach to group audits places more focus on identifying and assessing the risks of material misstatement, planning the approach to the audit and performing engagement procedures that respond to the assessed risks at the group financial statement level.
- Reinforcing the need for robust communication and interactions between the group engagement team, group engagement partner and competent auditors. There are also enhanced requirements in relation to professional scepticism and documentation. by clarifying what the group auditor may need to document in different situations.
- Clarification on how to address restrictions on access to people and information in a group audit, including restrictions on access to component management, those charged with governance of the component, component auditors, or information at the components.
- Clarification on how the concepts of materiality and aggregation risk apply in a group audit;

Now we will look at some of these key revisions in more detail.

Planning and Performing a Group Audit Engagement

ISA (UK) 600 establishes a framework for planning and performing a group audit engagement. The standard notes that a group may be organized in various ways, and its information system, including its financial reporting process, may or may not be aligned with its organizational structure.

The framework emphasises special considerations for establishing the overall group audit strategy and group audit plan and requires the group auditor to determine the nature, timing and extent of involvement of component auditors. The group auditor uses professional judgement in determining the components at which audit work will be performed. This determination is based on the group auditor's understanding of the group and its environment, and other factors such as the ability to perform audit procedures centrally, the presence of shared service centres, or the existence of common information systems and internal control also affect the group auditor's determination of components, including when it may be appropriate to combine certain entities or business units for purposes of planning and performing the group audit.

As component auditors may have greater experience with, and a more in-depth knowledge of, the components and their environments (including local laws and regulations, business practices, language, and culture) than the group auditor, they can be, and often are, involved in all phases of the group audit. It focusses the group auditor's attention on identifying, assessing and responding to the risks of material misstatement of the group financial statements, and emphasises the importance of designing and performing procedures that are appropriate to respond to those assessed risks of material misstatement.

Restrictions on Access to Information or People

The revised standard clarifies the various types of restriction issues and the ways in which the group auditor may be able to overcome restrictions on access to people and information, and audit documentation, including restrictions on access to component management, those charged with governance of the component, component auditors, or information at the components.

In particular, if the group engagement partner concludes that:

- (a) It will not be possible for the group auditor to obtain sufficient appropriate audit evidence due to restrictions imposed by group management; and

- (b) The possible effect of this limitation will result in a disclaimer of opinion on the group financial statements, the group engagement partner shall either:
- i. In the case of an initial engagement, not accept the engagement, or, in the case of a recurring engagement, withdraw from the engagement, when withdrawal is possible under applicable law or regulation; or
 - ii. When law or regulation prohibit an auditor from declining an engagement or when withdrawal from an engagement is not otherwise possible, having performed the audit of the group financial statements to the extent possible, disclaim an opinion on the group financial statements.

Component Materiality

Clarification is provided in the revised standard as to how the concepts of materiality and aggregation risk apply in a group audit. In this regard 'Aggregation risk' is the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole; and component performance materiality is an amount set by the group auditor to reduce aggregation risk to an appropriately low level for purposes of planning and performing audit procedures in relation to a component.

In applying ISA (UK) 320 (Revised June 2016) and ISA (UK) 450 (Revised June 2016), when classes of transactions, account balances or disclosures in the group financial statements are disaggregated across components, for purposes of planning and performing audit procedures, the group auditor shall determine:

- (a) Component performance materiality. To address aggregation risk, such amount shall be lower than group performance materiality.
- (b) The threshold above which misstatements identified in the component financial information are to be communicated to the group auditor. Such threshold shall not exceed the amount regarded as clearly trivial to the group financial statements.

Fostering the Appropriate Exercise of Professional Scepticism

The importance of professional scepticism is emphasised, including as part of the group auditor's:

- Direction, supervision and review of the work of engagement team members, including component auditors, which may inform the group auditor about whether the engagement team has appropriately exercised professional scepticism; and
- Evaluation of whether sufficient appropriate audit evidence has been obtained (including by component auditors) to provide a basis for forming an opinion on the group financial statements.

Robust Communications and Interactions Between the Group Auditor / Group Engagement Partner and Component Auditors Strengthened and clarified:

- The importance of two-way communications between the group auditor and component auditors, including the group auditor's expectation that communications will take place at appropriate times throughout the group audit.
- Various aspects of the group auditor's interaction with component auditors, including communicating relevant ethical requirements, determining competence and capabilities of the component auditor, and determining the appropriate nature, timing and extent of involvement by the group auditor in the work of the component auditor.

- It also highlights the importance of the group auditor's review of component auditor audit documentation. The review of component auditor audit documentation is directly related to, and influenced by, the group auditor's direction and supervision of the component auditors and the review of their work throughout the group audit.
- Ultimately, the increased interaction may result in more work for the group engagement team and group engagement partner, particularly in light of the enhanced responsibilities for direction, supervision and review of the work of component auditors.

The full revised standard can be viewed here: [ISA \(UK\) 600 revised](#)

The IAASB also produced a webinar on the revised standard which can be viewed at: <https://www.iaasb.org/publications/proposed-isa-600-webinar-group-audits>

The standard is not yet applicable, but firms should ensure that they will be in a position to satisfy its requirements when it becomes effective, including revising their audit methodologies as appropriate.

Author: James Barbour, Director – Policy Leadership

FRC Annual Review of Audit Quality

At the end of July, the Financial Reporting Council (FRC) published its annual review of audit quality. This provides an overview of its assessment of quality among the Tier 1 firms, which are those with the largest share of the UK Public Interest Entity (PIE) audit market. The findings whilst relating to the largest firms do provide useful pointers for audit firms of all sizes.

The FRC applies a risk-based approach to its audit inspections and pays particular attention to key areas of estimation and judgement (including impairment, valuation, going concern and provisions) as well as the audit of revenue and journal entries in its inspections. Additionally, the FRC also reviewed risk assessment (including fraud and climate risk), audit planning, and communications to Audit Committees.

The FRC's most common findings from its inspections continue to be in the audit of revenue and areas of estimation and judgement. For revenue, findings included issues with contract testing, data analytics and data input testing. For estimation and judgement, they were most often linked to weaknesses in the evaluation of key assumptions and judgements, and the challenge of management. Common findings relating to journals testing, General IT Controls (GITCs), inventory and provisions were also found. The FRC highlights the importance of the auditor's work in these areas:

- Auditors should obtain sufficient and appropriate audit evidence to assess whether revenue is accurately recognised as it is a key driver of the entity's results.
- Auditors should adequately assess and challenge management's evaluation of impairment as this often involves significant judgement and can be subject to management bias or error.
- Auditors should adequately assess and challenge the reasonableness of management's estimates and assumptions to respond to the risk of management bias.
- Journals testing is a key procedure to address the risk of management override of controls and fraud. Auditors should test the appropriateness of journals entries, including examining the supporting evidence for the items selected.
- Where an audit approach relies on IT systems, data and associated automated controls, related General IT controls should be tested to a satisfactory level to support the reliance placed and ensure that sufficient, appropriate audit evidence is obtained overall.
- Auditors should perform appropriate procedures to assess the existence and valuation of inventory as it can be significant to an entity's balance sheet

Good Practice Identified

The most common areas of good practice identified were largely consistent with those identified in previous inspection cycles. Several good practices were identified in the same areas as the common inspection findings. Most notably, all firms had good practice relating to the challenge of management for the audit of accounting estimates and judgements, with several examples in the areas of impairment and provisions. This demonstrates that consistency in audit execution remains a key area of challenge, and one in which firms have more to do to ensure consistent audit quality across their audits. Other examples of good practice related to effective use of specialists, challenge of management for related judgements and thorough risk assessment for climate and fraud related risks.

Quality Management

The International Standard on Quality Management (UK) 1 (ISQM (UK) 1) replaced the quality control standard (ISQC (UK) 1) and introduced a fundamental change for firms' quality management approaches. This evolution from quality control to a customised system of quality management means a transition from reactive quality checks to proactive, comprehensive, and risk-based quality management, which is more responsive to the complex and dynamic business landscape, and the diverse and nuanced challenges faced by different firms. ISQM (UK) 1 also emphasises the role of leadership and governance, the importance of a quality orientated culture, and the need for continuous improvement. Key differences between ISQC (UK) 1 and ISQM (UK) 1 include:

ISQC (UK)1 requires	ISQM (UK) 1 requires:
Specified quality control processes and policies.	Identification of risks and responses to enable achievement of specified quality management objectives, with few specified responses.
Policies and processes over human resources.	Quality management of human, intellectual and technological resources, including those from networks and service providers.
Policies and processes over consultations.	Broader quality management of information and communication, including information being communicated throughout the firm, with personnel communicating with the firm and one another.
A culture recognising the importance of audit quality.	A culture that recognises the importance of serving the public interest, professional ethics and behaviours, and all personnel being responsible for quality.
Monitoring and remediation processes focused on completed audit engagements.	Proactive monitoring of the System of Quality Management (SoQM) as a whole, with timely, effective remediation and an, at least annual, holistic evaluation, of the SoQM.
Quality focused remuneration policies for audit partners.	All leadership to be held responsible and accountable for quality, and those responsible for the SoQM to be evaluated with consideration of the evaluation of the SoQM.

The FRC reviewed the Tier 1 firms' implementation of ISQM (UK) 1 which included assessing the design and implementation of the firms' internal procedures for monitoring the effectiveness of their SoQMs and the processes and conclusions for their first annual evaluations. The FRC did not independently perform, or reperform, the firms' overall annual evaluations.

Key areas for improvement identified, included where firms needed to strengthen their monitoring processes to ensure that responses to quality risks are designed and operating effectively and to assess other relevant sources of information relating to the extent of mitigation of quality risks. Enhancing the evidencing of the firms' annual evaluation processes, including assessing if any findings indicate potential SoQM deficiencies, individually or in aggregate were also identified.

Notably, one firm ultimately concluded that it did not have reasonable assurance over their SoQM. As this is the first year of the new standard, the FRC are supporting firms in their development of effective and proportionate SoQMs and will continue to challenge their conclusions in future inspections.

Although designed to be scalable, the FRC noted that implementation of ISQM (UK) 1 has been more challenging for firms outside of Tier 1, particularly regarding the monitoring and remediation processes. In response to that, the FRC are increasing the frequency of its supervisory engagement with these firms to support continuous improvement through inspections, briefings, roundtables and publications.

Emerging Risks and Trends

Through its continuous engagement with the firms, the FRC identified firm specific emerging risks and trends that may impact on audit quality, including:

- The increased use of offshore delivery centres to perform higher risk, more complex audit work.
- Changes in firm structure that may increase the risk of conflicts or independence issues.
- Rapid growth and significant portfolio changes that directly impact audit quality because of insufficient resources.
- Changes to audit software that may not work as planned.

Artificial Intelligence (AI)

AI, and other technological advancements, is another key area of focus for the future of the audit profession. Whilst the FRC recognises opportunities for firms that engaging with technological developments might bring into the workplace, it expects them to adopt a measured approach to implementation of such technologies. Firms need to consider relevant regulations, guidance, and wider developing frameworks, including the UK Government's AI principles before introducing such technologies.

The FRC expects firms to bring to its attention any systemic risks or frictions are identified in relation to use of new technologies. The FRC also acknowledges that acquiring and implementing AI related tools and requisite skills can be expensive, potentially limiting smaller firms' ability to use them. Therefore, it encourages firms and their representative bodies to consider these challenges and to collaborate with it to find solutions.

Monitoring by the Quality Assurance Department of ICAEW of Tier 1 Firms

All Tier 1 firms are audit registered by ICAEW. Key findings on the audits requiring improvement or significant improvement were as follows:

- Errors in primary financial statements
- Weaknesses in audit of revenue
- Reliance on work done by other network firms
- Lack of challenge to management in relation to going concern
- Flaws in substantive analytical procedures
- Weaknesses in audit of inventory
- Lack of consideration of the potential capitalisation of development costs

Good practices identified were as follows:

- Challenge of management evident across audit areas such as:
 - accounting for prior period restatements, impairment and valuation
 - assumptions underlying expected credit loss provisions and going concern
- Robust approaches to the audit of revenue including
 - well thought-out use of 'proof in total' testing, and
 - inclusion of unpredictability in audit approach to inventory
- Clear evidence of interaction with component auditors, with supervision and review of their work
- Comprehensive audit documentation including:
 - response to potential litigation
 - internal consultation
 - consideration of impairment risks
 - journal selection and testing
 - work on going concern

The FRC's 'Annual Review of Audit Quality' can be viewed at: [FRC Annual Review](#)

Author: James Barbour, Director – Policy Leadership

FRC publishes full text of revised Financial Reporting Standards

In March this year the Financial Reporting Council (FRC) published its 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'. In September, it published the full text of these standards.

These can be viewed at: [FRS 102](#); and [FRS 105](#).

Both of these standards become effective for accounting periods commencing on or after 1 January 2026, with the exception of the supplier finance provisions which take effect a year earlier i.e. for accounting periods commencing on or after 1 January 2025. We held a webinar in September at which the FRC's Jenny Carter and Stephen Maloney spoke about how the periodic review amendments to UK GAAP will impact the financial statements of unlisted UK entities, including micro-entities.

The webinar can be viewed at: [UK GAAP Periodic Review Revisions](#).

In addition to the FRS 102 and FRS 105, the FRC also published the following revised documents in September which reflect amendments issued to date:

- Overview of the financial reporting framework
- FRS 100 Application of Financial Reporting Requirements
- FRS 101 Reduced Disclosure Framework
- FRS 103 Insurance Contracts
- Implementation Guidance to accompany FRS 103 Insurance Contracts'
- FRS 104 Interim Reporting

The latest documents are available on the FRC website's [accounting standards page](#).

Authors: James Barbour, Christine Scott, Standards – Policy

Private Equity – Letter from the FRC

Given developments in the audit firm environment, the Financial Reporting Council (FRC) has issued a letter addressed to certain audit firms and Recognised Supervisory Bodies (RSBs) regarding its approach to external private capital in UK audit firms. This outlines the FRC's approach to potential changes in ownership structures, emphasising the need to maintain audit quality, independence, and public interest focus; and encourages early engagement with the FRC for firms considering such changes and reaffirms the FRC's commitment to monitoring developments in this area.

UK law requires that audit firms undertaking statutory audit work must be controlled by qualified professionals. It also requires auditors to be independent. Currently there is only a handful of relatively small firms that have any form of external private capital in their ownership structure and rather the UK audit market is dominated by 100 per cent partner owned registered audit businesses delivering audit, wider assurance and related professional services.

The FRC's letter makes clear that ownership structures are a matter for the firms and that it is not in principle against a greater participation of external private capital in the UK audit market. The FRC's role is to protect the public interest and support growth and is primarily concerned with outcomes and behaviours by audit firms such as delivering high quality audits, upholding high standards of ethical conduct, and fostering a culture towards always acting with the public interest in mind. More broadly they are interested in the health of the audit market in terms of it being resilient and providing choice.

The FRC recognises that access to external private capital could, in the right circumstances, have potential benefits for the UK audit market. It may generate additional investment that could be used to enhance audit quality within firms that might not otherwise be able to fund such capabilities. Additional investment and expertise could potentially also help drive innovation, choice and growth in the sector.

However, it also highlights that there are important risks that will need to be carefully managed. As with any other major change within an audit firm that has the potential to affect its leadership and culture, a change in ownership structure via external private capital must be able to maintain and enhance over time the important public interest dimension of audit. It must also be able to protect independence as required by law and allow for any threats to that independence as a result of conflicts to be effectively safeguarded.

This public interest dimension of audit services is important because it supports economic growth and confidence in corporate UK as well as trust in the profession. After all, good quality audit carried out by independent professionals underpins investor confidence and enables businesses access to capital to invest and grow. It also supports broader confidence in financial reporting of UK plc from a range of other stakeholders such as pensioners, employees, creditors and broader society.

Like for any other significant change relating to a UK firm, any party interested in a change of ownership by introducing external private capital must be able to continue to provide assurance that it will be able to support the public interest, the independence dimensions of audit and all applicable regulatory expectations. It is important to demonstrate that the legal requirements, including those pertaining to control, are met both in substance and in form.

A firm that is interested in, or considering, a change of ownership to introduce private capital should engage with the FRC (in addition to its Recognised Supervisory Body) at an early stage and with full candour, assured that all such discussions will be treated in strictest confidence. The FRC would also welcome engaging directly and in confidence with any investors considering entering or expanding into the UK audit market to help explain the regulatory framework and expectations.

The FRC will continue to monitor developments closely and may update its position over time.

Author: James Barbour, Director – Policy Leadership

Centre for Public Interest Audit established

The Centre for Public Interest Audit (CPIA), was incorporated as a not-for-profit company, limited by guarantee in June; this is a new organisation that will bring together auditors from across the profession to shape best practice and inform the future of public interest entity (PIE) audit in the UK.

The CPIA's ambition is to act as a standalone voice on behalf of all PIE auditors, providing a profession-wide perspective on current and future practice, alongside clear-cut recommendations of areas for development and improvement. The CPIA's membership will comprise the full spectrum of UK PIE auditors as well as The Institute of Chartered Accountants in England and Wales (ICAEW) and ICAS. The CPIA is currently engaged on inaugural research on the current state, and future, of PIE audit and will publish its findings in the coming months. Baroness Margaret Ford of Cuninghame, OBE, has been appointed as Chair of the CPIA with further appointments to follow.

The CPIA recognises that audit and assurance plays a critical role in the UK's capital markets and the importance of tackling the most challenging areas of the industry cannot be underestimated. Its ambition is to proactively identify both shortcomings and best practice in public interest entity audit to support a more robust, resilient, forward-looking audit profession, delivering value for and enabling confidence among all stakeholders. Its mission, therefore, aligns with the UK government's aim to strengthen regulatory powers and improve public entity audit quality via its upcoming Audit Reform and Corporate Governance Bill. The CPIA will also look to be a supportive and constructive partner to the Financial Reporting Council as their remit transitions.

The objects for which the CPIA is established are:

- to support best practice in auditing public interest entities among all firms carrying out such audit work;
- to advance knowledge and education in relation to auditing public interest entities to promote consistently high standards of audit quality and to support newer entrants into the public interest entity audit market;
- to provide thought leadership on issues that impact the quality of audits of public interest entities; and
- to do all such other things as shall be thought fit to be incidental or conducive to the attainment of the Objects stated above.

Author: James Barbour, Director – Policy Leadership

This Audit News edition was edited by Michael Lavender, Senior Regulatory Reviewer



CA House, 21 Haymarket Yards, Edinburgh, UK, EH12 5BH
+44 (0) 131 347 0100
connect@icas.com
icas.com

 @ICASaccounting

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