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Key lessons from the FRC's report into the audit of BHS Limited

In the last few months the FRC has concluded a number of investigations, the highest profile of which being the audit of Taveta Investments Limited and its subsidiaries ("the Taveta Group") which included BHS Limited ("BHS").

The report makes a number of negative conclusions about the role of the auditor, not least questions over integrity which are discussed in more detail within the FRC's settlement documents - these can be viewed in more detail at https://www.frc.org.uk/news/august-2018/settlement-documents-in-relation-to-the-2014-audit

There are a significant number of points raised in the report – and ICAS AM encourages firms to review the report in full. In this article we will look at some of key messages in the report which are consistent with issues which have been raised as part of the ICAS audit monitoring process:

- the effectiveness of the RI supervision and review process;
- independence and objectivity – in relation to provision of non-audit services; and
- assessing and reporting on going concern.

First - it is worth setting out some key facts. At the time of the audit, BHS had been loss making for a number of years and was being supported by the Taveta group. In addition, the company had large deficits in two defined-benefit pension schemes as a result of which it had been engaging with the Pensions Regulator (TPR).

During the course of the BHS audit, and therefore prior to issuing the audit report, the auditor became aware of the likely sale of BHS. As highlighted by the FRC's settlement documents, completion of the audit was brought forward to accommodate this sale.

This is an important point – the financial statements were now likely to be subject to an even higher level of scrutiny than normal, and were now of interest to not just lenders and creditors, but also the purchaser and relevant professional advisors (as well as TPR as noted above!).

The effectiveness of RI supervision and review

Under ISA (UK) 220, the engagement partner is required to take responsibility for the overall quality of each audit engagement, for the supervision and performance of the audit engagement and for the auditor's report being appropriate in the circumstances.

The engagement partner is also required, on or before the date of the audit report, and through a review of the audit documentation and discussion with the engagement team, to be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

In the case of BHS, the FRC has raised an issue over both supervision of and communication with the audit team. In light of this, the work performed by the engagement partner was considered by the FRC to be insufficient to demonstrate the level of supervision that was to be expected.

In the case of poorer files reviewed on ICAS Audit Monitoring visits, the reviewer will often conclude that the RI review process has been insufficient or ineffective given the number and nature of issues raised. It is therefore important that there are timely reviews of the following by the engagement partner at appropriate stages during the engagement to allow significant matters to be resolved on a timely basis prior to signing:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and
- Other areas the engagement partner considers important.

Let us consider the second bullet point in relation to significant risks. Using the findings of the FRC in relation to the BHS audit as an example, the firm in this case identified four areas of significant risk at the planning stage (the ISA (UK) 240 risks in relation to revenue recognition and management override of control; impairment; and onerous lease provisions), however, the FRC reported that the engagement partner did not review specific work papers in relation to these areas.

Note that under ISA (UK) 220, an engagement partner need not review all audit documentation but may do so. However, as required by ISA (UK) 230, the partner must document the extent and timing of the reviews, and a common point raised on monitoring visits is the extent to which this review is evidenced on the audit file. Clearly areas of significant risk require the attention of the individual signing the audit report, and there have been instances on ICAS AM visits where the extent of this review is not clear. Often, in discussion with the firm, these matters have been discussed in detail as part of the audit process, however have not been recorded on the audit file during the completion process.

As reported by the FRC as regards the audit of BHS, this lack of supervision by the engagement partner and, to a lesser extent the senior manager, is significant, not least because both individuals recorded substantial amounts of time on non-audit services for the same client in the period leading up to completion of the audit. This leads us onto consideration of independence and objectivity:

Independence and objectivity

In its report, the FRC concluded that the audit firm failed to guard against the self-interest threat created by the substantial fees they generated in providing non-audit services to the Taveta Group. Specifically, the value of non-audit services that the firm provided the client group were eight times greater than the value of the audit services...... This included a contingent fee in relation to a pension incentive exercise.

Under the Ethical Standard (part B s5) (the section of the standard relating specifically to “non-audit services provided to audited entities”): “Where substantial fees are regularly generated from the provision of non-audit services and the fees for non-audit services are greater than the annual audit fees, the audit engagement partner has regard to the possibility that there may be perceived to be a loss of independence resulting from the expected or actual level of fees for non-audit services.”

Where non-audit fees generated from an audit client significantly exceed the audit fee, this non-audit work risks inappropriately influencing the auditor’s judgement and behaviour. On ICAS AM visits, we will review the level of non-audit fee and where significantly in excess of the audit fee, assess how the firm has considered the threat to objectivity and the safeguards employed to reduce that threat to an appropriate level. Where the firm cannot demonstrate that the risk can be sufficiently reduced this is a significant issue and treated very seriously by the monitoring team and the Authorisations Committee.

In the case of the BHS audit, not only had the firm performed a substantial amount of non-audit work for the Taveta Group, the engagement partner, senior manager and audit manager were all involved in performing this non-audit work. Indeed, the engagement partner is noted in the FRC report as being the single point of contact for the client group, had a central role in the provision of non-audit services generally, and was concluded to have a long or close business association with the client.

This nature of this risk is underlined by the ICAS Code of Ethics (the “Code”) and by the FRC Ethical Standard.

The **Code** defines a familiarity threat as “the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work”.

The **Ethical Standard** defines a familiarity (or trust) threat as “when the firm or a covered person predisposed to accept, or is insufficiently questioning of, the point of view of an entity relevant to the engagement. Such threats may arise, for example, where close personal relationships are developed with such an entity’s personnel through long association with the entity”.

By far the most common familiarity threat identified on monitoring visits, relates to long association. However, from time to time the monitoring team will encounter an issue where the engagement partner (or other members of the audit team) have been so involved with the client in terms of non-audit service provision and consultancy that there is similar evidence of a familiarity threat.

While neither the Code nor the Ethical Standard suggest that audit team members should be excluded from non-audit work in these circumstances, the firm is expected to identify these threats, apply appropriate safeguards, and document all considerations on the audit file and centrally as required. Such safeguards may include:

a. Consultation with an ethics partner (where one is appointed under the Standard);
b. Appointment of an independent partner on the audit (i.e. an engagement quality control reviewer);
c. Completely independent teams.

Note that, in relation to the audit of BHS, it has not been suggested that the objectivity of the audit team was impaired, rather that the threat should have been appropriately identified and safeguarded.

Assessing and reporting on going concern

It goes without saying that the going concern assumption is a fundamental principle in the preparation of financial statements.

On any audit, the assessment of the going concern basis can be complicated by uncertainty as to future income streams or availability of financial support. For example, where projections or cash flows are based on lending which has yet to be approved; or where a lender is expected to, but has not, confirmed future funding at the date of signing. Significant uncertainty about a company's ability to continue as a going concern must be disclosed in both the directors report and in the notes to the financial statements. This would include any doubts in relation to financial support at the date of signing.

The directors are also required to be able to demonstrate that the company will remain a going concern regardless of the uncertainty. It's the directors' duty to make these disclosures under current accounting standards. It's then the auditor's duty to refer to them in the audit report. For the auditors to agree with the Directors assessment of going concern, they will need to see evidence that can support this position. Such evidence will include cash flows, forecasts and budgets spanning at least one year from the date of signing the accounts.

The auditor should also consider the appropriateness of the assumptions that are being taken with regard to the going concern basis. It is also important to consider the regularity and predictability of any funding or financial support which underlies these assumptions.

In the case of BHS, and as reported by the FRC, the auditors had:

a. not obtained a going concern assessment from management; and
b. not obtained an assessment of how the company was to remain a going concern in the event of sale, and therefore no longer receiving support from the Taveta Group.

It is worth noting that the financial statements of BHS stated the going concern basis was appropriate because of the continued financial support of Taveta. In fact, there was no such undertaking. Specifically, the financial support offered by the group company was only whilst the company continued to be under its control. Remember, at the time the audit report was signed, the auditor knew that the BHS Group was likely to be sold.

If the appropriate audit evidence had been gathered, the auditor may have drawn the conclusion that a material uncertainty existed about BHS's ability to continue as a going concern. In addition, there is evidence that the disclosures in the financial statements of BHS Group and BHS were potentially incomplete, inaccurate and misleading.

Under the revised ISAs (UK), if the auditor believes that significant uncertainty exists in relation to the company's ability to continue as a going concern, and the uncertainty has been adequately disclosed by the directors, the auditor should issue an unqualified report, modified by including a 'material uncertainty' paragraph highlighting those disclosures.

If, in the worst-case scenario, the auditor believes the going concern basis is not appropriate or that the relevant disclosure given in the accounts is not adequate, then a qualified audit report should be issued. This is likely to create problems in dealing with stakeholders who read the accounts and who may have second thoughts about investing in a company with perceived financial issues. It is therefore important to discuss the issue of going concern with the directors as soon as practicable in the audit process.

Where the going concern assumption is not appropriate, then an entity prepares its accounts on a break-up basis with assets valued on the basis of expected realisation from a forced sale.

The Companies (Statutory Audits) Act 2018 - Ireland

The Companies (Statutory Audits) Act 2018 was signed into law on 25 July 2018, expected to have effect when the Minister for Business, Enterprise and Innovation appoints a commencement order in late September 2018.

The act builds on the 2006 EU audit directive and introduces significant reforms to the regulation and oversight of statutory auditors - the essential elements of the EU rules were introduced into Irish law in June 2016 by way of SI 312 of 2016. While a large part of the Bill has therefore been in place for almost two years in SI 312 – the new Bill will replace the current statutory instrument, elevate its provisions to primary legislation and introduce some new measures.

The 2018 Act only looks to amend the 2014 Act and other enactments, and does not include any stand-alone provisions, so the 2014 Act will continue to be referred to as the "Companies Act 2014", rather than being collectively cited with the 2018 Act.

The Bill retains the designation of IAASA in relation to public oversight of auditors - the recognised accountancy bodies (RABs),),), including ICAS, will continue to conduct the approval of statutory auditors and oversee their continuing education and have responsibility for quality assurance inspections and investigations and discipline with respect to audits of businesses that are not public interest entities.

While the majority of changes will not impact our firms, there are some key areas which firms with audit clients registered in Ireland should be aware.

The Bill inserts the new Part 27 into the Companies Act 2014 which sets out the rules governing how statutory audits must be carried out, the standards that auditors must meet and how IAASA and the accountancy bodies supervise those audits and auditors. It provides for IAASA to add to any international auditing standards adopted by the EU and to allow for a *proportionate approach to small undertakings*. While no changes have been made to the current ISAs, firms will require to monitor any changes made by IAASA in this regard.

The 2014 Act currently provides that where an Irish registered company is late filing its annual return, it will lose any entitlement to avail of audit exemption in respect of both that financial year, and the following year. The 2018 Act will amend the relevant sections of the 2014 Act so that in these circumstances the company will not lose the audit exemption entitlement in respect of the financial year to which the return relates but will instead lose it in respect of the two financial years immediately following.

The Bill introduces a new section (336(10)), which would permit IAASA to prescribe additional requirements in relation to the content of the auditors' report. This would be where IAASA considers it necessary to give effect to specific legal requirements or to add to the quality of the report. This provision will require our firms to monitor carefully any addition requirements in respect of the audit reports of Irish entities.

A copy of the Bill can be obtained at http://www.irishstatutebook.ie/eli/2018/act/22/enacted/en/html

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New ICAS guidance on Scottish charity auditor's reports

- **The ICAS Charities Panel has published new guidance on auditor's reports for ICAS firms acting as auditors of Scottish charities.**
- **The guidance is relevant for the audit of financial statements with reporting periods commencing on, or after, 17 June 2016.**
- **The illustrative auditor's reports are accompanied by commentary to assist the auditors of Scottish charities prepare auditor's reports tailored to the circumstances of their clients.**

The new guidance is intended to assist ICAS registered audit firms prepare auditor's reports for Scottish charities in accordance with International Standard on Auditing (ISA) (UK) 700: Forming an Opinion and Reporting on Financial Statements (revised June 2016) which has led to significant changes in the structure and wording of auditor's reports.

The guidance includes the following two illustrative auditor's reports:

- Unmodified auditor's report for a small standalone charitable company registered in Scotland.
- Unmodified auditor's report for a standalone non-company charity registered in Scotland.

The Scottish non-company charity illustration is applicable to charitable trusts, unincorporated associations and Scottish charitable incorporated organisations (SCIOs).

The accompanying commentary provides further guidance on:

- The accounting and reporting framework for Scottish charities.
- The legislative framework for the audit of Scottish charitable companies.
- Elements of the auditor's report, including the location of the Bannerman wording.

A copy of the guidance can be found at https://www.icas.com/technical-resources/new-icas-guidance-on-scottish-charity-auditors-reports

Reminder regarding charity auditor's responsibilities for the audit of financial statements

The auditor's responsibilities for the audit of financial statements are set out in the relevant legislation, in ISAs (UK) and ethical requirements and a description must be included in the auditor's report.

In the UK, the auditor is permitted to cross-refer to the applicable version of a 'Description of the Auditor's Responsibilities for the Audit of the Financial Statements' that is maintained on the website of an appropriate authority and this is the approach followed in the illustrative examples included in the Guide.

The auditor should not extend their audit work or broaden the matters on which they report in their auditor's report beyond the requirements of the relevant legislation and ISAs (UK) either at the request of their audit client or a third party, for example, a grant funder or, on the rare occasion, where this is relevant, a non-charitable parent.

Please contact the ICAS Policy Leadership Team, if you are asked to undertake additional audit work or prepare an auditor's report which goes beyond the auditor's responsibilities for the audit of the financial statements.

Revised guidance on the Strategic Report

The FRC has published revised Guidance on the Strategic Report, which encourages companies to consider wider stakeholders and broader matters that impact performance over the longer term.

The Guidance recognises the increasing importance of non-financial reporting while maintaining the key principles of the existing guidance and places a greater focus on the directors' duty to promote the success of the company under section 172 of the Companies Act 2006. This is complemented by new legislation that introduces a specific reporting requirement on how directors have had regard to broader matters when performing their duty, including considering the interests of employees, suppliers, customers and other stakeholders as well as impacts on the community and environment.

The new legislation is applicable to large companies for financial years beginning on or after 1 January 2019. A copy of the guidance is available at https://www.frc.org.uk/news/july-2018/revised-guidance-on-the-strategic-report

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Consultation: Draft Statement of Recommended Practice – Accounting by Limited Liability Partnerships (LLPs SORP)

The CCAB has published an updated draft of its LLPs SORP for comment. The underlying purpose of the SORP is to deal with issues that are specific to LLPs and ensure that, as far as possible, LLPs present financial statements that are comparable with those of other entities.

The CCAB has considered whether the 2017 FRS 102 Triennial Review amendments issued by the FRC in December 2017 create any issues specific to LLPs. In conclusion, limited though important changes to the LLPs SORP are considered necessary, including updates to:

- guidance on cash flow statement presentation to reflect the new requirement to disclose the changes in net debt between the beginning and end of the financial period;
- guidance on accounting by small LLPs to reflect simpler recognition and measurement requirements when accounting for certain loans;
- guidance on the revised recognition rules for intangibles assets acquired in a business combination; and
- guidance on merger accounting to reflect the extended definition of a group reconstruction.
- of a minor nature to maintain consistency with the revised FRS 102.

The updated SORP will be effective for periods commencing on or after 1 January 2019, with early adoption permitted provided all amendments are adopted from the same date, with some limited exceptions.

The draft SORP can be found on the CCAB website (www.ccab.org.uk), and the consultation will close on 17 October 2018.