Audit News – Winter 2020

We have had a number of queries from Audit Compliance Principals around receipt of Audit News. All Responsible Individuals in your firm should receive a copy by email. If this is not the case, please contact us, however, note that the most common issues are when:

- ICAS do not hold an up to date email address for the individual; or
- The individual has indicated elsewhere (such as on their own annual return) that they do not wish to receive email communications from ICAS; or
- Emails get caught in an anti-spam filter.

Note that the best way to ensure you receive all communications from ICAS is to give permission to the email that these communications come from (the vast majority come from update@update.icas.com). You can do this by:

- Adding us as a contact on Outlook and marking us as a safe sender.
- On Gmail, marking messages as 'Not Spam' when finding them as well as adding us as a contact.
- On Apple Mail, search for any messages in Junk, go to 'more' and mark as 'not junk'

Audit Monitoring update

2020 Audit Monitoring visits

As a result of the Covid-19 pandemic, and related restrictions, ICAS have suspended all face-toface monitoring activities until further notice, although we have continued to conduct monitoring activities on a remote basis. We have been contacting all firms due to receive an Audit Monitoring visit in the first quarter of 2021, with a view to conducting visits remotely. We will continue to be mindful of government guidance and will update all firms selected for a visit as the year progresses.

Please note that we are conscious of the difficulties that everyone is facing within the profession at the moment, however, are also required to ensure that our regulatory responsibilities are undertaken.

Mandatory audit quality course: Keeping Audit on the Right Track

This course aims to educate Audit Compliance Principals (ACPs) and Responsible Individuals (RIs) in developing a strong compliance function and preventing some of the recurring issues identified on audit monitoring visits.

As highlighted in the previous edition of audit news, the Covid-19 pandemic, and related restrictions, has resulted in the planned 2020 face to face courses being cancelled. The Committee approved the following changes to the course, and to mandatory attendance going forward:

- A video recording of the course is now available on the ICAS website. This is free for members to access any time they wish and is split into seven modules which can be viewed together or individually. The course material can be accessed (by logging into icas.com) at https://www.icas.com/regulation/regulatory-monitoring/keeping-audit-on-theright-track

Should members prefer to attend a face to face course, from 2021 (subject to government guidance) we will present one course each year, in Edinburgh, Glasgow and Aberdeen. The cost of attendance will be in line with previous years, and further information will be provided on **CA Connect**.

- **Firms are reminded that the mandatory aspect of this course has been updated. All ACPs and RIs are now required to view all modules of the online course, or attend a face to face course, once every 2 years (commencing from 1 September 2020). In addition, all new RIs or newly active RIs must view all modules of the online course or attend a face to face course within 12 months of becoming active**.

- **The Committee considers that the availability of the course online will ensure that this mandatory aspect will be more easily adhered to, and that this will maintain the focus on audit quality. Going forward, firms will be required to confirm adherence to the mandatory requirements via the Firm's Annual Return.**

COVID-19 updates and guidance

COVID-19 restrictions, delivering high quality audit work and the impact on audit reports – a reminder

In the period since lockdown commenced back in March 2020, given restrictions on travel and access to client premises and sites, auditors have faced a number of practical difficulties in carrying out audits.

It is extremely important that the current situation does not impact the delivery of high-quality audit work, and that this work continues to comply fully with the auditing and ethics standards. Additional time may be required to complete audits, and it is important that this is taken, in particular where circumstances have changed during the audit process. It is also vital that auditors obtain sufficient and appropriate audit evidence over all matters in support of their opinions, and that where alternative or remote procedures are conducted, that these are sufficient and appropriate in line with the requirements of the ISAs.

Given the significant impact of Covid-19, ICAS AM expects to see more modified audit opinions, in particular:

- Modifications related to going concern – including more 'material uncertainties in relation to going concern'.
- Where there have been challenges in obtaining appropriate and sufficient audit evidence as a result of ongoing restrictions – including limitation of scope qualifications and, in more severe cases, disclaimer of opinion.
- Disagreement around accounting treatment or material misstatement in the financial statements, including an adverse opinion.

In November 2020, The FRC's Developments in Audit 2020, reports audit quality remained too inconsistent in the most recent round of inspections, with 49 out of 130 audits inspected needing either improvement or significant improvement. This inconsistent audit quality was found in audits that were completed before the impact of the Covid-19 pandemic.

Against the backdrop of the pandemic, the FRC has highlighted key issues for audit as:

- Inconsistent audit quality;
- Audit market health and resilience; and
- The Covid-19 pandemic.

While the FRC has highlighted common concerns around the auditor's challenge of management they raise further concern that, given the shock of the Covid-19 pandemic, performance of high-quality audit may be harder to execute.

The FRC have highlighted the most significant impacts of the pandemic in the following areas:

- Judgements, especially around going concern – the business prospects of some companies are highly uncertain, raising questions about whether there is a material uncertainty around going concern. Other judgements have also become more difficult, for example, valuation of intangible assets and assessing impairment of assets.
- Remote working – Every audit engagement has been made more difficult by the need to switch to remote working. The inability to meet with entity management face-to-face continues to create additional risk.
- Controls and fraud risk – Remote working might also have made controls less effective, as some companies may have cut back on the number of people involved in the internal control processes. In addition, greater financial pressure on companies could increase the risk of control failures and fraud.

To maintain audit quality in these difficult times will be a significant challenge for auditors. ICAS AM advises all firms to engage with their audit clients as early as possible in the audit process to:

- set clear expectations as to the level of disclosure required in the financial statements covering the impact of Covid-19;
- discuss going concern, including the prospects of the entity given uncertainty about the economy, expectations for disclosure in the financial statements, and potential impact on the audit opinion;
- ensure audit teams have sufficient time to carry out their work to an appropriate standard; and
- set clear expectations that where the auditor is unable to obtain sufficient, appropriate audit evidence, this could result in modifications to the audit opinion.

Further guidance can be found on the ICAS and FRC websites:

- FRC Developments in Audit (November 2020) can be found here.
- Specific guidance on audit, accounts and corporate reporting can be found here: https://www.icas.com/professional-resources/coronavirus/practice/accounts-audit-andcorporate-reporting

- The FRC has provided further guidance for auditors, covering specific audit issues including going concern considerations, gathering audit evidence during lockdown, group audit restrictions; and modified audit opinions - https://www.frc.org.uk/covid-19guidance-and-advice

As part of the ICAS commitment to supporting the welfare of our members, students and staff, a hub has been launched for information and resources relating to the impact of the Coronavirus pandemic: https://www.icas.com/professional-resources/coronavirus

COVID-19 – Rent concessions – amendments to FRS 102 and FRS 105

The FRC has issued amendments to FRS 102 and FRS 105 which set clear requirements for recognising changes in operating lease payments arising from Covid-19-related rent concessions.

As a result of Covid-19, landlords may have granted rent concessions including temporary rent reductions or rent holidays. The amendments are intended to address the FRCs concerns around the consistency of accounting treatment of such concessions, by ensuring the financial statements reflect the economic substance and temporary nature of the arrangement.

As a result of the amendments, **a lessee** will recognise any change in lease payments (that meet the conditions of the standards) on a systematic basis over the period that the change was intended to compensate - i.e. the benefit is recognised over the period to which it relates rather than over the life of lease.

Note that the conditions relate to temporary rent concessions which have occurred as a direct consequence of the Covid-19 pandemic, and apply if, and only if, all of the following criteria are met:

a) the change in lease payments results in revised consideration for the lease that is less than the consideration for the lease immediately preceding the change;
b) any reduction in lease payments affects only payments originally due on or before 30 June 2021; and
c) there is no significant change to other terms and conditions of the lease.

A lessor will similarly recognise any change in lease income arising on a systematic basis over the period that the change was intended to compensate.

Note that a deferral of rent payments or extension to existing payment terms would not meet the above criteria.

The requirements are the same under both FRS 102 and FRS 105 with the exception of disclosures – under FRS 102 there is an additional requirement to disclose the amount of the change in lease payments recognised in the profit and loss account.

These amendments are effective for accounting periods beginning on or after 1 January 2020, with early application permitted. A copy of the amendments can be found here.

COVID-19 Support schemes – audit considerations

During the course of 2020, the number and in some cases complexity of the various government support schemes has evolved. ICAS AM are now reviewing files where both accounting for and auditing around the various support packages has been required. While this has often been well executed and documented by the audit teams, some common issues have been raised, and we would highlight the following areas which should ideally always be considered by the audit team:

Accounting for government grants

It is important to consider the timing of recognition of any income, expenditure, asset or liability in accordance with the underlying reporting framework, in this case Section 24 of FRS 102 applies for recognition and measurement requirements for government grants.

Government grants, such as the Coronavirus Job Retention Scheme (CJRS), should not be offset against the related expenditure (FRS 102 paragraph 2.52), and are most appropriately reflected within ‘other income’ in the case of a commercial entity. In the case of charities, the SORP reinforces this and specifically disallows the offset of any income and expenditure unless in certain very limited circumstances.

In terms of recognition, the CJRS will usually be recognised over the period of furlough. As regards other support grants, these will usually be recognised in income when grant proceeds are received or receivable.

In relation to the Coronavirus Business Interruption Loan Scheme (CBILS), section 24 of FRS 102 does not necessarily apply. In the case of CBILS there are three main elements, the loan itself, the business interruption payment (the government pays any interest and fees to the lender for 12 months), and the government backed guarantee. The accounting for CBILS has been subject to much debate, in particular whether the loan element amounts to a ‘market-rate’ loan.

Some consider that the stated rate of interest on a CBIL is likely to be a market rate of interest as the entity has actually gone to the market and been offered the loan by its bank – so accounting for the BIP element as a government grant (DR finance costs; CR other income) and the loan element as a basic financial instrument.

An alternative interpretation is that, because of the existence of the BIP payment, the lender is not obliged to pay the full amount of interest on the loan, resulting in a non-market interest rate overall. The loan would therefore be treated as financing transaction and initially measured at the present value of future payments discounted at a market rate of interest.

It is therefore important to review terms of all loan agreements and ensure the auditor’s judgement around disclosure of such arrangements is fully documented on the audit file.

If applying IFRS then International Accounting Standard (IAS) 20, Accounting for Government Grants and Disclosure of Government Assistance, applies. The requirements are very similar to those contained in section 24 of FRS 102.

You should also consider the requirements of IFRS 9, Financial Instruments.

Financial statement disclosures

It will be necessary to consider the level and nature of disclosures which are included, and it may be prudent to engage with clients as early as possible in the audit process to discuss expectations for these disclosures. For example, to determine to what extent disclosures will be made in the Directors or Trustees Annual Report and/or the notes to the financial statements.

In relation to accounting policies, COVID-19 may have resulted in new transactions and balances being recognised in the financial statements requiring information which was not previously required. For example, new or expanded policies might be needed to explain the treatment of:

- Government assistance loans
- Government or local authority grants
- Rent holidays
- Refunds/returns of goods or services.

You should also consider whether the financial statements require disclosure of any significant judgements and estimates associated with the accounting for them. The FRC’s Company Guidance (COVID 19) highlights some examples of judgements which might be relevant in the context COVID-19, including:

- Availability and extent of support through government support measures

- Availability, extent and timing of sources of cash, including compliance with banking covenants or reliance on those covenants being waived
- Duration of social distancing measures and their potential impacts.

Note that Section 1A of FRS 102 has no specific disclosure requirements in relation to grants, however a clear accounting policy and the overriding requirement to present a true and fair view is key, and therefore the suggestions above should be duly considered.

Specific considerations for charities

In terms of charity audit assignments, the following more specific audit considerations are also likely to be required.

In terms of general income recognition, the auditor should evaluate each income stream to determine if there is any impact from COVID-19 on the income recognition criteria set out in Module 5 of the Charities SORP (FRS 102), namely entitlement, probable receipt and reliable measurement. In particular, due to the circumstances of COVID-19, there may be variations to performance-related conditions for donations, contracts or grants that will result in income being recognised at a different point in time as well as the requirement for additional considerations surrounding the fund accounting for income streams, in respect of donor-imposed conditions.

For example:

- Potential deferral of income may now be required for events that have been postponed before the year-end and which are now due to take place after the year end.
- For those events that are cancelled, charities will need to consider whether there should be any repayments of entry fees or donations.
- There may also be further considerations in relation to any event income received which is donated to the charity despite the event cancellation, in lieu of a refund being made, as well as any gift aid that may then be possible to claim.
- In respect of membership fees, consideration of whether any refunds, future credits or enhanced benefits will be offered, and the related accounting in relation to these.

Consideration of entitlement also raises the potentially difficult issue of whether a charity was actually entitled to access the support scheme. The most obvious risk is that a charity seeks to avail itself of the CJRS arrangements where the respective posts are already deemed grant funded. HMRC has repeatedly insisted that "*if you have staff costs that are publicly funded (even if you're not in the public sector), you should use that money to continue paying your staff, and not furlough your staff*".

However, "*organisations can use the scheme if they are not fully funded by public grants and they should contact their sponsor department or respective administration for further guidance*." The devil is therefore in the detail and auditors should ensure they have sufficient appropriate evidence in respect of recognition of such funding, particularly given the potential impact on the charity, both financial and non-financial, should it be determined that a claim was erroneous and recovery be sought.

Further guidance

It goes without saying that the accounting for, and therefore audit considerations, of the pandemic can be complex and a good understanding of the various schemes which either have or continue to be in operation, as well as in depth knowledge of the specific entity which you are auditing, is essential.

Accounting for Government Grants awarded under the Small Business Grant Fund and the Retail, Hospitality and Leisure Grant Fund (November 2020)
https://www.icas.com/__data/assets/pdf_file/0007/562444/Accounting-for-small-business,retail,-hospitality-and-leisure-grants.pdf

Accounting for COVID-19 Government Business Support Measures - Guidance for Preparers (July 2020)
https://www.icas.com/__data/assets/pdf_file/0006/547215/Accounting-for-COVID-19Government-Business-Support-Packages-July-2020.pdf

Charity Resources

ICAS - Coronavirus information for charities
https://www.icas.com/landing/charities/charities-resources/coronavirus-information-forcharities

ICAEW - COVID-19 implications for charity accounting
https://www.icaew.com/technical/charity-finance-professional-community/coronavirus/covid19-implications-for-charity-accounting

OSCR – COVID-19 Guidance for Charities
https://www.oscr.org.uk/guidance-and-forms/covid-19-guidance-for-charities/

Joint SORP Making Body - Implications of COVID-19 control measures and charity financial reporting
https://www.charitysorp.org/media/648486/sorp-covid-19.pdf

The Charity SORP microsite - https://www.charitysorp.org/about-the-sorp/example-trusteesannual-reports/ - versions of the model accounts examples provided which consider the impact of the COVID-19 pandemic are ‘currently’ in preparation.

BREXIT – potential audit issues

The UK left the EU on 31 January 2020. From 1 January 2021, the UK will have left the EU Customs Union and Single Market. Firms should be aware of any changes that they will need to make to prepare for the end of the Transition Period as, for financial years beginning from 1 January 2021, some clients may lose certain accounting, audit and filing exemptions.

UK subsidiary with EEA parent taking exemption from audit – s479A CA2006

Firms are reminded of potential changes when preparing the financial statements for a client with an EEA parent company, who has previously taken exemption from audit further to the permissions in s479A of the Companies Act 2006.

The Brexit Regulations have now changed the requirement under s479A that a parent undertaking must be established in an EEA state, to it having to be established under the law of any part of the UK. This has the result that UK subsidiaries with an EEA parent will no longer meet the criteria for audit exemption.

This means that all UK subsidiaries with an EEA parent, where the group does not qualify as small under the UK audit exemption rules, will no longer be able to take advantage of s479A for financial statements of periods commencing after exit day (currently defined as the end of the transition period on 31 December 2020).

Potential accounting issues to keep in mind:

Group accounts - Intermediate UK parent companies with an immediate EEA parent may not be exempt from producing group accounts from January 2021.

Dormant subsidiary accounts - UK registered dormant companies with EEA parents will need to file individual annual accounts with Companies House for accounting periods beginning in January 2021.

Removal of other exemptions - EEA companies with a UK incorporated subsidiary will not be eligible for certain exemptions from preparing and filing accounts from 1 January 2021, including producing non-financial information statements and alteration of accounting reference dates.

IFRS users - All UK incorporated companies that are currently required to use EU-adopted IFRS will need to use UK-adopted international accounting standards for financial years that begin on or after 1 January 2021. These standards will be the same on 1 January 2021, but the UK will make its own decisions on adoption of IFRS from that date.

If you are an intermediate parent company in the UK with an EEA parent and your parent uses EU-adopted IFRS you can benefit from the s.401 exemption from the requirement to produce consolidated accounts at the UK group level because the UK has granted equivalence to EU-adopted IFRS.

In preparation for the end of the Transition Period, the UK Government has issued letters to audit firms and auditors to explain the arrangements that will be in place for auditors and firms from 1 January 2021.

These letters set out in detail the changes (some of which are covered above) that were featured in the BEIS presentation on YOUTUBE:
https://www.youtube.com/watch?v=l6a8QMM5JA4&feature=youtu.be

BEIS are also running a live webinar for the audit and accounting sectors on 15 December 2020. There will be a chance for Q&A. Anyone wishing to attend should register at: https://www.eventbrite.co.uk/e/accounting-and-audit-framework-transition-period-businessreadiness-tickets-129998010549 to join the webinar.

FRC review reveals where company reporting needs to improve

The Financial Reporting Council (FRC) has published its Annual Review of Corporate Reporting, which reveals the FRC's 'top ten' areas where improvements to reporting quality are needed so users of accounts have a clearer understanding of company performance and position.

In the last year, the FRC reviewed 216 accounts and wrote to 96 companies with substantive questions about their reports. Fourteen companies were required to restate their accounts in instances where significant non-compliance occurred.

The ten most frequently raised issues were in relation to:

- Judgements and estimates
- Impairment of assets
- Revenue
- Financial instruments
- Alternative performance measures
- Strategic report
- Statement of cashflows
- Provisions and contingencies
- Fair value measurement
- Business combinations

Ahead of the 2020/21 reporting cycle, the FRC has warned that preparers will face additional demands against the backdrop of the Covid-19 pandemic and increased economic uncertainty. The FRC also expects disclosure of forward-looking information that is specific to the entity and which provides insights into the board's assessment of business prospects and the methods and assumptions underlying that assessment.

A copy of the review can be downloaded at https://www.frc.org.uk/news/october-2020/frcreview-reveals-where-company-reporting-needs-t

The impact of revisions to ISA (UK) 570 – Going concern

The Financial Reporting Council (FRC) issued a revised ISA (UK) 570 (September 2019) in response to a number of enforcement cases and well-publicised corporate failures where the auditor's report failed to highlight concerns about the prospects of entities which collapsed shortly after these reports were issued. **The revised standard will require greater work on the part of the auditor to challenge management's assessment of going concern and is applicable for accounting periods commencing on or after 15 December 2019, but can be early adopted**

The changes to the standard mean that UK auditors will follow significantly stronger requirements than those required by current international standards. The revisions require:

- Greater work on the part of the auditor to more robustly challenge management's assessment of going concern, incorporating **thorough testing of the adequacy of supporting evidence** and **evaluation of the risk of management bias**.
- Greater use of the viability statement (where applicable for entities who comply with the UK Corporate Governance Code).
- New reporting requirements for the auditors of public interest entities (PIEs), listed and large private companies, including provision of a clear, positive conclusion on whether management's assessment is appropriate, and setting out the work performed in this respect.
- A stand back requirement in which the auditor draws their conclusions on going concern in consideration of all evidence obtained, whether corroborative or contradictory.

From issues raised during audit monitoring visits over the last few years, it is clear that some firms already struggle with the requirements of the ISA (UK) 570 (June 2016) with the most common issues not around the appropriateness of the audit report, but rather how the auditor has documented their work in support of the going concern conclusion.

The revised standard requires greater work effort on the part of the auditor, and includes further detail as to the types of procedures and testing that might be required in the following areas:

The risk assessment process and related activities at the planning stage

The auditor's evaluation of management's assessment of going concern

The auditor's evaluation of the sufficiency and adequacy of evidence obtained in support of the auditor's conclusion

Consideration of the impact on disclosures in the audit report in relation to going concern

A 'stand back' requirement, which requires the auditor to consider all evidence obtained before concluding on the going concern basis

The revised standard effectively impacts all audits with a 31 December 2020 year end onwards. Given the pandemic has raised the risk of going concern for a large number of entities, the auditor's work around going concern could be challenging, in particular where trying to gather evidence in support of their conclusion.

We would remind firms that the requirements of the revised standard have not changed as a result of Covid-19, and auditors should remain professionally sceptical at all times when evaluating management's assessment of going concern. ICAS will be releasing more guidance on consideration of going concern covering the impact of Covid-19 and the requirements of the revised standard on icas.com.

A copy of the revised standard can be downloaded from the FRC website at https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance

The impact of revisions to ISA (UK) 540 – Auditing accounting estimates and related disclosures

The revised ISA was published in December 2018 and is applicable for periods commencing 15th December 2019.

The requirements under the revised standard have changed significantly resulting in an increased work effort on the part of the auditor and the need to engage with management to obtaining an understanding of the nature and extent of estimation processes, and to challenge aspects of how these estimates are derived.

By their nature, accounting estimates can be difficult to audit. Often, they involve significant levels of management judgement and can be subject to uncertainty or a range of measurement outcomes. Over time, as a result of changes to financial reporting standards, accounting estimates have become more commonplace. This brings with it the risk that complicated estimates, which require a great deal of subjective judgement, are not reported clearly by management, or challenged appropriately by the auditor.

The previous version of the ISA was issued in June 2016, prior to a number of recent financial reporting changes. Consequently, given the extent of complexity, uncertainty and judgement around estimates and the risk of material misstatement, the ISA has been revised with a focus on auditor scepticism and challenge of management.

Like the 2016 version of the standard, the objectives of the auditor under the revised ISA are to evaluate whether accounting estimates and related disclosures are reasonable or are misstated in the context of the applicable financial reporting framework.

Examples of accounting estimates related to classes of transactions, account balances and disclosures include, but are not limited to: • Inventory obsolescence. • Depreciation of property and equipment. • Valuation of infrastructure assets. • Valuation of financial instruments. • Outcome of pending litigation. • Provision for expected credit losses. • Valuation of insurance contract liabilities. • Warranty obligations. • Employee retirement benefits liabilities. • Share-based payments. • Fair value of assets or liabilities acquired in a business combination, including the • determination of goodwill and intangible assets. • Impairment of long-lived assets or property or equipment held for disposal. • Non-monetary exchanges of assets or liabilities between independent parties. • Revenue recognised for long-term contracts.

The requirements under the standard however have changed significantly with additional focus on the risk assessment process and how the auditor responds to those risks; a greater emphasis on professional scepticism; and more prescriptive documentation requirements.

The IAASB have published illustrative examples of how you may consider a simple or complex estimate at https://www.iaasb.org/publications/isa-540-revised-implementation-illustrativeexamples-auditing-simple-and-complex-accounting

A focus on risk assessment

The risk assessment requirements of the standard are significant and will be based on auditors' understanding of the entity, its environment and internal control. The auditor will also have to consider the entity's transactions and other events and conditions that may give rise to the need for, or changes in, accounting estimates to be recognised or disclosed in the financial statements.

Some of the key risk assessment requirements of the 2018 ISA are as follows:

Requirement	Impact
Auditors are required to document their understanding of the entity and its environment in relation to its accounting estimates. This includes the system of internal control (as required by ISA(UK)315) and consideration of the relevant financial reporting framework.	Risk assessment procedures may include: • review of prior period working papers and financial statements • inquiry of management and review of minutes of meetings • performance of simple walk-through tests (where possible) of management's process for making the estimate • obtaining an understanding of the sector in which the business operates relevant to the estimate

	• determining whether management has an appropriate risk assessment process in place in relation to identification of estimates • investigating how management makes estimates including relevant methods, assumptions and sources of data • whether management uses an expert in relation to accounting estimates • whether the audit team requires specialist skills or knowledge to complete the risk assessment process.

Auditors require to perform a separate inherent and control risk assessment for each estimate, taking into account estimation uncertainty, complexity, subjectivity and other factors	<u>Inherent risk</u> Documentation at the planning stage should include the auditor's consideration of whether any of the accounting estimates identified represent a significant risk of material misstatement and the reasons for the judgements made. This will include consideration of inherent risk factors **for each estimate** including: • estimation uncertainty – the susceptibility of an estimate to a lack of precision in its measurement • complexity: the complexity involved in the process of making the estimate. • subjectivity: inherent limitations in the data or knowledge that is reasonably available. Other inherent risk factors that the auditor may wish to consider include: • any change in the nature or circumstances of the balance to which the estimate relates • any change in the requirements of the applicable financial reporting framework • the susceptibility of the estimate to misstatement due to management bias or fraud in making the accounting estimate. <u>Control risk</u> Control risk should be assessed at the assertion level for each estimate. This includes understanding what needs to be done to assess the effectiveness of the design of control activities around estimates and what to document. The auditor's evaluation that controls are effectively designed and have been implemented supports an expectation about the operating effectiveness of these controls in determining whether to test them. Accordingly, the auditor may determine that control activities exist but are limited in nature
	and therefore may assess control risk as high, opting instead for a fully substantive approach.

The requirement to perform a retrospective review of the effectiveness of management's estimation process in prior periods	Documentation should include a review of the outcome of accounting estimates made in the prior period or, where applicable, their subsequent re-estimation for the current period. This should include enquiry of management to formally review the outcome of previous estimates. Through performing a retrospective review, the auditor is able to understand the complexity or estimation uncertainty of accounting estimates used, and should therefore document their consideration of: • the effectiveness of management's previous estimation process, from which the auditor can obtain audit evidence about the likely effectiveness of management's current process. • susceptibility of accounting estimates to possible management bias. • changes that may be required to be disclosed in the financial statements.
Consideration of identified risks on a 'risk spectrum' which considers how those risk factors affect the likelihood or magnitude of misstatement.	This will require a change in thinking from attributing an overall 'high, medium or low' risk assessment, commonly applied by auditors. For example, an accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes – **complexity risk** may be assessed as **high**. The estimate of the provision, however, may involve little subjectivity and the degree of estimation uncertainty may therefore be low, depending on the nature of the inventory (**estimation risk** and **subjectivity risk** both assessed as **low**). This is a key driver of scalability in the revised standard because the higher the risk falls on the spectrum, the more work auditors will need to do to obtain sufficient appropriate audit evidence.

The auditor's response to risk: additional requirements

In response to the auditor's risk assessment, each estimate will have to be tested including procedures designed to test how management made the estimate.

The auditor's further procedures shall include one or more of the following approaches:

(a) Obtaining audit evidence from events occurring up to the date of the auditor's report
(b) Testing how management made the accounting estimate

(c) Developing an auditor’s point estimate or range

In some circumstances, obtaining audit evidence from events occurring up to the date of the auditor’s report may provide sufficient appropriate audit evidence to address the risks of material misstatement. For some accounting estimates, events occurring up to the date of the auditor’s report are unlikely to provide sufficient appropriate audit evidence regarding the accounting estimate, and may have to be combined with another of the approaches set out above.

Testing how management made the accounting estimate may involve:

- testing management’s process for making the estimate (including methods, assumptions, data and ranges)
- testing the estimate where this has been developed by a management’s expert
- testing controls (where appropriate).

An auditor’s point estimate or range is developed by the auditor, either by using a different model or the same model used by management but with different assumptions. A reason for implementing this approach could be where management has not taken appropriate steps to understand or address estimation uncertainty, including consideration of alternative assumptions or the performance of a sensitivity analysis.

The auditor may also consider this approach where:

- review of similar accounting estimates made in the prior period suggests that management’s process is not expected to be effective
- the entity’s controls over the process for making accounting estimates are not well designed or properly implemented
- events or transactions between the period end and the date of the auditor’s report have not been properly taken into account, and such events or transactions appear to contradict management’s point estimate.

More emphasis on professional scepticism

Accounting estimates by their nature are more susceptible to misstatement due to management bias or fraud. The revised ISA therefore places additional emphasis on professional scepticism. This is affected by consideration of inherent risk factors, increasing when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity or other inherent risk factors.

The revised ISA has several changes designed to emphasise the application of professional scepticism, including a focus on gathering evidence which may be contradictory and purposefully changing the language of the ISA to reinforce the challenge on management.

It is therefore important that auditors consider audit evidence carefully and ensure evaluation of evidence includes both corroboration of management explanations, and the gathering and consideration of contradictory evidence.

More documentation

As a result of the new requirements, there are more prescriptive documentation requirements ensuring that the file adequately records:

a) Key elements of the auditor’s understanding of the entity and its environment, including the entity’s internal control related to the entity’s accounting estimates

b) The linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level, taking into account the reasons (whether related to inherent risk or control risk) given to the assessment of those risks
c) The auditor's response(s) when management has not taken appropriate steps to understand and address estimation uncertainty
d) Indicators of possible management bias related to accounting estimates, if any, and the auditor's evaluation of the implications for the audit
e) Significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework or are misstated.

It is therefore extremely important that audit files document the auditor's journey from the risk assessment stage demonstrating sufficient scepticism.

Scalability?

The revised standard is intended to be scalable for all types of estimates. The auditor's work effort will therefore differ based on the auditor's assessment of the risk of material misstatement and the complexity of the estimate itself.

The standard notes that processes relevant to accounting estimates may be uncomplicated because the business activities are simple, or the required estimates may have a lesser degree of estimation uncertainty. Examples of paragraphs that include guidance on how the requirements of this ISA (UK) can be scaled include paragraphs A20–A22, A63, A67 and A84, however, and as noted above, breaking down risk across estimation uncertainty, subjectivity, complexity, and other risk factors is part of this process.

While this can be taken into consideration in respect of less complex entities and some ownermanaged businesses, auditors must maintain scepticism as controls over development of these estimates may be limited, and an owner-manager may have significant influence over their determination. The owner manager's role in making the accounting estimates will need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering the risk of management bias.

Note that firms auditing less complex entities or financial statements with low risk estimates will still require to document how the standard can be scaled for this work.

A copy of the revised standard can be downloaded from the FRC website at
https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance

Revision to ISA (UK) 700 - Forming an Opinion and Reporting on Financial Statements

Following a revision to ISA (UK) 700 (Revised January 2020), for audits of financial periods commencing on or after 15 December 2019, auditors are required to explain in the auditor's report to what extent the audit was considered capable of detecting irregularities, including fraud. This was already a requirement for auditors of public interest entities (PIEs) in ISA (UK) 700.

In particular, firms are directed to section 29-1 and guidance paragraphs A39-1 to A39-5 of the January 2020 standard, a copy of which can be downloaded from the FRC website at
https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance

The FRC has suggested use of the following wording in the statement of auditor responsibilities, and that the auditor should consider how this is tailored to each entity's individual circumstances:

"Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities, outlined above, to detect material misstatements in respect of irregularities, including fraud. The extent to which our procedures are capable of detecting irregularities, including fraud is detailed below:

[Explanation as to what extent the audit was considered capable of detecting irregularities, including fraud.]"

The auditor should ensure that any further explanation reports matters of significance in the context of the financial statements being audited, and therefore that these are specific to the circumstances of the entity and are not generic or boilerplate. The auditor may explain the extent to which aspects of the auditor's work addressed the detection of irregularities, for example:

- How the auditor obtained an understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- Which laws and regulations the auditor identified as being of significance in the context of the entity.
- The auditor's assessment of the susceptibility of the entity's financial statements to material misstatement, including how fraud might occur.
- The engagement partner's assessment of whether the engagement team collectively had the appropriate competence and capabilities to identify or recognise non-compliance with laws and regulations.
- Matters about non-compliance with laws and regulations and fraud that were communicated with the engagement team.
- The auditor's understanding of the entity's current activities, the scope of its authorisation and the effectiveness of its control environment where the entity is a regulated entity.
- In the case of a group, how the auditor addressed these matters at both at the group and component levels.
- Communications with component auditors to request identification of any instances of non-compliance with laws and regulations that could give rise to a material misstatement of the group financial statements

A copy of the revised standard can be downloaded from the FRC website at https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance

The FRC's Bulletin - Illustrative Auditor's Reports On United Kingdom Private Sector Financial Statements, can be found at https://www.frc.org.uk/auditors/auditassurance/standards-and-guidance/bulletins

There are conforming amendments to other ISAs including ISAs (UK) 240, 250A, and 600.

IAASA outlines COVID-19 and BREXIT as two key considerations when preparing 2020 financial statements

The Irish Auditing and Accounting Supervisory Authority (IAASA) has published its annual *Observations* paper highlighting some significant topics that those charged with governance should consider when preparing their financial statements for 2020.

While IAASA's remit extends only to companies with securities admitted to trading on a regulated market, the topics identified in the 2020 *Observations* paper could usefully be taken into consideration by a much wider range of preparers, approvers and auditors of financial statements.

The paper highlights some key areas that warrant close scrutiny in the upcoming reporting season including:

- the pervasive impact of the COVID-19 pandemic on the recognition, measurement, presentation and disclosure of income, expenses, assets and liabilities in companies' financial statements; and
- the challenges and uncertainties facing companies from Brexit.

IAASA have issued a number of further technical releases and announcements in the current period, including:

- A compendium of illustrative audit reports for use in the audit of Irish companies
- An ISA (Ireland) 701 Thematic Review
- A consultation on the revised ISA (Ireland) 315
- A paper on the audit of accounting estimates

These can be found on the IAASA website here.

As a reminder, as confirmed in our direct communication to firms in November 2019, any firm registered with ICAS to conduct audit work that wishes to do so in the Republic of Ireland is required to be separately approved to do so. Should you have any questions in this regard please direct these to: regulatoryauthorisations@icas.com

Local Audit and Accountability Act 2014: ICAS surrenders RSB Status for Local Audit from 1 January 2021

In November 2020, the Board of the Financial Reporting Council approved a request by ICAS to surrender our status as a Recognised Supervisory Body (RSB) under the Local Audit and Accountability Act 2014 ("the 2014 Act"). As a consequence, ICAS will cease to hold RSB status for local audit in England from 1 January 2021.

ICAS became a RSB for local audit in 2015. Only a small number of registered audit firms applied for authorisation to undertake local audit work under the 2014 Act. ICAS no longer authorises any firms for local audit work in England, and earlier this year the ICAS Regulation Board invited the Council to initiate the process to surrender our RSB Status for Local Audit in England.

ICAS remains a RSB for statutory company audit in accordance with the Companies Act 2006.

Should you have any questions in this regard please direct these to:
regulatoryauthorisations@icas.com