

AUDIT NEWS

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INTRODUCTION

Welcome to the summer edition of Audit News.

In this edition we have included an article on Financial Reporting Standard (FRS) 102 and potential audit issues that firms should consider as their clients embark on the transition process. We have also looked

at changes to the Audit Regulations; the introduction of interim calls into the Audit Monitoring process; the provisions of the Deregulation Act 2015 in relation to auditors leaving office; and a reminder about the ICAS mandatory Audit Quality Course.

We are also pleased to announce that our Audit Monitoring Annual Report, which outlines our activities in 2015, and provides a summary of findings from 2015 monitoring visits, has been released and is available on icas.com.

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FRS 102 – POTENTIAL AUDIT ISSUES

For accounting periods beginning on or after 1 January 2015, FRS 102 will be applied by the majority of large and medium-sized UK entities.

There are a number of key differences between previous UK GAAP and FRS 102, including areas where the accounting treatment under FRS 102 is substantially different.

The areas which have the biggest impact will depend on the individual circumstances of each entity. This article covers some aspects of the FRS 102 requirements in a limited way to illustrate areas of focus for audit firms, in particular in the year of transition but should not be seen as a substitute for the auditor reading FRS 102 in full. However, ICAS Audit Monitoring strongly recommends that principals and staff

undertake sufficient training in the requirements and do not rely solely on accounts preparation software.

There are three key areas to consider on transition to FRS 102:

- Audit risks – There are specific audit risks in relation to transition arrangements, including auditor judgement and appropriate professional scepticism.
- Potential ethics issues – There are ethical matters for auditors to consider if involved in the accounts preparation process - clients implementing FRS 102 may request your help and advice with transition; and
- Potential accounts / transition issues - There are significant challenges for audited entities and the firms auditing these FRS 102 disclosures and transition adjustments.

Audit risks relating to transitional arrangements

The following examples provide guidance on some of the areas that may give rise to audit risk including risk of material misstatement on transition.

Use of fair values for the first time

As part of the requirements of International Standard on Auditing (ISA) (UK and Ireland) 540, audit firms will need to document and consider how management has determined the amounts to include where FRS 102, particularly in relation to more complex financial instruments (those where section 12 of FRS 102 applies) requires the use of fair values:

- Where a particular fair value accounting estimate involves high estimation uncertainty, this should be identified as a significant risk; and
- Where a valuation calculation or technique is used by management, the auditor should seek to understand that calculation and aim to conclude on its appropriateness.

The audit firm should not accept or assume responsibility for determining appropriate fair values and it should be clear that responsibility for this rests with management of the entity. It may, however, be useful for auditors to advise their clients of the need to obtain valuations timeously where these will be required by management in the financial statement preparation process in order not to delay the audit process.

Application of 'undue cost or effort'

The auditor should identify any intention by management to claim 'undue cost or effort' as a rationale for non-compliance with certain requirements of FRS 102. The auditor should consider whether this is reasonable and appropriate, corroborate management explanations for non-compliance, and be prepared to challenge if appropriate.

Using undue cost or effort may be a way of introducing management bias and appropriate professional scepticism should be evident on the files reviewed.

Example – investment property

Section 16 of FRS 102 permits recognition of investment property using the cost model where "obtaining a reliable fair value would involve undue cost or effort". Where management have taken advantage of this exemption, the auditor should consider:

- the materiality of the property;
- whether management has previously obtained a valuation under Statement of Standard Accounting Practice (SSAP) 19;
- the users of the financial statements and their interest in fair value (consider an owner managed company with no borrowings vs. a company with external shareholdings and significant bank loans);
- management's ability to determine whether the investment property has been impaired below cost without undertaking a valuation; and
- management's rationale for concluding that the cost or effort involved is 'undue'.

Previously unidentified misstatements

In performing their work on opening balances and comparative information, auditors should plan their work to identify any errors that have not previously been reported. Such prior year misstatements should be dealt with as errors and may not be presented as transition adjustments.

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Fixed assets - Residual values

Under FRS 102, preparers of financial statements must consider depreciable amount through comparison of cost to residual value. Residual value is based on the estimated amount that an entity would currently obtain from the disposal of an asset, after deducting estimated costs of disposal, if the asset were already in the age and condition expected at the end of its useful life.

This means that, under FRS 102, residual values will change over time as prices fluctuate and which will be particularly evident in appreciating assets such as buildings. This was not the case under old UK GAAP.

The audit file should therefore document:

- whether the residual value used is appropriate;
- the risk that residual values used at each reporting date will have changed such that depreciation is materially misstated;
- evidence that establishes the current price for an asset at the reporting date.

Investment properties

As noted above, unlike SSAP 19, FRS 102 permits the use of cost less depreciation but only if fair value cannot be measured reliably without undue cost or effort;

In a key change from SSAP 19, where investment property is revalued under FRS 102, any changes in fair value are recognised in profit or loss. Under SSAP 19 movements were usually recognised in the Statement of Recognised Gains and Losses (STGRL).

In auditing the balance sheet at the date of transition, firms will have to consider the effect on any revaluation reserve which was created historically from the revaluation of investment property. In addition, in a change from FRS 19, FRS 102 requires deferred tax to be recognised on these fair value changes. Deferred tax is discussed further below.

Intangibles and goodwill

Section 18 of FRS 102 requires that intangible assets and goodwill be amortised over the useful economic life of the asset. The useful economic life of intangible non-current assets and goodwill is not more than ten years unless a reliable estimate of their useful economic lives can be made.

Under old UK GAAP many entities have opted for a significantly longer useful economic life and may wish to continue to do so. Provided that management can justify the longer useful economic life, there is no need to shorten the period over which goodwill is written off. Note, however, that indefinite lives are not permitted.

The file should document the auditor's consideration and robust challenge of either:

- Management's rationale to continue amortisation under the previously useful economic life; or
- Management's judgement in relation to a revised useful economic life on transition to FRS 102.

Also, it should be noted that the definition of an intangible asset now allows for such assets to be recognised where they arise from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations. This means that when a company acquires another entity it is possible that certain items that were previously consumed within the figure for goodwill will require to be separately identified and valued as separate intangible assets thus reducing the amount allocated to goodwill.

There is a possibility that review of the useful economic lives of goodwill and intangibles on transition may give rise to evidence that the previous assessment was not appropriate – this should be adjusted as an error rather than a transition adjustment.

Defined benefit schemes

Under FRS 102, entities are no longer required to involve an actuary when determining net liabilities arising from an entity's obligations under defined benefit schemes.

The auditor must, however, still conclude on whether the figures and disclosures included in the accounts are materially misstated. Not involving an actuary in obtaining those figures will increase the audit risk in this area.

Where an actuary is not involved, the auditor will need to form a particularly robust assessment of the pension scheme valuation, including whether management are competent to do this.

Where management does not involve an actuary and the auditor is unable to obtain sufficient appropriate audit evidence through alternative means, the auditor will need to consider modification of the auditor's report in relation to this limitation of scope. Given the potential impact of a pension scheme valuation on an entity's financial statements auditors are advised to discuss this matter early with their clients and to emphasise the benefit of having an actuary provide the valuation and to remind them of their responsibility of preparing accounts which show a true and fair view.

Going concern (ISA 570)

Transition to FRS 102 may result in more volatility in the financial statements, including the effect of fair value adjustments and revaluation movements. Such volatility could have implications for loan covenants and other agreements with an entity's stakeholders.

Where possible breaches of terms and conditions of such agreements have been identified, the auditor should perform procedures and document consideration of:

- possible implications for going concern status;
- consideration by management in its assessment of going concern and
- adequacy of the disclosures in the financial statements; and
- any implications for the audit report.

Financial Instruments

FRS 102 requires financial statements to separate financial instruments into 'basic' and 'other'. The former are covered in section 11 of FRS 102 and the latter in section 12. Many common financial instruments will satisfy the definition of a basic financial instrument e.g. cash; trade debtors, trade creditors etc (please refer to paragraphs 11.8 and 11.9 of FRS 102). However, whilst those covered by section 12 are generally of a more complex nature that does not necessarily mean that they are rare.

Auditors will therefore need to ensure that clients correctly identify financial instruments and account for them in accordance with the relevant provisions. As a very rough rule of thumb section 11 requires application of the amortised model (there are exceptions) to be applied and section 12 requires the use of fair value (there are exceptions).

Areas that might prove challenging for clients include the recognition and measurement of directors' loans and in group situations, inter-group loans. Careful consideration will be required as to whether such amounts are in fact capital contributions or loans. Consideration also needs to be given by auditors as to whether such loans are repayable on demand and whether they have been provided at below market rates of interest. Normally one would expect loans that are repayable on demand to be included at the balance outstanding. Where loans have been provided at an interest rate below market value then one would normally expect that this would need to be reflected in the amount shown in relation to the asset or liability on a company's balance sheet. The FRC Staff Education Note 16 'Financing Transactions' may be useful in this respect.

Foreign currency

Under SSAP 20, it was permissible to translate transactions at a rate specified in a forward contract. However, FRS 102 requires all transactions to be translated at the relevant rate of exchange at the time of the transaction. Also, monetary and non-monetary items carried at fair value should be retranslated at closing rates or the rate in force when the fair values were determined. Using a form of hedge accounting to translate at a rate specified in a forward contract is not permitted. FRS 102 does specify criteria that must be met to allow hedge accounting to be applied.

Distributable reserves

Auditors should be aware that the transition to FRS 102 may have an impact on the level of distributable reserves. For example, increases in the value of investment properties go to profit and loss account but are not realised and hence not distributable.

Potential ethics issues

While some audited entities will have internal resources available to deal with the transition to FRS 102, a large number will look to their auditor for help in completing the transition. Smaller entities in particular are likely to seek advice or assistance on adoption of the new standard.

Auditors need to remain independent of audited entities, and are bound by the FRC Ethical Standards which place limits on the services they can provide.

Whenever auditors are requested to provide non-audit services to audited entities, they are required to consider the potential threat to their objectivity or independence. The two key threats are likely to be the self-review threat and the management threat.

Self-review threat

A self-review threat exists when the results of a non-audit service performed by the engagement team or by others within the audit firm are reflected in the amounts included or disclosed in the financial statements.

Management threat

A management threat exists when the audit firm undertakes work that involves making judgements and taking decisions that are properly the responsibility of management.

The following types of non-audit service are those likely to be relevant to auditors of entities transitioning to FRS 102:

- accounting services;
- valuation services; and
- tax services.

Accounting services

Entities cannot simply subcontract the transition to FRS 102 to their auditor and ask them to make decisions about the preparation and presentation of financial statements under the new standard. Management should retain overall control of the process at all stages and should make all of the relevant decisions.

The current Ethical Standards actually exclude advice on the implementation of current and proposed accounting standards from the definition of accounting services. Note however, that in providing advice on the transition to FRS 102, the auditor is

still required to safeguard against:

- giving bookkeeping advice;
- deciding what accounting policies an entity should apply; and
- making specific accounting entries, where these go beyond a technical, mechanical or informative nature.

Each of these create potential self-review threats to the auditor's independence. Accordingly, it should be clearly established that management retains full responsibility for the basis on which financial information is prepared and presented, including:

- preparation and presentation of financial information;
- selection and application of accounting policies; and
- development of accounting estimates.

Valuation services

Valuations by nature involve a significant degree of judgement and are likely to have a material effect on the financial statements. The provision of specialist valuations by the auditor is unlikely to be allowed by Auditor Ethical Standard 5 (replaced by section 5 of the Financial Reporting Council's (FRC) Ethical Standard (ES) for accounting periods commencing on or after 17 June 2016) even if the audit firm implements specific safeguards.

This will be relevant during transition to FRS 102 in a number of areas of the financial statements. For example, where a specialist valuation of unlisted share investments is required - under FRS 102 these must be accounted for at fair value through P&L if the shares are publicly traded or their fair value can otherwise be measured reliably. All other such investments shall be measured at cost less impairment.

Audit firms should be careful to ensure that they are not making judgements which are rightfully those of management

Tax services

For entities other than listed companies, the auditor may prepare current or deferred tax calculations for the purpose of preparing accounting entries, provided those services:

- do not involve initiating transactions or taking management decisions;
- are of a technical, mechanical or an informative nature; and
- appropriate safeguards are applied.

There will be tax implications of transitioning to FRS 102, including a significant deferred tax impact on some valuation adjustments. The auditor should take care to ensure that any tax services provided are limited to the nature mentioned in the Ethical Standard(s).

Potential disclosure issues

First time adopters must prepare an opening FRS 102 statement of financial position (balance sheet) at the date of transition, using FRS 102 accounting policies. This will almost always lead to a prior years' adjustment from amounts previously stated under UK GAAP.

For example:

First time adoption of FRS 102 for a company with a year-end of 31.12.15; will require an opening balance sheet prepared at a transition date of 1.1.14 - i.e. the start of the comparative year.

This requires recognition, measurement and classification of all assets and liabilities at 1.1.14 under FRS 102 subject to the mandatory and optional exceptions contained in paragraphs 35.9 and 35.10 of FRS 102.

For Audit firms will need to perform additional procedures to determine whether comparative information has been appropriately presented within the financial statements.

This is likely to involve the performance of additional audit procedures to assess whether the comparative information has been accounted for and presented in accordance with FRS 102 in all material respects.

A detailed transition note is also required to be provided in the financial statements, detailing changes in accounting policy and their impact from UK GAAP to FRS 102. Differences between the comparative balance sheets should be reconciled and disclosed (so for a 31/12/15 year end, there would be a detailed FRS 102 vs UK GAAP reconciliation for the figures disclosed at 31/12/14).

As a non-standard disclosure item, there may be a risk that misstatements exist within the reconciliation, and work performed on the accuracy of this note should be clearly documented on the audit file.

Potential issues:

- Statement of financial position at transition not prepared;
- Incorrect transition date used (e.g. 1/1/15 instead of 1/1/14);
- All adjustments made at current year end rather than as a result of a prior year(s) adjustment.
- Adjustments being reflected incorrectly (in some cases the wrong way round);
- No transition note disclosed;
- An insufficiently detailed transition note.

Audit firms should either have access to a suitable financial statements disclosure checklist or establish policies and procedures to determine how they will assess whether the disclosures are complete.

In addition to completeness of disclosures, audit firms will need to design audit procedures that address the quality of the disclosures.

Taxation

As has been highlighted it is expected that on transition there may be a significant number of adjustments both to the carrying value of assets and liabilities recognised previously under Old UK GAAP and in terms of newly recognised assets and liabilities. For accounting purposes these adjustments will be made to the assets and liabilities as at the accounting transition date with a corresponding adjustment made directly to the opening profit and loss account reserves. Auditors need to be aware that there is also likely to be an impact on a company's corporation tax liability.

As stated at the start of this article, this is only a limited review of some of the issues auditors may face as clients begin to implement the new standard.

ICAS AM strongly recommends that principals and audit staff undertake sufficient training in the requirements and do not rely solely on accounts preparation software.

For further information, including technical guidance and upcoming course, search 'FRS 102' on icas.com

CHANGES TO THE AUDIT REGULATIONS

The Audit Regulations have been updated with effect from 17 June 2016 to take account of the changes initiated by the EU Audit Regulation and Directive of 2014 (ARD), which have been transposed into UK law by the Statutory Auditors and Third Country Auditors Regulations (SATCAR).

The impact of SATCAR applies across a whole range of audit activity in the shape of eligibility criteria; accounting standards; ethical standards; and governance criteria. However, they also include a reshaping of audit oversight and the enforcement process in the UK, and this restructure has required a number of changes in the Audit Regulations.

The legislation has taken the form of a short new legislation in its own right recognising the FRC as the ultimate competent authority, and then makes a number of amendments to the Companies Act 2006 and Schedule 10 to that act which sets out the role and obligations of the Recognised Supervisory Bodies (RSBs), including ICAS.

The new structure transfers the responsibility for the performance of the tasks associated with audit regulation (including licensing, monitoring, and enforcement) to the FRC, which in turn delegates these tasks to the RSBs to the extent it is permitted and wishes to do so. In the case of inspection and enforcement, the EU Audit Regulation and the Companies Act changes do not permit this role to be delegated where it relates to audit firms carrying out the audits of Public Interest Entities (PIE) in respect of those audits. The FRC under their delegation powers have also chosen to retain with the PIE audits a number of AIM and ISDX audits where the entities concerned have a capitalisation of more than €200m.

In practice most firms will see very little change in process from the current regime, but in reality the FRC will be exercising a lot

more control over the regulatory process. The following are of particular importance to note:

- The FRC will be able to apply enforcement sanctions direct without any contact with the RSBs, and can apply these not only to PIE and AIM auditors but to any audit firm where they have elected to take over the audit inspection and investigation of individual cases. This direct power is summarised at new audit regulations 1.02A, 1.02B and 7.11 and replaces the Auditor Regulatory Sanctions Procedure introduced in 2013; this had been set out in regulations 7.00A and 8.02 which are now deleted and 7.02 and 8.06 which are amended.
- The powers of the FRC also include the ability to move licences of individual firms between bodies or directly administer them themselves. In such cases the rules of the new RSB can apply to that firm. This requirement is set out in 1.02A.
- The ARD required some additional sanctioning powers be given to the regulatory bodies, and these have been brought into chapter 6 of the regulations. These include the ability to order repayment of an audit fee in part or whole, and to declare an audit report invalid (regulation 6.02(p)).

The future regulatory process as it is to apply in the Republic of Ireland has not yet been fully determined though some interim arrangements are to be enacted in June 2016. Consequently, these new Audit Regulations only apply to UK audits, and Irish audits will continue to be regulated under the 2013 edition of the Audit Regulations.

The final version of the updated Audit Regulations will be made available on the ICAS website in due course at www.icas.com

ICAS AUDIT MONITORING: INTERIM CALLS

ICAS Audit Monitoring (ICAS AM) has made an enhancement to the monitoring of firms registered to conduct audit work.

It can be the case that some firms are not subject to a monitoring visit for a period of 6 years, and ICAS AM consider that during such a time there may be significant changes either in the profession, or within firms, that may impact on the ongoing level of compliance.

In order to maintain contact with firms, and to build on the current monitoring process, some firms may be selected for a phone-call discussion with a member of the ICAS AM team to discuss various aspects around the audit work of the firm, with the objection of promoting continued compliance and quality.

All firms registered to conduct audit work with ICAS must receive a monitoring visit within the time prescribed by legislation and directives in place at that time. As at June 2016 this is at least every six years.

Given the length of time between such visits, there can be factors that impact on compliance, including but not limited to:

- A significant change in the partnership or structure of a firm;
- A change in who has responsibility over certain aspects of a firm (including the Audit Compliance Principal);
- Major changes in audit or accounting regulations; and/or
- A restructuring or merger with another firm.

Interim phone-call procedure

Where a firm has been selected for an interim phone-call, this is likely to take place around the mid-point of the expected visit cycle, and will be held with the Audit Compliance Principal. The firm will be notified in advance, and the length and content of an interim phone-call will be dependent on the risk factors identified. The phone-calls will generally include discussion on:

- Any changes to the firm since the previous visit, including partnership and Responsible Individual changes;
- The firm's audit client base, including any new and/or ceased engagements;
- Confirmation that fit and proper, independence and confidentiality declarations are completed by all partners and staff;
- Audit CPD undertaken, or confirmation on how audit competence has been, and will be, maintained;
- The Audit Compliance Review process;
- Audit procedures in place; and
- Attendance at the ICAS mandatory audit course.

The process will also allow firms to ask questions of ICAS AM, and it is anticipated that this process will support the developmental approach to regulation that ICAS AM has adopted.

THE DEREGULATION ACT 2015

The Deregulation Act 2015 is effective for accounting periods commencing on or after 1 October 2015. Schedule 5 of the Act simplifies the requirement to provide information to shareholders, creditors, Companies House and relevant accounting bodies when an auditor leaves office.

When an auditor of a non-public interest entity leaves office other than at the end of the period for appointing auditors for a private company or at the end of an accounts meeting for a public company, no notification will be required if the reason for leaving is an exempt reason, unless there are issues which the auditor needs to bring to the attention of the members or the creditors.

Exempt reasons are:

- The firm ceasing to practice;
- If the company has become audit exempt;
- If the company is a subsidiary of a UK parent where the parent prepares group accounts and the ceasing auditor is being replaced by the group auditor; or
- If the company is being wound up under an insolvency procedure

The Deregulation Act can be downloaded [here](#).

ICAS MANDATORY COURSE ATTENDANCE – KEEPING AUDIT ON THE RIGHT TRACK

As we have previously communicated, the second cycle of our mandatory audit course has now commenced. The previous two courses have been consolidated into one single course, lasting three hours, and is called 'Keeping Audit on the Right Track'.

We would like to remind firms of the mandatory requirement with regards this course, which stipulates that:

- Each Audit Compliance Partner (ACP) will be required to attend at least once in the three year period from 1 January 2016 to 31 December 2018;
- Each Responsible Individual (RI) will be required to attend at least once in the five year period from 1 January 2016 to 31 December 2020;
- Each newly approved RI will be required to attend the course within 12 months of approval; and
- Each RI who was previously inactive, but who is now undertaking an active RI role again, will be required to attend the course within 12 months of becoming active.

We will be presenting two further courses in 2016, and you can book a place on one of these courses at www.icas.com

- 4th November 2016 in Dundee; and
- 9th November 2016 in Glasgow.

We would also like to make you aware that due to the increased mandatory requirement, the number of courses held going forward will be greater than in previous years. We also confirm that there will be annual courses in Aberdeen; Glasgow; and Edinburgh, in addition to rotating various locations throughout the cycle, including, but not limited to, London in 2017 and Inverness in 2018.

