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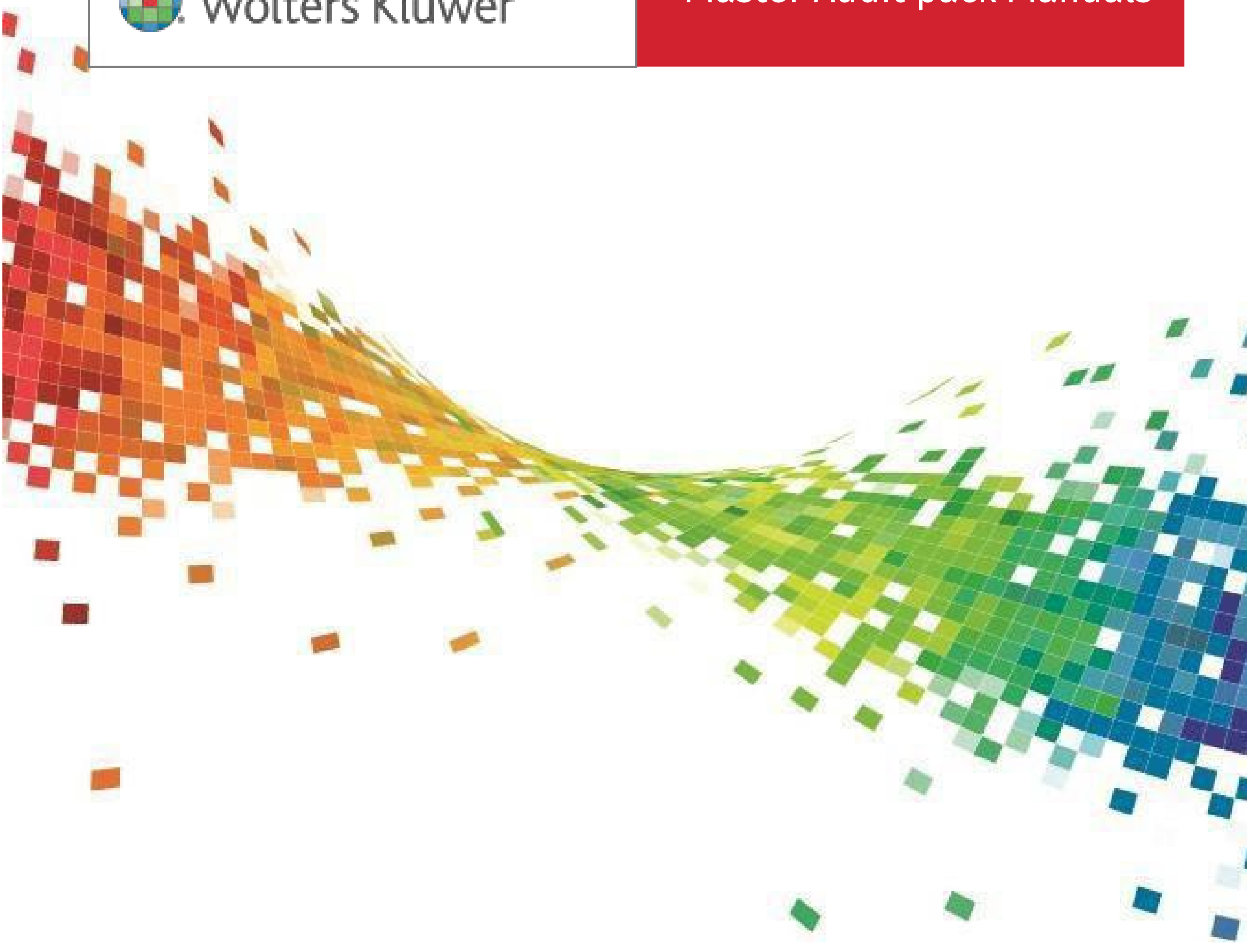
CCH Audit Automation

PCAS Company v18
PCAS Pensions v17
PCAS Academies v11
PCAS Charities v17
PCAS Non Audit v17

Master Audit pack Manuals



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1. Initial procedures

1.1 Scope and framework

Purpose, scope and structure

This Audit methodology ~~area of *Navigate Audit*~~ provides practical insights to auditors to enable them to carry out audits in anefficient manner. An audit needs to be effective both in terms of cost and in achieving the audit objectives.

This guidance deals with the general principles of auditing a private company, or group, underUK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022).* This guidance assumes that the auditor has checked the relevant legislative and other requirements and has determined that the entity in question does, indeed, require an audit. It does not cover:

- auditing accounts under FRS 101, FRS 105 or IFRS;
- the requirements of auditing a specific industry;
- auditing specialist entities such as charities, clubs, pension schemes and academies; and
- independent examinations, assurance engagements, audits of interim statements, abbreviated audit reports and audit reports not on financial statements.

~~Further guidance on these areas is available elsewhere on Croner-i Tax and Accounting.~~

Guidance for specific master packs such as Pensions, Academies and Charities are included as separate chapters below.

The process of performing an efficient and effective audit can be divided into the followingthree parts, which form the basis of the structure of this guidance:

- planning;
- execution; and
- completion.

Planning considers the steps that should be taken to enable the auditor to plan an efficient and effective audit. Execution considers the design and execution of the audit plans. There isa separate section for each of the individual FRS 102 financial statement areas that may be referred to in the audit file. Completion runs through the completion and review proceduresthat should be applied when finalising an audit assignment.

Referencing system

All references are considered to be alphabetical characters by the system. Hence, if you have referenced schedules 1, 2...., 10, 11 the order would be shown on screen as 1, 10, 2,... as that is the correct alphabetical order. To ensure that the schedules are displayed in a logical order, you should prefix lower numbers with zeros to pad all references to the same length, e.g. 001, 002, 010.

When entering references, it is not necessary to include a prefix of the letter identifying the section that the working paper belongs to, this will automatically be added by the system.

Forms

Audit Automation provides for up to 3 levels of review to be recorded on every lead schedule, working paper, programme and checklist. The details of who has reviewed working papers are shown both on screen and on the section divider if the pack is printed. It is not therefore necessary to record the details of the review on the face of the document itself, unless you have a particular reason to do this.

Templates

Forms that don't take the format of programmes or checklists are provided as templates, either in Word or for Excel. To use a template, add a new document and click in the Template field of the Client Document Dialog. A list of templates will be shown from which you can select the one to be used. For further information please refer to the Audit Automation Reference Manual.

Audit framework

When undertaking an audit, the auditor must comply with current auditing and ethical standards and take account of a good deal of guidance material. These consistmainly of:

- International Standards on Auditing (UK) (ISA(s) (UK)) and Quality Standards, issued by the FRC;
- the FRC Ethical Standards;
- FRC Practice Notes;
- FRC Bulletins;
- Statements of Standards for Reporting Accountants;
- Audit Regulations; and
- various other publications including guidance from the Audit & Assurance Faculty of the ICAEW.

ISAs and ISQM 1 and 2

The ISAs, along with International Standard on Quality Management (UK) 1 *Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements (July 2021) (Updated March 2023)* (ISQM (UK) 1) and International Standard on Quality Management (UK) 2 *Engagement quality reviews (July 2021) (Updated March 2023)* (ISQM (UK) 2) contain basic principles and essential procedures, together with related guidance in the formof explanatory and other material, including appendices.

The focus of ISQM (UK) 1 is on the firm's system of quality management at a whole firm level rather than in respect of individual audits. Therefore, whilst this guidance refers to ISQM (UK) 1 where appropriate, it does not cover all of its requirements.

~~Further guidance on ISQM (UK) 1 and ISQM (UK) 2 is available in the Audit quality and compliance area of *Navigate Audit* and in *Navigate Practice Management*.~~

FRC Ethical Standard

The Ethical Standard (ES) contains basic principles and essential procedures (identified in bold type), together with related guidance in the form of explanatory and other material. The standard covers the integrity, objectivity and independenceof auditors and applies in the audit of financial statements as well as other public interest assurance engagements. The current Ethical Standard was issued in December 2019 and replaced the June 2016 version.

FRC Practice Notes

Practice Notes are intended to assist auditors in applying auditing standards of general application to particular circumstances and industries. Practice Notes are persuasive rather than prescriptive. However, they are indicative of good practice,even though they may be developed without the full process of consultation and exposure used for FRC Standards.

FRC Bulletins

Bulletins are issued to provide auditors with timely guidance on new or emerging issues. Like Practice Notes, Bulletins are also persuasive rather than prescriptive, andindicative of good practice.

Many Bulletins cover matters pertaining to specialist audit reports such as those relating tointerim statements, public sector and listed entities, etc. revised and other specific reports.These are outside the scope of this guidance, however have been referred to where they areconsidered to provide useful additional guidance.

Statements of Standards for Reporting Accountants

These are also issued by the FRC and are outside the scope of this guidance.

Audit Regulations

The Audit Regulations are published by the ICAEW on behalf of the ICAEW, ICAS and ICAI and must be complied with. Provisions relating to firms as a whole rather than toindividual audit principals are outside the scope of this guidance.

Other publications and legislation

The various Institutes, the ACCA and the CCAB also publish a number of useful newsletters and guidance for auditors. The ICAEW Audit & Assurance Faculty in particular publishes a lotof useful guidance. Firms should ensure that at least one senior member of the audit team isa member of the Audit & Assurance Faculty.

There are also various Acts of Parliament and Statutory Instruments which contain general rules for the appointment, function and removal of auditors, and rules governing which entities require an audit, such as the Companies Act and Charities Act. Some entities are governed by their own special legislation, which may also state whether they are required tobe audited.

1.2 Acceptance, continuance and independence

Quick overview

This section sets out an overview of the acceptance, continuance and independence procedures when performing an audit engagement.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance ~~found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*~~.

This section relates to section C~~ in the *Navigate Audit* tool~~s.

Scope and definitions

Scope

ISA (UK) 210 (Revised June 2016) (Updated May 2022) *Agreeing the Terms of Audit Engagements* is effective for the audit of financial statements for periods commencing on or after 17 June 2016.

ISA (UK) 220 (Revised July 2021) *Quality Management for an Audit of Financial Statements* is effective for the audit of financial statements for periods beginning on or after 15 December 2022.

ISA (UK) 300 (Revised June 2016) (Updated May 2022) *Planning an Audit of Financial Statements* is also effective for the audit of financial statements for periods commencing on or after 17 June 2016.

The Revised Ethical Standard 2019 was issued in December 2019 and became effective on 15 March 2020.

ISA (UK) 210 provides guidance to ensure that the preconditions for an audit are present and that there is a common understanding between the auditor and the entity prior to accepting or continuing the engagement. This is covered in Engagement letters.

Key definitions

Term	**Definition**
Engagement partner	The partner or other individual, appointed by the firm, who is responsible for the audit engagement and its performance and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body. For an audit of financial statements, the engagement partner is a key audit partner.

Engagement quality review

An objective evaluation of the significant judgements made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed on or before the date of the engagement report.

Engagement quality reviewer

A partner, other individual in the firm, or an external individual, appointed by the firm to perform the engagement quality review.

Engagement team

All partners and staff performing the audit engagement, and any other individuals who perform audit procedures on the engagement, excluding an auditor's external expert and internal auditors who provide direct assistance on an engagement.

Firm

A sole practitioner, partnership or corporation or other entity of professional accountants, or public sector equivalent.

Network firm

A firm or entity that belongs to the firm's network.

Network

A larger structure:

(i) that is aimed at cooperation; and

(ii) that is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality management policies or procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

Partner

Any individual with authority to bind the firm with respect to the performance of a professional services engagement.

Personnel

Partners and staff of the firm.

Professional standards

International Standards on Auditing (UK) (ISAs (UK)) and relevant ethical requirements.

Relevant ethical requirements

Principles of professional ethics and ethical requirements that are applicable to professional accountants when undertaking the audit engagement. Relevant ethical requirements ordinarily comprise the provisions of the International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) related to audits of financial statements, together with national requirements that are more restrictive.

Auditors in the UK are subject to ethical requirements from two sources: the FRC's Ethical Standard concerning the integrity, objectivity and independence of the auditor, and the ethical pronouncements established by the auditor's relevant professional body.

Response (in relation to a system

Policies or procedures designed and implemented by the firm to address one or more quality risk(s):

of quality management)	(i) policies are statements of what should, or should not, be done to address a quality risk(s). Such statements may be documented, explicitly stated in communications or implied through actions and decisions; and (ii) procedures are actions to implement policies.
Staff	Professionals, other than partners, including any experts the firm employs.

Source: ISA (UK) 220:12

The definitions in this table are taken from ISA (UK) 220 (Revised July 2021)*, which is effective for audits of financial statements for periods beginning on or after 15 December 2022. The definitions relevant to the previous version of ISA can be found in* ISA (UK) 220 (Revised November 2019).

Acceptance and continuance procedures

ISA (UK) 300:6 requires the auditor to:

- undertake appropriate procedures regarding acceptance and continuance at the beginning of the audit in accordance with the requirements of ISA (UK) 220;
- evaluate compliance with ethical and independence requirements (see Ethics and independence); and
- establish the terms of the engagement, in accordance with ISA (UK) 210 (see Engagement letters).

It is clear from ISAs that such work should not be set in stone, and should be monitored and reassessed throughout the audit as required. However, the main element of this work should be performed before any other audit procedures are started and, for continuing engagements, this may be at the end of the prior year's audit.

ISA (UK) 220 is clear that the engagement partner has ultimate responsibility for ensuring that the engagement team is aware of all relevant ethical issues which may impact the audit and also states that the engagement partner must alert the firm to the discovery of any information during the course of delivery of the audit which may have caused the firm to decline the engagement had it been aware of that information sooner. The engagement partner will need to consult with the firm around whether it remains appropriate to continue with the audit or whether resignation is the appropriate course of action. There may also be ethical concerns which the firm will need to consider against the Ethical Standard, with any breaches identified being reported to those charged with governance at the earliest opportunity. Further guidance is in Ethical Standard.

ISA (UK) 220:A50 notes that such procedures include the consideration of:

- the integrity and ethical values of the owners, key management and those charged with governance (for example, directors or trustees);
- whether sufficient and appropriate resources are available to perform the engagement;

- whether management and those charged with governance have acknowledged their responsibilities in relation to the engagement;
- whether the audit team has the competence and capabilities, including sufficient time, to perform the engagement – this is particularly important where the practice is dealing with either a large entity or an entity working in a specialist area; and
- significant matters that have arisen during the current or previous audit, and their implications for continuing the relationship.

One of the main reasons for such preliminary procedures is to ensure that the engagement partner and the firm as a whole are independent. Auditors must, if they are to undertake a proper audit, be able to demonstrate that they have been objective. This objectivity can only be assured if a firm is, and is seen to be, independent.

Objectivity is the state of mind which has regard to all considerations relevant to the task in hand, but no other considerations. Both objectivity and independence are key concepts in the FRC's Revised Ethical Standard (ES), issued in December 2019.

Ethical Standard

The Ethical Standard applies to audit engagements and other public interest assurance engagements. A fundamental objective of any such engagement is that the intended users trust and have confidence that the audit or assurance opinion is professionally sound and objective. This in turn should enhance the credibility for users of the information the opinion covers. Auditing standards (such as ISA (UK) 200, ISA (UK) 220 and ISA (UK) 600) directly require engagement partners to understand (and demonstrate they understand and take into consideration) the ethical requirements relevant to the circumstances of the particular engagement they are undertaking.

Part A of the Ethical Standard sets out the overarching principles of integrity, objectivity and independence, together with supporting ethical provisions. Together, these establish a framework of ethical outcomes that are required to be met by the auditor or assurance practitioner to provide a basis for user trust and confidence in the integrity and objectivity of the practitioner in performing the engagement. As an overarching principle, the Standard operates on a 'Threats and Safeguards' model, whereby auditors should assess whether any of the typical threats to independence (such as self-interest, advocacy or intimidation amongst others) exist and outline the steps taken to mitigate the threat and ensure stakeholders can be assured that the engagement team remains independent and is able to provide an objective view of the entity. These identified threats and safeguards should also be communicated to those charged with governance at both planning and reporting stages and kept under constant review throughout. A key part of any firm's quality management processes will be to establish processes for practitioners to affirm their independence on an ongoing basis; engagement partners should ensure that they are familiar with these processes and take responsibility for communicating expectations in this area.

Part B sets out specific requirements relevant to certain circumstances that may arise in audit and other public interest assurance engagements:

- Section 1 of Part B covers General requirements and guidance;
- Section 2 is Financial, business, employment and personal relationships;
- Section 3 is Long association with engagements and with entities relevant to engagements;

- Section 4 is Fees, remuneration and evaluation policies, gifts and hospitality, litigation;
- Section 5 is Non-audit/additional services; and
- Section 6 is Provisions available for audits of small entities.

These specific requirements are designed to assist in meeting the ethical outcomes required by the overarching principles and supporting ethical provisions. However, circumstances relating to engagements vary widely and meeting the ethical outcomes required by the overarching principles and supporting ethical provisions is paramount.

Insight – Ethical concerns

- Personal relationships: perhaps the most obvious example of an ethical concern is the risk that interpersonal relationships may prevent an auditor from remaining objective. Affirming independence at an early stage and encouraging openness throughout the process is key here. Teams should also consider less obvious relationships, for example whether a business relationship may exist between the firm and client (for example, a rental agreement for office space) or one or more members of the team may have a financial interest in the client (for example, through a pension or similar investment vehicle);
- Long association (or "familiarity" threat): the engagement team will need to consider whether core members of the team may have worked with the client for a long period of time, which may render the relationship too close to be objective. There may also be regulatory requirements depending on the industry in question. Practitioners should also consider varying their approach even in situations where the team has been rotated to ensure an element of unpredictability is brought into the process; and
- Fees: Ethical Standard Sections 4 and 5 consider levels of fees and non-audit services, containing specific requirements to ensure that the level of non-audit or other service fees charged to the client does not reach such a level that would impair the auditor's ability to remain objective (this is a self-interest threat). Engagement teams will typically need to consult internally to ensure any proposed additional fee remains in line with the firm's policy and ethical standards as well as communicate and agree additional fees with those charged with governance as well as management.

However, compliance with the specific requirements may not always be sufficient to achieve this as Part B does not, nor is it practicable for it to, address all possible circumstances that may exist. Accordingly, practitioners need to be alert for, and respond appropriately to, other circumstances that create threats to meeting the ethical outcomes required by the overarching principles and supporting ethical provisions. Whether the ethical outcomes required by the overarching principles and supporting ethical provisions are achieved is always paramount and is a matter to be determined by exercising professional judgement. Any identified breaches of the standard during the course of the audit should be reported to those charged with governance at the earliest opportunity.

Importantly, consideration of whether the ethical outcomes required by the overarching principles and supporting ethical provisions have been met should be evaluated by reference to the perspective of an objective, reasonable and informed third party. Judgement and transparency are crucial here: not all relationships or additional fees, for example, will constitute a breach but practitioners must clearly document and communicate their rationale for decisions taken.

Much of the guidance in the Ethical Standard needs to be considered at a firm level as well as at an individual engagement level. ~~More detailed guidance on the content of the Ethical Standard is available on Croner-i Tax and Accounting in the Audit quality and compliance area of *Navigate Audit* as well as in~~

~~the *Practice Management* section.~~

Adequate resources

The audit engagement partner should consider whether the firm has adequate resources, and that the staff have the necessary skills to perform the audit properly. Auditors should remember that under ISQM (UK) 1, the resources used by the engagement team include not only human resources, but also technological resources (for example tools used for obtaining audit evidence, as well as those tools enabling remote meetings and communication) and intellectual resources (such as audit templates, checklists and tools).

This is especially relevant if the client operates in an unusual or niche industry sector, or where there are specific legislative requirements – for example, charities, pension schemes, financial services, trade unions, etc. It is not uncommon for firms to accept a new client in such a field without having the specialist skills and knowledge to adequately perform the audit. However, it remains the auditor's responsibility to ensure that work performed on the engagement meets the required quality standard. As such, the auditor may need to consider the use of an external auditor's expert. For example, where a firm is undertaking the audit of an entity with a number of complex estimates, such as property or defined benefit pension net liability valuations, an appropriately qualified valuer or actuary may be engaged to review the assumptions and methodology employed by management's expert in calculating the estimate – further guidance on this is available in Using the work of experts. Alternatively, the firm may also use an information service to provide support on more specialist engagements. ~~Specialist audit and assurance tools are available from Croner-i for charity, pension scheme, club, academy and client money engagements.~~

~~A template form for assessing firm resources and future staffing needs is available in Templates and Letters in *Navigate Practice Management*.~~

Proper performance

It is also worth considering whether there are any other aspects of the client, or any other factors, that will adversely affect the firm's ability to perform the audit properly. For example, there may be questions as to the integrity of the client's management, and these may raise doubts over the reliability of explanations and information provided by management. Such doubts may cause the auditor not to accept the audit assignment.

Client integrity

The auditor should consider their knowledge and recent experience of the client, and consider whether there are any matters which adversely affect their opinion of the client's integrity. Examples of such matters include changes in ownership, sharp business practices, undue pressure on fees, inappropriate limitations on the scope of the audit and aggressive changes in attitude towards accounting policies, financial reporting issues and payment of tax.

Documentation of independence

For individual staff in the practice

The audit regulations require that, on an annual basis, each principal, member of staff, subcontractor and consultant who is involved in audit work must complete an independence form. This form will, *inter alia*, record details of any audit clients with which that individual has an involvement. The audit compliance principal should review all the forms and ensure that the relevant audit files are appropriately updated. Such procedures should help to ensure that an individual does not become involved in an audit when it is not appropriate to do so.

All individuals involved in audit work must keep the audit compliance principal fully informed of any changes to the circumstances recorded on their annual statement, so that these can also be fed through to the relevant audit file.

~~The Audit quality and compliance area of *Navigate Audit* contains extensive guidance on whole-firm audit procedures and the Audit compliance templates section includes an example 'fit and proper' form.~~

For individual engagements

The audit tools also contain an independence questionnaire which is designed to demonstrate that adequate consideration has been given to independence matters in accepting appointment/reappointment for a particular audit. It also demonstrates that the firm has adequate resources and the appropriate technical knowledge necessary to carry out the audit properly.

The form requires details to be recorded of all non-audit services provided, including whether or not there is informed management. The form also requires the auditor to state whether the alternative provisions or the exemptions available in the Ethical Standard Section 6 (Provisions Available for Audits of Small Entities) in respect of the provision of non-audit services are to be adopted.

The form must be completed and signed by the partner prior to any detailed work being commenced on the audit.

Where any of the questions have been answered with a 'yes', the partner must specify precisely what action is to be taken to safeguard independence or overcome the problems with available resources or technical knowledge.

Any 'yes' answer will create either an ethical or practical issue, which may require consultation. As a result, the form may have to be signed off by a second partner who is independent from the audit. This is a mandatory requirement in the case of 'public interest' audits and those of higher audit risk. If this is not possible, the form may have to be signed by the firm or organisation with whom consultation takes place. However, the audit firm retains ultimate responsibility for the audit.

Where there are any fees outstanding it is necessary for the responsible individual to consider whether the fees outstanding taken together with the fees for the current audit could constitute a significant loan. Significance should be measured in respect of the individual partner and the practice fees and not in respect of materiality for the client. If the decision is that the work can commence this should be corroborated by a second partner. This is not necessary if you are a sole practitioner. As a minimum there must be an agreement in place for the payment of the previous year's audit fee before the current audit can start.

Ongoing review

Independence should not only be considered at the planning stage. It is important that the engagement team are alert to any matters arising during the audit that may affect independence. For example, requests by the client for additional accounting support or to assist in calculating a stock provision create new self-review threats for which safeguards must be implemented. Best practice would be for teams to reaffirm independence prior to approval of the audit report by the engagement partner and document this on file as well as in their report to those charged with governance.

There are several points where the engagement team can document their affirmation of independence ~~within the *Navigate Audit* tools~~; the **Independence questionnaire: Acceptance and continuance** (**C3**) the **Notes of engagement team planning meeting** (*template* **C10**), the **Planning memorandum** (*template* **C1**) and the **Detailed file completion checklist** (**B1**) and **Final completion and close down** (**A1**).

Safeguards applied

The ~~*Navigate*~~ *Audit* tools contain an Independence questionnaire: Acceptance and continuance (C3) which addresses independence issues. This form requires the auditor to record whether the alternative provisions (where there is informed management) or exemptions (where there is not informed management) in ES Section 6 (PAASE) are to be adopted.

The ~~*Navigate*~~ *Audit* tools also contain an additional form (Independence questionnaire: Safeguards applied (C3.1)) to assist in documenting the extent of the threats to independence identified on the Independence questionnaire: Acceptance and continuance (C3), such as those arising from providing accounting and tax services and the safeguards applied. This form is intended for smaller, less-complex entities where it is common to provide a number of non-audit services that are mostly of a routine compliance nature.

At the end of each audit, consideration should be given to whether or not it is appropriate to be reappointed/continue in office for the following year. This is undertaken in the 'Independence and ethics' section of the Detailed file completion checklist (B1).

Quality managment

As well as ISA (UK) 220 which addresses quality management from the perspective of an individual audit, ISQM (UK) 1 *Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements* looks at quality management from the perspective of the firm as a whole. ISQM (UK) 1 requires that policies and procedures are established requiring, for appropriate engagements, an engagement quality review that provides an objective evaluation of the significant judgements made by the engagement team and the conclusions reached in formulating the report.

ISA (UK) 220 notes that the engagement partner is responsible for, "in the context of the firm's system of quality management", maintaining two-way communication between the engagement team and the firm's audit quality function by factoring in quality risks arising from information obtained from other engagements and communicated to the engagement team and feeding information obtained from the specific engagement back to the centre to inform the firm's overall quality management strategy.

The auditor should therefore ensure that planning documentation includes consideration of whether quality issues communicated from the centre apply at an individual engagement level and, where relevant, recognise that an engagement quality review is required.

~~Further guidance on quality management in audits, as well as engagement quality reviews, is available in Audit Quality and Compliance.~~

Staffing and budgets

Staffing should really be undertaken at the same stage as the assessment of independence (see Documentation of independence). This first involves considering whether there are adequate staff with the necessary knowledge to enable the practice to undertake the audit of this particular client (see Adequate resources).

The auditor should then consider the level of staff required for the job. This can be done by reviewing the types of skills considered necessary for each individual level within a practice, e.g. the attributes that are necessary for an audit manager or an audit senior and then comparing the results to an assessment of the complexity of the client's operations. This should enable the auditor to determine which levels of staff should be used for which areas of the audit.

Having gone through this process, the auditor should decide which staff within the practice should be used on the audit. It is not appropriate to simply use the staff that are available at the time that the audit is undertaken. The auditor must ensure that the audit is undertaken by staff who have suitable qualifications and experience.

Note that ISA (UK) 220:25 states:

'The engagement partner shall determine that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner, taking into account the nature and circumstances of the audit engagement, the firm's policies or procedures, and any changes that may arise during the engagement.'

ISA (UK) 220:A86 also notes that supervision includes consideration of whether the engagement team have sufficient time to carry out their work. A budget should therefore be prepared to ensure that sufficient time has been allocated for the audit staff to complete the engagement. Budgets are normally analysed by how long is needed to complete each of the individual sections. Not only should the budget include an allocation of time for each individual section, but the auditor should also ensure that sufficient time is allowed for answering review points and for an engagement quality review if necessary. The budgeting process should be undertaken at the same time as the overall timetable for the audit is agreed with the client and senior members of the audit team.

Where the firm has insufficient information to complete a detailed budget accurately, an estimate should be made and the staff required to complete a detailed record of the time taken on each aspect of the audit in the current year. This record can then be used to prepare the budget for the subsequent year.

In the ~~*Navigate*~~ *Audit* tools, the following schedules are available for documentation in this area: **Other planning issues (C11)**, **Audit administration (C12)** and **Budget and performance summary** ~~(**C14**).~~ *Budgets are available as part of Audit Automation.*

Leadership responsibilities for managing and achieving quality on audits

ISA (UK) 220:13 – 15 refers to the responsibilities of the engagement partner with regard to 'managing and achieving quality on the audit engagement' through effective oversight of the project, effective delegation of responsibility to appropriately skilled team members and influencing the behaviour of the engagement team by clearly communicating the firm's expectations, culture and values and maintaining a focus on professional ethics and scepticism. The engagement partner is expected to create an environment for the engagement that emphasises the firm's culture and expected behaviour of team members.

In creating this environment, the engagement partner takes responsibility for emphasising:

- that all engagement team members are responsible for contributing to the management and achievement of quality at the engagement level;
- the importance of professional ethics, values and attitudes to the members of the engagement team;

- the importance of open and robust communication within the engagement team, and supporting the ability of engagement team members to raise concerns without fear of reprisal; and
- the importance of each engagement team member exercising professional scepticism throughout the audit engagement.

Insight – Scalability

The nature and extent of the actions of the engagement partner to demonstrate the firm's commitment to quality will depend on a number of factors including the size, structure, geographical spread and complexity of the firm and the engagement team, as well as the nature and circumstances of the audit engagement.

Where the engagement team consists of just a few people, influencing the desired culture through direct interaction and conduct may well be sufficient. At the other end of the scale, where there is a much larger engagement team perhaps spread over multiple locations, more formal communications may be necessary.

Within the explanatory material which supports these requirements in the standard, this responsibility is further subdivided into three key areas.

Sufficient and appropriate involvement

The engagement partner should take an active role in the project, from the agreement of resources and planning of procedures through to execution and review, including maintaining sufficient oversight to ensure that the team are able to course correct or vary the nature, timing and extent of audit procedures where required. Even though the partner may assign tasks to other members of the engagement team, the engagement partner continues to take overall responsibility for quality on the engagement through direction and supervision of those members of the team, and review of their work.

Communication

The engagement partner must take overall responsibility for ensuring that communications in respect of the audit are timely and of sufficient quality. This may include:

- Internal communications with the engagement team; appropriate communication channels should be put in place to ensure that all team members are kept up to date with relevant information and a culture of timely communications is adhered to;
- Communications with others involved in the audit, such as auditor's experts or internal auditors upon whose work the team may be looking to place reliance;
- Individuals within the wider firm; this is typically members of the firm's audit quality function or operational support such as schedulers; and
- External parties; in particular those charged with governance, management or regulatory bodies to whom the firm may also have to report on the engagement.

Professional scepticism

The engagement partner must communicate the importance of professional scepticism at every stage of the audit from acceptance through to completion. Similarly, they must also identify and mitigate risks to professional scepticism which may arise in certain circumstances, typically where the team is under time, budget or resource constraints. Failure to exercise due professional scepticism as a result of one of these or related conditions is a key risk to audit quality – see Professional Scepticism for further details.

Documentation is key to demonstrating adherence to the ISA. Project and/or budget plans, detailed engagement team meeting minutes, summaries of key matters arising and documentation of any consultations with quality management support are examples of documents which should be retained along with evidence of engagement partner review to demonstrate compliance with ISA (UK) 220. Furthermore, engagement leads may wish to include evidence of their review and agreement of key deliverables such as audit plans and Audit Findings Reports with management and those charged with governance as evidence of their involvement in the audit and quality management over communications.

1.3 Engagement letters

Quick overview

Prior to commencing an audit, the auditor needs to agree the terms of that audit engagement with management and, where appropriate, those charged with governance.

~~Further guidance can be found in the *Engagement letter tool* and Engagement letter templates in *Navigate Practice Managment*, which includes a comprehensive online tool for creating engagement letters.~~

A modular engagement letter template is available under ENG

Scope and definitions

Scope

ISA (UK) 210 (Revised June 2016) *Agreeing the Terms of Audit Engagements*, which was updated in July 2017, is effective for the audit of financial statements for periods commencing on or after 17 June 2016.

ISAs require that prior to commencing an engagement, the auditor and the client should agree on the terms of that engagement and these terms should be recorded in writing. ISA (UK) 210 provides guidance on engagement letters issued by the auditor covering:

- agreeing terms of engagement in writing;
- respective responsibilities of the auditor and those charged with governance;
- imposed limitations on audit scope;
- changes to the terms of the audit engagement;
- recurring audits; and
- changes in engagements.

In addition, ISA (UK) 210 includes guidance on the Preconditions for an audit.

ISA (UK) 210 was updated in July 2017. Following a revision of ISA (UK) 250 Section A, the application material now suggests it may be relevant to refer, in the engagement letter, to the auditor's responsibilities to report identified or suspected non-compliance with laws or regulations.

In June 2008, the Financial Reporting Council issued guidance on auditor liability limitation agreements. It is outlined in Liability limitation.

ICAEW guidance includes TECH 09/15BL *Managing the professional liability of accountants* and a helpsheet *Engagement Letters*, which provides example wording for engagement letters in a variety of scenarios. This helpsheet was last issued in July 2016 and last reviewed in February 2020.

Key definitions

Term	Definition
Preconditions for an audit	The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

Source: ISA (UK) 210:4–5

Purpose of engagement letters

ISA (UK) 210 requires that the auditor and the client should agree on the terms of the engagement and these terms should be recorded in writing.

The purpose of an engagement letter is to:

- define clearly the extent of the auditor's responsibilities;
- minimise the possibility of any misunderstanding between the client and the auditor; and
- provide written confirmation of the auditor's acceptance of appointment, the scope of the audit and the form of the report.

There may be occasions when an engagement letter is not appropriate, but the terms should still be agreed in some other form of contract.

It is important that the letter takes account of the relevant legislative requirements and should be tailored for each assignment.

The ISA is primarily concerned with the audit of annual financial statements but the guidance to it notes that its principles can be applied to other audit related assignments, such as reporting on interim financial information or review of UK Corporate Governance Code compliance statements.

The guidance in the ISA does not encompass other services such as tax and accounting and separate letters may be required for each such service. Such services may be included in the audit engagement letter, but if so, the paragraphs must be clearly distinguished from those relating to the audit.

Preconditions for an audit

An auditor should only accept or continue with an audit when the basis upon which it is to be performed has been agreed. This will involve:

- establishing whether the preconditions for an audit are present; and
- confirming the understandings of the auditor and those charged with governance.

The preconditions for an audit are only present when the auditor can determine that the financial reporting framework to be applied by those charged with governance is acceptable and that those charged with governance understand and acknowledge their responsibility for:

- the preparation of the financial statements in accordance with that financial reporting framework;
- internal control systems that are adequate to ensure that financial statements can be prepared that are free from material misstatement; and
- providing the auditor with access to information relevant to the preparation of the financial statements, additional information requested by the auditor and individuals from whom the auditor may wish to gather audit evidence.

If those charged with governance impose a limitation on the scope of the auditor's work such that the auditor believes the limitation will result in them disclaiming an opinion on the financial statements, then the auditor should not accept such a limited engagement as an audit engagement, unless they are required by law or regulation to do so.

If the preconditions for an audit are not present, the auditor discusses the matter with those charged with governance. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement where they have determined that the financial reporting framework being applied is unacceptable, or where those charged with governance have not agreed to provide the auditor with additional information requested for purposes of the audit.

Additional information that the auditor may request from management for the purpose of the audit may include when applicable, matters related to other information in accordance with ISA (UK) 720 (Revised November 2019) *The Auditor's Responsibilities Relating to Other Information*.

Contents of the letter

An engagement letter should be sent to each new client as soon after the acceptance of the appointment as possible and certainly before the commencement of any audit work.

The contents of an audit engagement letter may vary for each client, but reference should be made to:

- the objective of the audit of the financial statements;
- the responsibilities of the auditor;
- those charged with governance's responsibility for the financial statements;
- the scope of the audit, including reference to applicable legislation, regulations or pronouncements of professional bodies to which the auditor adheres;
- identification of the applicable financial reporting framework for the preparation of the financial statements;
- the form of any reports or other communication of results of the engagement; and

- a statement that there may be circumstances in which a report may differ from its expected form and content.

Where these matters are prescribed by law or regulation they need not be included in the letter, except to set out that such law or regulation applies and obtain confirmation form those charged with governance that they acknowledge and understand their responsibilities as set out in Preconditions for an audit.

The auditor may also include in the engagement letter:

- where applicable, the requirement for the auditor to communicate key audit matters in the auditor's report in accordance with ISA (UK) 701 (Revised November 2019) (Updated January 2020) *Communicating Key Audit Matters in the Independent Auditor's Report* (see Audit reports);
- the fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered;
- arrangements regarding the planning and performance of the audit;
- expectation of receiving written confirmation of oral representations made by management and those charged with governance;
- expectation that management will provide access to all information of which management is aware that is relevant to the preparation of the financial statements, including information relevant to disclosures;
- agreement of management to make draft financial statements available to the auditor on a timely basis including all information relevant to their preparation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation of disclosures), and any 'other information', as defined in ISA (UK) 720;
- expectation that management will inform the auditor of any facts that may affect the financial statements of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued;
- descriptions of any other letters or reports the auditor expects to issue to the client;
- any confidentiality of other letters and reports to be issued and, where appropriate, the conditions, if any, on which permission might be given to make those reports available to others;
- basis on which fees are computed and any billing arrangements;
- complaint procedures;
- arrangements concerning the involvement of other auditors, experts or internal audit;
- for an initial audit, arrangements to be made with the predecessor auditor;
- a description of the auditor's responsibilities under law, regulation or relevant ethical requirements that address reporting identified or suspected non-compliance with laws and regulations to an appropriate authority;
- a restriction of audit liability, where this is possible;
- a reference to any further agreements between auditor and client; and

- a request for the client to confirm acceptance of the terms of engagement.

When the auditor is not required to communicate key audit matters, it may be helpful for them to make reference in the terms of the audit engagement to the possibility of communicating key audit matters in the auditor's report.

Wording for engagement letters for a number of different entity types covering a wide range of services is available in the ~~*Engagement Letter Tool* and~~ Engagement letter templates ~~in *Navigate Practice Management*.~~

Recurring audits

Once agreed, the letter will remain in force until it is replaced, but should be reviewed annually to ensure that it is appropriate to the client's circumstances. If a change has taken place, then a new letter may need to be sent. A copy of the most recent letter would usually be kept on the permanent file.

A new engagement letter may be appropriate when there is:

- any indication that the client misunderstands the objective and scope of the audit;
- any revised or special terms of the audit engagement;
- a recent change of management;
- a significant change in ownership;
- a significant change in the client's business;
- a change in the financial reporting framework adopted for the preparation of the financial statements; or
- a change in legal or professional requirements.

Where a new letter is not considered necessary, it may nevertheless be appropriate to remind the client of the original letter.

Group and joint audits

The ISA does not deal with group or joint audits. However, accepted practice suggests that where the same firm of auditors is appointed for several companies within a group, they should consider whether separate letters should be sent to each board. The decision will be influenced by:

- who appoints the auditor of the component;
- whether a separate audit report is to be issued on the component;
- whether the terms are the same for each component;
- legal requirements;
- the extent of any work performed by other auditors; and
- the degree of ownership by the parent.

Where a group letter is sent, it should clearly identify the companies concerned and confirmation should be obtained from each board.

Where joint auditors are appointed, the audit engagement should be described in similar terms by each firm and a joint letter be sent if there are no additional services provided by either party.

Further guidance on group audits is in Consolidation and groups.

Changes in terms

The ISA states that the auditor 'shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so'. If they consider the changes appropriate, the auditor obtains written agreement to them.

Such situations arise from:

- changes in circumstances affecting the need for the service;
- misunderstandings as to the nature of the audit originally requested; or
- restrictions of the scope of the engagement.

Where the auditor considers the changes inappropriate, normally because it may lead to the recipients of the audit report being misled in some way, they should consider their position and, if necessary, take legal advice. If the auditor decides to withdraw from the engagement, they should consider whether the reasons for this have to be notified to any party. For example, under the *Companies Act* 2006, the outgoing auditor must send a notice of any circumstances which they consider should be brought to the attention of the members or creditors of the company. The auditor may also need to provide a statement of reasons for ceasing to hold office to the appropriate audit authority. ~~Guidance is available on Access to information by successor auditors and template letters are in Assignment letters.~~

Disengagement

Where the auditor ceases to hold office in circumstances where no other auditor is appointed, it may be appropriate to write to the client to formally terminate the appointment. This situation may arise where an audit client becomes eligible for and claims exemption from audit or where an insolvency practitioner is appointed as administrator or liquidator. ~~A template disengagement letter is available in the *Engagement Letter Tool* and Engagement letter templates in *Navigate Practice Management*.~~

Liability limitation

Background

The *Companies Act* 2006, s. 532 provides that any provision that exempts an auditor from any liability in connection with the audit shall be void, except in the case of liability limitation agreements.

From 6 April 2008, when the *Companies Act* 2006, s. 532–538 came into force, auditors were permitted to limit their liability to their statutory audit clients as long as they obtain the agreement (under a liability limitation agreement) of the company and its shareholders.

Other legislation may permit or prohibit liability limitation arrangements in respect of statutory audit for other types of entities. Where legislation is silent on the subject, contractual limitation of liability may well be possible, provided that the contract terms do not fall foul of the *Unfair Contract Terms Act* 1977.

Provisions of the *Companies Act* 2006, s. 532–538 do not apply to statutory audit of limited liability partnerships (LLPs).

FRC guidance

Guidance on Auditor Liability Limitation Agreements was published by the Financial Reporting Council (FRC) in June 2008. The guidance outlines the measures to improve auditor liability that are allowed under the *Companies Act* 2006, gives specimen clauses for use in agreements, and explains the process to be followed for obtaining shareholder approval.

However, there were issues with introducing this into practice, mainly caused by the US authorities' non-acceptance of these agreements and the unwillingness of major companies and auditors to implement them without acceptance by the US authorities. As a result, these agreements are rarely used in practice.

Liability limitation agreements

A liability limitation agreement will limit the liability owed by the auditor in relation to negligence, breach of duty or breach of trust occurring during the course of the audit. In order for the liability agreement to be valid, it must:

- cover only one financial year;
- be approved by a resolution of the company's shareholders, as follows:

- for public companies, at a general meeting;
- for private companies, by written resolution, if preferred;
- for group companies, by each company in the group, not just the holding company; and

- be 'fair and reasonable'.

The courts can ultimately decide whether a liability limitation agreement is 'fair and reasonable'.

The actual limit on liability can be set out a number of different ways:

- based on the auditor's proportionate share of the responsibility for any loss;
- purely by reference to the 'fair and reasonable' test;
- a cap of liability (either in monetary terms or the basis of an agreed formula); or
- a combination of some or all of the above.

The FRC guidance sets out specimen 'principal terms' for each method of limiting liability above, together with example clauses which can be added to the relevant principal terms to form a liability limitation agreement.

The liability limitation agreement can be entered into at any time before the accounts for the year are approved. The existence of any such agreement and its principal terms must be disclosed in a note to the company's annual accounts.

Liability limitation – other services

Where an engagement letter covers both an audit in respect of which limitation of liability is prohibited and non-audit services in respect of which the auditor wishes to limit their liability, the letter should make clear that any limitation of liability applying to the non-audit services does not apply to the audit.

Small companies and micro-entities

The application material in ISA (UK) 210 notes that EU law imposes restrictions on the number of disclosures that can be prescribed by law or accounting standards for small companies and micro-entities even though the financial statements of those entities are required to give a true and fair view. This means that such companies, when preparing financial statements in compliance with prescribed requirements may not include all the disclosures considered necessary for the purposes of a true and fair view, particularly in relation to matters relating to the use of the going concern assumption.

In the case of a small company, it is not sufficient for the auditor to conclude that the financial statements give a true and fair view simply because they contain all the prescribed disclosures and the auditor in this case may wish to draw attention in the engagement letter to the fact that additional disclosures may be required if the auditor is to give an unqualified opinion.

In the case of micro-entities, the situation is slightly more complicated, although it is expected that the vast majority of such companies will take advantage of audit exemption. For these companies, the law presumes that compliance with the prescribed requirements is sufficient to give a true and fair view. The auditor is thus precluded from insisting on additional disclosures. As this financial reporting framework does not acknowledge that to achieve fair presentation of the financial statements, it may be necessary for management to either provide additional disclosures or to depart from a requirement of the framework, it is not considered to be a fair presentation framework as defined in ISA (UK) 200 (Revised June 2016) (Updated January 2020) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)*. Accordingly, this financial reporting framework is considered to be a compliance framework. Under ISA 700 (UK) (Revised November 2019) (Updated January 2020) *Forming an Opinion and Reporting on Financial Statements*, an auditor can only provide an unmodified opinion in respect of a fair presentation framework and would therefore be unable to do so for micro-entities as to do so may result in the auditor's report being misunderstood by users.

The guidance notes that it may be possible for the auditor to mitigate the potential misunderstanding through the prominent inclusion of an Other Matter paragraph, addressing this in the auditor's report in accordance with ISA (UK) 706 (Revised June 2016) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. In this situation, the engagement letter should also refer to the proposed form of report.

Current issues and further resources

Further resources

Engagement letter templates ~~and guidance notes~~ are available in the ~~*Engagement Letter Tool* and Engagement letter~~ templates ~~in *Navigate Practice Management*.~~

1.4 The permanent file

Quick overview

This section covers the information that should be held on a permanent audit file.

Firms may also keep a correspondence file, this is covered in Planning overview.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.

This section relates to the Permanent Audit File schedules in Audit tools.

The permanent file

The permanent file should contain information and documentation of a ‘permanent’ nature that is relevant to the audit and is likely to be useful for several assignments. Supporting documentation specific to the current year audit should be filed on the current year audit file.

Sufficient time should be budgeted for reviewing and updating the permanent audit file. In particular, care should be taken when there is change to the key partner or manager on the assignment that the permanent file is up to date, particularly if new staff involved in the audit no longer have access to the original partner or staff member involved.

The contents of the file should be reviewed at the planning stage of the audit, and any necessary amendments made. The permanent file should be organised into sections, similar to the following:

- general and statutory information;
- engagement details;
- taxation;
- assets;
- contracts, leases and agreements; and
- the financial statements for previous years.

Statutory information

The permanent file should contain some basic statutory information about the client. This should include such things as a list of shareholders, details of any current mortgages and charges, directors’ interests in the shares and debentures, as well as a copy of the latest confirmation statement and any elective resolutions. A copy of the memorandum and articles of association or other governing document, such as a trust deed, should also be placed on the file. The auditor should highlight any issues relating to these items that are of particular interest, particularly unusual terms, for example, restricted borrowing powers or the treatment of gains and losses on the disposal of investment properties.

Statutory information (**PAF01**) is available in the ~~Permanent Audit File to assist with documentation.~~ *Background information.*

The permanent file should only contain information relevant to the audit. Statutory information that is no longer of immediate relevance to the audit should be placed on a separate file or archived.

Engagement details

The permanent file should also contain a copy of the most recent letter of engagement. Whilst some firms do not issue engagement letters for other services, they are mandatory for audit engagements under ISA (UK) 210:10 of ISA (UK) 210 *Agreeing the terms of audit engagements*. The letter should be reviewed annually, not only to ensure that it is the most up-to-date version from a technical viewpoint, but also that it reflects all of the work to be undertaken for the client. The letter of engagement is a contract between the auditor and client, and if it does not reflect the actual work being undertaken, it will not be valid in the event of any dispute.

The terms of engagement should be reviewed at the beginning of the assignment, as well as at the end. Reviewing the terms in advance of the audit offers an opportunity to issue an updated letter to the client and to ensure that this is signed and returned before the audit work commences.

All firms should ensure that a copy of the letter of engagement is retained, either electronically or in hard copy.

Further guidance on engagement letters is in Engagement letters and template letters and wording are in the ~~*Engagement Letter Tool* and Engagement letter~~ templates ~~in *Navigate Practice Management*.~~

Other information

Depending on the nature of the client, the permanent file may also contain the following types of information:

- tax information of direct relevance to the audit (such as copies of any PAYE dispensations);
- details of any major assets, properties, etc.
- copies of any contracts, leases and agreements that could have an impact on the audit. This may include details of bank overdrafts and loan facilities, securities, covenants, finance and operating leases, etc. The auditor should review each document and note or highlight any key points that could be of relevance to the audit – for example:

- the banking facility letter may contain details of banking covenants, which if broken may result in withdrawal of funding, giving rise to a going-concern risk;
- covenants and guarantees may need to be disclosed in the financial statements; and
- lease agreements should contain details of the amounts to be paid and the period of the lease, including any break clauses, options to purchase, etc. These will materially affect the accounting for and disclosure of leases; and

- copies of other permanent information that the auditor may wish to refer to during the course of the audit should be placed on file, for example, copies of any letters of comment sent to the client and details of the client's responses.

Previous years' financial statements

The auditor may wish to maintain copies of the signed financial statements within the permanent file. However, on the basis that most firms will incorporate a copy of the previous year's financial statements on the current file, it may be more appropriate to retain signed financial statements on a separate dedicated file.

1.5 Documentation

Quick overview

This section covers the general requirements around audit documentation. Specific requirements relating to certain stages of the audit are covered in the relevant sections, including in Planning overview and Final completion and planning for next year.

Scope and definitions

Scope

ISA (UK) 230 (Revised June 2016) (Updated May 2022) *Audit Documentation* is effective for audits of financial statements for periods commencing on or after 15 December 2019.

ISA (UK) 230 provides standards on documentation covering:

- form of working papers;
- content of working papers;
- changes to audit documentation after the date of the auditor's report;
- assembly of the final audit file; and
- confidentiality, safe custody and retention of audit documentation.

Other ISAs contain documentation requirements and application material relating to specific aspects of the audit. These are covered in the sections of this guide dealing with the relevant topics and are summarised in Other documentation requirements.

ISQM (UK) 1 (July 2021) (Updated March 2023) *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance and Related Services Engagements* and the Audit Regulations also contain requirements regarding Engagement performance, including the need to establish quality objectives addressing engagement documentation standards and issues around confidentiality, custody and ownership of working papers.

Whilst audit documentation remains the property of the auditor, Audit Regulation 3.09 and the Companies Act require certain information to be made available to successor auditors. ~~This is covered in the Audit quality and compliance area of *Navigate Audit*.~~

Auditors may also be asked in other situations to grant access to their files to third parties, usually acting on behalf of a prospective purchaser of, or provider of finance to, the entity. Guidance on steps that may be taken by the auditor to mitigate risk in these situations is provided in ICAEW Technical Release Audit 04/03 *Access to Working Papers by Investigating Accountants* (see Access to working papers).

Key definitions

Term	**Definition**
Audit documentation	The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as 'working papers' or 'workpapers' are also sometimes used). In the UK, audit documentation shall include all documents, information, records and other data required by ISQM (UK) 1, ISAs (UK) and applicable legal and regulatory requirements.
Audit file	One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
Experienced auditor	An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of: (i) Audit processes; (ii) ISAs (UK) and applicable legal and regulatory requirements; (iii) The business environment in which the entity operates; and (iv) Auditing and financial reporting issues relevant to the entity's industry.

Source: ISA (UK) 230:6

Purpose of documentation

ISA (UK) 230 requires the auditor to document matters which are important in providing audit evidence to support the audit opinion and evidence that the audit was carried out in accordance with ISAs (UK).

The purpose of working papers on an audit is to provide a clear trail of the figures from the basic input to the final financial statements, to show the sources of information the auditor has received and to document the audit work performed, together with the conclusions drawn.

Working papers are any material the auditor obtains, prepares or retains in the course of their audit. Working papers may be in electronic or paper form and may include, for example, scanned documents and electronic files, including e-mail.

Working papers provide a record of supervision and review, the planning and performance of the audit by the staff and the evidence to support the audit opinion. They provide the individuals responsible for approving the audit report with the means to satisfy themselves that the work delegated has been properly performed. Other advantages of working papers are that they are seen as providing a source of reference that may be used in subsequent years and that they encourage a methodical approach.

Form and content of audit documentation

Working papers should be sufficiently complete and detailed so as to provide an overall understanding of the audit. They should contain information on planning the audit, the nature, timing and extent of the audit procedures performed and the results and conclusions from the procedures.

Extent of documentation

ISA (UK) 230 requires that working papers should be sufficient to allow an ‘experienced auditor, having no previous connection with the audit’ to be able to understand:

- the nature, timing and extent of the audit procedures performed to comply with the ISAs (UK) and applicable legal and regulatory requirements;
- the results of the audit procedures performed, and the audit evidence obtained; and
- significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.

For statutory audits of financial statements, the ISA requires the auditor to retain any other data and documents in the audit documentation that are of importance in support of their report.

This represents a high bar in terms of the extent of the audit documentation required and makes clear that the audit file needs to be able to ‘stand on its own’.

The auditor should ensure that every schedule on file has a purpose. The auditor should avoid including superfluous information (copy invoices, etc.) that adds nothing to the audit evidence but which makes the file much more difficult and time consuming to review.

Where certain information is being included for purposes other than audit comfort, the auditor may wish to consider placing this in a separate file, for example on a permanent file or correspondence file.

Form and content of working papers

Because of a wide variety of circumstances in which working papers have to be prepared and the many types of business transactions to which they relate, it is not practicable to lay down a standard form for their preparation suitable for each and every situation. How the relevant information can best be shown, what audit procedures need to be applied and how their results can best be summarised will depend on the particular circumstances. They should, however, be set out in such a way that the key facts are readily apparent.

Working papers should be **clear** and **logical** and should fully explain their purpose. Every working paper, regardless of whether it is prepared on paper or electronically, should contain:

- the **name** of the client;
- the **purpose** of the schedule;

- the **initials** of the person preparing the schedule and the person reviewing it (see Identification of the preparer and reviewer);
- the **dates** on which the schedule was prepared and reviewed;
- the **accounting period** for which the schedule was prepared;
- the precise **details** of the audit work performed; and
- the **conclusions** drawn from that work.

Working papers should be designed for each engagement, the nature and scope of the engagements will impact the working papers. Consideration should be made of the following:

- the nature of the engagement;
- the identified risks of material misstatement;
- the extent of judgement required in performing the work and evaluating the results;
- the significance of the audit evidence obtained;
- the nature and extent of exceptions identified;
- the need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained; and
- the specific methodology and technology the auditor uses.

Professional judgement always needs to be exercised. If the auditor is using standardised working papers, such as checklists and specimen letters to aid efficiency and control, the auditor needs to make sure sufficient time is spent completing them in detail.

If schedules have been drawn up by the client, the auditor requires evidence that they have been properly prepared before relying on them.

The term ‘working papers’ refers to the record of all of the evidence that the auditor considers it necessary to collect in order to support an opinion. This may relate to the current year or be of a permanent nature, i.e. of continuing importance and as a result, be filed separately in a permanent audit file. The specific nature will depend on the engagement.

Example: Contents of working papers

- information on the legal nature of the client, including copies of important documents;
- information concerning the industry and the economic and legislative environments within which the entity operates;
- evidence of the planning process, including any changes;
- notes on the accounting and internal control systems including extracts from the entity’s internal control manual;
- assessment of inherent and control risks at the financial statements and assertion level;

- consideration of and conclusions on the work of internal audit;
- analyses of transactions and balances, including significant ratios and trends;
- audit programmes showing the nature, timing and extent of the audit procedures performed in response to risks at the assertion level, and the conclusions thereon;
- evidence that the work performed by assistants was supervised and reviewed;
- an indication as to who performed the audit procedures and when they were performed;
- correspondence with other auditors, experts and third parties;
- details of audit procedures applied where components of the financial statements are audited by another auditor;
- correspondence with the entity, including reports to management and notes of discussions with management concerning audit matters;
- letters of representation from management;
- a summary of the significant aspects of the audit, the conclusions reached and how matters have been resolved and the views of those charged with governance; and
- copies of the approved financial statements and auditor's reports.

Data maintained in an electronic format must be properly backed up and also protected from future amendment.

Working papers prepared by the client

The auditor must ensure that any work undertaken on working papers provided by the client is clearly recorded. It is not necessary to rewrite a schedule just because the client prepared it. Similarly, where there are items relevant to the current year on the previous year's file, it is acceptable to leave a copy on the previous file and bring the original forward, as long as it is marked to show that it has been reviewed for any necessary amendment.

Documenting characteristics of items tested

ISA (UK) 230 requires that the identifying characteristics of the specific items or matters being tested should be documented.

The characteristics recorded will vary depending on the items being tested, but may specifically identify the actual items tested.

Example – Identifying characteristics

For a detailed test of entity-generated purchase orders, the auditor may identify the actual documents tested by providing their purchase order number, or alternatively, indicate the population as a whole.

For a review of credit notes over a certain amount, the auditor may document the scope of the procedure and the threshold value above which items were reviewed.

Recording the items tested at this level of detail allows the subsequent investigation of exceptions or inconsistencies as well as enabling the audit team to be accountable for its work.

Typically, however, copies of the entity's records will only be required when they are necessary for an experienced auditor to understand the work performed and the conclusions reached.

The ISA gives several illustrative examples, including those in the table below.

Procedure or type of sample	Information to be documented
Selection of purchase orders	Date and unique purchase order number
Systematic sampling	Source of items being selected, starting point and sampling interval
Inquiry of client staff	Date(s) of inquiry plus the name and role of the member(s) of staff
Observational test	Process/control/matter being observed, the name and role of the member(s) of staff, and where and when the observation was carried out

Judgement areas

ISA (UK) 230 requires that working papers should include the auditor's reasoning on all significant matters which require the exercise of judgement, together with the auditor's conclusions thereon.

The ISA provides examples of items which would be deemed to be 'significant matters':

- matters that give rise to significant risks;
- results of audit procedures which indicate either that financial information could be materially misstated or that there is a need to revise the auditor's previous assessment of the risks of material misstatement;
- circumstances where the auditor has significant difficulty in performing their procedures;
- concerns about the entity's ability to continue as a going concern; and
- findings that could result in a modification to the auditor's report or the inclusion of an Emphasis of Matter paragraph.

The working papers should note the relevant facts at the time the judgement was reached. This is particularly important where it concerns a difficult area which may be questioned later with the benefit of hindsight. The ISA suggests that use of a summary of significant matters cross-referenced to detailed working papers may aid consideration of these matters together with assisting with review of the work performed and conclusions reached. This may form part of a 'completion memorandum'.

In the ~~*Navigate*~~ *Audit tools*, these matters may be documented in Summary of significant audit matters (**B4**).

The ISA also requires the auditor to document any discussion held with management and others, including those charged with governance, about significant matters.

Where the auditor has found information that contradicts the final conclusion on a significant matter, the inconsistency should be documented on file, together with an explanation of how the final conclusion was reached. This does not mean, however, that incorrect or superseded documentation should be retained on file.

The ISA states that oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached. However, they may be useful to explain or clarify information contained in the audit documentation.

Documentation of departures from ISAs (UK)

Where it is necessary to depart from the requirements of the basic or essential procedures in an ISA, the auditor is required to document the alternative procedures followed and the reasons for the departure. This does not apply to procedures that are not relevant to the engagement, e.g. in the second and subsequent years of an audit the auditor need not apply the standards in ISA (UK) 510 (Revised June 2016) *Initial Audit Engagements – Opening Balances* regarding initial engagements.

Identification of the preparer and reviewer of documentation

ISA (UK) 230 specifically requires the recording of who performed and who reviewed the audit work and the date such work was completed, including the extent of the review.

However, the requirement to document who reviewed the audit work does not imply a need for each specific working paper to include evidence of review. The audit documentation should, however, evidence who reviewed specific elements of the audit work performed and when. This may be on a control sheet rather than by, for example, initialling and dating each sheet of documentation itself. See Reviewing the file for guidance.

The ~~*Navigate*~~ *Audit* tools provide space on each schedule for initials and date, and this is summarised in the Progress sheet.

Conclusions

A conclusion should be drawn for each audit area. Not only should the audit programme be concluded upon, but for each main test within each area there should be a record of:

- the aim of the tests;
- the work performed;
- the results obtained; and
- the conclusion reached.

The conclusion section provides space for a planning conclusion as well as a final conclusion. The planning conclusion can be used to document, particularly where there has been significant tailoring of the audit approach, that the partner has approved the approach being taken to the audit of the particular section before the work is commenced. The final conclusion is then used to confirm that:

- the work detailed in the audit programme has been carried out;
- the results have been adequately recorded;
- all necessary information has been collected for the presentation and disclosure in the financial statements;
- sufficient appropriate evidence has been obtained to support the audit conclusion reached; and
- subject to any matters highlighted, the balance is/isn't fairly stated.

If an alternative conclusion is appropriate, the audit programme should state clearly the alternative conclusion reached, with adequate explanation for the conclusion to be understood.

Before reaching an alternative conclusion, consideration should be given to whether or not there are any additional audit procedures that could be carried out to enable an unqualified confirmation of the audit objectives to be given.

Specific documentation requirements – compliance monitoring

In addition to documentation requirements specified elsewhere in ISAs, ISQM (UK) 1 requires that the firm includes specific required responses to quality risks identified. These responses require that before accepting or continuing an audit engagement, the firm assesses and documents whether:

- the firm complies with the independence and objectivity requirements in the *Revised Ethical Standard* 2019;
- there are threats to the firm's independence, and the safeguards applied to mitigate those threats;
- the firm has the competent personnel, time and resources needed in order to carry out the audit in an appropriate manner; and
- the key audit partner is eligible to be appointed as a statutory auditor.

At the engagement level, examples of this type of documentation may include:

- documentation of the firm's consideration of independence at the take on or continuance stage;
- documentation of issues arising, most commonly non-audit fees or additional fees which may arise as the engagement continues; and
- evidence of the results of internal consultations with firm or external audit quality teams where required by internal processes or similar.

Timing is also a key consideration here. For example, where a consultation is required with regards to the level of a proposed additional or non-audit fee, work on those elements of the project should not commence until the team are able to demonstrate that relevant approval has been obtained and relevant communications made to key stakeholders.

Firms are required to keep the documents and information required by ISQM (UK) 1 and the documentation requirements of other applicable ISAs (UK) for at least six years from the date of the auditor's report. This period may be longer if necessary to satisfy the requirements of any applicable laws or regulation relating to data protection and to meet the requirements for any applicable administrative and judicial proceedings.

ISA (UK) 220 specifies certain documentation requirements where engagement quality control reviews are carried out.

ISQM (UK) 1 also specifies certain matters that need to be documented at the firm level regarding the firm's systems, procedures and controls. ~~This is considered in further detail in the Audit quality and compliance area of *Navigate Audit*.~~

Other specific documentation requirements

In addition to the requirements of ISA (UK) 230, a number of other ISAs specify requirements relating to audit documentation. These include:

- ISA (UK) 210 (Revised June 2016) (Updated May 2022) – the engagement letter;
- ISA (UK) 220 (Revised July 2021) – matters identified, relevant discussions with personnel, and conclusions reached with respect to fulfilment of responsibilities relating to relevant ethical requirements, including those related to independence, and the acceptance and continuance of the client relationship and audit engagement; the nature and scope of, and conclusions resulting from, consultations undertaken during the audit; engagement and how such conclusions were implemented; and, If the audit engagement is subject to an engagement quality review, that the engagement quality review has been completed on or before the date of the auditor's report. Also all significant threats to the firm's independence as well as the safeguards applied to mitigate those threats;
- ISA (UK) 240 (Revised May 2021) (Updated May 2022) – matters relating to fraud including conclusions from the team discussion; fraud risk and the audit response thereto; communications with management and those charged with governance; the results of procedures designed to address the risk of management override and the reasons (if any) for rebutting the presumed risk of fraud in relation to revenue recognition;
- ISA (UK) 250 Section A (Revised November 2019) (Updated May 2022) – identified or suspected non-compliance with laws or regulations and the results of discussions with management, those charged with governance and others, as applicable;
- ISA (UK) 260 (Revised November 2019) (Updated May 2022) – where matters required to be communicated with those charged with governance are communicated orally, details including when and to whom they communicated. For public interest entities, other data and documents important in supporting the additional report to the audit committee;
- ISA (UK) 300 (Revised June 2016) (Updated May 2022) – the overall audit strategy and audit plan including any changes thereto and reason for such changes;
- ISA (UK) 315 (Revised July 2020) – the engagement team discussion; key elements of understanding of the entity and its environment, sources of information and risk assessment procedures performed;

evaluation of the design of identified controls, and determination whether such controls have been implemented; risks identified and controls related to significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for the significant judgments made;

- ISA (UK) 320 (Revised June 2016) (Updated May 2022) – materiality levels including overall financial statement materiality, specific materiality, performance materiality and any changes to these levels as the audit progressed;
- • ISA (UK) 330 (Revised July 2017) (Updated May 2022) – overall responses to address assessed risks at the financial statement level and audit procedures performed; linkage with risks at the assertion level and the results of the audit procedures; (where applicable) the conclusion reached about relying on controls tested in previous periods. Documentation should also demonstrate that information in the financial statements agrees or reconciles with underlying accounting records, including agreeing or reconciling disclosures derived from outside the general and subsidiary ledgers;
- ISA (UK) 450 (Revised June 2016) (Updated May 2022) – 'clearly trivial' level; accumulated misstatements and the auditor's conclusion as to whether misstatements are material (see Recording uncorrected misstatements);
- ISA (UK) 540 (Revised December 2018) (Updated May 2022):
    - 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;
    - 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;
    - the auditor's response(s) when management has not taken appropriate steps to understand and address estimation uncertainty;
    - indicators of possible management bias related to accounting estimates, if any, and the auditor's evaluation of the implications for the audit; and
    - significant judgements 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.
- ISA (UK) 550 (Updated May 2022) – names of identified related parties and nature of related party relationships;
- ISA (UK) 600 (Revised November 2019) (Updated May 2022) – matters relating to group audits including:
    - analysis of components showing which are significant and the type of work performed on each component;
    - nature timing and extent of involvement in the work of component auditors;
    - written communications with component auditors;
    - nature timing and extent of work performed by component auditors including, where applicable, the group audit team's review of relevant parts of the component auditor's documentation;
    - sufficient appropriate documentation to enable the competent authority to review the work of the group auditor; and

    - the group audit team must make arrangements to ensure that the competent authority will be able to gain access to audit documentation of the work carried out by a component auditor, should they wish to inspect it in connection with a quality assurance review or investigation.

- ISA (UK) 610 (Revised June 2016) (Updated May 2022) – evaluation of the internal audit function, where the auditor uses the work of internal audit;

- ISA (UK) 620 (Revised November 2019) (Updated May 2022) – any request for advice from an auditor's expert together with the advice received;

- ISA (UK) 701 (Revised November 2019) (Updated May 2022) – where applicable, determination of key audit matters to include in the auditor's report;

- ISA (UK) 720 (Revised November 2019) (Updated May 2022) – procedures performed on 'other information' accompanying the financial statements and a copy of the final version of such other information;

- ISQM (UK) 1 (July 2021) (Updated March 2023) also imposes requirements regarding:

    - documentation of the engagement quality control review (EQCR) where applicable;
    - documentation to facilitate external monitoring of group audits by regulators;
    - records of any complaints made in writing about the performance of audit engagements; and
    - documentation of the system of quality management.

- ISQM (UK) 2 (July 2023) (Updated March 2023) – sets requirements around the documentation of engagement quality reviews (EQR).

Initial procedures to be undertaken and documented on each audit

There are a number of audit procedures that should be considered at the beginning of each audit section. Although these have not been separately identified within each of the individual financial statement sections within the Execution area, to avoid repetition, they are nonetheless crucial to ensuring that the objectives are all fully met.

These procedures are listed below:

- a lead schedule should be prepared, or checked, containing the current year's figures, reconciled to the nominal ledger and trial balance, and enquiries made into any major variations from expectations should be documented;

- opening balances should be agreed to the previous year's financial statements where appropriate; and

- any material journal entries or other adjustments made during the course of preparing the financial statements should be examined (see Fraud in the audit).

In the ~~*Navigate*~~ *Audit* tools, these procedures are covered in the audit programmes for each financial statement area and the **V** section schedules.

ISAs also require the auditor to review and consider whether any amendment is needed to the initial materiality and/or the original assessment of risk throughout the audit. The auditor should then follow this through to ensure that any necessary revisions are made to the audit plan and the audit approach. Also, where an adjustment is made to either materiality or risk and audit work has already been undertaken, the auditor must consider if any further work needs to be undertaken on the basis of this revised assessment. This consideration must be documented.

> The audit programmes for each financial statement area within the ~~*Navigate*~~ *Audit* tools contain a guidance note to remind the auditor that when performing the work, the risk assessment and/or materiality calculations may need to be revised due to identified information or circumstances and relevant schedules should be updated for any changes to risks and/or materiality.

Similarly, the extent of any planned reliance on internal controls should be reviewed, and a decision made as to whether this remains appropriate.

Analytical review procedures should be applied throughout the audit (see Substantive analytical procedures). This should be the case even where the auditor has not identified any suitable analytical review procedures that provide sufficient comfort to enable a reduction in the sample size. It should be standard procedure to review for any large and unusual items and to obtain an explanation for anything that looks ‘odd’. Scepticism is essential and the auditor should investigate anything that does not feel right rather than focusing entirely on the samples that the papers require.

Assembly of the final audit file

Assembly of the final audit file is covered in Final completion and planning for next year.

Changes to audit documentation

Changes to audit documentation after the date of the audit report are covered in Final completion and planning for next year.

Confidentiality, custody and ownership of working papers

The audit working papers are the property of the auditor. Papers relating to accountancy work will normally be the property of the client although this will depend on the particular circumstances. Certain papers may be made available to clients but care should be taken not to undermine the independence or validity of the audit process. Because of their confidential nature, they should not be divulged to third parties without the client’s permission, although some third parties, for example HMRC, may have a right of access in certain circumstances. However, whatever the circumstances, they should not be seen as a substitute for the client’s accounting records.

ISQM (UK) 1: 60 - 61 states that “the firm shall establish a period of time for the retention of documentation for the system of quality management that is sufficient to enable the firm to monitor the design, implementation and operation of the firm’s system of quality management, or for a longer period if required by law or regulation.”

The standard, therefore, is not prescriptive about the actual length of time and nature of documents required to be retained, but firms should clearly consider the industry sector, regulatory and legislative environment in which they operate as well as the requirements of their own internal quality management system, in particular the monitoring and remediation program which will require them to retain papers for review. This period would not typically be expected to be less than 6 years, though longer retention may be required in some circumstances. Similarly, both regulatory and internal quality reviews will usually require auditors to provide an archived copy of the full audit file, Draft or 'rough' working papers are usually not required, however practitioners are also not likely to be able to claim credit for work documented in this way in retrospective reviews. This should be factored into considerations of Retention of audit documentation.

Retention of working papers

Retention of working papers is covered in Retention of audit documentation.

Access to working papers

When a company becomes a target for potential purchasers, the purchaser's investigating accountants will frequently want access to the audit working papers to assist in their investigations. The granting of access to working papers in these circumstances involves issues of confidentiality and the possibility that the auditor may be alleged to have accepted an additional duty of care.

The Audit Faculty of the ICAEW issued Audit 4/03: *Access to Working Papers by Investigating Accountants*, to attempt to facilitate the agreement of access to working papers in these situations and update previous guidance. It recommends that access to papers is granted on the basis of client authorisation and 'release' letters. These seek to deal with confidentiality issues and limit as far as possible additional risks.

Change of auditor

Where there is a change of auditor, guidance on access to working papers by the successor auditor is covered in First-year audits ~~and the Audit quality and compliance area of *Navigate Audit*.~~

1.6 Professional scepticism

Quick overview

This section sets out an overview of professional scepticism when performing an audit engagement.

Scope and definitions

Scope

ISA (UK) 240 (Revised May 2021) (Updated May 2022) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* is effective for the audit of financial statements for periods commencing on or after 15 December 2021.

ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement (July 2020)* is effective for the audit of financial statements for periods commencing on or after 15 December 2021.

Several ISAs mention the importance of professional scepticism, in particular ISA (UK) 240 and ISA (UK) 315.

Key definitions

Term	Definitions
Professional Scepticism	An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Source: ISA (UK) 200:13(l)

The sceptical mindset

It is generally accepted that a sceptical mind is a requirement of a rigorous audit performed with due professional care. The degree of scepticism required is less clear-cut, but one way of looking at the idea of professional scepticism is as an attempt to strike a balance between too much and too little scepticism. Too little scepticism may diminish the effectiveness and rigour of the audit, but too much risks inefficiencies and an unnecessary increase in costs.

This initial mindset is largely a personal attribute and audit firms need to consider a number of character traits which underlie auditor scepticism when recruiting auditors:

- curiosity and a questioning mind;
- deferral of judgement and not making premature conclusions;
- understanding management behaviour and motivations;
- self-confidence; and
- freedom of action.

A sceptical mindset can be improved through effective training and procedures. Perhaps unfortunately, auditors are also likely to become more sceptical when they have been personally involved in an investigation of an audit failure.

The ISAs (UK) explicitly require that the auditor plans and performs the audit with professional scepticism, while keeping in mind that circumstances may be present which cause the financial statements to be materially misstated.

The problem that many auditors have with the concept of professional scepticism is that there is no single way of demonstrating that the auditor has exercised scepticism when conducting an audit in accordance with ISAs (UK). Notwithstanding this problem, professional scepticism is a mind-set; a sceptical mindset will enable the auditor to question aspects of the entity and the financial statements that are being audited, rather than merely accepting information at face value. This questioning mindset will then enable the auditor to form conclusions on the information at hand. The concept of professional scepticism is very closely related to the concepts of independence and objectivity – two traits which are fundamental ethical principles. The auditor's independence enhances their ability to act with integrity, be objective and maintain an attitude of professional scepticism.

Professional scepticism can be exercised by being alert to any audit evidence that may contradict other audit evidence obtained. It can also be exercised by calling into question the reliability of documents or responses to inquiries. Note that unless there is reason to believe the contrary, ISA (UK) 240:14 sets out that the auditor may accept records and documents as genuine. If matters come to light that cause the auditor to believe that a record or document may not be authentic, or that terms in a document have been modified but not disclosed to the auditor, the auditor is required to investigate further (see Audit evidence for guidance).

Professional scepticism includes being alert to conditions that may indicate a potential fraud risk, and thus developing audit procedures that adequately respond to the circumstances.

Example – Corroborating management's explanations

Firm A is auditing a subsidiary that installs bespoke doors. The company has been trading in the UK for the past four years and has yet to show a profit. UK management are under pressure to improve the performance of the company.

Three months before its year end, the company installed several sets of revolving doors in a large office building. The invoice value, to the customer, was £400,000. At the year end the invoice was in trade debtors and three months after the year end it remains unpaid. The auditors have enquired of management whether the debt is bad, and management have said that the customer will pay in the next two weeks once a few small snags have been addressed with the doors. Specialist engineers from another company in the group are due to visit the customer in the next few days to rectify the problem, and then the customer will settle the outstanding invoices.

The auditor must address the risk that management might be overly positive about this situation as their motivation might be to report the best position in their financial statements. The auditor will require corroborating evidence to support the representations concerning the process for recovering this debt. Management might provide copies of correspondence to and from the client, but professional scepticism might demand that the auditor seek further reassurances.

In this situation corroboration from the other company in the group would appear to be valuable, as they should not share management's possible motivation to manipulate reported profits. However, the auditor should be aware that the other company's view of things might not be complete because they will be relying upon communications from management in the UK.

The auditor might consider getting a direct confirmation from the customer. They should ensure that this is delivered directly to them and not through management, who could possibly falsify the documentation. Additionally, or perhaps alternatively, the auditor could seek representations from engineers working for the company rather than from management. Of course there is the risk of collusion, but this is often less likely outside of management.

The auditor's precise response to this situation, and the degree of scepticism applied, will of course vary according to the auditor's own professional judgement, responding to the particular circumstances. The important thing that will always be present is the need to apply and document a sceptical approach.

Part of this sceptical mindset means an auditor being able to identify alternative ways that the audited entity could have approached the relevant issues. Without the ability to consider alternatives the auditor can only analyse what has been put in front of them by management. This can often seem reasonable if management's approach is thought to be the only way to approach the issue. If the auditor has alternative approaches in their mind, then it can be said that they are independent in mind, which is a key element of ethical independence. Such an auditor has an independent standpoint from which they are then able to challenge or influence management's perspective.

Example - Forming an auditor's expectations

An auditor attends the stock-take for a company that buys and sells grain. The grain is stored in large silos. The grain dealer's operations director escorts the auditor from silo to silo explaining what grain is in each one and showing the auditor how full each silo is and how that converts to tonnage.

Let us consider two different approaches that the auditor might take to this stock-take. Both approaches involve physically inspecting the contents of a sample of silos or possibly every silo.

Auditor A is very challenging. After inspecting the contents of each silo they ask the director how they can distinguish between different grains and different grades of grain. They ask how the quantity in each silo is converted into tonnage; about moisture content and how that is calculated and what impact it has on weight, and so on. Auditor A continues to ask questions until they are fully satisfied that they have sufficient evidence and that it makes sense.

Auditor B does not ask the same detailed questions as auditor A. Auditor B simply inspects the grain silos, taking samples from each silo to ensure that they are what the director has said they are. The samples are taken haphazardly from within the silo so as to be able to confirm that the whole silo is filled with same grain. Auditor B is mindful that the entity could be fraudulently overstating stock by concealing a lower grade or quality grain under a higher quality (and value) product.

Auditor B looks at the documentation supporting the size of the silos when they were commissioned and measures the moisture content themselves. Auditor B calculates the relevant grain tonnages themselves and then checks the company's record. They only challenge management assertions when a figure does not correspond with their own calculations.

Whilst auditor A appeared to be asking the most questions, this was only because of their innate lack of knowledge of the business. Auditor A acquired all their knowledge about grain storage from the directors of the company, which makes it much more difficult to challenge management assertions. Auditor B was more experienced in the industry, so could simply get on with testing management's assertions against their own expectations. This meant that they had greater independence of mind and were able to form their own perspective from which to challenge management. This allowed auditor B to provide management with a more robust challenge than was possible from an auditor who lacked this independent perspective. Auditor B's knowledge of the entity also enabled them to perform a better risk assessment, because they understood what management could do if they were motivated to overstate the value of stock. As such auditor B could design and perform tests that addressed these risks.

Professional bodies and regulators believe that it is in the public's interest to re-emphasise to both auditors and others who play an important role in an audit of financial statements of the need to adopt and maintain a degree of professional scepticism during the course of an audit. This has been highlighted in a number of FRC Thematic Reviews in recent years, most recently in May 2018 in the FRC's Audit Culture Thematic Review. This clearly notes that a number of actions are required to establish, promote and embed an appropriate audit culture, including 'giving additional prominence to audit specific behaviours and values within the firms' cultural design, including the fundamental principles of integrity, objectivity, independence and professional scepticism that underpin high quality audit'.

Insight – Types of bias and possible mitigations

The revised standard identifies several different types of bias, unconscious or otherwise, which may impact the auditor's judgement as follows:

- availability bias, which is a tendency to place more weight on events or experiences that immediately come to mind or are readily available than on those that are not;
- confirmation bias, which is a tendency to place more weight on information that corroborates an existing belief than information that contradicts or casts doubt on that belief;
- groupthink, which is a tendency to think or make decisions as a group that discourages creativity or individual responsibility;
- overconfidence bias, which is a tendency to overestimate one's own ability to make accurate assessments of risk or other judgments or decisions;
- anchoring bias, which is a tendency to use an initial piece of information as an anchor against which subsequent information is inadequately assessed; and
- automation bias, which is a tendency to favour output generated from automated systems, even when human reasoning or contradictory information raises questions as to whether such output is reliable or fit for purpose.

The standard offers the following possible mitigations for these:

- remaining alert to changes in the nature or circumstances of the audit engagement that necessitate additional or different resources for the engagement, and requesting additional or different resources from those individuals within the firm responsible for allocating or assigning resources to the engagement;
- explicitly alerting the engagement team to instances or situations when vulnerability to unconscious or conscious auditor biases may be greater (e.g., areas involving greater judgment) and emphasizing the importance of seeking advice from more experienced members of the engagement team in planning and performing audit procedures;
- changing the composition of the engagement team, for example, requesting that more experienced individuals with greater skills or knowledge or specific expertise are assigned to the engagement;
- involving more experienced members of the engagement team when dealing with members of management who are difficult or challenging to interact with;
- involving members of the engagement team with specialized skills and knowledge or an auditor’s expert to assist the engagement team with complex or subjective areas of the audit;
- modifying the nature, timing and extent of direction, supervision or review by involving more experienced engagement team members, more in-person oversight on a more frequent basis or more in-depth reviews of certain working papers for:
  - complex or subjective areas of the audit;
  - areas that pose risks to achieving quality on the audit engagement;
  - areas with a fraud risk; and
  - identified or suspected non-compliance with laws or regulations;
- setting expectations for:

- less experienced members of the engagement team to seek advice frequently and in a timely manner from more experienced engagement team members or the engagement partner;
- more experienced members of the engagement team to be available to less experienced members of the engagement team throughout the audit engagement and to respond positively and in a timely manner to their insights, requests for advice or assistance; and
- communicating with those charged with governance when management imposes undue pressure or the engagement team experiences difficulties in obtaining access to records, facilities, certain employees, customers, vendors or others from whom audit evidence may be sought.

When to apply professional scepticism

Professional scepticism needs to be applied throughout the entire audit, even at the stage of accepting the engagement. An example of this might be when considering the integrity of the principal owners and management. In addition, professional scepticism should be applied in:

- identifying and assessing risks of material misstatement;
- designing the nature, timing and extent of further audit procedures which are responsive to the assessed levels of risk;
- evaluating audit evidence – e.g. recognising the need to increase the quantity of audit evidence, or to obtain evidence which is more relevant and reliable for areas which have a higher assessed risk;
- designing and performing substantive analytical procedures;
- addressing situations when management disagree with the auditors – e.g. refusing to allow the auditor to send a confirmation request;
- drawing conclusions based on the audit evidence obtained - e.g. assessing the reasonableness of estimates made by management in preparing the financial statements; and
- forming an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Example – Challenging the client

Company A provides corporate services, such as incorporation and management of offshore companies and charges an annual management fee to its clients. The year end is 31 December and all invoices are sent on 31 December for the previous year. The directors aim to sign off the financial statements and finalise the audit by 31 January each year because they like to do things early. There are no external reporting deadlines.

The auditor cannot rely upon after date payments to verify the recoverability of the debtors, as none have been paid by 31 January. The directors refuse to allow a debtors circularisation.

The auditor should consider whether the directors might want to manipulate the financial statements and overstate debtors. If they did, then it would be very difficult to detect, given the constraints. The auditor should understand why the clients are being invoiced for twelve months of service in arrears. Is this standard industry practice?

Does it make sense?

The auditor should robustly challenge the company's refusal to permit a debtors circularisation. Also, a sceptical auditor might wonder why such a tight reporting deadline is being imposed for no obvious reason.

Ultimately the auditor should consider the impact of this on their audit opinion or whether indeed they should reaccept appointment next year.

Planning and the audit team meeting

Audit planning is integral to the audit, and the audit team planning meeting is an ideal opportunity to re-affirm the importance of professional scepticism. In this meeting the team can discuss the susceptibility of the financial statements to material misstatement. Consideration should be given not only to susceptibility in general terms, but also to how the financial statements could be materially misstated due to fraud or error. Many audit firms fall into the trap of relying on past experience of the honesty and integrity of clients, and hence document that there are no issues relating to fraud/error on the grounds that no fraud/error was noted in prior year audits. In this situation, a firm would need to make an effort to maintain scepticism to mitigate the familiarity threat arising from their ongoing professional relationship with the client.

During the audit team meeting, the team should discuss scenarios such as the following:

- How could management override internal controls to commit a fraud?
- How could employees manipulate deficiencies in internal controls for personal financial gain?
- How could related party relationships give rise to a fraud risk factor?
- How could the financial statements be materially misstated because of error?

These are some of the key points that should be discussed among the engagement team to demonstrate that professional scepticism is being applied. It may be the case that there is no fraud/error present, but the idea of applying professional scepticism is for the auditor to remain alert to the possibility that there could be fraud or error. This mirrors the very nature of fraud in particular, which is designed not to be detected and may therefore be accompanied by an outward appearance of normality.

It is also particularly important to apply professional scepticism when addressing areas of the financial statements that are complex, significant or which contain a high degree of judgement on the part of the client. The auditor can then challenge management's assumptions, for example in relation to:

- Accounting estimates, including fair value accounting estimates and related disclosures – particularly:
- evaluating the reasonableness of the significant assumptions used by management for accounting estimates that give rise to significant risks;
- determining whether changes in accounting estimates, or in the method for making them from the prior period, are appropriate in the circumstances; and
- reviewing the judgements and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.

- related party transactions and relationships: remaining alert during the audit for information which may indicate previously unidentified or undisclosed related party relationships or transactions;
- significant transactions outside the ordinary course of business: evaluating whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into so as to engage in fraudulent financial reporting or to conceal misappropriation of assets or the reliability of external confirmation requests;
- consideration of laws and regulations: remaining alert for instances of non-compliance with laws and regulations, or suspected non-compliance. This applies particularly to those which may have a material effect on the financial statements, or on the client's operations. The latter could cause the business to cease trading or bring into question the entity's ability to continue as a going concern;
- consideration of whether the going concern assumption is appropriate in the company's circumstances. This would include evaluating management's plans for future actions, whether the outcome of these plans is likely to improve the situation and whether they are feasible; and
- if the auditor is auditing significantly unusual or highly complex transactions, they must apply professional scepticism because the nature of these transactions may give rise to material misstatement of the financial statements. They will therefore merit heightened attention by the auditor.

Sometimes management's representations can be very persuasive and can lead to the auditor downgrading risk in a particular audit area or audit assertion. Auditors need to ensure that management are not being put in a position where they can blind the auditor to a risk area, perhaps because the auditor was not sufficiently well informed about how the entity and industry operate.

Documentation

One of the main reasons that audit firms are criticised by professional bodies and regulators where professional scepticism is concerned is the lack of evidence proving that the auditor has applied professional scepticism when it comes to the file review. Where audit firms have documented certain points, it is often clear that the auditor is relying on past experience where the client's honesty and integrity is concerned; merely saying that because fraud/error was not noted in previous audits, then it can be assumed that the current year's audit will also not contain material misstatement due to fraud and/or error.

Care must also be taken by audit firms when they rebut the presumption that fraud in relation to revenue recognition is not applicable to the client. The presumption itself may be rebutted in cases where there may be a single type of simple revenue transaction (for example, leasehold revenue from a single-unit rental property). Management override of internal controls is also recognised as a significant risk in ISA (UK) 240:31 and therefore the auditor must undertake the required procedures laid down in the ISA and not simply overlook this requirement because of past beliefs concerning the client's integrity and honesty.

An auditor can evidence professional scepticism in conversations that they hold with those charged with governance (TCWG). For example, it might be the case that the audit client has applied a certain accounting practice which might be permitted under GAAP but which the auditor does not consider to be appropriate in the company's circumstances. Challenging such practices and making sure that the notes of any discussions are documented are key in demonstrating that professional scepticism has been applied.

Audit documentation is critical because it demonstrates that the requirements of the ISAs (UK) and legislation have been applied. ISA (UK) 230 *Audit Documentation* requires the auditor to prepare sufficient audit documentation to enable an experienced auditor, having no previous connection with the audit, to understand, among other things, the significant decisions made regarding significant matters arising during the audit, the conclusions reached thereon, and significant judgements made in reaching those conclusions. Discussions with management and TCWG should also be documented including the nature of any significant matters discussed and when and with whom the discussions took place. By ensuring such matters are properly documented, this will help the auditor demonstrate how significant judgements and key audit issues were addressed and how the auditor has evaluated whether sufficient and appropriate audit evidence has been obtained.

The following are examples of where appropriate audit documentation should be on file and where the matters and judgements are significant (note the list below is not exhaustive):

- the decisions reached during the audit team discussion concerning the susceptibility of the financial statements to material misstatement due to fraud;
- the decisions reached during the audit team discussion concerning the susceptibility of the financial statements to material misstatement due to fraud with related parties;
- communication with management and TCWG, regulators and others in respect of fraud;
- identified or suspected non-compliance with laws and regulations and the results of discussions with management and, where applicable, TCWG and other parties external to the entity;
- the basis for the auditor's conclusions concerning the reasonableness of accounting estimates and their disclosure which give rise to significant risks and any indicators of possible management bias;
- identified information which is inconsistent with the auditor's conclusions concerning a significant matter and how that inconsistency was addressed;
- the basis for the auditor's conclusions concerning the reasonableness of areas of subjective judgements; and
- the basis for the auditor's conclusion about the authenticity of a document when the procedures applied by the auditor caused them to believe that the document may not be authentic.

Insight – Documentation

Documentation needs to show for example that where any doubts arose about an explanation provided, the audit team have questioned the entity appropriately and not just taken the client at their word.

Reviewing the audit

The audit engagement partner should also demonstrate the application of professional scepticism when taking responsibility for:

- the direction, supervision and performance of the audit;
- reviews of work performed; and
- the engagement team undertaking appropriate consultation on difficult or contentious matters, and considering the conclusions reached from such consultations.

Applying professional scepticism when reviewing audit evidence is critical. Audit evidence has to be both sufficient and appropriate, as well as covering the relevant audit assertions. An auditor can demonstrate professional scepticism by questioning and considering both the sufficiency and appropriateness of the audit evidence gathered in light of the circumstances. Where the auditor doubts the reliability of information, or where evidence points to potential fraud risk, the ISAs (UK) require the auditor to investigate further and to determine what additional procedures are necessary to resolve the issue.

Firms often run into difficulty with regulators and professional bodies during audit file reviews because they believe that management and TCWG are honest and that their integrity is intact. While this may be the case in the majority of audits, a belief that a client is honest and has integrity does not relieve the auditor of their responsibility under the ISAs (UK) to maintain professional scepticism. It also does not allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

Reviewers should review with an open mind, not placing any reliance, nor forming expectations, based on the previous year's audit. Every review should be treated with the same sceptical attitude as if the client is new that year.

What can audit firms do to ensure professional scepticism is achieved?

The firm's leadership and the examples that it sets will essentially drive the internal culture of the audit firm. Therefore, audit engagement partners need to ensure that audit staff understand the importance of professional scepticism and the need to have a questioning mind. Audit firms should have policies and procedures in place that accord with the requirements of ISQM (UK) 1 *Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements* (July 2021). Such policies and procedures should specifically emphasise the importance of exercising professional scepticism throughout the course of an audit. In addition, the firm should consider documenting the importance of exercising professional scepticism when:

- establishing policies and procedures which are designed to promote an internal culture recognising that quality is essential when performing engagements;
- promoting a quality-oriented internal culture through clear, consistent and frequent actions and messages from all levels of the firm's management;
- ensuring that the firm has sufficient personnel with the necessary competence, capabilities and commitment to ethical principles; and

- developing and implementing internal training and continuing professional development for all levels of the firm's personnel.

Demonstrating professional scepticism is not just needed at a firm level – it should also be demonstrated at the engagement level. The audit engagement partner is responsible for the overall quality of the audit to which they are assigned, and this is why it is important that audit engagement partners communicate the importance of professional scepticism to the staff who are deployed on the audit. Auditors should not be hindered by clients in the execution of their duties and should not be in fear of reprisals and in issuing auditor's reports which are appropriate in the circumstances.

Audit firm procedures are also of particular importance when responding to negative findings from audit testing. The nature and extent of additional work to be performed is likely to be a decision taken by the hierarchy of the audit team, and will be strongly influenced by the firm's policies, procedures and methodologies.

Insight – Audit Quality Inspection findings

Improving the consistency of audit teams' application of professional scepticism is an example of a finding from the latest Audit Quality Inspection report. Classic examples of failing to exercise professional scepticism are:

- not understanding the business and consequently not changing audit procedures for the particular client in question;
- over-reliance on management representations, without getting corroborative evidence;
- relying on management's procedures instead of designing and performing your own tests;
- failure to investigate conflicting explanations or to use alternative assumptions;
- failure to obtain appropriate third-party confirmations; and
- not having the confidence to challenge management.

Further reading

The FRC has issued the following papers that provide useful further reading:

- FRC Professional Judgement Guidance (2022);
- FRC Professional Judgement Framework (2022);
- FRC Professional Judgement Guidance Illustrative Examples (2022);
- FRC Professional Judgement Guidance - Expectations Paper (2022); and
- What Makes a Good Environment for Auditor Scepticism and Challenge.

2. Planning

2.1 First year audits

Quick overview

This section covers the auditor's responsibilities in relation to the opening balances, comparatives and other relevant issues when performing a first-year audit where the prior period financial statements were not audited or were audited by a predecessor auditor.

The commentary here deals with the general principles of auding a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.

This section relates to **Sup 1** in the Private Company (PCAS) based audit tools

Scope and definitions

Scope

When performing a first-year audit where the prior period financial statements were not audited or were audited by a predecessor auditor (initial engagements), the auditor must consider whether material errors in the opening balances might give rise to errors in the current financial period.

ISA (UK) 510 (Revised June 2016) *Initial Audit Engagements – Opening Balances* was issued in June 2016 and is effective for periods commencing on or after 17 June 2016. It deals with the auditor's responsibilities in relation to opening balances, including matters requiring disclosure such as contingent liabilities, in initial engagements.

ISA (UK) 300 (Revised June 2016) *Planning an Audit of Financial Statements*, effective for periods commencing on or after 17 June 2016, also contains requirements and guidance applying to initial audits. Before starting an initial engagement, it requires the auditor to perform procedures regarding the acceptance of the client relationship and to communicate with the predecessor auditor.

Whether or not the audit is an initial engagement, the auditor must consider whether comparative information is properly presented in the financial statements.

ISA (UK) 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements* was issued in October 2009, effective for periods commencing on or after 15 December 2010, although in June 2016 an additional paragraph was added to the application material relating to initial engagements for public interest entities. It was not revised by the FRC but was reissued as ISA (UK) 710 in June 2016.

Key definitions

Term	**Definitions**
Comparative information	The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Corresponding figures

Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Comparative financial statements

Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor’s opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Initial audit engagement

An engagement in which either:

i. the financial statements for the prior period were not audited; or

ii. the financial statements for the prior period were audited by a predecessor auditor.

Opening balances

Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

Predecessor auditor

The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

Source: ISA (UK) 510 , ISA (UK) 710

Audit objectives

When conducting an initial audit engagement, ISA (UK) 510:3 requires the auditor to obtain sufficient appropriate audit evidence about whether:

- opening balances contain misstatements that materially affect the current period’s financial statements (see Opening balances and comparatives); and
- appropriate accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements, or any changes are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

The auditor must consider whether comparative information is properly presented in the financial statements (see Opening balances and comparatives).

Preliminary engagement activities

Before starting an initial engagement, ISA (UK) 300:13 requires the auditor to:

- perform procedures required by ISA 220 (UK) Revised November 2019 (Updated May 2022) *Quality Control for an Audit of Financial Statements* regarding the acceptance of the client relationship (see Acceptance, continuance and independence); and
- to communicate with the predecessor auditor, where there was one, in accordance with ethical requirements (see Access to information by successor auditor).

An engagement letter will be required.

When planning an initial engagement, the auditor should also consider any major issues regarding the application of accounting principles or auditing standards discussed with management in connection with the auditor selection process and will need to consider how sufficient appropriate audit evidence regarding opening balances will be obtained.

Much of the planning for initial engagements will be identical to that for continuing engagements, however the first-year auditor will not be able to draw on their knowledge of the client from earlier work.

Access to information by successor auditors

Where the prior period financial statements were audited, the auditor should arrange to review the predecessor auditor's working papers for the last financial period audited. This will often provide the auditor with useful information regarding the client's organisation, operations and accounting systems and potential risk areas as well as providing audit evidence regarding opening balances and comparative information.

In the case of a public interest entity, the auditor is required to obtain an understanding of the methodology used by the predecessor auditor sufficient to explain to those charged with governance any planned substantial variation in the weighting of system and compliance testing compared with the previous audit.

Where the entity is a UK company the auditor has a statutory right to obtain information from the predecessor auditor's working papers. *Companies Act* 2006, Sch. 10 permits a successor auditor access to relevant information held by the predecessor auditor. This requirement is incorporated into the Audit Regulations (regulation 3.09), however its scope is not extended. Therefore, the requirement to provide information to a successor auditor applies only to companies and other entities mentioned in the Act. In particular, it does not apply to unincorporated charities or to pension schemes.

Auditors of new clients should treat requesting access to the predecessor auditor's working papers as a standard procedure and justify why it was not done rather than having to justify why it is necessary.

Technical Release AAF 01/08 *Access to Information by Successor Auditors* provides practical guidance on the application of *Audit Regulation* 3.09 to both successor and predecessor auditors. The main points to note are set out below.

- Information is for the purposes of the successor's audit and must not be disclosed to a third party, unless the successor is required to do so by a legal or professional obligation. The term 'third party' includes the client, although the successor may discuss the information with the client where to do so is a necessary part of the audit work. Because the auditor is complying with a mandatory requirement, providing access to relevant information will not breach professional confidentiality or data protection laws. However, because of the danger of tipping off, any money-laundering report and papers recording the predecessor's related consideration of apparently suspicious activities should not be provided by the predecessor to any person (including the successor) unless the predecessor has clear advice that to do so would be lawful.

- The right does not alter the existing liability of each auditor in relation to its respective audit.
- The request can only be made after formal appointment of the successor auditor. The provision of information should be on a timely basis.
- The request must be in writing and should not include unnecessary information. It should be as specific as possible and should avoid, wherever possible, a request for 'all relevant information'. It does not matter whether those working papers are filed on the current audit file, a permanent file or a systems file.
- The predecessor should be prepared to assist the successor by providing oral or written explanations on a timely basis.
- The period for which information is requested would normally be the period in respect of the last audit report signed by the predecessor and would include any subsequent interim review. If the successor considers that it needs information relating to an earlier period, then the successor should be prepared to list precisely what information is required and give reasons that demonstrate why such additional information is 'relevant' in accordance with the regulations.
- It would be usual for the basis on which the information is to be provided to be documented in writing by an exchange of letters between the two auditors, copied to the audited entity.

~~Guidance on suitable wording, including example letters, is provided in AAF 01/08, and Assignment letters.~~

Practicalities of access

Where working papers are held electronically, the predecessor will need to consider how to provide access to the relevant audit documentation without putting at risk the confidentiality of the firm's audit methodologies or confidential information of other clients.

It is reasonable for the successor to make notes of the review but there is no obligation to allow copying of audit working papers. AAF 01/08 states that it would be reasonable to allow, as a minimum, the copying of extracts of the books and records of the client. It would also be reasonable and helpful to allow copying of papers such as breakdown of analyses of financial statement figures and documentation of the client's systems and processes.

If the successor does ask to copy documents, it would be sensible for the predecessor to check them and to keep a record of which items were copied.

AAF 01/08 also suggests that it would be reasonable for the predecessor auditor to seek to recover costs, but without any element of profit. However, there is no obligation on the successor to make any payment and therefore the predecessor may wish to look to the client for recovery of costs.

Opening balances and comparatives

In circumstances where the financial statements for the previous period were audited by another firm of auditors, the auditor should follow the same approach for auditing opening balances as outlined in Nominal ledger, opening balances and comparatives, however, ISA (UK) 510 also requires the auditor to carry out some additional procedures for initial engagements.

ISA (UK) 510 requires the auditor to read last year's financial statements and auditor's report for information relevant to opening balances, including disclosures.

The auditor must also obtain sufficient appropriate audit evidence about whether the opening balances contain material misstatements that could affect the current period's financial statements by checking that:

- the prior period's closing balances have been appropriately brought forward into the current period or, when appropriate, have been restated; and
- opening balances reflect the application of appropriate accounting policies.

To do this, the auditor must perform one or more of the following procedures:

- review the predecessor auditor's working papers;
- consider whether audit procedures performed in the prior period provide evidence regarding the opening balances; or
- perform specific procedures in order to gain assurance over opening balances.

It is possible for the new auditor to request (in writing) access to the previous auditor's audit working papers (see Access to information by successor auditors). This alone may enable the new auditor to gain sufficient appropriate audit evidence over opening balances, but if such reliance is to be placed on these papers, the new auditor must assess the professional competence and independence of the previous auditor.

Where a review of the previous auditor's working papers is unsatisfactory, the auditor should perform additional procedures for opening balances and comparatives as are appropriate (see Unaudited comparatives for example procedures).

The auditor should consider the risk of material misstatement in the current period's financial statements due to errors in the opening balances and ensure that those risks and appropriate responses are reflected in the risk assessment.

Unaudited comparatives

In situations where either the client has grown and exceeded the audit threshold for the first time, or where a client requests a voluntary audit for the first time, the prior year comparatives will not have been audited.

In circumstances where comparatives are unaudited, further procedures will be required, for which guidance is given in ISA (UK) 510:A6-A7.

Current assets and liabilities

For current assets and liabilities, some audit evidence can usually be obtained as part of the current period's audit procedures. In other cases, additional audit procedures may be necessary.

The collection of opening trade debtors and payment of opening trade creditors during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In the case of inventory, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- observing a current physical stocktake and reconciling it with the opening position;
- performing audit procedures on the valuation of the opening inventory items; and
- performing audit procedures on gross profit and cut-off.

Non-current assets and liabilities

For non-current assets and liabilities, such as tangible fixed assets, investments and long-term creditors, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties for example, for long-term bank loans and investments. In other cases, the auditor may need to carry out additional audit procedures.

Consistency of accounting policies

ISA (UK) 510:8 requires the auditor to obtain sufficient, appropriate audit evidence about:

- whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements; and
- whether changes in the accounting policies have been appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Review the predecessor auditor's report

The auditor should consider relevant information in the predecessor's audit report on the prior year financial statements.

If there was a modification to the predecessor's audit opinion, the auditor must evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements. See Assessing risk.

In some situations, a modification to the predecessor auditor's opinion may not be relevant and material to the opinion on the current period's financial statements. For example, this may be the case where there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been resolved in the current period.

If the modification remains relevant and material to the current period's financial statements, the opinion on those financial statements must be modified in accordance with ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report* and ISA (UK) 710 *Comparative*

Information – Corresponding Figures and Comparative Financial Statements.

Impact on the audit report

The auditor will need to consider the impact of findings in relation to opening balances and consistency of accounting policies on the current year auditor report. Further guidance, including links to illustrative audit reports and wording, can be found in Drafting the audit report.

Opening balances

If the auditor is unable to obtain sufficient appropriate audit evidence regarding opening balances, the auditor is required to express a qualified opinion or disclaim an opinion, as appropriate, in accordance with ISA (UK) 705 .

If a conclusion is reached that the opening balances contain a material misstatement that impacts the current period which is not appropriately accounted for, presented or disclosed, the auditor is required to express a qualified or an adverse opinion, as appropriate, in accordance with ISA (UK) 705.

Consistency of accounting policies

A qualified or adverse opinion must also be given as appropriate in accordance with ISA (UK) 705 if the auditor determines that:

- the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or
- a change in accounting policies is not appropriately accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework.

Modification to the opinion in the predecessor auditor's report

The auditor must also consider the impact of any modification to the previous year's audit opinion on the report for the current period (see Review the predecessor auditor's report).

Additional disclosures if prior period financial statements were audited by a predecessor auditor

If the prior period financial statements were audited by a predecessor auditor, and the auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor must state in an 'Other Matter' paragraph in the auditor's report for the current period:

- that the financial statements of the prior period were audited by the predecessor auditor;
- the type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- the date of that report.

Additional disclosures if no audit was conducted in the previous period

Where no audit was conducted in the previous period, ISA (UK) 710:14 requires the auditor to state in an ‘Other Matter’ paragraph in the auditor’s report for the current period that the corresponding figures are unaudited.

2.2 Planning overview

Quick overview

ISAs set out certain documentation requirements throughout the audit and this section considers the requirements relating to planning.

This section relates to section C in the PCAS-based audit tools.

Scope and definitions

Scope

ISA (UK) 300 (Revised June 2016) (Updated May 2022) *Planning an Audit of Financial Statements* is effective for the audit of financial statements for periods commencing on or after 17 June 2016.

ISA (UK) 300 provides guidance on the planning process covering:

- the role and timing of planning;
- involvement of key engagement team members;
- preliminary engagement activities;
- planning activities;
- documentation; and
- considerations for initial audit engagements.

ISAs require certain elements of planning to be discussed with those charged with governance to improve the efficiency and effectiveness of the audit. Communications with those charged with governance are covered in Reports to management. However, the overall audit strategy and the audit plan remain the auditor’s responsibility.

Prior to planning, acceptance procedures must be followed and these are considered in Acceptance, continuance and independence and in Engagement letters. In line with ISA (UK) 220:23, the engagement partner must not only comply with the firm’s internal processes as well as the ethical standards and independence considerations; it is important that any relevant information obtained during the acceptance process is factored into the audit strategy. For example, acceptance or continuance will typically include a review of relevant press coverage of the audited body and consideration of any other relevant knowledge from the wider world, as well as considerations of how the prior period audit went (for continuing clients), for instance whether management applied undue pressure or were difficult to work with. These considerations should also form part or the audit strategy conversation.

More detail on particular aspects of planning are given in sections including Understanding the entity, Accounting systems processes and controls, Preliminary analytical procedures, Assessing materiality, Assessing risk, Audit team planning meeting, Determining the audit approach, Service organisations, Using the work of internal auditors, Using the work of experts and Documentation.

Key definitions

Term	Definition
Engagement partner	The partner or other individual, appointed by the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body. For an audit of financial statements, the engagement partner is a key audit partner.
Engagement team	All partners and staff performing the engagement and any other individuals who perform procedures on the engagement, excluding an external expert and internal auditors who provide direct assistance on an engagement.

Source: ISQM (UK) 1:16

Objectives and benefits of effective planning

ISA (UK) 300:4 states ‘the objective of the auditor is to plan the audit so that it will be performed in an effective manner’. Inadequate attention paid to the planning of the audit may result in a lot of wasted time and effort, and very often means that some risk areas that should be addressed are missed. Furthermore, each audit performed by a firm needs to comply fully with ISAs (UK). These are mandatory and non-compliance can lead to reportable findings if the firm were to be visited by a regulator or professional review body such as the ICAEW Quality Assurance Department (QAD), FRC Audit Quality Review (AQR) team or ACCA monitoring unit.

It is important that everyone is committed to the auditing process and understands the benefits to be gained from effective planning. These benefits include the ability to:

- identify and concentrate on the problem and high-risk areas;
- help the auditor decide on ways of auditing particular areas;
- help the auditor assign work to the appropriate level of staff, with the relevant experience;
- enable the auditor to communicate to staff what work they have to do and which working papers are expected;
- avoid, or at least predict, the possible overruns on budgeted fees and ensure that the audit is carried out efficiently and effectively;
- facilitate the control and review of work; and
- ensure that the auditor is able to reach an appropriate audit opinion.

In many respects, it is the last two points that require most focus. Many people do not invest the necessary time and effort in planning because they believe that they have insufficient time, especially when they are being put under pressure to reduce or maintain fee levels. Many auditors are tempted to just wade in and only appreciate later that this will usually result in more work being undertaken in the long run.

In addition, it is important to note that a job that has been properly planned is much easier and quicker to review. This not only saves the valuable time of the more expensive members of the audit team, it also reduces the chances of something important being missed, thus reducing audit risk.

The ISAs (UK) place great emphasis on documenting the auditor's knowledge of the client and the potential risks arising. Much of this work feeds directly into the audit planning and so this area is more important than ever in achieving a compliant yet efficient audit. The approach to accounting estimates, reliance on management appointed experts or the use of auditor appointed experts and other specialist areas therefore must be set out at the planning stage as part of the audit approach.

Planning is discussed in the context of recurring audits and is described as 'not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement'. However, some planning activities will, by necessity, have to be completed at the beginning of the audit, such as understanding the legal and regulatory framework within which the entity operates and briefing the audit team.

The audit planning process

The stages of audit planning are set out below. Each stage must be properly documented:

(a) assessing client acceptance and auditor independence;

(b) reviewing correspondence and discussing matters with the client;

(c) updating and reviewing the permanent file;

(d) recording or updating the systems notes, and assessing the design and implementation of controls;

(e) undertaking preliminary analytical procedures;

(f) assessing overall materiality and section-specific materiality;

(g) assessing risk at the financial statement and assertion levels and determining suitable responses to those risks;

(h) considering the audit approach that should be taken on each individual section of the audit;

(i) assessing performance materiality;

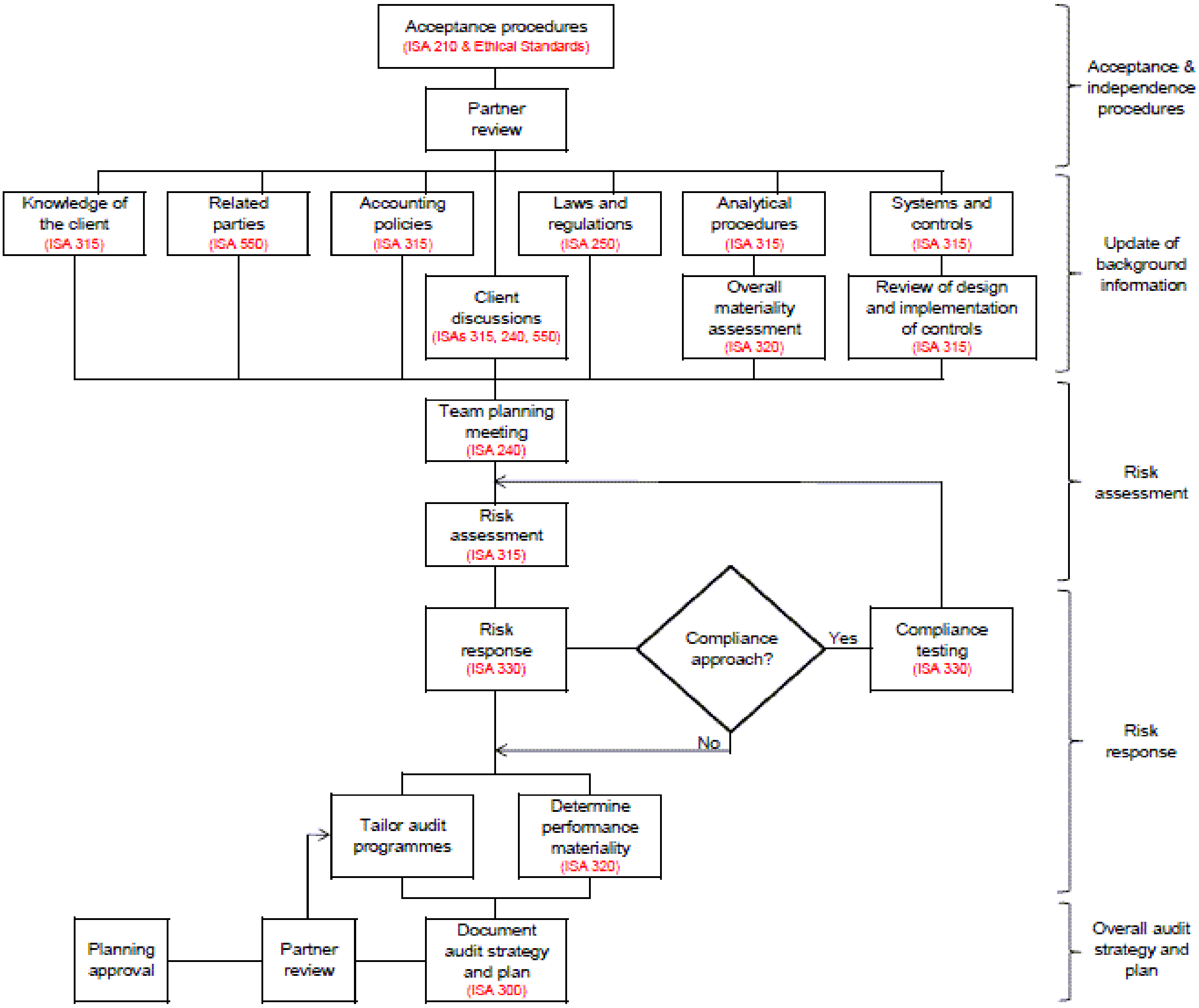
(j) determining which staff should undertake which tasks and for how long they will be needed;

(k) documenting the overall audit strategy and plan; and

(l) review and authorisation of the planning by the partner.

There are several points during the audit where added input is required from the client in order to complete the planning process. This means in practice that audit planning cannot usually be completed in a single step and may require at least three stages. As the planning should be substantially complete before the core audit work begins, this means starting the audit planning early, ideally before the client's year end.

Whilst there is flexibility in the order in which the elements of audit planning may be completed, the following flowchart gives a suggested order.

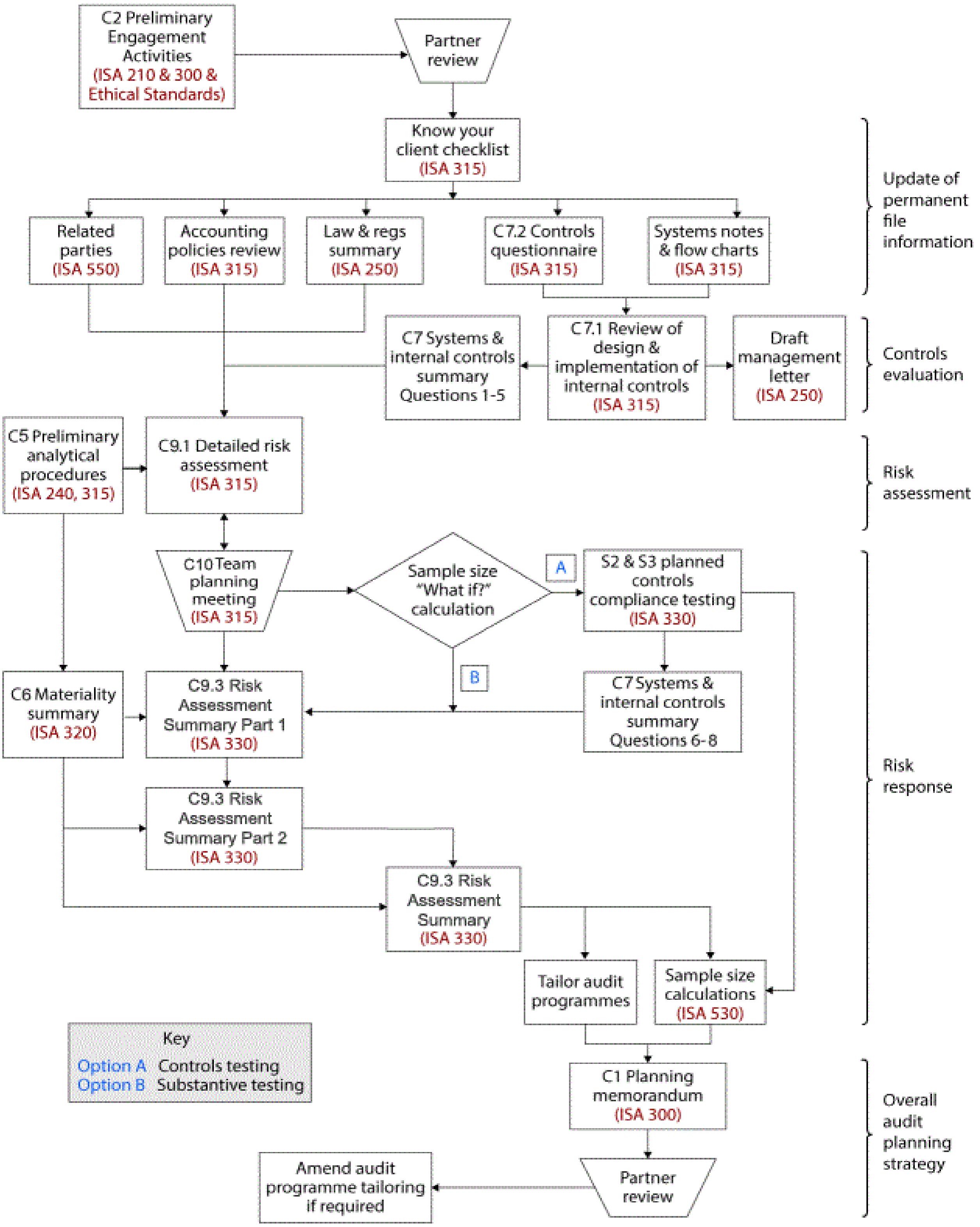

Acceptance procedures
(ISA 210 & Ethical Standards)
Partner review
Knowledge of the client (ISA 315)
Related parties (ISA 550)
Accounting policies (ISA 315)
Laws and regulations (ISA 250)
Analytical procedures (ISA 315)
Systems and controls (ISA 315)
Client discussions (ISAs 315, 240, 550)
Overall materiality assessment (ISA 320)
Review of design and implementation of controls (ISA 315)
Team planning meeting (ISA 240)
Risk assessment (ISA 315)
Risk response (ISA 330)
Compliance approach?
Yes
No
Compliance testing (ISA 330)
Tailor audit programmes
Determine performance materiality (ISA 320)
Planning approval
Partner review
Document audit strategy and plan (ISA 300)
Acceptance & independence procedures
Update of background information
Risk assessment
Risk response
Overall audit strategy and plan

The approach in the audit tools is built around the planning memorandum. A proforma memorandum is provided with suggested headings but is otherwise blank. There are then a series of optional forms and checklists that may be used as either a guide to matters to be addressed in the planning memorandum or to replace relevant sections of the memorandum.

It must be stressed that the forms and checklists are optional. If an audit is particularly simple, then it may be that matters that are required to be documented by the ISAs in a particular area can be addressed simply by a paragraph in the planning memorandum. However, except for all but the simplest entities, it is likely that some or all of the optional forms and checklists will be needed to guide the auditor in the requirements of the ISAs. This is not an all or nothing decision, a combination of a planning memorandum and some forms and checklists is likely to be used in most cases.

A flow chart that illustrates the planning process is set out below. The flowchart refers to specific forms within PCAS. However, as noted above, these are optional and if a detailed planning memorandum were prepared, then all references to C section forms would be to C1.

Approach to planning


C2 Preliminary Engagement Activities (ISA 210 & 300 & Ethical Standards)
Partner review
Know your client checklist (ISA 315)
Related parties (ISA 550)
Accounting policies review (ISA 315)
Law & regs summary (ISA 250)
C7.2 Controls questionnaire (ISA 315)
Systems notes & flow charts (ISA 315)
Update of permanent file information
C7 Systems & internal controls summary Questions 1-5
C7.1 Review of design & implementation of internal controls (ISA 315)
Draft management letter (ISA 250)
Controls evaluation
C5 Preliminary analytical procedures (ISA 240, 315)
C9.1 Detailed risk assessment (ISA 315)
Risk assessment
C10 Team planning meeting (ISA 315)
Sample size "What if?" calculation
A
S2 & S3 planned controls compliance testing (ISA 330)
B
C6 Materiality summary (ISA 320)
C9.3 Risk Assessment Summary Part 1 (ISA 330)
C7 Systems & internal controls summary Questions 6-8
C9.3 Risk Assessment Summary Part 2 (ISA 330)
C9.3 Risk Assessment Summary (ISA 330)
Tailor audit programmes
Sample size calculations (ISA 530)
Risk response
Key
Option A Controls testing
Option B Substantive testing
C1 Planning memorandum (ISA 300)
Partner review
Amend audit programme tailoring if required
Overall audit planning strategy

Note that some of these stages are not as labelled but part of the Audit Automation software, such as Materiality and Identified Risks – please see the mapping chart at the end of this manual for further *guidance.*

Direction, supervision and review

As part of the audit planning, the auditor needs to plan time for the direction, supervision and review of others' work. The nature, timing and extent of the direction and supervision of audit team members and review of their work will depend on a number of factors including their experience and the complexity of the areas in which they are working. For areas of higher risk of material misstatement, the extent of direction and supervision may be increased.

Direction, supervision and review is not relevant where the audit work is carried out by the audit engagement partner who is a sole practitioner. However, that individual must be content that the audit has been performed in accordance with ISAs and a sole practitioner may plan to consult with an outside source on particularly difficult or complex areas.

The correspondence file

A useful part of the planning process is the review of the correspondence file. This serves to remind the auditor of issues which have arisen during the course of the year that could have an impact on the audit.

The auditor should carefully review the correspondence within the file, making a more detailed note on any specific issues that would have a significant bearing on the audit approach. The auditor should look for matters which significantly affect the audit – for example:

- correspondence confirming the amount of corporation tax payments on account during the year should help the auditor to check the accuracy of the corporation tax control account entries;
- details of non-audit services provided that were not notified to the audit engagement principal;
- discussions with the client prior to year end regarding bonuses might influence the auditor's expectations of wages and salaries expense and accruals when undertaking preliminary analytical procedures; and
- indications that the owners are considering selling the business would affect the audit risk assessment.

In firms where separate correspondence files are maintained in each department, it is important that the auditor reviews them all.

Documentation

Many firms find the use of standard forms beneficial when undertaking the planning of an audit. They serve as a checklist to help ensure that nothing is missed. However, they are not usually sufficient by themselves, and a planning memorandum is strongly recommended to gather the planning work into a concise summary. Whilst ISAs do not specifically require production of a planning memo, ISA (UK) 300:12 specifically requires documentation of the overall audit strategy, the audit plan and any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. This is usually best done in a planning memo.

This will act as a record of the key decisions considered necessary to properly plan the audit and communicate significant matters to the engagement team. Documentation of the audit plan also acts as a record that the planning has been properly completed, which can be reviewed and approved before further work is undertaken.

In the audit tools, the Planning Memorandum (C1) is available to document the audit strategy and plan. This can be completed either using free form notes, a reference to the relevant checklist or a combination of both. Where the company is a parent preparing group financial statements the planning memorandum should address both single company and group perspectives.

Audit strategy

The audit strategy sets out the scope, timing and direction of the audit in broad terms, and guides the development of the more detailed audit plan. The audit strategy therefore includes:

- determining the audit scope, including the financial reporting framework used, any industry-specific reporting requirements and the locations of any subsidiaries, associates, etc;
- ascertaining the reporting objectives in order to plan the audit timetable and agree the nature and timing of any additional reports required;
- considering the key factors that, in the auditor’s professional judgement, will determine the focus of the engagement team’s efforts;
- considering the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- ascertaining the nature, timing and extent of resources necessary to perform the engagement.

Developing this overall audit strategy helps the auditor to determine matters such as which members of the audit team should be used for specific audit areas and whether experts are needed for complex areas. For example, using appropriately experienced team members for high risk areas, how many team members to attend the inventory count, the extent of review of other auditor’s work, the timing of such work and how these team members and resources are to be managed, directed and supervised.

The appendix to ISA (UK) 300 contains a very useful list of matters the auditor may consider in establishing the overall audit strategy, which could be used as a checklist as part of the audit planning process (although not all matters will be applicable to every audit).

In the audit tools, schedules ~~C3.1 (Strategy: general) and C3.2 (Strategy: group audits)~~ are available to assist auditors to ascertain an overall strategy, both for individual entities and for parent companies preparing group financial statements.

Audit plan

Once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the overall audit strategy. Although the overall audit strategy is normally established before developing the detailed audit plan, the two activities are not necessarily discrete or sequential processes but are closely interrelated, since changes in one may result in consequential changes to the other.

The audit plan is more detailed than the audit strategy, and includes the nature, timing and extent of audit procedures to be performed by the audit team members in order to obtain sufficient appropriate audit evidence. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

The audit plan includes:

- a description of the nature, timing and extent of planned risk assessment procedures, sufficient to assess the risks of material misstatement;
- a description of the nature, timing and extent of planned further audit procedures at the assertion level for each material class of transactions, reflecting the auditor's decision whether or not to test the operating effectiveness of controls, and the nature, timing and extent of planned substantive procedures; and
- details of other planned procedures that are required to be carried out so that the engagement complies with ISAs (UK).

Much of this information will be documented within the standard forms of the audit system being used, but it is nevertheless useful to include key matters relating to these issues within the planning memorandum as well as the audit strategy. In this way, the planning memorandum can also be used as a briefing document for the more junior members of the audit team. This is particularly useful if they were unable to attend the audit planning meeting (see Audit team planning meeting). Reading the planning memo should give members of the audit team a good overview of the client, the key issues and how they are planned to be addressed.

Individual financial statement area audit programmes

The audit programmes for each financial statement area contain the main tests that would normally need to be undertaken when carrying out an audit. However, the programmes should always be considered in the light of the specific needs of the client. It is important that the programmes reflect the risks and audit objectives of the specific client. As such, the programmes must be amended to include any additional tests required to meet specific aspects of the client. Equally, some of the common tests may be inappropriate and can be removed.

Disclosures

Determining the nature, timing and extent of planned risk assessment procedures, and further audit procedures, as they relate to disclosures is important in light of both the wide range of information and the level of detail that may be encompassed in those disclosures. Further, certain disclosures may contain information that is obtained from outside of the general and subsidiary ledgers, which may also affect the assessed risks and the nature, timing and extent of audit procedures to address them.

Rather than leaving disclosures until the end of the audit, consideration of disclosures early in the audit assists the auditor in giving appropriate attention to, and planning adequate time for, addressing disclosures in the same way as classes of transactions, events and account balances. Early consideration may also help the auditor to determine the effects on the audit of:

- significant new or revised disclosures required as a result of changes in the entity's environment, financial condition or activities (e.g. a change in the required identification of segments and reporting of segment information arising from a significant business combination);
- significant new or revised disclosures arising from changes in the applicable financial reporting framework (e.g. the introduction of new UK GAAP, changes to disclosures where a small company ceases to be eligible for the small companies regime or a change in framework from UK GAAP to IFRS);
- the need for the involvement of an auditor's expert to assist with audit procedures related to particular disclosures (e.g. disclosures related to pension or other retirement benefit obligations); and
- matters relating to disclosures that the auditor may wish to discuss with those charged with governance.

Non-use of standard forms

Most firms will use an audit system, which will contain a number of standard forms to assist in undertaking and documenting an audit. However, the approach will need to be tailored to the needs of the client. A free-form memorandum can also be used to document the auditor's understanding of the business and the basis for the risk assessments made.

Partner review

Once all of the planning forms have been completed, it is essential that the planning is reviewed and approved by the audit partner before the engagement commences. This should be performed before the audit commences to ensure changes to the audit approach can be made if needed.

File reviews often show that there has been inadequate review at the planning stage by the partner, as noted in the Audit monitoring report from the QAD. This invariably results in an inefficient audit, with unnecessary procedures being performed and jobs running over budget. It can also result in technical errors and omissions not being picked up. It should be remembered that the partner is responsible for the overall quality of the audit, including the direction, supervision and performance of the audit. Much of this responsibility is fulfilled by a robust review of the audit planning.

If a second or independent partner review is needed, they should be involved at the planning stage to review the planning approach.

Ongoing review

It is essential that planning be considered as an ongoing process during the audit. ISA (UK) 300:A2 states that, 'planning is not a discrete phase of an audit, but rather a continual and iterative process ...'. ISA (UK) 300:A13 goes on to state that 'as a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan ...'.

Audit planning evolves and changes throughout the audit whenever something arises that would impact on the original plan. The staff should consider at the beginning and end of any individual section if anything has occurred to affect their original assessment of risk and identification of the appropriate audit procedures to be undertaken. Any changes in the approach adopted or the assessment of risks and materiality should be formally documented. Two examples follow.

- A potential fraud is identified during the audit fieldwork in an area originally assessed as low risk. This may lead the auditor to consider this a higher risk area, which would either influence the level of work to be undertaken or would lead to some specific additional procedures being undertaken to ensure that the full impact of such fraud has been identified and reflected within the financial statements.
- The results of the substantive procedures performed during the audit fieldwork contradict the audit evidence obtained from testing the operating effectiveness of controls. The auditor would need to re-evaluate some or all of the planned audit procedures based on their revised consideration of assessed risks at the assertion level.

2.3 Assessing risk

Quick Overview

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing appropriate audit procedures and responses to the assessed risks of material misstatement.

This section covers identifying and assessing risks prior to designing an appropriate audit approach, covered in Determining the audit approach.

This section relates to section **C9** in the PCAS-based audit tools

Scope and definitions

Scope

ISA (UK) 200 (Revised June 2016) (Updated May 2022) Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK) explains that as the basis for their opinion, ISAs (UK) require the auditor to obtain reasonable assurance that the financial statements as a whole are free from material error whether due to fraud or error. Reasonable assurance is a high level of assurance, albeit not an absolute level of assurance.

In order to obtain this reasonable assurance, the auditor exercises professional judgement and maintains professional scepticism in carrying out their work and is required, among other things:

- to identify and assess the risks of material misstatement in the financial statements based on an understanding of the entity and its environment, including the entity's internal control; and
- to obtain sufficient appropriate audit evidence through designing and implementing appropriate responses to the assessed risks.

The following ISAs deal specifically with the process of obtaining an understanding of the entity, identifying and assessing risks and designing and implementing appropriate audit responses. These are:

- ISA (UK) 315 (Revised July 2020) Identifying and Assessing the Risks of Material Misstatement;
- ISA (UK) 330 (Revised July 2017) (Updated May 2022) The Auditor's Responses to Assessed Risks; and
- ISA (UK) 240 (Revised May 2021) (Updated May 2022) The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.

In addition, the following ISAs (UK) provide further requirements and guidance on identifying and assessing risks of material misstatement regarding specific matters or circumstances:

- ISA (UK) 540 (Revised December 2018) (Updated May 2022) *Auditing Accounting Estimates and Related Disclosures;*
- ISA (UK) 550 (Updated May 2022) *Related parties;*
- ISA (UK) 570 (Revised September 2019) (Updated May 2022) *Going concern;* and
- ISA (UK) 600 (Revised November 2019) (Updated May 2022) Special considerations – Audits of Group Financial Statements (Including the Work of Component Auditors).

ISA (UK) 330 is covered in Determining the audit approach

ISA (UK) 315 sets out requirements on understanding the entity, including its internal control, and using this understanding to assess the risks of material misstatement in the financial statements. The ISA covers:

- risk assessment procedures and related activities (covered in Understanding the entity);
- the required understanding of the entity and its environment, including the entity's internal control (covered in Accounting systems, processes and controls and IT systems, risks and controls.
- identifying and assessing the risks of material misstatement; and
- documentation.

Key definitions

Term	**Definition**
Assertions	Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement.
Business risk	A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
Inherent risk factors	Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be qualitative or quantitative, and include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to

management bias or other fraud risk factors insofar as they affect inherent risk.

Internal control

The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

The term "controls" refers to any aspects of one or more of the components of internal control.

Relevant assertions

An assertion about a class of transactions, account balance or disclosure is relevant when it has an identified risk of material misstatement. The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (i.e., the inherent risk).

Risks arising from the use of IT

Susceptibility of information processing controls to ineffective design or operation, or risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information) in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes.

Risk assessment procedures

The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Significant risk

An identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur;

or

That is to be treated as a significant risk in accordance with the requirements of ISAs (UK).

Significant class of transactions, account balance or disclosure

A class of transactions, account balance or disclosure for which there is one or more relevant assertions.

Source: ISA (UK) 315:12

General principles

The auditor's assessment of and response to risk arguably represents the most important audit stage. This section on assessing risk, followed by Audit team planning meeting and Determining the audit approach look at this process in more detail.

In the audit process, the following needs to be brought together to enable effective and full consideration of risk on the audit:

- Understanding the entity
- Accounting systems, processes and controls
- Preliminary analytical procedures
- Assessment of materiality

The auditor's risk identification and assessment process is also iterative and dynamic. Following from the planning stage and the auditor's understanding of the entity, initial expectations of risks may be developed and refined as the auditor progresses through the risk identification and assessment. Under ISA (UK) 315:7 auditors are required to revise the risk assessment, and associated procedures, based on audit evidence obtained from performing further audit procedures or if new information is obtained.

Before looking in detail at how the auditor assesses risk on a particular audit, it is useful to take a step back and look at why there is risk.

Risk derives from the expression of opinion in the audit report, and there are three key elements to consider:

- The auditor states that the audit has been conducted in accordance with ISAs;
- The opinion that the financial statements give a true and fair view; and
- The opinion that the financial statements have been properly prepared in accordance with the relevant statute, and for companies, that the directors' report and strategic report are consistent with the financial statements.

All three of these elements require the application of robust professional scepticism and an appropriate level of specialism or knowledge.

Assertions

ISA (UK) 315:A190 identifies a number of assertions made in financial statements, and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

Assertion	**Definition**	**Category affected**		
		Transactions and events	**Account balances**	**Presentation and disclosure**
Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.	✓	✓	

Existence	Assets, liabilities, and equity interests exist.		✓	
Occurrence	Transactions and events that have been recorded and disclosed have occurred and pertain to the entity.	✓		✓
Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.	✓		✓
Accuracy, valuation and allocation	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.		✓	✓
Rights and obligations	The entity holds or controls the rights to assets; and liabilities are the obligations of the entity.		✓	✓
Cut off	Transactions and events have been recorded in the correct accounting period.	✓		
Classification	Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.	✓	✓	✓
Presentation	Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.			✓

In the PCAS tools, these assertions are combined into the following assertions:

Assertion	**Definition**	**Related ISA requirements covered**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.	ISA (UK) 315.A190 paragraph: (a)(ii); (b)(iii)
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.	ISA (UK) 315.A190 paragraph: (a)(i); (b)(i); and (b)(ii)
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.	ISA (UK) 315.A190 paragraph: (a)(iii)
V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.	ISA (UK) 315.A190 paragraph: (b)(iv)
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and	ISA (UK) 315.A190 paragraph: (a)(iv); (a)(v); (a)(vi); (b)(v); and (b)(vi)

	understandable in the context of the requirements of the applicable financial reporting framework.	

The audit programmes in the tools contain suggested tests to address these assertions. In each audit work programme there is a section setting out the common audit objectives for that audit area, although this should be tailored by the auditor, as well as a summary of the risks, controls and assertions relevant to that audit area. By keeping specific audit objectives in mind, audit tests can be efficiently designed to meet them, ensuring that the combination of tests planned covers all the objectives for the audit area.

Designing and performing risk assessment procedures

As a basis for assessing risk, it is important to design and perform the risk assessment procedures in a manner that will ensure sufficient appropriate audit evidence is obtained, effort to counter bias and apply scepticism is made, whilst balancing the need for an efficient and timely audit.

In practice, this means considering the following:

Professional scepticism and bias

Professional scepticism is necessary for the critical assessment of audit evidence. The auditor needs to design and perform risk assessment procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory (ISA (UK) 315:13).

Designing and performing risk assessment procedures to obtain audit evidence in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. The auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence. In addition to information from other sources, sources of information for risk assessment procedures may include:

- interactions with management, those charged with governance, and other key entity personnel, such as internal auditors; and
- certain external parties such as regulators, whether obtained directly or indirectly.

A robust and open engagement team discussion, including for recurring audits, may lead to improved risk assessments e.g. it may help the auditor identify specific areas of the audit where exercising professional scepticism may be particularly important, or lead to the involvement of more experienced and appropriately skilled staff related to those areas.

Scalability

The nature and extent of risk assessment procedures will vary based on the nature and circumstances of the entity (e.g., the formality of the entity's policies and procedures, and processes and systems). The auditor uses professional judgement to determine the nature and extent of the risk assessment procedures to be performed to meet the requirements of the ISAs.

The risk assessment procedures to be performed the first time an engagement is undertaken may be more extensive than procedures for a recurring engagement. In subsequent periods, the auditor may focus on changes that have occurred since the preceding period.

The auditor may perform substantive procedures or tests of controls concurrently with risk assessment procedures when it is efficient to do so. Audit evidence obtained that supports the identification and assessment of risks of material misstatement may also support the detection of misstatements at the assertion level or the evaluation of the operating effectiveness of controls.

Conducting inquiries

Inquiries of management, those responsible for financial reporting, other appropriate individuals and employees with different levels of authority may offer the auditor varying perspectives when identifying and assessing risks of material misstatement.

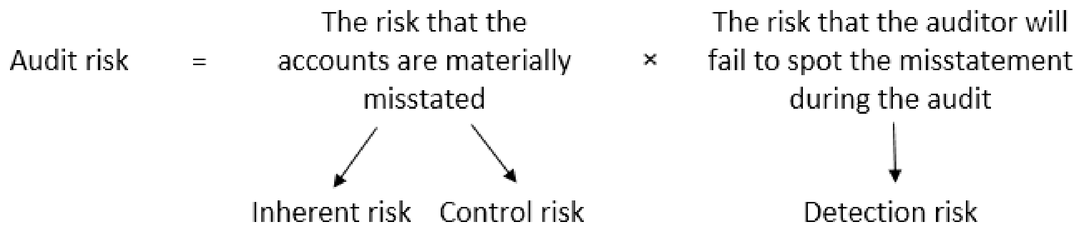
ISA (UK) 315:A23 provides the following examples of how inquiries may provide risk assessment perspectives:

- Inquiries directed towards those charged with governance may help the auditor understand the extent of oversight by those charged with governance over the preparation of the financial statements by management. ISA (UK) 260:23 identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard;
- inquiries of employees responsible for initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies;
- inquiries directed towards in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contractual terms;
- inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers;
- inquiries directed towards the risk management function (or inquiries of those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting; and
- inquiries directed towards IT personnel may provide information about system changes, system or control failures, or other IT-related risks.

Audit risk

ISA (UK) 200:17 requires the auditor to '… obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level …'.

Audit risk is defined by ISA (UK) 200 as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk, which can be illustrated as follows:


Audit risk = The risk that the accounts are materially misstated × The risk that the auditor will fail to spot the misstatement during the audit

Inherent risk

Control risk

Detection risk

Detection risk

This is the risk that the auditor will fail to spot that the financial statements are materially misstated. It is dealt with by the audit tests and approach that is adopted by the audit team, aspects looked at in detail in the Execution sections. This includes the auditor's judgement on how to test an area and the conclusions drawn from the test results obtained. It should be remembered that detection risk is influenced by the judgement exercised by the auditor during the audit.

Financial statement level risks

ISA (UK) 315:A195 explains that risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions.

Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance or disclosure level (e.g., risk of management override of controls). Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level.

In circumstances where risks of material misstatement are identified as financial statement level risks due to their pervasive effect on a number of assertions, and are identifiable with specific assertions, the auditor is required to consider those risks when assessing inherent risk for risks of material misstatement at the assertion level.

Example - financial statement level risk

ISA (UK) 315:A195 provides an example of a financial statement level risk where an entity faces operating losses and liquidity issues and is reliant on funding that has not yet been secured. In such a circumstance, the auditor may determine that the going concern basis of accounting gives rise to a risk of material misstatement at the financial statement level. In this situation, the accounting framework may need to be applied using a liquidation basis, which would affect all assertions pervasively.

Assertion level risks

ISA (UK) 315:A201 sets out that risks of material misstatement at the assertion level are risks that do not relate pervasively to the financial statements.

In assessing risks at the assertion level, the auditor may conclude that some risks of material misstatement relate more pervasively to the financial statements as a whole and potentially affect many assertions. If so, the auditor may update the identification of risks at the financial statement level.

In summary, the **inherent risks** influence the auditor's assessment of the **likelihood** and **magnitude** of misstatement for the identified risks at the assertion level. The greater the degree to which a class of transactions, account balance or disclosure is susceptible to material misstatement, the higher the inherent risk assessment is likely to be.

Considering the degree to which **inherent risk factors** affect the susceptibility of an assertion to misstatement helps with assessing and designing a more precise response to such a risk.

The concept and assessment of inherent risk is outlined in detail within this guidance.

Inherent risk

ISA (UK) 200:13(n)(i) defines **inherent risk** as the susceptibility of assertions to misstatement before we consider any controls over the assertions.

A risk of misstatement that is 'inherent' to an assertion exists, regardless of any controls that are in place. Factors affecting inherent risk can be internal or external and are often documented in the Permanent file.

Some inherent risks are generally considered to be more important than others in relation to particular types of assets, liability or transaction – for example:

a. complex calculations are more likely to be misstated than simple calculations. Thus, the inherent risk in a complex calculation (such as absorption of overheads into 'work in progress') will be higher; and

b. the use of accounting estimates that are subject to significant measurement uncertainty have a higher inherent risk than financial statements consisting of routine, factual data.

Inherent risk factors

Inherent risk factors are characteristics of events or conditions that affect susceptibility of an assertion about a class of transactions, account balance or disclosure, to misstatement, whether due to fraud or error, and before consideration of controls. Such factors may be qualitative or quantitative, and include:

- complexity;
- subjectivity;
- change;
- uncertainty; or
- susceptibility to misstatement due to management bias or other fraud risk factors.

In obtaining the understanding of the entity and its environment, the applicable financial reporting framework and the entity's accounting policies, the auditor also understands how inherent risk factors affect susceptibility of assertions to misstatement in the preparation of the financial statements.

Complexity

Complexity arises either from the nature of the information or in the way that the required information is prepared, including when such preparation processes are more inherently difficult to apply.

Example

ISA (UK) 315 Appendix 2 provides the following examples of where complexity may arise:

- In calculating supplier rebate provisions because it may be necessary to consider different commercial terms with many different suppliers, or many interrelated commercial terms that are all relevant in calculating the rebates due; or
- When there are many potential data sources, with different characteristics used in making an accounting estimate, the processing of that data involves many interrelated steps, and the data is therefore inherently more difficult to identify, capture, access, understand or process.

When complexity is an inherent risk factor, there may be an inherent need for more complex processes in preparing the information, and such processes may be inherently more difficult to apply. As a result, applying them may require specialised skills or knowledge, and may require the use of a management's expert – see guidance on using the work of experts.

Subjectivity

Subjectivity arises from inherent limitations in the ability to prepare required information in an objective manner, due to limitations in the availability of knowledge or information, such that management may need to make an election or subjective judgement about the appropriate approach to take and about the resulting information to include in the financial statements. Because of different approaches to preparing the required information, different outcomes could result from appropriately applying the requirements of the applicable financial reporting framework. As limitations in knowledge or data increase, the subjectivity in the judgements that could be made by reasonably knowledgeable and independent individuals, and the diversity in possible outcomes of those judgements, will also increase.

Example

When management judgement is more subjective, the susceptibility to misstatement due to management bias, whether unintentional or intentional, may also increase. For example, significant management judgement may be involved in making accounting estimates that have been identified as having high estimation uncertainty, and conclusions regarding methods, data and assumptions may reflect unintentional or intentional management bias.

Change

Change results from events or conditions that, over time, affect the entity's business or the economic, accounting, regulatory, industry or other aspects of the environment in which it operates, when the effects of those events or conditions are reflected in the required information. Such events or conditions may occur during, or between, financial reporting periods.

Example

For example, change may result from developments in the requirements of the applicable financial reporting framework, or in the entity and its business model, or in the environment in which the entity operates. Such change may affect management's assumptions and judgements, including as they relate to management's selection of accounting policies or how accounting estimates are made or related disclosures are determined.

Uncertainty

Uncertainty arises when the required information cannot be prepared based only on sufficiently precise and comprehensive data that is verifiable through direct observation. In these circumstances, an approach may need to be taken that applies the available knowledge to prepare the information using sufficiently precise and comprehensive observable data, to the extent available, and reasonable assumptions supported by the most appropriate available data, when it is not. Constraints on the availability of knowledge or data, which are not within the control of management (subject to cost constraints where applicable) are sources of uncertainty and their effect on the preparation of the required information cannot be eliminated.

Example

ISA (UK) 315 Appendix 2 provides an example of estimation uncertainty arising when the required monetary amount cannot be determined with precision. The outcome of the estimate is not known before the date the financial statements are finalised, which introduces the risk factor of uncertainty.

For further guidance see Auditing accounting estimates.

Susceptibility due to management bias or other fraud risk factors

Susceptibility to management bias results from conditions that create susceptibility to intentional or unintentional failure by management to maintain neutrality in preparing the information. Management bias is often associated with certain conditions that have the potential to give rise to management not maintaining neutrality in exercising judgement (indicators of potential management bias), which could lead to a material misstatement of the information that would be fraudulent if intentional. Such indicators include incentives or pressures insofar as they affect inherent risk (for example, as a result of motivation to achieve a desired result, such as a desired profit target or capital ratio), and opportunity, not to maintain neutrality.

Other inherent risk factors that affect susceptibility to misstatement of an assertion may include:

•the quantitative or qualitative significance of the class of transactions, account balance or disclosure; or

•the volume or a lack of uniformity in the composition of the items to be processed through the class of transactions or account balance, or to be reflected in the disclosure.

Factors relevant to the susceptibility to misstatement due to fraud in the form of fraudulent financial reporting or misappropriation of assets are described in ISA (UK) 240 and in more detail in the section on fraud and error.

Example

ISA (UK) 315 Appendix 2 sets out that when management judgement is more subjective, the susceptibility to misstatement due to management bias, whether unintentional or intentional, may also increase. For example, significant management judgement may be involved in making accounting estimates that have been identified as having high estimation uncertainty, and conclusions regarding methods, data and assumptions may reflect unintentional or intentional management bias.

Examples of inherent risk factors

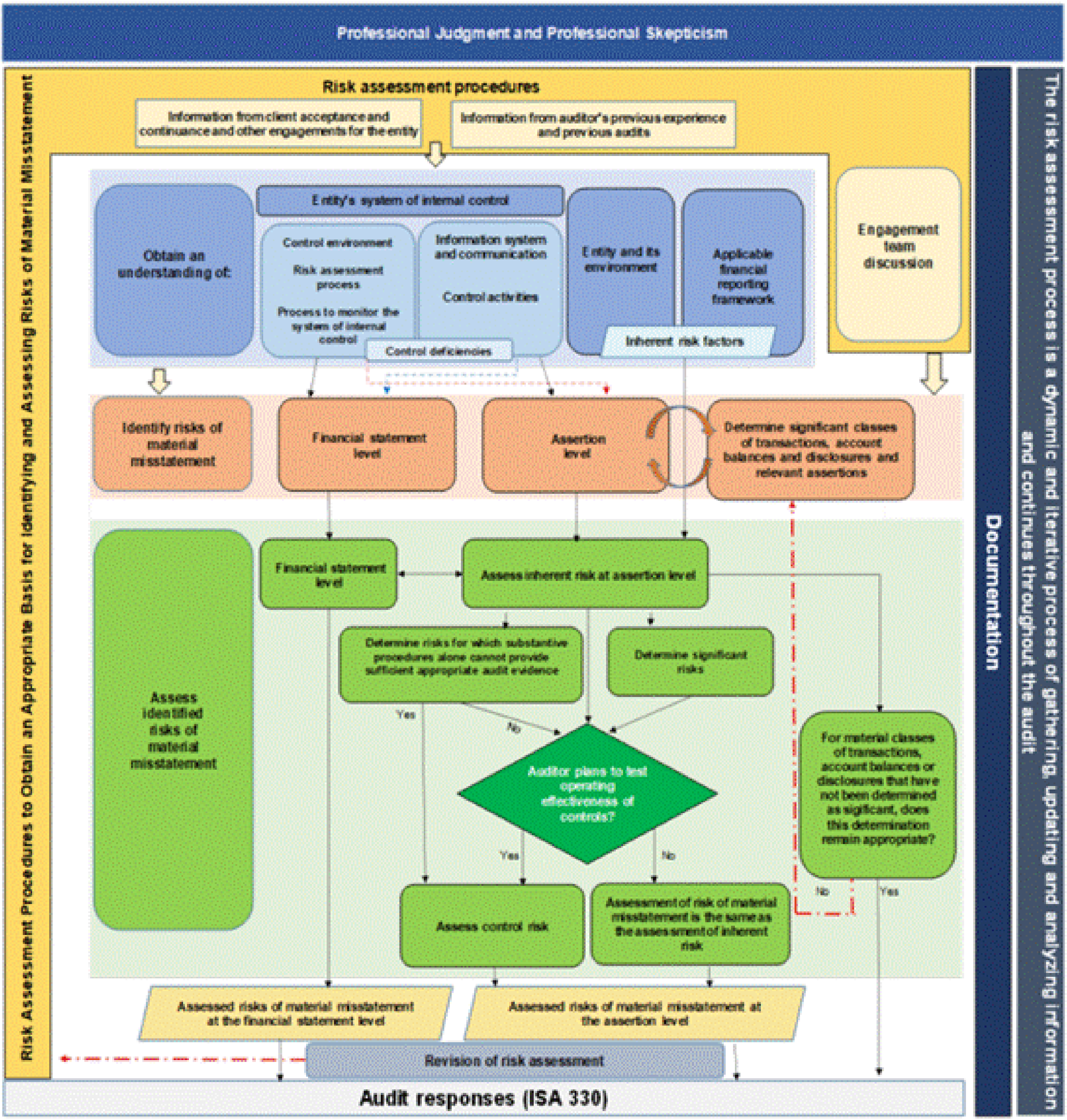
The following table of examples of risks at the assertion level is provided in ISA (UK) 315 Appendix 2, covering examples of events or conditions and the relevant inherent risk factor which may indicate the existence of risks.

Relevant inherent risk factor	**Examples**
Complexity	• Regulatory: Operations that are subject to a high degree of complex regulation. • Business model: The existence of complex alliances and joint ventures. • Applicable financial reporting framework: Accounting measurements that involve complex processes. • Transactions: Use of off-balance sheet finance, special-purpose entities, and other complex financing arrangements.
Subjectivity	• A wide range of possible measurement criteria of an accounting estimate. For example, management's recognition of depreciation or construction income and expenses. • Management's selection of a valuation technique or model for a non-current asset, such as investment properties.
Change	• Economic conditions: Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies. • Markets: Operations exposed to volatile markets, for example, futures trading. • Customer loss: Going concern and liquidity issues including loss of significant customers. • Industry model: Changes in the industry in which the entity operates. • Business model: Changes in the supply chain. Developing or offering new products or services or moving into new lines of business. • Geography: Expanding into new locations • Entity structure: Changes in the entity such as large acquisitions or reorganisations or other unusual events. Entities or business segments likely to be sold. • Human resources competence: Changes in key personnel including departure of key executives. • IT: Changes in the IT environment. Installation of significant new IT systems related to financial reporting.

	• Applicable financial reporting framework: Application of new accounting pronouncements. • Capital: New constraints on the availability of capital and credit. • Regulatory: Inception of investigations into the entity’s operations or financial results by regulatory or government bodies. Impact of new legislation related to environmental protection.
Uncertainty	• Events or transactions that involve significant measurement uncertainty, including accounting estimates, and related disclosures. • Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.
Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk	• Reporting: Opportunities for management and employees to engage in fraudulent financial reporting, including omission, or obscuring, of significant information in disclosures. • Significant transactions with related parties. • Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end. • Transactions that are recorded based on management’s intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
Other events or conditions that may indicate risks of material misstatement at the financial statement level:	• Lack of personnel with appropriate accounting and financial reporting skills. • Control deficiencies – particularly in the control environment, risk assessment process and process for monitoring, and especially those not addressed by management. • Past misstatements, history of errors or a significant amount of adjustments at period end.

Assessing inherent risk

Since inherent risk factors can affect the approach to the audit, as well as impacting on individual assertions, the approach of most audit systems in assessing inherent risk can be illustrated in the following diagram.


Professional Judgment and Professional Skepticism
Risk Assessment Procedures to Obtain an Appropriate Basis for Identifying and Assessing Risks of Material Misstatement
Risk assessment procedures
Information from client acceptance and continuance and other engagements for the entity
Information from auditor's previous experience and previous audits
Obtain an understanding of:
Entity's system of internal control
Control environment
Risk assessment process
Process to monitor the system of internal control
Information system and communication
Control activities
Control deficiencies
Entity and its environment
Applicable financial reporting framework
Inherent risk factors
Engagement team discussion
Identify risks of material misstatement
Financial statement level
Assertion level
Determine significant classes of transactions, account balances and disclosures and relevant assertions
Assess identified risks of material misstatement
Financial statement level
Assess inherent risk at assertion level
Determine risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence
Determine significant risks
Yes
No
Auditor plans to test operating effectiveness of controls?
Yes
No
Assess control risk
Assessment of risk of material misstatement is the same as the assessment of inherent risk
For material classes of transactions, account balances or disclosures that have not been determined as sigificant, does this determination remain appropriate?
No
Yes
Assessed risks of material misstatement at the financial statement level
Assessed risks of material misstatement at the assertion level
Revision of risk assessment
Audit responses (ISA 330)
Documentation
The risk assessment process is a dynamic and iterative process of gathering, updating and analyzing information and continues throughout the audit

SOURCE: IAASB ISA 315 First Time Implementation Guide

Having identified relevant risk factors, the auditor needs to consider their impact in two ways.

Firstly, some risks may relate pervasively to the financial statements as a whole and potentially affect many assertions typically as a result of a weak control environment. Examples would be concerns about the integrity of the entity's management or untrained or inexperienced staff in a key accounting role. This is **financial statement level risk**.

Secondly, some of the risk factors may have a particular impact on specific assertions of specific balances or transactions within the financial statements. This is **assertion level risk**.

An example inherent risk assessment questionnaire (**C9** and ~~**C9.1**~~ ***Inherent risk questions***) can be found in PCAS *methodology Audit Automation* and this guidance considers some of the issues arising under each of the questionnaire topic areas, using the same order as in the questionnaire. Much of the information needed for each question should have already been obtained and documented in the permanent file, the auditor's review of the correspondence file and through the preliminary analytical review work already performed, as discussed in Understanding the entity, Accounting systems, processes and controls and Preliminary analytical procedures. The questionnaire should therefore be used as an aide in reviewing such information with a view to identifying risk factors affecting the particular client, the impact of those risks and how they will be managed.

In severe situations, the weakness of internal control may raise doubts about the auditability of the financial statements, for example unscrupulous management may lead to a very high risk of management misrepresentation in the financial statements or very poor accounting records may mean that insufficient audit evidence is available to support an audit opinion. In such cases, the auditor may issue a qualification or disclaimer of opinion. If the situation is severe, the only action available to the auditor is to resign. Auditors should carefully consider the ethical implications and the impact – see guidance on Acceptance, continuance and independence and Drafting the audit report.

Spectrum of inherent risk

In assessing inherent risk, the auditor uses professional judgement in determining the significance of the combination of the likelihood and magnitude of a misstatement. The assessed inherent risk relating to a particular risk of material misstatement at the assertion level represents a judgement within a range, from lower to higher, on the spectrum of inherent risk.

In order to make sense of this spectrum of risk in an audit tool and working papers, the Croner-I audit tools use a scale of 1–5 for the rating of risks; 1 being the lowest level of risk; 5 being the highest.

The judgement about where in the range inherent risk is assessed may vary based on the nature, size and complexity of the entity, and considers the assessed likelihood and magnitude of the misstatement and inherent risk factors.

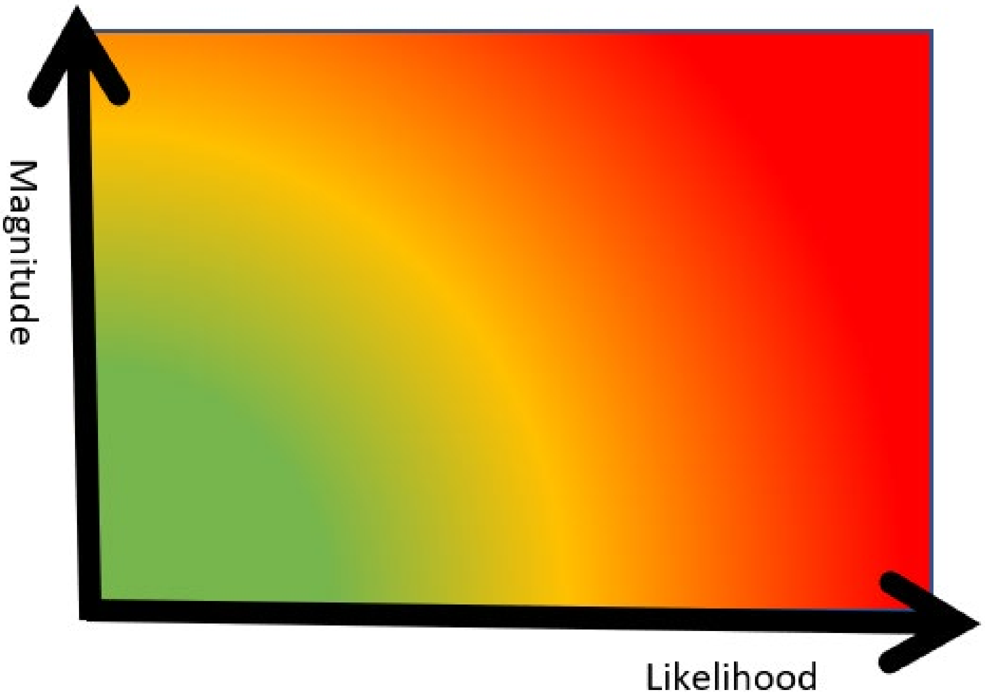
Likelihood and magnitude of a misstatement

ISA (UK) 315:A212 notes the auditor uses the significance of the combination of the **likelihood** and **magnitude** of a possible misstatement in determining where on the spectrum of inherent risk (i.e. the range) inherent risk is assessed. The higher the combination of likelihood and magnitude, the higher the assessment of inherent risk; the lower the combination of likelihood and magnitude, the lower the assessment of inherent risk.

In considering the likelihood of a misstatement, the auditor should consider the possibility that a misstatement may occur, based on consideration of the inherent risk factors.

In considering the magnitude of a misstatement, the auditor considers the qualitative and quantitative aspects of the possible misstatement (i.e. misstatements in assertions about classes of transactions, account balances or disclosures may be judged to be material due to size, nature or circumstances).

For a risk to be assessed as higher on the spectrum of inherent risk (IR), it does not mean that both the magnitude and likelihood need to be assessed as high. A higher IR may arise from a risk with a lower likelihood of occurring but with a very high magnitude of misstatement if it does happen.



Example – likelihood and magnitude of inherent risk

As an example, if the likelihood of the client's office being flooded is considered low, this could be plotted towards the left-hand side of the likelihood axis. Even if it did flood, the significance in terms of the financial statements being materially misstated may also be low on the magnitude axis, e.g. the building is insured and all accounting records are backed up off-site, so the significance of the event to the financial statements may be low.

In comparison, the likelihood of stock being incorrectly valued may be considered to be in the middle of the likelihood axis. However, the magnitude for the financial statements of stock being materially misstated could be considered higher.

Hence, the auditor is more likely to identify risks over stock in relation to the flood, as the risk level is much higher considering both the likelihood and magnitude of misstatement.

The consideration of the likelihood and magnitude of risk is also important in planning an efficient and effective audit. The auditor needs to focus the work on the areas of highest risk to minimise the likelihood of overlooking a material misstatement, whilst justifying why other areas are less risky, and therefore do not need to have as much attention.

Within the PCAS audit excel tool the likelihood and magnitude of risk is documented on the risk assessment schedules (**C9.3** and **C9.4**) within the planning section. The combination of magnitude and likelihood is quantified and documented on a scale of 1 to 5, with 1 being low and 5 being high.

In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may designate risks of material misstatement within categories along the spectrum of inherent risk, based on their assessment of inherent risk. These categories may be described in different ways, to be able to assess the risks on a scale of low (e.g. 1) to higher (e.g. 5) and thus plan appropriate audit work to mitigate those risks.

Regardless of the method of categorisation, the assessment of inherent risk, and the design and implementation of further audit procedures to address the identified risks at the assertion level, must be responsive to the assessment of inherent risk and the reasons for that assessment.

Control risk

Risks of material misstatement at the assertion level consist of two components, **inherent** and **control** risk.

Control risk is the risk that the client's systems and procedures will not prevent, detect or correct a misstatement that could occur (in an assertion about a class of transactions, account balance or disclosure), that could cause material misstatement in the financial statements, either individually or when aggregated with other misstatements.

The documentation, review of design, checking of implementation and, where applicable, testing of the operational effectiveness of systems and controls is explained in Accounting systems, processes and controls. Having completed these tasks, the auditor should consider the impact on the risk of material misstatement.

Control risk can be understood as either 'high' or 'low'. The control risk level over a particular assertion can only be confirmed as not 'high', if relevant controls have been tested for operational effectiveness i.e. controls are either effective, or they are not, in addressing risk. Overall risk is assessed at the same level as inherent risk, unless the auditor plans to test the operating effectiveness of controls.

It is important to note that an internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control s. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The ISAs (UK) provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed – see Determining the audit approach.

For the audit risk assessment, control risk is only assessed where the auditor plans to test the operating effectiveness of controls. Where the auditor does not plan to test the operating effectiveness of controls, the assessed risk level for the audit remains the same as the assessed level of inherent risk i.e. control risk has no impact on the risk assessment.

Insight - control risk versus the control environment

It is important to note the difference between the audit assessment of "control risk" and the "control environment".

Control risk is assessed in terms of individual control activities, and forms part of the risk assessment process to determine if reliance may be placed on controls to address the risks of material misstatement in an assertion. As noted above and in ISA (UK) 315:34, control risk will only be assessed where the auditor plans to test the operating effectiveness of controls, although understanding the control environment is a requirement that must be performed on all audits.

The auditor's understanding of the overall control environment is different because it is a broader and bigger picture assessment. It forms a part of understanding the entity's system of internal control, feeding into the assessment of the risks of material misstatement at the financial statement level, and the auditor's overall responses are therefore affected by this – see Understanding the entity chapter.

An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end.

Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

Such considerations have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach) - see Determining the audit approach.

Assessing control risk

ISA (UK) 315 outlines that the auditor's plans to test the operating effectiveness of controls is based on the expectation that controls are operating effectively, and this will form the basis of the auditor's assessment of control risk. The initial expectation of the operating effectiveness of controls is based on the auditor's evaluation of the design, and the determination of implementation, of the identified controls in the control activities component. Once the auditor has tested the operating effectiveness of the controls in accordance with ISA (UK) 330, the auditor will be able to confirm the initial expectation about the operating effectiveness of controls. If the controls are not operating effectively as expected, then the auditor will need to revise the control risk assessment.

The auditor's assessment of control risk may be performed in different ways depending on preferred audit techniques or methodologies and may be expressed in different ways. It will require an understanding of the design and implementation of controls, which can be achieved through walkthroughs, review of the entity's processes to monitor controls, or may involve considering previous audit evidence and whether circumstances have changed.

To the extent that the control to be tested does not fully address the assessed inherent risk, the auditor determines the implications on the design of further audit procedures to reduce audit risk to an acceptably low level.

If the auditor plans to test the operating effectiveness of controls, it may be necessary to test a combination of controls to confirm the auditor's expectation that the controls are operating effectively.

The auditor may plan to test both direct and indirect controls, including general IT controls, and, if so, take into account the combined expected effect of the controls when assessing control risk.

For further guidance see IT risks and controls, General IT controls and Accounting systems, processes and controls.

Control environment

Auditors need to gain understanding of the control environment relevant to the preparation of the financial statements, through performing risk assessment procedures under ISA (UK) 315:21. Further guidance is provided in Understanding the entity.

Where the entity is controlled by people who have a reasonable level of experience and competence in managing such a business, the risks are likely to be lower. However, many owner-managers have expertise in the area that their business trades in, but none in business administration. This lack of competence in managing a business may result in increased risk of error. The auditor should consider the past history and any earlier problems experienced with the client.

In many owner-managed companies, even where there is a separate accounting department, the directors may be in a position to override any controls and exert influence over the transactions that occur. The auditor must therefore assess at the planning stage the impact this will have on risk.

In line with ISA (UK) 315:24 the auditor should identify whether, and how, management monitors the controls over the systems and key business processes relevant to the preparation of the financial statements, and whether there may have been any breaches or failures during the period that could give rise to misstatements due to error and/or fraud.

Risks that cannot be mitigated by substantive procedures alone

ISA (UK) 315:33 require the auditor to determine any assertion level risks which may not be mitigated by planning and performing substantive tests alone. Such risks are likely to arise in an environment where much of the entity's information is initiated, recorded, processed or reported electronically with little or no manual intervention.

In such an integrated system, audit evidence may only be available electronically and its sufficiency and appropriateness will depend on the effectiveness of the controls over its accuracy and completeness. If such controls are not operating properly, the potential for fictitious transactions to be created or existing transactions to be amended without detection may be large.

In such a situation, the auditor should plan and perform tests of controls to satisfy themselves that controls are working to eliminate any risk of material misstatement, as required by ISA (UK) 330:8. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from datasets to sort transactions with specific characteristics, or to test an entire population instead of a sample. Guidance on testing controls is available in Accounting systems, processes and controls and IT system, risks and controls.

ISA (UK) 540 (Revised December 2018) provides further guidance related to accounting estimates about risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. In relation to accounting estimates this may not be limited to automated processing but may also be applicable to complex models.

Example

ISA (UK) 315:A224 explains that it is typically not possible to obtain sufficient appropriate audit evidence relating to revenue for a telecommunications entity based on substantive procedures alone. This is because the evidence of call or data activity does not exist in a form that is observable. Instead, substantial controls testing is typically performed to determine that the origination and completion of calls, and data activity is correctly captured (e.g., minutes of a call or volume of a download) and recorded correctly in the entity's billing system.

Significant risks

Significant risks

ISA (UK) 315:32 requires auditors to determine which of the risks identified are, in the auditor's judgement, risks that require special audit consideration ('significant risks'). In exercising this judgement, the auditor shall exclude the effects of identified controls related to the risk.

ISA (UK) 315:A10 explains that significance can be described as the relative importance of a matter and is judged by the auditor in the context in which the matter is being considered.

Significance of risks may be considered in the context of how, and the degree to which, inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur. The auditor may first identify those assessed risks of material misstatement that have been assessed higher on the spectrum of inherent risk to form the basis for considering which risks may be close to the upper end. Being close to the upper end of the spectrum of inherent risk will differ from entity to entity and will not necessarily be the same for an entity period on period. It may depend on the nature and circumstances of the entity for which the risk is being assessed.

As outlined in Determining the audit approach, identifying a risk as being 'significant' has particular implications under ISAs.

ISAs identify a number of risks which are significant by default, in particular:

- all risks of material misstatement due to fraud (ISA (UK) 240:27); and
- significant related party transactions outside the entity's normal course of business (ISA (UK) 550:18).

Whilst the risk from undisclosed related parties or related party transactions is not significant by default, it is highly likely that the risk will nevertheless be identified as being significant. There are also a number of mandatory procedures in ISA (UK) 550 which must be performed in response to such an issue.

Determining significant risks

The determination of which of the assessed risks of material misstatement are close to the upper end of the spectrum of inherent risk, and are therefore significant risks, is a matter of professional judgement, however, the following general guidance is useful in deciding whether a risk may be determined as significant:

- changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions;
- significant risks arise on most audits. It can be deduced from this that if the risk assessment has not identified any significant risks, the auditor should review the risk assessment again to ensure that none have been missed;
- the effect of any identified controls related to the risk should be excluded when making the decision over significance;
- routine – non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because they have lower inherent risks;

- significant risks often relate to significant non-routine transactions that are unusual, either due to their size or nature, and occur infrequently, and to judgemental matters (e.g. accounting estimates) as a result of:

- greater management intervention to specify the accounting treatment;
- greater manual intervention during data collection and processing;
- complexity in data collection and processing to support account balances;
- complex calculations or accounting principles, which may also be unfamiliar;
- the difficulty of planning and implementing effective controls over non-routine transactions; and
- transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved;

- significant risks are often derived from business risks that may result in a material misstatement e.g. Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions.

When considering the nature of the risks, the auditor should consider:

(1) whether the risk is a risk of fraud;

(2) whether the risk is related to recent significant economic, accounting or other developments;

(3) the complexity of transactions;

(4) whether the risk involves significant transactions with related parties;

(5) the degree of subjectivity in the measurement of financial information related to the risk; and

(6) whether the risk involves significant transactions that are outside the entity's normal course of business, or which otherwise appear unusual.

Having identified significant risks, the auditor considers the controls, if any, in place to mitigate those risks. As such risks are often from non-routine transactions, there may not be controls specific to each risk, but general procedures for responding to such risks such as approval processes for any transaction falling outside of the standard accounting process.

If the auditor wishes to rely on the operating effectiveness of controls to mitigate a significant risk, they will plan and perform tests of controls. In addition, substantive procedures to address the significant risk to be planned and performed so that they are specifically responsive to the identified significant risk. The auditor's response to those assessed risks is guided by ISA (UK) 330.

Example – significant risk

Cash at a supermarket retailer would ordinarily be determined to be a high likelihood of possible misstatement (due to the risk of cash being misappropriated); however, the magnitude would typically be very low (due to the low levels of physical cash handled in the stores). The combination of these two factors on the spectrum of inherent risk would be unlikely to result in the existence of cash being determined to be a significant risk.

An entity is in negotiations to sell a business segment. The auditor considers the effect on goodwill impairment and may determine there is a higher likelihood of possible misstatement and a higher magnitude due to the impact of inherent risk factors of subjectivity, uncertainty and susceptibility to management bias or other fraud risk factors. This may result in goodwill impairment being determined to be a significant risk.

In the PCAS tools, flags for the treatment of the above specified risk types as significant are included on the Risk Assessment Summaries (C9.3 and C9.4) as well as columns for the classification of risks identified as being between 1 and 5 on the spectrum of risk.

Management override of controls

Management override of controls is a significant risk area, which is present in all clients to some extent. It is outlined in ISA (UK) 240 as existing due to "management's unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk."

Irrespective of the auditor's assessment of risks of management override of controls, auditors need to design and perform audit procedures to address the risk. This is considered in more detail in Fraud in the audit and Determining the audit approach.

Response to significant risks

Determining significant risks allows the auditor to focus more attention on those risks that are on the upper end of the spectrum of inherent risk, through the performance of certain required responses, including:

- controls that address significant risks are required to be identified with a requirement to evaluate whether the control has been designed effectively and implemented;
- ISA (UK) 330 (Revised July 2017) (Updated May 2022) requires controls that address significant risks to be tested in the current period (when the auditor intends to rely on the operating effectiveness of such controls) and substantive procedures to be planned and performed that are specifically responsive to the identified significant risk;
- ISA (UK) 330 (Revised July 2017) (Updated May 2022) requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk;
- ISA (UK) 260 (Revised November 2019) (Updated May 2022) requires communicating with those charged with governance about the significant risks identified by the auditor;
- ISA (UK) 701 (Revised November 2019) (Updated May 2022) requires the auditor to consider significant risks when determining those matters that required significant auditor attention, which are matters that may be key audit matters;
- timely review of audit documentation by the engagement partner at the appropriate stages during the audit allows significant matters, including significant risks, to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report; and

- ISA (UK) 600 (Revised November 2019) (Updated May 2022) requires more involvement by the group engagement partner if the significant risk relates to a component in a group audit and for the group engagement team to direct the work required at the component by the component auditor.

Further guidance is available in Determining the audit approach.

Financial reporting

Financial reporting

ISA (UK) 315:19-20 requires the auditor to understand and consider financial reporting as part of the risk assessment, including:

- the applicable financial reporting framework, and the entity's accounting policies and the reasons for any changes thereto;
- how inherent risk factors affect susceptibility of assertions to misstatement and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework, based on the understanding of the entity and its environment; and
- evaluating whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework.

The engagement partner and other key engagement team members are specifically required to discuss the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement (ISA (UK) 315:17) – see Audit team planning meeting.

Where there have been instances of failure to comply with generally accepted accounting principles in previous years, details of these should be recorded, along with the reasons and the effect that this had on the audit opinion. The updated review of accounting policies should also be considered at this point.

Areas of the financial statements which could be disputed by tax authorities (e.g. HMRC) should also be considered, these might include items such as stock and debtor provisions, the capitalisation of assets and deduction of certain expenses.

The auditor should consider at the planning stage whether there is any likelihood of there being undisclosed related parties and transactions within the financial statements. This should include reviewing the register of related parties, the updating of which is discussed in Understanding the entity.

It should be noted that ISA (UK) 240:26 presumes there are risks of fraud in revenue recognition. Therefore, the auditor should ordinarily expect to identify this when completing the risk assessment. If the auditor concludes that this presumption is not applicable to the client, the reasons for arriving at this conclusion must be documented.

Where this is a transition to a new accounting framework (e.g. a move to FRS 102), then this will also bring increased risks of misstatement or disclosure error in the year of transition.

Fraud and error

Under ISA (UK) 240:27, any identified risks of material misstatement due to fraud must be treated as significant risks (see Significant risks). Fraud is considered in more detail in Fraud in the audit.

ISA (UK) 240 makes clear that, due to the nature of fraud, there will always be a risk that a material fraud may not be identified, even in an audit properly planned and performed under ISAs. Nevertheless, the auditor should obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. In doing so, the auditor should maintain an attitude of professional scepticism throughout the audit. Professional scepticism is discussed in greater detail in Audit team planning meeting in the context of the audit team meeting.

During periods of change, the financial statements become far more susceptible to error. When a member of staff leaves or joins, there is far greater likelihood of an error occurring and the impact on the general risk of the entity should be assessed. There may also be a specific risk to a certain class of assets or transactions, depending on the area in which the member of staff works.

- If there has been any previous experience or incidents that could call into question the integrity or competence of the management, there may be a risk of fraud or error respectively. Such instances should be recorded on the permanent file but, in practice, this type of information may only be known by the partner, who will often have known the client longer than the rest of the audit team.

- Any unusual financial reporting pressures can lead to a higher risk of misstatement – as a result of either fraud or error. Under time pressure it is far more likely that mistakes will be made. If there are significant budgetary pressures, particularly where these impact bonus payments, then the auditor should consider the likelihood that the figures may be manipulated to reflect a different position.

- The existence of any major weaknesses in the design and operation of the accounting and internal control system will be assessed as a result of the work undertaken on the client’s systems, which is detailed in Accounting systems, processes and controls.

The auditor should consider the competence and conditions of the staff working in the accounting department and if the circumstances of the company may increase inherent risk, including issues surrounding staff morale and restructuring, which can have an impact on the likelihood of there being error and/or fraud.

Revenue recognition

There is a presumption that there are fraud risks in relation to revenue recognition (ISA (UK) 240:26). This is not the same as an automatic significant risk, as it may be possible to rebut this presumption. Where this is the case, ISA (UK) 240 specifically requires the reason(s) for drawing such a conclusion to be explicitly documented on the audit file.

Contrary to popular belief amongst auditors, this is not simply a question of cut-off. ISA (UK) 240:A28 explores a number of different ways that revenue may be inappropriately recognised, including premature revenue recognition due to an inappropriate accounting policy, fictitious revenues (invoices) and inappropriate deferral of revenue to later periods. The auditor should therefore consider all audit assertions and the fraud possibilities affecting each one.

ISA (UK) 240 gives an example of when rebuttal may be possible in paragraph A30, namely a company leasing out a single property. The chances of revenue being subject to fraud is slim as it would be immediately noticed. It would also be extremely difficult to perpetrate if the property was under a lease agreement and the rent was paid by direct bank transfer on a regular basis.

In practice, however, it is extremely difficult to rebut this presumption, as most clients will be too large and/or complicated. The presence of material cash sales or income will also negate the ability to rebut the presumption. In the vast majority of audits revenue recognition needs to be identified as a significant risk.

Accounting estimates

Whilst ISA (UK) 540 does not automatically designate estimates with high uncertainty risk as having significant risks, paragraph 17 of the ISA does require the auditor to specifically consider whether this is the case. Due to the nature of accounting estimates, it is likely that many will have high estimation uncertainty and, therefore, may well be associated with significant risks.

As well as looking at the actual outcome of prior periods' accounting estimates, ISA (UK) 540 requires the auditor, as part of the risk assessment process, to evaluate the degree of estimation uncertainty associated with an accounting estimate. Estimation uncertainty is defined in the ISA as 'susceptibility to an inherent lack of precision in measurement'. Accounting estimates are considered in detail in Auditing accounting estimates.

The ISA also notes that the degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias. This work may therefore be undertaken at the same time as reviewing accounting estimates for bias in accordance with the requirements of ISA (UK) 240 (see Determining the audit approach).

Example – accounting estimate

For many estimates, there are standard valuation models available on the market, reducing the level of complexity within the estimate to the lower end of the spectrum.

However, consider an entity that has entered into a derivative financial instrument contract that needs to be measured at fair value. The instrument is not publicly traded and requires the use of a particular specialised model to determine its fair value. The model needs data from a number of internal and external sources and requires specialised knowledge to select the most appropriate data source and to interpret the results.

The estimate here is forward looking and requires some judgement over the inputs, creating increased estimation uncertainty. The auditor is also aware that management has limited experience in making these judgements, as the accounting estimate is an item that is only considered once a year and that is also outside the normal course of business. The estimation uncertainty and the fact that this is outside the normal course of business are likely to move the assessment of inherent risk up the spectrum of inherent risk. As such, the auditor may consider that management's lack of experience in considering this accounting estimate, with lack of knowledge regarding where to obtain appropriate information to support the assumptions and the judgement, make this a significant risk.

Previous audits

The auditor's previous experience with the entity and from audit procedures performed in previous audits may provide the auditor with information that is relevant to determine the nature and extent of risk assessment procedures, and the identification and assessment of risks of material misstatement. The auditor should consider how reliable the accounting records have been in the past. If there have always been problems, then whatever promises are made by the client, it is unlikely that this is going to change during the current audit.

The impact of the auditor's prior experience of the client should also be considered, particularly:

- whether this is a new or longstanding client;
- past misstatements and whether they were corrected on a timely basis;
- whether there have been any audit qualifications in recent years;
- those particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example, due to their complexity;
- the nature of the entity and its environment, and the entity's system of internal control (including control deficiencies); and
- significant changes that the entity or its operations may have undergone since the prior financial period.

If the auditor intends to use prior engagements' information for the purposes of the current audit, ISA (UK) 315:A41 requires auditors to determine whether information and work remains relevant and reliable. If the nature or circumstances of the entity have changed, or new information has been obtained, the information from prior periods may no longer be relevant or reliable for the current audit. To determine whether changes have occurred that may affect the relevance or reliability of such information, the auditor can make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems. If the information is not reliable, the auditor may consider performing additional procedures that are appropriate in the circumstances.

Client factors

Auditors should always review knowledge obtained of the client to consider any specific indications of risks in relation to material misstatement, whether by fraud or error. For example:

- auditors need to identify the related parties and transactions that exist and whether these present additional risks to the financial statements. The permanent audit file should include a list of known related parties and this should be reviewed, updated and discussed annually;
- where the entity is part of a group structure, additional risks may arise, e.g. due to the complexity of the structure and other auditors involved; and
- evaluating risks against the entity's own risk assessment in process in relation to the preparation of the financial statements. However in many clients, it is unlikely that there will be many, if any, risk assessment procedures that the auditor can use in identifying relevant risks.

Further guidance can be found in Understanding the entity.

Business risks

Objectives, strategies and related business risks

An understanding of the business risks that have an effect on the financial statements assists the auditor in identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements.

This includes management's plans for the business, which the auditor should have already documented or updated on the permanent file. One issue with smaller businesses, especially those without a formal business plan, is that they may not have any specific strategies or plans for the future. This does not mean there are no risks in this area. In many sectors, particularly those with fierce competition or risk of obsolescence for technological or other reasons, a business with no plan and which is treading water and not moving forward can be as at much or even greater risk than one which is.

The auditor should also consider any ongoing pressures or influences on management, such as remuneration policies, the expectations of external parties and more senior management.

Not all aspects of the business model are relevant to the auditor's understanding. Business risks are broader than the risks of material misstatement of the financial statements, although business risks include the latter. Not all business risks give rise to risks of material misstatement, but the following may increase the risk of material misstatement:

- inappropriate objectives or strategies, ineffective execution of strategies, or change or complexity;
- a failure to recognize the need for change may also give rise to business risk (e.g. the development of new products or services that may fail, a market which is inadequate to support a product or service / flaws in a product or service that may result in legal liability and reputational risk); and
- incentives and pressures on management, which may result in intentional or unintentional management bias, and therefore affect the reasonableness of significant assumptions and the expectations of management or those charged with governance.

Examples:

An entity's business model may rely on the use of IT in different ways:

- The entity sells shoes from a physical store, and uses an advanced stock and point of sale system to record the selling of shoes; or
- The entity sells shoes online so that all sales transactions are processed in an IT environment, including initiation of the transactions through a website.

For both of these entities the business risks arising from a significantly different business model would be different, notwithstanding both entities sell shoes.

Revision of risk assessment

The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. Where audit evidence is obtained from performing further audit procedures, or new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and modify the further planned audit procedures accordingly.

Documentation

In the PCAS-based tools, the following schedules aid with documentation of the risk assessment process.

Risk Assessment (C9)	**Guides through the risk assessment process.**
Detailed Risk Assessment ~~(C9.1)~~ *Inherent risk questions*	Questionnaire is intended to assist in the identification of risks that may apply to the client. The questionnaire can also be used to record how low-level risks will be managed.
Risk Assessment Summary - financial statement level risks ~~(C9.3)~~ *Identified Risks*	To record the risk, response and outcome in respect of the financial statement level risks arising.
Risk Assessment Summary – assertion level risks ~~(C9.4)~~ *Identified Risks*	To record the risk, response and outcome in respect of the assertion level risks arising.
Fraud risk factors (C9.2)	Checklist to consider potential fraud risk factors.
IT risk identification (C7.3)	Assessing if IT applications and environment are subject to risks
Assessment of IT risks and general IT controls (C7.4) *In templates*	Assessing further IT risks and general IT controls

Evaluating the risk assessment

Many audit systems use checklists or questionnaires to help the auditor determine risk. Whilst these can be useful, they should not be applied without thought, especially when auditing entities in niche sectors. The auditor should consider all of the answers that have been given and ensure they have been adequately addressed by the audit planning.

Within most audit systems, the risk assessment will affect the amount of audit work to be undertaken, so it is vital to complete the risk assessment stage properly. An overly prudent assessment will lead to over-auditing, inefficiency and added expense. On the other hand, an unduly lenient assessment may result in insufficient audit work being undertaken and material misstatements going undetected.

The auditor’s response to risk is considered in Determining the Audit Approach.

2.4 Understanding the entity

Quick overview

This section covers the process of gaining a thorough understanding of the entity and its environment, prior to using that information to identify and assess the risks of material misstatement and plan and execute an audit of the financial statements.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to schedule **C4** in the in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

ISA (UK) 200 (Revised June 2016) (updated May 2022) Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK) states the overall objective of the auditor is to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. In order to do this, the auditor needs to gain a thorough understanding of the entity and its environment, including the entity's internal control, and to document that information in a suitable form.

ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* deals with the process of obtaining an understanding of the entity and its environment, and the applicable financial reporting framework and the entity's system of internal control, in order to identify and assess the risks of material misstatement at the financial statement level and assertion level. ISA (UK) 315 covers:

- risk assessment procedures and related activities (covered in this section);
- the required understanding of:

- the entity and its environment (covered in this section);
- the applicable financial reporting framework (covered in this section); and
- the entity's system of internal control (covered in Accounting systems, processes and controls);

- identifying and assessing the risks of material misstatement (covered in Assessing risk); and
- documentation.

In July 2020, the FRC revised ISA (UK) 315 together with conforming amendments to other standards. The revisions to the standard are designed to drive a more robust and consistent risk identification and assessment, enhancing the basis upon which auditors design and perform audit procedures that are responsive to the risks of material misstatement and, thereby, obtain sufficient appropriate audit evidence to provide a basis for the audit opinion.

The revised standard is effective for audits of financial statements for periods beginning on or after 15 December 2021, although early adoption is permitted. References to ISA (UK) 315 throughout this section refer to the 2020 version, unless otherwise stated.

Key definitions

Term	Definition
Assertions	Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement.
Business risk	A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
Controls	Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context: i. policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions; and ii. procedures are actions to implement policies.
Inherent risk factors	Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be qualitative or quantitative, and include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.
Risk assessment procedures	The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Source: ISA (UK) 315:12

Audit objectives

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

In order to identify and assess the risks of material misstatement, ISA (UK) 315 requires the auditor to obtain an understanding of the entity and its environment, and the applicable financial reporting framework and the entity's system of internal control relevant to the preparation of the financial statements.

This section deals with understanding of the entity and its environment and the applicable financial reporting framework. Obtaining an understanding of the entity's system of internal control is dealt with separately in Accounting systems, processes and controls.

The auditor's understanding of the entity and its environment and its applicable financial reporting framework is obtained through performing risk assessment procedures.

Risk assessment procedures and related activities

ISA (UK) 315:14 requires the auditor to perform the following risk assessment procedures to obtain an understanding of different aspects of the entity and its environment, its applicable financial reporting framework and its system of internal control:

- enquiries of management and of other appropriate individuals within the entity, including individuals within the internal audit function (if the function exists);
- analytical procedures; and
- observation and inspection.

When designing and performing risk assessment procedures, ISA (UK) 315:15 requires the auditor to consider information from:

- procedures regarding acceptance or continuance of the client relationship or the audit engagement (see Acceptance, continuance and independence); and
- where applicable, other engagements performed by the engagement partner for the entity.

Information gained at the prior year's audit will also be of use when performing risk assessment procedures in the current year (see Prior year information).

Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion. They do, however, enable the auditor to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence.

Although concentrated at the early stages of the audit, procedures to obtain an understanding of the entity, its environment and internal control, will be performed throughout the audit and the auditor's expectations may change as new information is obtained. Such procedures may also assist the auditor in developing initial expectations about classes of transactions, balances and disclosures, although they were not specifically designed to.

Enquiries of management and others

Management will be a key source of information, but other directors or staff may be able to provide different perspectives which highlight the risk of material misstatement.

Information may also be obtained through enquiries with the internal audit function, if the entity has such a function (see Using the work of internal auditors).

Example – Enquiries of management and others

- Talking to sales personnel may uncover a change in sales trends or contractual arrangements with customers.
- Meeting with the internal audit function may highlight potential problems with the design or effectiveness of the internal control system.

Further examples are provided in ISA (UK) 315:A23.

Analytical procedures

Analytical procedures may identify unusual transactions or trends which may indicate material misstatements, or have other audit implications.

At the risk assessment stage such analytical procedures tend to be at a high level, as they are not required to be performed in accordance with the requirements of ISA (UK) 520 *Analytical Procedures*, and are therefore likely only to provide a broad initial indication of a misstatement which will require further investigation.

Further guidance on performing analytical procedures at the risk assessment stage, including the use of data analytics, is available in Preliminary analytical procedures.

Observation and inspection

Observation and inspection may support, corroborate or contradict management representations or may provide information directly. Procedures will normally include:

- observation of entity activities and operations;
- inspection of documents (such as business plans and strategies), records and internal control manuals;
- reading reports (such as quarterly management reports and minutes of directors' meetings);
- inspection of the entity's premises and facilities;
- observing the behaviours and actions of management or those charged with governance;
- observation or inspection of information obtained from external sources, such as credit agencies, news and other media, regulators or other external documents about the entity's financial performance etc.; and
- tracing transactions through the information systems relating to financial reporting, i.e. walkthroughs.

The auditor also needs to consider whether information obtained from their client acceptance or continuance process is relevant to identifying risks of material misstatement. In addition, if the engagement partner has performed other engagements for the entity, they shall consider whether information obtained is relevant to identifying risks of material misstatement.

Prior year information

For ongoing audits, information gained at the prior year's audit will be of use when performing risk assessment procedures in the current year. However, the ISA requires the auditor to determine whether changes have occurred since the previous audit that may affect the relevance of such information in the current audit. The continuing relevance of such information can be determined by performing system walkthroughs.

Information gathered during any interim review may also be relevant to the year-end risk assessment procedures, but its ongoing accuracy should also be confirmed.

In addition, information gathered in previous audits may highlight particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example, due to their complexity.

Understanding the entity and its environment

In order to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements, and to identify potential risk areas, ISA (UK) 315:19–20 requires the following areas to be included in the auditor's understanding of the entity and its environment:

- organisational structure and ownership;
- governance;
- business model, including the extent to which the business model integrates the use of IT;
- industry, regulatory and other external factors;
- internal and external measures used to assess the entity's financial performance (see Financial performance assessment measures);
- the applicable financial reporting framework, the selection, application and appropriateness of accounting policies, including the reasons for any changes (see Financial reporting framework and accounting policies);
- how the inherent risk factors affect susceptibility of assertions to misstatement and the degree to which they do so.

The Understanding the entity aide-memoire (**C4**) is available in the PCAS based audit tools to assist the auditor in recording an understanding of the entity and its environment.

Structure and ownership

ISA (UK) 315:19(a)(i) requires the auditor to perform risk assessment procedures to obtain an understanding of the entity's organisational structure and ownership, this may help in understanding matters such as:

- the complexity of the entity's structure;
- the ownership, and relationships between owners and other people or entities, including related parties;
- the distinction between the owners, those charged with governance and management; and
- the structure and complexity of the entity's IT environment (see IT systems, risks and controls).

Complexity of the entity's structure

A client may have a complex structure with subsidiaries, etc. in multiple locations. In addition to consolidation difficulties, other issues may arise, such as whether investments are joint ventures, subsidiaries, or associates, and whether such issues have been adequately disclosed in the financial statements. These factors may increase the susceptibility to risks of material misstatement.

Ownership and relationships

An understanding of the ownership and relations between owners and other people or entities is important in determining whether related party transactions have been identified, accounted for and disclosed appropriately.

Guidance on identifying, accounting for and disclosing related party transactions is available in *Navigate UK GAAP Accounting*:

- Private Company (FRS 102) – Related parties (section 33); and
- Small Company (FRS 102 1A) – Related party disclosures (Section 33).

Details of related parties

The audit file should contain details of all known related parties, plus details of any regular or past transactions with them. Documentation of all related parties and their relationships with the client is a formal requirement of ISA (UK) 550:28. The ISA acknowledges that due to their nature, related parties and transactions may not always be easy to identify, and lists the following documents or records that could be inspected to search for information about related parties and transactions:

- third party confirmations (in addition to bank and legal confirmations);
- tax returns;
- information supplied by the client to regulatory authorities;
- shareholder records (to determine the names of principal shareholders);
- statements of conflict of interest of directors;
- records of investments and those of the client's pension schemes;
- directors' contracts and/or agreements;

- specific invoices and correspondence from the client's professional advisors;
- life assurance policies acquired by the client;
- significant contracts renegotiated during the period under audit; and
- internal auditors' reports.

ISA (UK) 550 also contains a number of mandatory procedures for assessing risk in relation to related party transactions at the planning stage, namely:

- discussion of the risk of material misstatement arising from related party transactions at the audit team planning meeting (see Audit risk);
- asking management about the existence and identification of related parties, their relationships to the client and the nature and purpose of any transactions therewith; and
- obtaining details of the controls (if any) operating over related party transactions, including those over the identification of related parties and authorising of related party transactions.

Care needs to be taken when making inquiries of management and/or those charged with governance, to ensure that they have a thorough understanding of who or what is included within the definition of a related party. Auditors therefore need to be specific about what needs to be disclosed so that the directors can provide complete answers to the auditor's inquiries.

The disclosure of related party transactions is important, and the risk of incomplete disclosure may be high for certain clients. It is important that the register of related parties is kept relevant and up to date, and that the risk of undisclosed related party transactions existing is carefully considered.

If a client refuses to provide the auditor with complete information about related parties, this constitutes a limitation on audit scope, and is likely to result in an audit qualification if not resolved satisfactorily.

It is important to note that there are no exemptions from the requirements of ISA (UK) 550, so the issue must be fully addressed on all audits, including those for small clients and charities etc.

Details of related parties (**X3**) is available *as a template* in the PCAS based audit tools to assist with documentation of this area.

Further guidance on related parties is given in Related party transactions.

Pension schemes

To be able to identify any risk factors associated with the entity's pension scheme arrangements, the auditor will need to obtain a thorough understanding of the entity's pension schemes.

The accounting and disclosure requirements for defined benefit pension schemes can be particularly complex. Obtaining the figures for the accounts will generally require the input of an actuary, and the process will necessitate careful planning and organisation by both the entity's management and the auditor, and should therefore be considered at as early a stage as possible. See Defined benefit pension schemes for further guidance.

For entities that have schemes such as Small Self-Administered Schemes ('SSASs'), there will also be loans and other transactions between the entity and the scheme which will need disclosure in the financial statements.

Governance

ISA 315:19(a)(i) requires the auditor to perform risk assessment procedures to obtain an understanding of how the entity is governed. Understanding how the entity is governed may help the auditor understand whether there is appropriate oversight of the entity's system of internal control.

Examples of matters that may be relevant in obtaining an understanding of the governance of the entity are provided in ISA (UK) 315:A60, these include:

- whether any or all of those charged with governance are involved in managing the entity;
- the existence of a non-executive board, and its separation from executive management;
- whether those charged with governance hold positions that are an integral part of the entity's legal structure (e.g. as directors);
- the existence of an audit committee, and its responsibilities;
- the responsibilities of those charged with governance for oversight of financial reporting, including approval of the financial statements.

Business model

Objectives, strategies and related business risks

ISA (UK) 315:19(a)(i) requires the auditor to understand the client's business model, including the extent to which the business model integrates the use of IT. Understanding the business model, and how it is affected by its business strategy and business objectives, may then assist the auditor in identifying business risks that may have an effect on the financial statements.

Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Business risk is a wider concept than the risk of material misstatement of the financial statements, but understanding business risk will increase the likelihood of identifying such risk. Whether a business risk will result in a risk of material misstatement will depend on the entity's circumstances.

Business risks that increase the susceptibility to risks of material misstatement may arise from:

- inappropriate objectives or strategies, ineffective execution of strategies, or change or complexity;
- a failure to recognise the need for change, for example:

- the development of new products or services that may fail;
- a market which is inadequate to support a product or service;
- flaws in a product of service that may result in legal liability and reputational risk; or

- incentives or pressures on management, which may result in intentional or unintentional management bias, and therefore affect the reasonableness of significant assumptions and the expectations of management or those charged with governance.

Some examples of matters to consider when obtaining an understanding of the entity's business model, objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements are set out in the table below.

Aspects of business model, objectives and strategies	**Potential business risks**
Industry developments.	The client does not have the personnel or expertise to deal with changes in the industry.
New products and services.	There is an increased product liability.
Expansion of the entity's business.	Demand has not been accurately estimated.
New accounting requirements.	Incomplete or improper implementation, or increased costs.
Regulatory requirements.	Increased legal exposure.
Current and prospective financing requirements.	The loss of financing doe to the client's inability to meet requirements.
Use of IT.	Systems and processes are incompatible.
The effects of implementing a strategy, particularly and effects that will lead to new accounting requirements.	Incomplete or improper implementation.

Some clients, especially smaller ones, may not have a formal business plan or written plans and objectives for the business. To understand the business risk for such entities, the auditor must make enquiries and observations of management. However, the absence of any sort of strategy or plan for the business may in itself be a risk, particularly in certain industries which, for example, depend heavily on fashions, trends or the latest technology, or are highly competitive. Such issues can have a significant impact on the going concern of an entity if not adequately addressed by the directors.

As well as affecting going concern directly, the objectives and strategies of the client can lead to other risk factors.

Example – Business risks arising from objectives and strategies

A manufacturing client plans to move production abroad to save costs. This might give rise to following situations.

- there will be a foreign exchange risk when the overseas costs are converted back into Sterling;
- inadequate local knowledge of the country in question may result in an increased risk of non-compliance with local laws and regulations, giving rise to fines and penalties, etc.;

- new staff with no experience of the company or particular product(s) may result in production problems and give rise to quality control issues, with adverse knock-on effects on the company's reputation and customer goodwill; or
- overseas tax may need to be considered, possibly including transfer-pricing regulations.

As part of the entity's system of internal control, management will ordinarily identify business risks and develop an approach to address them. Understanding the entity's process for identifying, assessing and addressing business risks relevant to financial reporting is covered in Accounting systems, processes and controls.

Description of the business model

The audit file should include a description of the entity's business model.

The business model describes how the entity creates, preserves and captures financial or broader value for its stakeholders. Appendix 1 to ISA (UK) 315 sets out what the description of the business model typically covers, including:

- the scope of the entity's activities, and why it does them;
- the entity's structure and scale of its operations
- the markets or geographical or demographic spheres, and parts of the value chain, in which it operates, how it engages with those markets or spheres (main products, customer segments and distribution methods), and the basis on which it competes;
- the entity's business or operating processes (e.g., investment, financing and operating processes) employed in performing its activities, focusing on those parts of the business processes that are important in creating, preserving or capturing value;
- the resources (e.g., financial, human, intellectual, environmental and technological) and other inputs and relationships (e.g., customers, competitors, suppliers and employees) that are necessary or important to its success; and
- how the entity's business model integrates the use of IT in its interactions with customers, suppliers, lenders and other stakeholders through IT interfaces and other technologies.

To understand the activities of the entity included in its business model, the auditor should consider the entity's business operations, its investments and investment activities, and its financing and financing activities.

Business operations

The description of the entity's business operations might include information about customers, suppliers and any other relevant information.

The following matters should be considered:

- nature of revenue sources (e.g., manufacturer, wholesaler, banking, insurance or other financial services, import/export trading, utility, transportation, and technology products and services);

- products or services, and markets (e.g., major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes);
- involvement in electronic commerce such as Internet sales and marketing activities;
- conduct of operations (e.g., stages and methods of production, business segments, delivery of products and services, details of declining or expanding operations, or activities exposed to environmental risks);
- alliances, joint ventures, and outsourcing activities;
- geographic dispersion and industry segmentation;
- location of production facilities, warehouses, and offices;
- location and quantities of inventories;
- key customers;
- important suppliers of goods and services (e.g., long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time");
- employment arrangements (including the existence of union contracts, pension and other post employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters), consider location, supply and wage levels etc.;
- research and development activities and expenditures; and
- transactions with related parties.

Example – Risks arising from business operations

An entity that is largely dependent on one main customer or supplier may be at risk if that entity moves its business elsewhere or ceases trading.

Investments and investment activities

The auditor should consider the following in relation to the entity's investments and investment activities:

- planned or recently executed acquisitions, mergers or disposals of business activities;
- investments and dispositions of securities and loans;
- capital investment activities, including investments in plant and equipment and technology, and any recent or planned changes; and
- investments in non-consolidated entities, including non-controlled partnerships, joint ventures and non-controlled special-purpose entities.

Example – Risks arising from investment activities

Some clients – typically, charities – are dependent on investments to provide an income stream. A stock market downturn can put the going concern of such entities at risk. There may be a significant risk of accounting errors arising where entities are investing in complex financial instruments which need to be valued.

Financing and financing activities

The auditor should consider the following in relation to the entity's financing and financing activities:

- ownership structure of major subsidiaries and associated entities, including consolidated and non-consolidated structures;
- debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements (e.g. leasing of property, plant or equipment for use in the business);
- beneficial owners (e.g. local, foreign, business reputation and experience);
- related parties; and
- use of financial instruments, including derivative financial instruments.

Example – Risks arising from financing arrangements

The financial statements of highly geared entities may, for example, be at risk of manipulation in order to meet banking covenants, or be at risk of continuing as a going concern if interest rates rise substantially or credit is withdrawn.

Use of financial instruments

The auditor should consider the following:

- the financial instruments to which the entity is exposed, and their purpose and risks;
- the accounting and disclosure requirements (see Financial reporting framework and accounting policies);
- management's process for valuing financial instruments, including whether management has used an expert or service organisation (see Using the work of experts and Service organisations);
- the evidence supporting managements assumptions;
- the systems of internal control and the information systems that ensure that all instruments are completely and accurately recorded, payments and receipts are monitored and financial risks are analysed and monitored (see Accounting systems, processes and controls); and
- the accounting policies applied and in particular any application of hedge accounting.

Documenting key business processes

Guidance on identifying and documenting the client's key business processes can be found in Accounting systems, processes and controls.

Industry, regulatory and other external factors

ISA (UK) 315:19(ii) requires the auditor to understand the industry, regulatory and other external factors affecting the entity and its environment.

Industry factors

Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments.

ISA (UK) 315:A68 sets out the following conditions to consider:

- the market and competition, including demand, capacity, and price competition;
- cyclical or seasonal activity;
- product technology relating to the entity's products; and
- energy supply and cost.

Any other factors that could affect the business should also be considered.

Understanding the industry conditions affecting the entity is useful in identifying external risks, and often these will impact in some way on going concern risk.

Example – Risks arising from industry conditions

Clients in industries where technology advances rapidly must run effective research and development programmes to remain competitive.

Regulatory factors

Relevant regulatory factors include the regulatory environment, which includes, the applicable financial reporting framework and the legal and political environment, among other matters.

To understand the regulatory environment, the auditor should consider:

- the regulatory framework for the industry in which the entity operates;
- legislation and regulation that significantly affects the entity's operations, e.g. labour laws and regulations;
- taxation legislation and regulations;
- government policies affecting the conduct of the entity's business, such as:

- monetary policies, including foreign exchange controls;
- fiscal policies;
- financial incentives (e.g. government aid programmes); and
- tariffs or trade restriction policies.

Further specific requirements related to compliance with significant laws and regulations applicable to the entity and the industry or sector in which it operates are contained in ISA (UK) 250 Section A – *Consideration of laws and regulations in an audit of financial statements*.

Compliance with significant laws and regulations

Register of significant laws and regulations

ISA (UK) 250A requires the auditor to obtain a general understanding of the legal and regulatory framework applicable to the client and its industry sector, and how the entity is complying with that framework, including the procedures followed by the client to ensure compliance.

The objective is to identify those laws or regulations that may give rise to business risks that have a fundamental effect on the client's operations, and to consider their impact. For example, non-compliance with certain laws and regulations may cause the client to cease operations or call into question the client's continuance as a going concern.

Laws and regulations can be divided into:

- laws and regulations governing financial statements;
- general business laws and regulations; and
- other specific laws and regulations.

The audit file should include details of significant laws and regulations applicable to the client. To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, ISA (UK) 315:A11 notes that the auditor may:

- use the existing understanding of the entity's industry, regulatory and other external factors;
- update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- enquire of management:

- as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- concerning the entity's policies and procedures regarding compliance with laws and regulations; and
- regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

Detailed guidance on laws and regulations for the auditor is in Consideration of laws and regulations.

Register of laws and regulations (**D6**) *available as a template* in the PCAS based audit tools will assist with documentation of this area.

Other external factors

Other external factors the auditor should consider include:

- general economic conditions (e.g. recession, growth);
- interest rates;
- availability of financing;
- inflation; and
- currency revaluation.

Financial performance assessment measures

ISA (UK) 315:19(a)(iii) requires the auditor to understand the measures used, internally and externally, to assess the entity's financial performance.

Understanding the performance measures used internally by management, and externally, helps the auditor to consider whether these measures create pressures on the entity to achieve performance targets. Such pressures can increase the susceptibility to misstatement due to management bias or fraud.

Performance measures may also indicate the likelihood of risks of misstatement of related financial statement information. For example, performance measures may highlight that the entity has an unusually rapid growth or profitability when compared to industry averages.

Performance measures used by management

By understanding which areas management are keen to monitor and review, the auditor can make assumptions about the areas which management perceive to be of relatively high risk. In turn, the existence of such performance measures may create a pressure on management, which may lead to motivation to misstate the financial statements.

The auditor should make enquiries of management as to what key indicators are used for evaluating performance. Performance measures may also be identified by considering the information the entity uses to manage its business. If the enquiry indicates an absence of performance measurement or review, the auditor should consider whether there is an increased risk of misstatements not being corrected or detected.

Information used by management to monitor performance may include:

- key performance indicators (both financial and non-financial);
- key ratios and operating statistics;
- trends;
- period-on-period financial performance (revenue growth, profitability, leverage etc.);
- forecasts, budgets and variance analysis;

- segment information and divisional, departmental or other level performance reports;
- employee performance measures and incentive policies; and
- comparison of an entity's performance with that of competitors.

Much of this information is likely to be internally generated and the auditor must consider whether it is likely to be accurate and precise enough to detect material misstatement. This requires the auditor to consider what specific performance measures are important to the entity, and whether any risks arise from these measures.

Example – Risks arising from performance measures used by management

In a business where turnover growth is the most important factor, sales staff may be pressurised into doing business with uncreditworthy customers, or even to generate fictitious sales, especially if their remuneration is based – at least in part – on reaching sales targets.

Considerations for smaller entities

Although smaller entities may not have formal performance review procedures, management are still likely to focus on a number of performance indicators. The auditor can observe these in the same way as for larger entities.

Segment information

The auditor should consider the methods used by management in determining segment information used to measure financial performance, such as:

- sales, transfers and charges between segments, and elimination of inter- segment amount;
- comparisons with budgets and other expected results, e.g. operating profits as a percentage of sales;
- the allocation of assets and costs among segments; and
- consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Performance measures used externally

The entity's financial performance may also be reviewed and analysed by external parties, particularly where financial information is publicly available. The auditor should consider what specific performance measures are important to external parties, and whether any risks arise from these measures.

External parties might include:

- analysts or credit agencies;
- news and other media, including social media;
- tax authorities;
- regulators;

- trade unions; and
- providers of finance.

Example – Risks arising from performance measures used externally

Key measures for many charities include the amount of administrative expenses and/or fundraising costs compared to the income generated, as funding bodies often look at these ratios when making decisions about funding. This might result in pressure to manipulate income recognition or to not account for all expense invoices.

Financial reporting framework and accounting policies

The ISA also requires the auditor to consider whether the accounting policies selected and applied by the entity are suitable given the nature and circumstances of the entity and its environment, and evaluate whether the policies are appropriate and consistent with the applicable financial reporting framework (for example FRS 105, FRS 102, FRS 101 or IFRS).

The aim here is to identify risks that arise from the accounting policies applied by the client.

Example – Risks arising from accounting policies

Examples of potential risks arising from accounting policies include the following:

- those arising from whether development costs should be capitalised or expensed, and if the former, from what point and over what period should they be amortised;
- inappropriate revenue recognition policies, which can also impact on the tax due; and
- non-depreciation of buildings on the grounds that the depreciation charge and accumulated depreciation are immaterial. This is in accordance with FRS 102:17, but there is a need to consider the accumulated depreciation, which can become material over time.

Significant accounting policies (**C4.1**) is available *as a template* in the PCAS based audit tools to assist with documenting the evaluation of accounting policies.

Applicable financial reporting framework

To understand the applicable financial reporting framework, and how it applies in the nature and circumstances of the entity, the auditor should consider:

- accounting principles and industry specific practices - certain industries have industry-specific policies which, generally, should be followed unless there is a good reason not to do so. One way to check this is to compare the client's accounting policies with those of a competitor or other entity in the same industry sector. These can be obtained either from Companies House or, in the case of a listed company, from its website;

- industry-specific significant classes of transactions, account balances and related disclosures in the financial statements (e.g. research and development for pharmaceuticals);
- the entity’s accounting for areas such as:

- revenue recognition;
- financial instruments, including related credit losses;
- foreign currency; and

- the entity’s accounting for unusual or complex transactions, including those in controversial or emerging areas, for example accounting for cryptoassets and share-based payments.

Selection and application of accounting policies

The auditor should understand the entity’s selection and application of accounting policies, including any changes, and evaluate whether the accounting policies are appropriate and consistent with the applicable financial reporting framework. The auditor should consider:

- the methods the client uses to recognise, measure, present and disclose significant and unusual transactions;
- the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- changes in the environment that might affect accounting policies, such as changes in the appliable financial reporting framework or tax reforms;
- new financial reporting standards that may be relevant. Consideration should be given to when and how the client will adopt such requirements;
- the auditor should also be looking out for unusual policies. It is important that accounting policies are designed to suit the client and its business, for example, a policy of depreciating IT equipment over three years straight line may not be suitable for the IT equipment used by an overseas aid charity in a disaster relief zone, or an innovative tech company; and
- where the client has changed its selection of, or method of applying, a significant accounting policy, the auditor should consider the reasons for the change and whether it is appropriate and consistent with the applicable financial reporting framework.

The auditor should also consider whether sufficient information is disclosed in the financial statements to enable users to understand the accounting policies adopted and how they have been implemented, and whether accounting policies adopted are reviewed regularly by management to ensure that they remain appropriate.

Guidance on changes in accounting framework (e.g. from FRS 105 to FRS 102) is provided in Change in accounting framework.

Engagement team discussion

ISA (UK) 315:17 has a requirement for the engagement partner and other key members of the engagement team to discuss the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement.

It is the engagement partner's responsibility to determine which matters are to be communicated to engagement team members not involved in the discussion.

Further guidance on this discussion is in Audit team planning meeting.

A schedule for recording the engagement team discussion is included at **C10** *available as a template* in the PCAS based audit tools.

Accounting estimates

This area is covered by ISA (UK) 540 *Auditing accounting estimates and related disclosures*. At the outset of the audit, the auditor needs to have a good understanding of the entity and its environment and the entity's internal control, including an understanding of how management identifies areas where accounting estimates may be needed. In order to do this, the auditor should make inquiries of management, which should specifically include any changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

Schedules **C8** *Understanding accounting estimates* and **C8.1** *Review of accounting estimates available as a template* in the PCAS based audit tools provide space to document these matters. The audit approach should then address the specific steps to be taken to obtain sufficient evidence as to the reasonableness of the estimates.

Examples of accounting estimates

Virtually all statutory financial statements will contain some accounting estimates, such as:

- useful economic life of goodwill and other intangibles;
- useful economic lives of property, plant and equipment (i.e. depreciation);
- carrying value of investments;
- provisions for obsolete and slow-moving stocks;
- provisions for bad and doubtful debts;
- provisions for warranty obligations;
- defined benefit pension plan liabilities;
- revalued assets, e.g. property;
- financial instruments at fair value;
- financial instruments not traded in an active and open market;
- share-based payments;
- costs arising from litigation;

- outcome of long term contracts; and
- accruals.

The entity and its environment

As part of understanding the entity and its environment, ISA (UK) 540:13 requires the auditor to consider:

- the transactions and other events that may give rise to the need for, or changes in, accounting estimates to be recognised or disclosed in the financial statements;
- the requirements of the applicable financial reporting framework related to accounting estimates, and how they apply to the entity, including how they are affected by inherent risk factors; and
- regulatory factors relevant to accounting estimates.

Based on the understanding of the matters above, the auditor should then consider the nature of the accounting estimates and related disclosures that would be expected to be included in the entity's financial statements.

The entity's internal control

As part of understanding the entity's system of internal control, ISA (UK) 540:13 requires the auditor to consider:

- the nature and extent of oversight of governance in place over the financial reporting process relevant to accounting estimates;
- how management identifies the need for, and applies, specialised skills or knowledge relating to accounting estimates. Experts are commonly used in connection with the valuation of tangible fixed assets (especially property) and the surplus or deficit for defined benefit pension schemes;
- how the entity's risk assessment process identifies and addresses risks relating to accounting estimates;
- the entity's information system as it relates to accounting estimates, including:

- how information relating to accounting estimates and related disclosures for significant classes of transactions, account balances or disclosures flows through the entity's information system; and
- for such accounting estimates and related disclosures, how management:

(i) selects or designs, and applies, the methods used, including the use of models (Models are more likely to arise in relation to fair value estimates, but may also be found in other accounting estimates such as calculation-driven provisions);

(ii) selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions; and

(iii) selects the data to be used;

- understands the degree of estimation uncertainty, including through considering the range of possible measurement outcomes;
- addresses the estimation uncertainty, including selecting a point estimate and related disclosures;
  - identified controls over management's process for making accounting estimates. In many cases, especially with smaller clients, there may be few controls in relation to accounting estimates; and
  - how management reviews the outcome of previous accounting estimates and responds to the results of the review.

More detailed guidance on obtaining an understanding of the entity's internal control is provided in Accounting systems, processes and controls.

ISA (UK) 315:A115-A117 provide further guidance where the auditor determines that management has not taken appropriate steps to understand and address estimation uncertainty. Additional procedures that the auditor may request management to perform to understand estimation uncertainty include:

- consideration of alternative assumptions; or
- the performance of a sensitivity analysis.

In considering whether it is practicable to develop a point estimate or range, the auditor should ensure that independence requirements are not compromised, including relevant ethical requirements that prohibit the auditor from assuming management responsibilities. If, after considering management's response, the auditor determines that it is not practicable to develop an auditor's point estimate or range, the auditor must consider the implications for the audit or the opinion on the financial statements.

Review of prior year accounting estimates

The auditor is required to review the outcome of accounting estimates included in last year's financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period (for example, if a litigation provision is still needed in the following year's financial statements as the case has still not been resolved). In some cases, a retrospective review over several periods may be appropriate when the outcome of an accounting estimate is resolved over a longer period.

Example – Bad debt provision

The prior year's bad debt provision should be compared to the level of actual write-offs and monies recovered in the current period. If it was found that the actual bad debt expense in the year in relation to the previous year's debts was materially higher than the brought forward bad debt provision, the auditor might conclude there to be a risk of material understatement of the bad debt provision in the current year.

Example - Depreciation

An accounting estimate that may be material on many audits is depreciation. However, care needs to be taken when undertaking this review in relation to depreciation. The purpose of depreciation is to spread the cost of a fixed asset across its useful economic life, not to maintain the asset's net book value close to net realisable value. Rather than looking at profits or losses on sale of assets, a better approach might be to look at the disposal proceeds for fully depreciated assets in the year. This may indicate whether useful economic lives and/or residual values are inappropriate.

The review of the outcome of the previous year's estimates is a risk assessment procedure to be performed at the audit planning stage.

2.5 Change in financial reporting framework

Quick overview

This section covers the audit implications where there has been a change in financial reporting framework.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to schedule **C11** in the in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

Companies may transition to either FRS 102 or FRS 105 for the first time; for instance, a micro-entity may outgrow the size criteria and be required to adopt FRS 102, or a company delisting from a stock exchange may transition from IFRS to FRS 102.

An entity may also be required to, or choose to, adopt IFRSs in its financial statements.

There are a number of matters that the entity and the auditor will need to consider in advance of the audit and at the planning stage, including:

- ethical considerations;
- resourcing;
- preparing for the transition;
- understanding the impact on the entity;
- understanding the differences between the financial reporting frameworks;
- comparatives and transitional adjustments; and
- documentation of the transition audit work.

Other planning issues (**C11**) is available in the PCAS based audit tools to assist with documentation where there has been a change in financial reporting framework.

Ethical considerations

Where an entity changes their applicable financial reporting framework the auditor must carefully consider their position when it comes to the transition process – particularly in light of any ethical threats that may arise (e.g. where the auditor is actively involved in a client's transition process).

Many entities are likely to benefit from the support of their auditors in the transition process, however, the auditor needs to ensure that ethical matters are considered, including how professional scepticism will be maintained, before providing assistance to clients. For example, clients may ask the auditor:

- to provide accounting assistance in the preparation of financial statements under the new financial reporting framework;
- for advice on the tax consequences that might arise as a result of the transition; or
- for assistance with valuations under the new financial reporting framework.

In all of these situations, the auditor must carefully document the nature of the service and consider all threats and safeguards before concluding whether the client can be assisted.

In providing such advice, the auditor needs to guard against giving bookkeeping advice or making specific accounting entries that go beyond those permitted by the FRC's Revised Ethical Standard 2019, Section 5, i.e. beyond those considered to be of a technical, mechanical or informative nature.

When considering the extent to which the auditor may provide advice to clients on the transition to the new financial reporting framework, it should be clearly established that management retains full responsibility for all financial information, including the selection and application of appropriate accounting policies. Management cannot ask their auditor to make decisions about the preparation and presentation of financial statements under the new standard. Whilst the auditor can assist in identifying the choices that need to be made and discussing them with management, the auditor cannot make any of these choices for management.

Similarly, the Revised Ethical Standard 2019 contains strict prohibitions on the provision of valuations by the auditor. On transition to the new financial reporting framework, an entity may be required to carry more items at a valuation than under their previous GAAP. Where the entity is not familiar with valuation techniques for such items, they may ask the auditor for assistance. However, in accordance with the Revised Ethical Standard 2019, the auditor is not permitted to provide a valuation for a listed entity where the valuation is material, nor for any other entity where the valuation involves a significant degree of subjective judgement and has a material effect on the financial statements, either separately or in aggregate with other valuations provided.

Resourcing and competency

Availability of suitable resources

The suitability of audit staff involved in auditing the transition must be carefully considered. In cases where the transition process is particularly complex, suitable appropriate judgements will need to be made by the auditor so as not to compromise audit quality. Audit firms will need to ensure that the engagement partner themselves and the staff involved in the assignment in the year of transition are sufficiently competent.

Use of experts

The auditor may need to rely on the work of experts when auditing the transition (e.g. when it comes to property valuations, pension funds or financial instruments), in which case the provisions in ISA (UK) 620 *Using the work of an auditor's expert* will be relevant (see Using the work of experts).

Reporting timeframes

For clients with specific reporting requirements (e.g. deadlines for submission of the financial statements to a regulatory body), auditors will need to have specific reporting time frames factored into the overall audit plan. As the transition process will inevitably require more work, careful consideration must be given to reporting dates when discussing the audit timetable with the client. This may involve additional resources being assigned to certain audit areas to ensure compliance with the reporting timetable and hence have an impact on the firm's resources.

Preparing for transition

It is the responsibility of the directors of the company to ensure that the transition process is undertaken without a material impact on the business.

The client should be advised to start preparing for the transition as early as possible. To ensure the client entity is appropriately prepared for the transition, the auditor may wish to have an early discussion with the client about their plans, including considering the following areas:

- clarifying the responsibilities of management;
- establishing a timeline for transition;
- communicating changes with stakeholders;
- assessing the need for any additional resources or training;
- identifying the differences between the entity's current accounting policies and the new financial reporting framework;
- identifying any changes in financial data and additional information needed to meet the revised requirements;
- identifying any impact on wider business issues, such as considering bank covenant arrangements;
- planning the transition process; and
- implementing the changes.

Impact on the entity

ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material* Misstatement requires the auditor to obtain an understanding of the entity and its environment, including its applicable financial reporting framework in order to identify and assess the risks of material misstatement. The auditor will therefore need to understand the impact that the transition process has had on the business.

Transitioning to a new financial reporting framework will affect some entities more than others and the level of audit work to be performed by the auditor will depend on the impact that the transition has on the entity.

Consideration should be given to (among other client-specific issues):

- the environment in which the client operates;
- the technical ability of the staff undertaking the transition;

- the resources which the client has available to deal with the transition;
- how the accounting system will be tested to ensure compliance with the new framework;
- whether there have been any exceptions reported by the financial reporting system of which the auditor should be aware;
- changes to accounting policies as a result of the new framework; and
- the adequacy of the disclosures in the first-year reporting under the new framework.

At the planning stage, the auditor will gain an understanding of how smoothly the transition process has been undertaken by the client and the impact that the transition has had on the financial statements. If the client has had considerable difficulties dealing with the transition, or if exceptions have been reported by the accounting system during the process, this is going to have an impact on the overall risk assessment (i.e. there is an increased risk of material misstatement) and procedures should be tailored specifically to address these risks.

Discussions with management at the planning stage should involve clearly identifying the information that the auditor will require and instructions from the engagement partner to the team in ensuring that the audit evidence gathered over the transition is both sufficient and appropriate to meet the requirements in ISA (UK) 500 *Audit evidence*.

Matters that should be considered by the auditor at the planning stage of the audit include:

- Are there any particular areas of concern which have been identified at the planning stage relating to the transition process? For example, has the client had particular difficulty with the transition?
- Are there any increased pressures on the client to deliver a certain level of results? If so, how does the risk assessment at the planning stage deal with this risk of material misstatement?
- Have changes to the accounting systems provided an increased opportunity for fraud? If so, how is this dealt with in the fraud risk assessment?
- How reliable is the client's accounting system? If it is not reliable, or there are ongoing problems with the system, this will increase the risk of material misstatement due to the transition.

The auditor must consider the quality of the information from which the new information has been generated. The auditor will need to understand the entity's information system and consider the controls over that information. Guidance on obtaining an understanding of the information system is provided in Accounting systems, processes and controls.

Differences between the financial reporting frameworks

The auditor must be familiar with the differences between the financial reporting frameworks. The auditor must identify the specific policies that are changing as a result and the risks arising from those changes.

Particular issues to consider at the planning stage may include:

- Valuations of fixed assets: does the new framework require or allow the client to switch from revaluation to depreciated historic cost?

- Has the client considered deferred tax implications on revalued assets under the new framework at the date of transition?
- Are short-term employee benefits accrued by employees, but not paid until the subsequent accounting period, material? If not, would they become material when aggregated with other misstatements identified during the audit?
- Does the client have any financial instruments that will be measured differently under the new framework? If so, who has valued these? Will the auditor need to use the services of an expert to corroborate the valuation (especially if they are complex financial instruments)?

FRS 102 transition

The FRC released *Fact Sheet 7 – FRS 102: Transition to FRS 102* in December 2018, to highlight the requirements of FRS 102:35 *Transition to FRS 102*.

Guidance on the accounting requirements when transitioning to FRS 102 and FRS 105 can be found in *Navigate UK GAAP Accounting*:

- • Private Company (FRS 102) – Transition to FRS 102 (Section 35);
- • Small Company (FRS 102 1A) – Transition to FRS 102:1A (Section 35); and
- • Micro Entity (FRS 105) – Transition to FRS 105 (Section 28).

The *GAAP at a Glance* tool sets out key recognition and measurement differences between FRS 102, IFRS and FRS 105.

IFRS transition

Where an entity is required, or chooses, to adopt IFRSs in its financial statements, similar issues arise as with transition to FRS 102.

In 2014, the ICAEW's Audit and Assurance Faculty issued Technical Release Audit 03/04 *Auditing Implications of IFRS Transition* providing specific guidance for auditors in this area. This technical release remains extant although auditors will need to bear in mind that IFRS and auditing and ethical standards have changed considerably since then.

Technical Release Audit 03/04 may also be relevant to entities applying FRS 101 *Reduced Disclosure Framework.*

Guidance on the first-time adoption of IFRS can be found in *Navigate IFRS Accounting*.

The *GAAP at a Glance* tool sets out key recognition and measurement differences between FRS 102, IFRS and FRS 105.

Comparatives and transitional adjustments

The date of transition is the commencement of the comparative period. Comparatives will need to be restated under the new framework and an opening statement of balances at the date of transition also prepared. There may be some items in the financial statements for which management may find it difficult to obtain historical valuations and such information should be gathered as soon as possible.

Transitional adjustments may be permitted and/or required in certain areas, for example, property valuation, recognition of forex forward contracts, deferred tax provisions.

Such adjustments may reduce reserves to such a level that they affect dividends already paid out if not considered in good time.

Guidance on auditing comparatives can be found in Nominal ledger, opening balances and comparatives.

Documentation

The work undertaken on the transition process must be clearly documented in order that the audit engagement partner can form an overall conclusion as to whether the financial statements are free from material misstatement due to the transition process.

Key judgements and decisions made by the team must be recorded adequately within the working papers. This will also include forming a conclusion as to whether the transitional disclosures are adequate and enable the users of the financial statements to understand the impact that the transition process has had on the entity's financial performance, financial position and cash flows. The use of an up-to-date disclosure checklist in ensuring disclosures are adequate is strongly advised. Disclosure checklists are available *as part of Audit Automation* ~~in *Navigate UK GAAP Accounting.*~~

Other considerations

Assurance work

Some audit clients may ask their auditors to offer some form of assurance at an early stage in the transition process (for example, on the appropriateness of accounting policies). Some assurance work at an early stage in the transition process may go to serve as forms of audit evidence provided they are adequately documented. This may be the case if, for example, the client requests the auditor to review the opening balance sheet after transition to offer comfort to the client that the transition process has been undertaken properly. Care should be taken by the auditor if a review engagement is undertaken before the detailed audit work because the procedures in a review engagement are limited and may not generate sufficient appropriate audit evidence over the transition process in isolation and hence additional procedures should be implemented to ensure the sufficiency and appropriateness of the audit evidence.

Preliminary analytical procedures

Preliminary analytical review procedures can be very useful in the context of a transition because these may highlight trends or fluctuations which the auditor is not expecting and therefore appropriate attention should be focused on these areas, which will affect the audit plan. Changes to the audit plan should be adequately documented.

Audit methodologies

Auditors should consider their own processes and audit methodologies. The firm's procedures should be adequate to address the risk of fraud, keeping in mind that a new accounting framework may bring with it an increased emphasis on fair value accounting, new accounting policy choices and the restatement of prior year's financial statements, all of which give opportunity to the increased risk of material misstatement due to fraud.

2.6 Accounting systems, processes and controls

Quick overview

This section covers the documentation of the entity's systems, process and controls and the process of gaining a thorough understanding of the entity's system of internal control, prior to using that information to identify and assess the risks of material misstatement and plan and execute an audit of the financial statements.

This section also covers testing the operational effectiveness of the entity's controls, so that reliance may be placed on the controls operating over the client's systems.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas~~ of *Navigate Audit*.~~

This section relates to schedules C4, C7, C7.1 and C7.4 *(available in templates)* and section S in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

Understanding internal controls

ISA (UK) 200 (Revised June 2016) (updated May 2022) Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK) states the overall objective of the auditor is to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. In order to do this, the auditor needs to gain a thorough understanding of the entity and its environment, including the entity's internal control, and to document that information in a suitable form.

Three ISAs deal specifically with the process of obtaining an understanding of the entity, identifying and assessing risks and designing and implementing appropriate audit responses. These are:

- ISA (UK) 315 (Revised July 2020) Identifying and Assessing the Risks of Material Misstatement;
- ISA (UK) 330 (Revised July 2017) (Updated May 2022) The Auditor's Responses to Assessed Risks; and
- ISA (UK) 240 (Revised May 2021) (Updated May 2022) The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.

ISA (UK) 315 sets out requirements on understanding the entity, including its internal control, and using this understanding to assess the risks of material misstatement at the financial statement and assertion level. The ISA covers:

- risk assessment procedures and related activities (covered in Understanding the entity);
- the required understanding of:
- the entity and its environment (covered in Understanding the entity);
- the applicable financial reporting framework (covered in Understanding the entity); and
- the entity's system of internal control (covered in this section);
- identifying and assessing the risks of material misstatement (covered in Assessing risk); and
- documentation.

In July 2020, the FRC issued revised ISA (UK) 315 together with conforming amendments to other standards. The revisions to the standard are designed to drive a more robust and consistent risk identification and assessment, enhancing the basis upon which auditors design and perform audit procedures that are responsive to the risks of material misstatement and, thereby, obtain sufficient appropriate audit evidence to provide a basis for the audit opinion.

The revised standard is effective for audits of financial statements for periods beginning on or after 15 December 2021, although early adoption is permitted. References to ISA (UK) 315 throughout this section refer to the 2020 version, unless otherwise stated.

Testing the operational effectiveness of controls

In certain circumstances, the auditor may decide to try to place reliance on the controls operating over the client's systems, and testing the operational effectiveness of controls is mandatory in certain circumstances set out in ISA (UK) 330. Testing the operational effectiveness of controls is covered in this section.

Key definitions

Term	Definition
Assertions	Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement.
Business risk	A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
Controls	Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context: i. policies are statements of what should, or should not, be

done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions; and

ii. procedures are actions to implement policies.

General information technology (IT) controls

Controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information (i.e., the completeness, accuracy and validity of information) in the entity's information system.

Information processing controls

Controls relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information).

IT environment

The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies. For the purposes of this ISA (UK):

i. an IT application is a program or a set of programs that is used in the initiation, processing, recording and reporting of transactions or information. IT applications include data warehouses and report writers; and

ii. the IT infrastructure comprises the network, operating systems, and databases and their related hardware and software.

Inherent risk factors

Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be qualitative or quantitative, and include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.

Risk assessment procedures

The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

System of internal control

The system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. For the purposes of the ISAs (UK), the system of internal control consists of five inter-related components:

i. control environment;

ii. the entity's risk assessment process;

iii. the entity's process to monitor the system of internal control;

iv. the information system and communication; and

v. control activities.

Source: ISA (UK) 315:12

Audit objectives

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

In order to identify and assess the risks of material misstatement, ISA (UK) 315 requires the auditor to obtain an understanding of the entity and its environment, and the applicable financial reporting framework and the entity's system of internal control relevant to the preparation of the financial statements.

This section deals with understanding the entity's system of internal control. Obtaining an understanding of the entity and its environment, and the applicable financial reporting framework is dealt with separately in Understanding the entity.

The auditor's understanding of the system of internal control is obtained through performing risk assessment procedures. Risk assessment procedures are required to understand and evaluate each of the five inter-related components of the system of internal control, which are:

- the control environment;
- the entity's risk assessment process;
- the entity's process to monitor the system of internal control;
- the information system and communication; and
- control activities.

The requirement to obtain an understanding of the entity's system of internal control applies even if the auditor is not going to place reliance on the operational effectiveness of controls. These must be documented in accordance with the requirements of ISA (UK) 315, and the design and implementation of controls must be checked.

In addition, the auditor needs to be able to conclude as to whether the client has maintained books and records deemed 'adequate' in accordance with the *Companies Act* 2006 . This will necessitate the auditor obtaining an understanding of the entity's accounting and internal control systems.

In obtaining an understanding of the entity's accounting and internal control systems, the auditor should ensure that the entity's processes and systems are well documented, paying particular attention to control aspects (see Documenting processes, systems and controls).

Controls testing or compliance-based approach

Testing controls, where possible, can lead to a more effective audit with reduced levels of substantive audit work. As the auditor is already required to document the systems and assess the design and implementation of controls to comply with ISA (UK) 315, it may require only a little more time to go one stage further and test the operational effectiveness of the controls. Combining this with substantive analytical procedures can reduce the level of detailed substantive testing.

Understanding the client's business and how the systems work is far more exciting than testing numerous invoices for a substantive test, and can provide the audit team with a more interesting and stimulating approach.

Other benefits of understanding the client's systems, processes and controls

Understanding how a client's systems work will enable the auditor to provide the client with useful commercial feedback on the way the business is run, providing the client with recommendations that can be utilised to ensure that the client remains effective in the marketplace.

The auditor may also identify weaknesses in the client's systems and commercial points can be included in the management letter or management report, highlighting to the client where it could be losing money, or could make more money if the controls were put in place.

It is also possible that a full systems review may be requested by the client, which could lead to further work for the practice.

Risk assessment procedures

ISA (UK) 315:14 requires the auditor to perform the following risk assessment procedures to obtain an understanding of different aspects of the entity and its environment, its applicable financial reporting framework and its system of internal control:

- enquiries of management and of other appropriate individuals within the entity, including individuals within the internal audit function (if the function exists);
- analytical procedures; and
- observation and inspection.

Risk assessment procedures and related activities are covered in further detail in Understanding the entity.

Direct and indirect controls

Controls are embedded within the components of the entity's system of internal control and may be direct or indirect.

Direct controls are those controls that are sufficiently precise enough to prevent, detect or correct misstatements at the assertion level.

Indirect controls are controls that support direct controls, and therefore have an indirect effect on the likelihood that a misstatement will be detected or prevented on a timely basis. The more indirect the relationship between an indirect control and the direct control that is being considered, the less effective that control may be in addressing related misstatements.

The controls in the information system and communication, and control activities components are primarily direct controls.

Controls in the control environment, the entity's risk assessment process and the entity's process to monitor the system of internal control are primarily indirect controls, however some controls may also be direct controls.

Examples of direct and indirect controls are set out in ISA (UK) 315:A147 and A149.

Example – Direct control

The controls that an entity has established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the risks of material misstatement relevant to the existence and completeness assertions for the inventory account balance.

Example – Indirect control

A sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the risks of material misstatement relevant to the completeness assertion for sales revenue. Accordingly, it may be less effective in addressing those risks than controls more directly related thereto, such as matching shipping documents with billing documents.

The control environment

In the *~~Navigate~~ Audit* tools, the Internal control aide-memoire (**C7.1**) is provided to assist in obtaining an understanding of the entity's control environment.

The control environment includes the attitudes, awareness, and actions of management of internal control and its importance within the business. The control environment also includes the governance and management of the entity and sets the tone of an organisation, providing discipline and structure and influencing staff. Having a strong control environment therefore forms the foundation of good internal controls.

ISA (UK) 315:21 requires the auditor to understand the set of controls, processes and structures that address the following elements of the control environment:

- how management's oversight responsibilities are carried out;
- when those charged with governance are separate from management, the independence of, and oversight over the entity's system of internal control by, those charged with governance;
- the entity's assignment of authority and responsibility;
- how the entity attracts, develops and retains competent individuals; and
- how the entity holds individuals accountable for their responsibilities in the pursuit of objectives of the system of internal control.

It is clear that the size and complexity of the entity will affect its implementation of these elements. For example, in smaller, less complex entities there may not be many, if any, layers of management between the staff and directors, and detailed codes of conduct and staff manuals may not exist. The control environment may be more informal in such entities, but its characteristics still set the tone and ethos of the organisation and have an important bearing on control risk.

Once the auditor has obtained an understanding of the elements above, the auditor is required to evaluate whether:

- management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behaviour;
- the control environment provides an appropriate foundation for the other components of the entity's system of internal control considering the nature and complexity of the entity; and
- control deficiencies identified in the control environment undermine the other components of the entity's system of internal control.

Obtaining information about the control environment

Obtaining relevant information about the control environment can be done in several ways, including:

- enquiry of management and staff;
- observation of the actions and decisions of management and staff; and
- inspection of documents such as organisation diagrams, job descriptions, staff handbooks, firm-wide policies and communications to staff.

The information obtained by the second of these methods is likely to increase the longer the client is with the firm. Care therefore needs to be taken when auditing a new client for the first time, where the auditor's experience of the client is very limited.

For some elements, documentary evidence may be limited. For example, a commitment to ethical values is often demonstrated rather than documented. In smaller entities, communication between management and other personnel may be particularly informal. In such situations, the auditor's observations will be important.

Much of the information relevant to understanding the control environment may be in the heads of the partner and manager, who may have worked on the client for the longest time and thus built up detailed knowledge and experience. It is important to document such matters on the file so that they can be fully taken into account when considering risk.

Management's oversight responsibilities

The auditor should understand how management's responsibilities are carried out, such as creating and maintaining the entity's culture and demonstrating management's commitment to integrity and ethical values.

Controls can only be effective where those who create, administer, and monitor them are people of integrity with ethical values. The integrity and ethical behaviour of client staff are those of the organisation as a whole, and are the product of the entity's ethical and behavioural standards or codes of conduct, how they are communicated (e.g. by policy statements or codes of conduct) and how they are reinforced in practice (e.g. action taken by management to remove or reduce incentives and temptations that might prompt staff to engage in dishonest activities).

Independence and oversight of those charged with governance

When those charged with governance are separate from management, the auditor should understand how those charged with governance demonstrate independence from management and exercise oversight of the entity's system of internal control.

The level of involvement of those charged with governance is critical to a strong control environment. Apart from being responsible for the overall oversight of the organisation and its control, other relevant activities undertaken by them include scrutiny of staff's activities, raising and pursuing difficult questions with management and staff and taking suitable action, and oversight of the design and effective operation of whistle blower procedures.

The auditor should consider:

- whether there are sufficient individuals who are independent from management and objective in their evaluations and decision making;
- how those charged with governance identify and accept oversight responsibilities; and
- whether those charged with governance retain oversight responsibility for management's design, implementation and conduct of the entity's system of internal control. This will be influenced by:

- their independence from management and their ability to evaluate the actions of management;
- whether they understand the entity's business transactions; and
- the extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework, including whether the financial statements include adequate disclosures.

Assignment of authority and responsibility

The auditor should understand how the entity assigns authority and responsibility in pursuit of its objectives. This links into the entity's organisational structure. Organisational structures vary widely, but to be effective should suit the needs of the particular organisation, taking into account its size, industry sector and operations, amongst other things.

The auditor should consider:

- key areas of authority and responsibility and appropriate lines of reporting:
- policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties; and
- policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognise how and for what they will be held accountable.

Attracting, developing and retaining competent individuals

The auditor should understand how the entity attracts, develops and retains competent individuals in alignment with its objectives. This will include considering how the entity ensures that individuals have the necessary skills and knowledge to do their assigned job.

Example – Commitment to attracting, developing and retaining competent individuals

ISA (UK) 315 includes the following examples:

- standards for recruiting the most qualified individuals with an emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behaviour. Such standards demonstrate the client's commitment to competent and trustworthy people;
- training policies that communicate prospective roles and responsibilities, including practices such as training schools and seminars that illustrate expected levels of performance and behaviour; and
- periodic performance appraisals driving promotions that demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Accountability

The auditor should understand how the entity holds individuals accountable for their responsibilities in pursuit of the objectives of its system of internal control.

Example – How individuals are held accountable

ISA (UK) 315 includes the following examples:

- mechanisms to communicate and hold individuals accountable for performance of controls responsibilities and implement corrective actions as necessary;
- establishing performance measures, incentives and regards for those responsible for the entity's system of internal control, including how the measures are evaluated and maintain their relevance;
- how pressures associated with the achievement of control objectives impact the individual's responsibilities and performance measures; and
- how the individuals are disciplined as necessary.

Internal audit function

Where the entity has an internal audit function, in understanding the control environment, the auditor should consider how management has responded to the function's findings and recommendations regarding identified control deficiencies relevant to the preparation of the financial statements, including:

- whether and how such responses have been implemented; and
- whether they have been subsequently evaluated by the internal audit function.

Further guidance can be found in Using the work of internal auditors.

The entity’s risk assessment process

In the ~~*Navigate*~~ *Audit* tools, the Internal control aide-memoire (**C7.1**) is provided to assist in obtaining an understanding of the entity’s risk assessment process. Risk Assessment (**C9)**, includes a section on evaluation of the entity’s risk assessment process.

The entity’s risk assessment process is how it identifies and responds to business risks and their consequences. The auditor is required to obtain an understanding of this process and evaluate whether it is appropriate.

The auditor will be interested in how management:

- identifies business risks relevant to the entity’s financial reporting objectives;
- assesses their significance, including the likelihood of their occurrence; and
- decides how to manage those risks.

An example might be the risk of material misstatement due to a significant estimate. Relevant risks may also include both internal and external events and circumstances which adversely affect the entity’s ability to initiate, record, process, and report financial data.

The entity’s risk assessment process can assist the auditor in identifying risks of material misstatement, however, if the auditor discovers material risks which were not identified by the entity’s process they should consider whether there is a weakness which should be reported to those charged with governance and must take this into consideration in their evaluation of the entity’s risk assessment process.

Risks can arise or change due to circumstances, examples of which include:

- changes in the regulatory, economic or operating environment;
- new members of staff;
- new information systems;
- rapid growth of the business, particularly if the expansion is into new products, activities, markets or countries;
- new technology;
- restructurings, including staff redundancies and changes in organisational structure;
- new accounting pronouncements; and
- use of IT.

Although smaller clients may not have formal, structured risk assessment processes, the above issues are still relevant to all organisations. Management may be aware of risks related to these objectives not through a formal process, but through direct personal involvement with employees and outside parties.

Risks not identified by management

Where the auditor identifies further risks of material misstatement that were not identified by management through their risk assessment process, ISA (UK) 315:23 requires the auditor to:

- determine whether any of those risks are of a kind that they expect would have been identified by management and, if so, obtain an understanding of why the entity's risk assessment process failed to identify those risks; and
- consider the implications for their evaluation of the entity's risks assessment process.

Monitoring the system of internal control

In the ~~*Navigate*~~ *Audit* tools, the Internal control aide-memoire (**C7.1**) is provided to assist in obtaining an understanding of the entity's process for monitoring controls.

The monitoring of controls is a process to assess the quality of internal control performance over time to ensure that controls continue to operate effectively, and it requires corrective action to be taken where necessary.

ISA (UK) 315:24 requires the auditor to understand the entity's process for monitoring the system of internal control relevant to the preparation of the financial statements. This includes:

- understanding the entity's monitoring activities and its internal audit function; and
- understanding the sources of the information used to monitor the system of internal control, and the basis upon which management considers this information to be sufficiently reliable.

The auditor should then evaluate whether the entity's process for monitoring the system of internal control is appropriate to its circumstances, considering the nature and complexity of the entity.

Insight – Monitoring processes in less complex entities

Smaller, less complex entities may have no formal process for monitoring the system of internal control. For such entities, the auditor may consider understanding the periodic reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements to gain an understanding of the monitoring process.

Monitoring activities

The auditor should understand the entity's ongoing and separate evaluations for monitoring the effectiveness of its controls, and how control deficiencies are identified and remediated.

Ongoing monitoring should be built into the normal recurring activities of management. For example, monitoring the timeliness and accuracy of bank reconciliations prepared by staff.

In many larger organisations, the work of the internal audit function may contribute to the monitoring of controls. However, the monitoring activities of smaller, less complex entities are more likely to be informal and, typically, will be performed as a part of the overall management of the organisation. For example, a key monitoring control in a smaller, less complex, client is the review of management information against budget or forecast. Management's close involvement in the business often means that managers can identify significant variances from expectations and financial reporting inaccuracies.

The entity's monitoring process should encompass both the day-to-day operation of the controls and the overall design of the control system. The auditor should consider:

- the design of the monitoring activities, e.g. whether monitoring is ongoing or periodic;
- the performance and frequency of the monitoring activities;
- the evaluation of the results of the monitoring activities, on a timely basis, to determine whether the controls have been effective; and
- how identified deficiencies have been addressed through appropriate remedial actions, including timely ommunication of such deficiencies to those responsible for taking remedial action.

Where the information used to monitor the controls is taken from the information system itself, the auditor should consider how the entity ensures it is reliable. Guidance on IT related controls can be found in IT systems, risks and controls.

Internal audit function

Where the entity has an internal audit function, the auditor should obtain an understanding of the nature of the internal audit function's responsibilities, its organisational status and the activities performed, or to be performed. This will enable the auditor to understand the role that the internal audit function plays in the monitoring process.

Further guidance can be found in Using the work of internal auditors.

The information system and communication

In the ~~*Navigate*~~ *Audit* tools, the Internal control aide-memoire (**C7.1**) is provided to assist in obtaining an understanding of the entity's information system and communication.

ISA (UK) 315:25 requires the auditor to understand the entity's information system and communication relevant to the preparation of the financial statements.

Information system

ISA (UK) 315:25(a) requires the auditor to understand the entity's information processing activities, including its data and information, the resources to be used in such activities and the policies that define, for significant classes of transactions, account balances and disclosures:

- how information flows through the entity's information system, including how:

- transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated in the general ledger, and reported in the financial statements;
- information about events and conditions, other than transactions, is captured, processed and disclosed in the financial statements;

- the accounting records, specific accounts in the financial statements and other supporting records relating to the flows of information in the information system;

- the financial reporting process used to prepare the financial statements, including disclosures; and
- the entity's resources, including the IT environment, relevant to its information processing activities.

The auditor should then consider whether the entity's information system, along with its communication, appropriately supports the preparation of the entity's financial statements in accordance with the applicable financial reporting framework.

The auditor may obtain an understanding of the information system in various ways, including:

- enquiries of relevant personnel;
- inspection of policy or process manuals or other documentation of the entity's information system;
- observation of the performance of the policies or procedures by entity's personnel; and
- selecting transactions and tracing them through the applicable process in the information system (i.e., performing a walk-through).

The auditor should consider the human resources involved in the entity's information processing and their impact on the integrity of the information system, including:

- the competence of individuals undertaking the work;
- whether there are adequate resources; and
- whether there is appropriate segregation of duties.

Components of the information system

Information systems contain information that make it possible for management to operate, control and report on a business. The transactions that are recorded, processed and reported by the information system are the results of business processes.

This information can relate to operational, financial or compliance matters or a combination of these – for example:

- ***Operational matters*** – production statistics, sales by customer, market share, warranty claims, stock movement reports;
- ***Financial matters*** – management accounts, budgets, cash-flow forecasts, trial balance, debtors' listings, bank reconciliations; and
- ***Compliance matters*** – personnel data, tax information, trading statistics.

Auditors are interested in the information systems that help management produce reliable financial statements. These consist of the activities and policies, and accounting and supporting records, designed and established to:

- initiate, record and process entity transactions (as well as to capture, process and disclose information about events and conditions other than transactions) and to maintain accountability for the related assets, liabilities and equity;

- resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- process and account for system overrides or bypasses to controls;
- incorporate information from transaction processing in the general ledger (e.g., transferring of accumulated transactions from a subsidiary ledger);
- capture and process information relevant to the preparation of the financial statements for events and conditions other than transactions, such as the depreciation and amortisation of assets and changes in the recoverability of assets; and
- ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarised and appropriately reported in the financial statements.

There may be an overlap between the purposes for which the information is used. For example, auditors will review the sales system to identify how dispatches of sales are recorded and processed for the purposes of the financial statements, while the client may review the reports produced from the sales system to look at sales by customer for production purposes.

Types of information system

An information system can be defined as any of the following:

- **formal** – for example, IT-based accounting systems processing data;
- **informal** – for example, conversations with suppliers, regulators and customers (credit control);
- **routine** – for example, sales and purchases recording; or
- **one-off** – for example, market research initiatives, estimating provisions at the year end.

Whatever the nature of the system, auditors need to understand and evaluate its likely effectiveness in communicating information to management as part of the overall control of the business.

Business processes

Business processes result in the transactions that are originated, recorded, processed and reported by the information system. Appendix 3.16 to ISA (UK) 315 sets out that an entity's business processes include the activities designed to:

- develop, purchase, produce, sell and distribute an entity's products and services;
- ensure compliance with laws and regulations; and
- record information, including accounting and financial reporting information.

Identifying the key business processes to document

In order to identify the key business processes to be documented, the following steps should be considered:

- identify the significant account balances displayed in the financial statements (using prior knowledge of the business);

- consider the underlying nature of the transactions (routine, non-routine or accounting estimates); and
- identify the client's procedures that process these transactions.

When deciding what to document, the auditor needs to consider what is important for the business rather than just focusing on large numbers in the financial statements.

Example – Key business processes

If the client was a consultancy business, a key business process would be wages and salaries. Not only is this a large expense in the financial statements but a key factor in controlling the business and productivity, as such a business is a service-based industry.

Key business processes will often include those for recording sales, purchases, fixed assets, stock, wages and salaries.

It should also be noted that it does not matter whether the client's information system is manual or automated; it should still be documented and understood.

Many clients will operate processes that are not relevant to the preparation of the financial statements and therefore – in accordance with ISA (UK) 315 – need not be considered.

Documentation

Whatever documentation method auditors use, in order to confirm the auditor's understanding of the information they have been given, they should include the following elements in their documentation:

- initiation of the transaction;
- processing; and
- accounting records.

Initiation of the transaction

A transaction is any event (sale, purchase, cash receipt), between the client and a third party, which needs to be included in the financial statements. Each party to the transaction receives something from the transaction – for example, purchase of some goods for the customer and cash receipt for the client.

At the initiation stage, the information needed will include date, party, quantity and sometimes price. This will be the minimum information used to record the transaction in the system. This stage of the process can be split into the following three parts:

- ***data capture*** – no transaction has occurred but information has been processed (for example, a purchase order);
- ***initiation*** – for example, goods are received and checked and a goods received note is completed; and
- ***data entry*** – for example, the goods received note details are entered onto the system to be matched with the invoice when sent from the supplier.

Processing

Processing considers how the system gathers all the information about individual transactions and combines this information into accounting records. It is particularly important that this area is considered and recorded. The auditor must understand how the processing function works in order to be able to audit it efficiently.

Accounting records

The auditor should review the information produced and consider whether it is sufficient to produce the accounting records.

Other areas requiring special attention

The client's procedures for consolidation and obtaining appropriate information in respect of pension scheme surpluses or deficits should also be documented, where relevant.

Communication

Communication involves providing an understanding of individual roles and responsibilities relevant to the entity's system of internal control. Communication may be via policy, accounting and financial reporting manuals, electronically, orally and through the actions of management.

ISA (UK) 315:25(b) requires the auditor to understand how the entity communicates significant matters that support the preparation of the financial statements and related reporting responsibilities in the information system and other components of the system of internal control:

- between people within the entity, including how financial reporting roles and responsibilities are communicated;
- between management and those charged with governance; and
- with external parties, such as those with regulatory authorities.

The auditor should evaluate whether the entity's information system and communication appropriately support the preparation of the financial statements.

Control activities

In the ~~*Navigate*~~ *Audit* tools, the Internal control aide-memoire (**C7.1**) includes a section on understanding the control activities of the entity.

The control activities component includes the specific individual controls that are designed to ensure the proper application of policies in all other components of the entity's system of internal control. They are the policies and procedures that help ensure that management's wishes are carried out. The auditor is required to identify the controls that address the risks of material misstatement at the assertion level, and then evaluate their design and implementation.

Identifying controls

Controls within the control activities component include information processing controls and general IT controls, which may be automated or manual and can be used by both management and staff at various stages in the process.

In order to understand the controls within an entity's control activities component, the auditor considers how a particular activity, individually or in conjunction with others, prevents, detects or corrects a material misstatement.

Types of controls

Controls include policies and procedures relating to the following:

- authorisations and approvals;
- reconciliations;
- verifications (e.g. validation checks of automated calculations);
- physical or logical controls; and
- segregation of duties.

Authorisation and approvals

Authorisations affirm that a transaction is valid and typically take the form of an approval by management, or of an automated verification that the transaction is valid.

Example – Automated approval

An example of an automated approval is given in Appendix 3:20 to ISA (UK) 315.

When an invoice unit cost is automatically compared with the related purchase order unit cost within a pre-established tolerance level. Invoices within the tolerance level are automatically approved for payment. Those invoices outside the tolerance level are flagged for additional investigation.

Reconciliations

Reconciliations compare two or more data elements. If differences are identified, action is taken to bring the data into agreement. Reconciliations generally address the completeness or accuracy of processing transactions.

Verifications

Verifications compare two or more items with each other or compare an item with a policy, and will likely involve a follow-up action when the two items do not match or the item is not consistent with policy. Verifications generally address the completeness, accuracy, or validity of processing transactions.

Physical or logical controls

These activities encompass the physical security of assets, including against unauthorised access, acquisition, use or disposal. The extent to which physical controls intended to prevent theft of assets are relevant to the financial reporting and will depend on the susceptibility of those to misappropriation, as well as their materiality.

Example – Physical or logical controls

Examples include limiting access to assets, records, computer programs and data files, and periodic counting of cash or stock.

Segregation of duties

This should reduce the opportunities for any one person to be in a position to both perpetrate and conceal errors or fraud in the normal course of their duties.

Example – Segregation of duties

Examples include:

•bank reconciliations are prepared and reviewed by two independent individuals; and

•purchase orders must be approved by an assigned individual who is independent of the preparer.

Identifying controls

To identify the controls that address the risks of material misstatement at the assertion level, the auditor should consider:

- controls that address a significant risk;
- controls over journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments;
- controls for which the auditor plans to test operating effectiveness;
- other controls the auditor considers appropriate, based on professional judgement. These might include:

- controls that address risks assessed as higher on the spectrum of inherent risk but have not
- been determined to be a significant risk;
- controls related to reconciling detailed records to the general ledger; or
- complementary user entity controls, if using a service organisation (see Service organisations).

Examples of controls addressing risks at the assertion level can be found here.

Controls that address a significant risk

ISA (UK) 315:A158 sets out that regardless of whether the auditor plans to test the operating effectiveness of controls that address significant risks, the understanding obtained about management's approach to addressing those risks may provide a basis for the design and performance of substantive procedures responsive to significant risks as required by ISA (UK) 330.

Risks relating to significant non-routine or judgemental matters are often less likely to be subject to routine controls, however, management may have other responses intended to deal with such risks, such as:

- controls, such as a review of assumptions by senior management or experts;
- documented processes for accounting estimations; and
- approval by those charged with governance.

Assessed risks of material misstatement due to fraud are treated as significant risks. ISA (UK) 240 requires the auditor to understand controls related to significant risks due to fraud, and further explains that it is important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud.

Controls over journal entries

It is important to identify controls over journal entries because the way in which information is incorporated from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or non-standard, or automated or manual. Journal entries may be susceptible to unauthorised or inappropriate intervention or manipulation.

In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. In automated general ledger and financial statement preparation systems, journal entries may exist only in electronic form and may therefore be more easily identified through the use of computer assisted audit techniques (CAATs).

Plans to test operating effectiveness

ISA (UK) 330 requires the auditor to test the operating effectiveness of controls that address risks of material misstatement at the assertion level for which it is not possible to obtain sufficient appropriate audit evidence through substantive procedures alone. As such, when controls exist that address these risks, they must be identified and evaluated.

IT controls

Based on the controls identified, the ISA then requires the auditor to identify the IT applications and other aspects of the entity's IT environment that are subject to risks arising from the use of IT. The auditor should then consider how the entity has responded to risks arising from IT, including how controls within the control activities component have responded to different risks posed by the IT environment, and whether the integrity of the information and security of the data has been maintained. Guidance can be found in IT systems, risks and controls and General IT controls.

Design and implementation of controls

For each control identified, the auditor is then required to:

- evaluate whether the control is designed effectively to
- address the risk of material misstatement at the assertion level; or
- support the operation of other controls; and
- determine whether the control has been implemented by.

See Assessing the design and implementation of controls for guidance.

Reviewing the design and implementation of controls (**C7.2**) is provided in the ~~*Navigate*~~ *Audit* tools to assist with this area.

Manual and automated elements of internal control

An entity's system of internal control is likely to include both manual and automated elements. For smaller, less complex entities, there is likely to be a greater emphasis on manual procedures, but even for some large entities, elements of their internal control system may still rely heavily on manual intervention. The benefits and risks of using automated controls are as follows:

Benefits

An entity is able to:

- consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- enhance the timeliness, availability and accuracy of information;
- facilitate the additional analysis of information;
- enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- reduce the risk that controls will be circumvented; and
- enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases and operating systems.

Risks

- reliance on systems or programmes that are inaccurately processing data, processing inaccurate data, or both;
- unauthorised access to data that may result in destruction of data or changes to data, including the recording of unauthorised or non-existent transactions or inaccurate recording of transactions. Particular risks occur where multiple users access a common database;
- the possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties;
- unauthorised changes to data in master files;
- unauthorised changes to systems or programmes;
- failure to make necessary changes to systems or programmes;
- inappropriate manual interventions; and
- potential loss of data or inability to access data as required.

Manual systems or elements of systems may be more suitable when judgement and discretion are required, such as for:

- large, unusual or non-recurring transactions;
- circumstances where errors are difficult to define, anticipate or predict;
- changing circumstances that require a control response outside the scope of an existing automated control; or

- monitoring the effectiveness of automated controls.

However, manual controls are generally less reliable than automated controls as they rely on people to perform them. Therefore, it cannot be assumed that a manual control has been applied consistently.

If the auditor plans to test the operating effectiveness of an automated control, the auditor should consider whether the operating effectiveness of the related general IT controls that support the functioning of that automated control also need to be tested.

Guidance on the automated elements of control can be found in IT systems, risks and controls and General IT controls.

Limitations of internal control

Internal control, however well designed and implemented, can at best only provide reasonable assurance about achieving an entity's financial reporting objectives. Even automated controls are subject to some human involvement and, therefore, human error. There may have been errors at the programming stage, operatives may input data incorrectly and individuals receiving reports from the system may not understand the purpose of such reports.

In addition, all controls are subject to override by collusion of one or more individuals.

In smaller, less complex entities, formal segregation of duties may be more challenging, and the potential for override of controls by an owner-manager may be greater.

Deficiencies in internal control

Based on the evaluation of each of the five components of the entity's system of internal control, the auditor must determine whether control deficiencies have been identified.

The auditor may determine that some of the entity's policies in a component are not appropriate to the nature and circumstances of the entity, which may be an indicator of control deficiencies.

The effect of control deficiencies on the design of further audit procedures should be considered.

If control deficiencies are identified, the auditor must apply professional judgement to determine whether, individually or in combination, the deficiencies constitute a significant control deficiency.

Example – Significant control deficiencies

ISA (UK) 315:A183 provides examples of circumstances that may indicate a significant control deficiency exists. These include:

- the identification of fraud of any magnitude that involves senior management;
- identified internal processes that are inadequate relating to the reporting and communication of deficiencies noted by internal audit;
- previously communicated deficiencies that are not corrected by management in a timely manner;

- failure by management to respond to significant risks, for example, by not implementing controls over significant risks; and
- the restatement of previously issued financial statements.

Examples of controls

This section gives examples of controls grouped by assertion and by financial statement area. The lists are not exhaustive, but they may give the auditor an idea as to what type of controls to expect.

By assertion

The following are examples of controls that are relevant to the completeness, existence and accuracy assertions and could, if working properly, enable the auditor to reduce the substantive work required over these assertions.

Example – Controls relevant to the completeness, accuracy and existence assertions

Example controls in place:

Completeness

- sequential numbering of goods despatched notes (GDNs) and goods received notes (GRNs);
- sequentially numbered till rolls and cash banked daily;
- exception reports of missing numbers;
- numbered stock sheets at a stocktake;
- matching of invoices to GDNs and GRNs;
- fixed asset numbers;
- numbered job cards followed through the manufacturing process;
- numbers assigned to employees for personnel and payroll purposes; and
- pre-listing and comparison – for example, 12 payments listed compared to 12 payments entered onto the accounting system (batch totals).

Existence

- signed proof of despatch by the customer on receipt of goods;
- sales credits are authorised before despatch;
- goods checked on receipt and a GRN completed and matched to the supplier invoice;
- exception reports of despatch notes producing more than one invoice;
- signed contracts for all employees;

- regular physical inspection of assets owned by the company;
- stock checks carried out on a regular basis;
- purchase invoices are authorised by an appropriate person;
- checking data to master files (for example, stock prices); and
- Authorisation – for example, purchase orders authorised before an order is placed.

Accuracy

- regular review of the customer database to ensure that customer names and addresses are correct;
- price list updated and regularly reviewed for changes;
- payments made are checked against the supporting documentation and authorised;
- employee payroll records are only updated from signed contracts each year following director approval; and
- validity checks are undertaken to ensure, for example, that sales discounts are always within a specific range.

By financial statement area

In the controls section of each financial statement guidance area are example controls which could, if working properly, enable the auditor to reduce the substantive work required in these areas.

- intangible assets and goodwill;
- fixed assets;
- finance leases;
- investment property;
- investments in group and associated undertakings and other investments;
- financial instruments;
- inventory;
- construction contracts;
- debtors and prepayments;
- cash at bank and in hand;
- creditors and accruals;
- loans and borrowings;
- provisions, contingencies and financial commitments;

- defined benefit pension schemes;
- share capital, reserves and statutory records;
- current and deferred taxation;
- income;
- expenditure;
- wages, salaries and other remuneration;
- share-based payments;
- foreign currency, discontinued operations and borrowing costs;
- related party transactions; and
- value added tax.

Assessing the design and implementation of controls

Once the controls relevant to the preparation of the financial statements have been documented, the auditor should assess the design and implementation of those controls. It is important to clearly distinguish between this and the testing of the operational effectiveness of controls.

Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is theoretically capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists (i.e. the information obtained about the systems from discussion with client staff is correct) and that the client is actually using it. However, this will not provide sufficient evidence that the actual operation of the control is effective throughout the period.

Schedule **C7.2** is provided in the *~~Navigate~~ Audit* tools for the review of the design and implementation of controls relevant to the financial statements *(available in templates).* This schedule should be completed on every audit as a review of the design and implementation of controls relevant to the financial statements is required on every audit, even where a substantive approach is being adopted.

The auditor should consider the design of a control before checking whether it has been implemented, as there is little point in checking the implementation of a control that is known to be inherently weak or ineffectual by design. For example, performance of a bank reconciliation at the end of each month would normally be considered a good control. However, if it is only performed in one direction, i.e. outstanding items in the cash book are vouched to bank statements, and not also vice versa, then it is not a well-designed control.

Suitable procedures to test the design and implementation of controls may include:

- inquiring of entity personnel;
- observing the application of specific controls;
- inspecting documents and reports; and
- tracing transactions through the information system.

ISA (UK) 315:A177 is explicit in stating that inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented. Therefore wherever inquiries are made of the client's staff in connection with the design and implementation of controls, additional audit procedures must be undertaken as well.

One popular way to approach the testing of the design and implementation of controls is to summarise a list of key controls and test them individually. This tends to work well for smaller, less complex, clients where there are relatively few controls to check.

Many firms use walk-through tests to check the design and implementation of controls. This approach tends to work best for larger clients where there are a number of controls operating throughout each transaction stream, and so each control can be picked up and checked as an item is walked through the system.

When designing and performing walk-through tests, the auditor should consider the following:

- the test should examine whether the document controls are actually operating at each stage, rather than just focussing on following documents through the system. The systems documentation should be reviewed to ensure that the controls that need to be implementation-checked are easy to identify (see Narrative notes);
- one walk-through test per business process or transaction stream is normally sufficient for testing design and implementation of a control;
- the walk-through should cover the whole of each transaction stream. For example, in a sales walk-through, testing should not stop at raising the invoice and reconciling the control account, but should also follow through to cover receipts, banking and credit control procedures;
- the walk-through needs to be documented with enough information to enable another auditor to reperform the tests;
- the auditor should challenge management as to what would happen in different situations, i.e. the usual person who approves an invoice is on holiday. It is helpful to understand any 'work-arounds' which may not be documented on the system notes as this could impact how effective the implementation of the control is;
- it is not essential to sign-off on the implementation of controls before the detailed testing is started. The planning could be signed off subject to testing implementation; and this would then be the first work undertaken on-site and the sign-off would then be updated with the results of the testing. What matters is that the work on implementation of controls is undertaken before the detailed testing in that area.

The design and implementation of internal control will vary from entity to entity and will differ depending on the entity's size and complexity. For smaller, less complex entities, the five components of internal control may be blurred with an owner-manager taking sole responsibility for elements of each of them. Although the components of internal control may not be clearly distinguished in less complex entities, their purpose will still stand.

Testing the operational effectiveness of controls

Under certain circumstances, the auditor may decide to try to place reliance on the controls operating over the client's systems. ISA (UK) 330:8 notes that this is mandatory if:

- the auditor’s assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level (for example, completeness of cash sales).

In order to place reliance on them, the relevant controls of the client must be tested to ensure that they have operated effectively throughout the period under audit. This is **not** the same as checking that controls have been implemented (though it may be more efficient to undertake both types of testing at the same time). Testing the operating effectiveness of controls is often referred to as ‘compliance testing’.

Many firms choose to undertake compliance testing at the same time as the main audit fieldwork, often because the audit planning is being completed in the office and not out on site at the client’s premises. However, if the results of the compliance testing are not successful, the audit approach will almost certainly have to be changed, impacting on the substantive testing. If audit fieldwork has already been started it might result in increased time pressure if staff need to extend substantive samples.

It is generally more efficient to undertake any planned controls testing at the planning stage, which will allow the planning of the audit approach with a greater degree of confidence. However, this often necessitates a visit to the client’s premises. Performing the planning out on site is generally recommended wherever possible. Not only does it allow for such procedures to be completed at the planning stage, it also gives the auditor more visibility and the client may obtain a greater appreciation of how much work goes into the audit.

In the ~~*Navigate*~~ *Audit* tools, all work on testing the operational effectiveness of controls is recorded in the **S section** . If a wholly substantive approach is applied then the S section is not required. Review of the design and implementation of controls that is required on every audit is recorded in the **C section** .

Types of controls tests

The main techniques used to test such controls are:

- observation;
- inquiry;
- inspection; and
- computation.

Observation and inquiry require the checking of information obtained from other sources. The auditor may want to consider performing these tests at different times during the period being audited, as the test only ensures that the test is working when the control is actually observed. This could be considered at the planning stage, during an interim visit or at the stocktake. Alternatively, where a control is computerised, the use of computer assisted audit techniques (CAATs) may provide excellent audit evidence throughout the period. It may even be possible to check every instance of operation of a control using CAATs very quickly, rather than having to select a sample.

It should be noted that – as set out in ISA (UK) 330:A26 – tests of inquiry alone are not sufficient to test the operational effectiveness of controls, and therefore additional procedures should always be carried out.

Sampling

Controls will vary in their frequency of performance – for example, daily reconciliation of the cash sheets to the cash in the till, or monthly bank reconciliations. The number of computations or inspections that the auditor should perform will depend on the frequency of the control and the auditor's judgement, as the types of sampling methodology used for substantive testing of a monetary population (see Sampling and misstatement evaluation) are not usually suitable when testing controls. However, the following table has some rough guidelines.

Frequency of control activity	Suggested sample size
Quarterly	2
Monthly	3
Weekly	5
Daily	15
More frequently than daily (e.g. per transaction)	20–30

Sample sizes for compliance testing need to be carefully thought through in advance, as inappropriately small sample sizes will result in insufficient evidence to justify reliance on the control.

The sample size chosen may also depend on the level of reliance planned. For example, if a lower level of reliance is being placed on a per-transaction control because two other detailed substantive tests will also be performed, then a sample size of 20 may be sufficient. If only one other substantive analytical review test is to be performed in that area and thus a greater level of reliance is being placed on the controls testing to provide sufficient evidence, a larger sample of, say, 30 items may be needed.

It is also important to carefully consider how to apply the sample size to the population. This can be done in a random way – to give every instance of the control operating an equal chance of being selected. However, it may also be beneficial to bias the sample. For example, if testing an authorisation control, it might be worth deliberately testing some items during the relevant director's or staff member's holidays or sick leave, as often this is when controls lapse.

Impact of testing results

Where controls exist, it is worth considering whether it would be more efficient and cost effective to go that additional step beyond the mandatory assessment of design and implementation to actually testing those controls for their reliability. Even the smallest entity is likely to have some controls operating, and the compliance approach can be very effective.

The main advantage of the controls testing or compliance approach is that when the testing is successful, the amount of additional substantive testing can usually be reduced, a benefit that is considered further in Sampling and misstatement evaluation.

An additional benefit is that such controls need only be tested every three years, provided the auditor has checked that the area is not high risk and that there have been no changes to those controls in those years. If there have been changes, the auditor could not rely on the testing that was performed in previous years and would have to test those controls for the period under audit.

If any instances of a control not operating properly are identified, the auditor should consider:

- the reason for the error, and whether it is possible to conclude if it was systematic, recurring or isolated;
- any impact on the system itself;
- the implications for the audit, particularly the risk assessment (see Assessing risk) and resulting audit approach (see Determining the audit approach);
- whether further testing is required; and
- the need to report to management.

Compliance testing is usually done early in the audit process. If the auditor discovers significant weaknesses in controls, the sooner that management is informed and the sooner that any changes required can be actioned. This may necessitate sending an interim report to management at the planning stage. Reports to management are considered further in Reports to management.

Concluding on reliance on controls

Where the auditor has evaluated the operating effectiveness of controls, the auditor needs to conclude whether or not the controls are sufficient to enable the company to prepare financial statements that show a true and fair view as required by the *Companies Act*.

In many instances, particularly for smaller, less complex entities, the auditor may conclude that there are no controls that can be relied upon for audit purposes. In such cases the auditor should still consider whether any controls could be introduced which could provide additional audit comfort and/or enable the client to maintain more effective control over the business.

Documenting processes, systems and controls

The audit file should contain a record of the entity's business processes, systems and controls relevant to the preparation of the financial statements.

The easiest way to document key business processes and controls is to start from the final figures included within the financial statements, and work back to the initiating transaction. This approach ensures that only necessary information is documented. For example, if the auditor started from a dispatch note, there may be several copies that are sent to different places. The auditor is interested in the copy sent to the accounts department to raise the invoice. By working from the sales account and tracking back to the dispatch note, the auditor will immediately identify the documents used for the accounting records.

The documentation of the entity's key business processes and controls is usually most effectively documented as narrative notes, diagrams and flowcharts. These can either be used individually or in conjunction with each other, depending on the size and complexity of the client and the preferences of the auditor.

Questionnaires can be useful in helping the auditor gain an understanding of the overall system. However, these should be used only as an aide memoire and the auditor should ensure that sufficient consideration is given to their completion, with care taken to ensure that all aspects of the client's key business processes and controls are covered.

Narrative notes

Narrative notes are usually sufficient for smaller, less complex clients. When documenting the accounting system, the auditor’s notes will need to include:

- a brief description of the key business processes;
- a description of the controls at each stage of the process; and
- a walk-through or other testing to confirm the auditor’s understanding (see also Assessing the design and implementation of controls).

The notes should:

- be clear and concise;
- be easy to review; and
- lay out the controls in a logical manner.

A two-column approach can work well, with the systems notes in the left-hand column and details of the controls operating at each stage in the right-hand column. Some firms use a four-column approach, with additional columns for risks identified and points for the letter of comment, which ties in the systems notes directly with the risk assessment. Key controls should be clearly highlighted in the notes.

Flowcharts

Flowcharts can be a useful and efficient approach to documenting a system, particularly for larger or more complicated clients. The same points will need to be considered as for narrative notes, as follows:

- the chart should be clear and concise;
- standard symbols and shapes should be used where possible. Where standard symbols and shapes are not used, a key should be provided;
- controls should be identified and commented upon; and
- the chart needs to be easy to review.

Flowcharts can give a good overview of how the system works, particularly for the person performing the review, and a combination of narrative notes and flowcharts for more complicated areas can be very effective. In practice, these can be produced in Excel or with specific flowcharting software packages.

2.7 IT systems, risks and controls

Quick overview

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

This section covers the IT systems, risks and controls element of this requirement.

The process of understanding the entity's system of internal control is covered in Accounting systems, processes and controls.

This section relates to section **C7.2 and C7.3** in the PCAS-based audit tools.

Scope and definitions

Scope

ISA (UK) 315 deals specifically with the process of obtaining an understanding of the entity's information systems, identifying and assessing IT related risks and designing and implementing appropriate audit responses.

In accordance with ISA (UK) 315, auditors need to understand the risks related to the information systems that help management produce reliable financial statements. IT risks arise through the susceptibility of information processing controls to ineffective design or operation, or risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information) in the entity's information system. This may be due to ineffective design or operation of controls in the entity's IT processes.

The auditor is only required to identify the IT applications and other aspects of the IT environment that are subject to risks for the identified controls in the control activities component i.e., those controls that are relevant to the audit (see Accounting systems, processes and controls). These identified controls are focused on information processing controls that directly address the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information).

From this, the auditor is then required to identify **the related risks arising from the use of IT and the entity's general IT controls that address such risk** (see General IT controls).

The accounting systems are integral to the production of the financial statements and there may be an overlap with other areas of IT, depending on the purposes for which the information is used. For example, auditors will review the sales system to identify how dispatches of sales are recorded and processed for the purposes of the financial statements; while the client may review the reports produced from the sales system to look at sales by customer for production planning purposes and credit control.

The nature and extent of the client's IT systems and information processing will inform the audit approach and the appropriateness of substantive procedures, tests of controls or use of data analytics.

Key definitions

Term	Definition
General information technology controls (GITCs)	Controls over the entity’s IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information (i.e., the completeness, accuracy, and validity of information) in the entity’s information system. Also see the definition of *IT environment*.
IT environment	The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies.
IT application	An IT application is a program or a set of programs that is used in the initiation, processing, recording and reporting of transactions or information. IT applications include data warehouses and report writers.
IT infrastructure	The IT infrastructure comprises the network, operating systems, and databases and their related hardware and software.
IT processes	The IT processes are the entity’s processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations.
Information processing controls	Controls relating to the processing of information in IT applications or manual information processes in the entity’s information system that directly address risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information). Information processing controls may be automated (i.e., embedded in IT applications) or manual (e.g., input or output controls) and may rely on other controls, including other information processing controls or general IT controls. Also known as ‘IT application controls’ or ‘input-processing-output controls’.
Risks arising from the use of IT	Susceptibility of information processing controls to ineffective design or operation, or risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information) in the entity’s information system, due to ineffective design or operation of controls in the entity’s IT processes (see IT environment).
Information policies	Information policies are policies that define the information flows, records and reporting processes in the entity’s information system. Risks to the integrity of information arise from susceptibility to ineffective implementation of the entity’s information policies.
Risk assessment procedures	The audit procedures performed to obtain an understanding of the entity and its environment, including the entity’s internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Significant risk	An identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or that is to be treated as a significant risk in accordance with the requirements of other ISAs (UK).
Databases	Databases store data that is used by the IT applications and interrelated data tables. This data may be accessed directly through database management systems by personnel with the relevant administration privileges.
Operating system	The operating system manages the communications between hardware, IT applications and other software in the network. IT applications and databases may be directly accessed through the operating system.
Network	Networks are used to transmit data and share information, resources and services through common communications links. Typically the network establishes the layer of logical security (enabled through the operating system) to access underlying resources.

Source: ISA (UK) 315

The following table has further definitions that are not defined in the ISAs (UK) but are mentioned in ISA (UK) 315 in relation to IT systems, risks and controls.

IT term	**Definition**
On premise	IT solutions that reside within an organisation's premises and are powered by in-house computer services e.g., in-house server hardware, software licenses and maintenance.
Cloud-based	Cloud-based solutions rely on the internet to connect users to third-party hosted or remote servers that power their applications and make data accessible remotely (via the cloud).
Enterprise Resource Planning (ERP) systems	A single system that delivers integrated management of main business processes and applications, often in real time.
Blockchain technology	A blockchain is a series of linked blocks of information which combine to create a chronological, permanent and immutable database, connected in a chain like sequence. It is held on a distributed network ledger which requires multiple verification before transactions can be finalised.
Robotics	Robotics is the intersection of science, engineering and technology that produces machines, called robots, that substitute for (or replicate) human actions.
Artificial intelligence	Artificial intelligence leverages computers and machines to mimic the problem-solving and decision-making capabilities of the human mind.

Mainframes	A mainframe or mainframe computer is a large powerful computer, usually with a large storage capacity, which can be used by many people at the same time, and which can do very large or complicated tasks.
Client server	A form of computer networking where the data or web application is hosted on a server and accessed by client computers.
Software as a service (SaaS)	A software licensing and delivery model in which software is licensed on a subscription basis and is centrally hosted by a third party. SaaS is also known as 'on-demand software' and web-based/ web-hosted software. Examples of SaaS include Google G Suite, Salesforce, MailChimp or Adobe.
End-user computing tool	An IT tool created using existing databased applications or existing software, such as spreadsheet software and simple databases.
Perimeter layer	Cybersecurity term. Generally understood as a security layer ensuring that both the physical and digital security methods protect a business as a whole. E.g., firewalls that protect the business network against external forces.
Internal network layer	Cybersecurity term. Similar to the perimeter layer, generally understood as who and what devices can access the system. Covers what people and devices can access once inside the system. E.g., Limiting access to parts of the network that are necessary to employees for their job roles, limiting damage and impact where devices are compromised.

Understanding the entity's use of IT

ISA (UK) 315:25 requires auditors to obtain an understanding of the information system and communication relevant to preparation of the financial statements, through performing risk assessment procedures. An entity's use of information technology (IT) is directly linked to this understanding in that it affects the way the information relevant to the preparation of the financial statements is processed, stored, and communicated. As a result, it affects how the entity's system of internal control is designed and implemented.

An entity's system of internal control is likely to involve IT to some extent. The most common examples that would typically be identified in many entities are:

- Information processing applications, desktop and laptop computers, databases and associated operating systems;
- data storage; and
- software applications for core functions including finance and accounting systems, journal posting, client billing, payroll, HR and bank integrations.

Information systems produce reports containing information that make it possible for management to operate, control and report on a business. This information can relate to operational, financial or compliance matters or a combination of these – for example:

- *Operational matters* – production statistics, sales by customer, market share, warranty claims, stock movement reports;
- *Financial matters* – management accounts, budgets, cash-flow forecasts, trial balance, debtors' listings, bank reconciliations; and
- *Compliance matters*- personnel data, tax information, trading statistics.

The use of IT should be appropriately understood in order to develop an understanding of its relevance to the audit, which is outlined in detail throughout this guidance.

IT environment

The IT environment includes all the IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies. ISA (UK) 315 sets out three specific elements within the IT environment: IT applications, IT infrastructure and IT processes, which should be understood as relevant to the audit.

IT applications	An IT application is a program or a set of programs that is used in the initiation, processing, recording and reporting of transactions or information. IT applications include data warehouses and report writers.
IT infrastructure	The IT infrastructure comprises the network, operating systems and databases, and their related hardware and software.
IT processes	The IT processes are the entity's processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations.

Generally, IT benefits an entity's system of internal control by enabling an entity to:

- consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- enhance the timeliness, availability and accuracy of information;
- facilitate the additional analysis of information;
- enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- reduce the risk that controls will be circumvented; and
- enhance the ability to achieve effective segregation of duties by implementing security controls in IT applications, databases and operating systems.

The structure and complexity of the entity's IT environment will vary depending on the nature of the IT applications, infrastructure and processes.

Obtaining an understanding of the entity's IT environment may be more easily accomplished for a less complex entity that uses commercial software and does not have access to the underlying software (source code) to make any program changes. Such entities may not have dedicated IT resources but may have a person assigned in an administrator role for the purpose of granting employee access or installing vendor-provided updates to the IT applications. Specific matters that the auditor may consider in understanding the nature of a commercial accounting software package, which may be the single IT application used by a less complex entity in its information system, include:

- The extent to which the software is well established and has a reputation for reliability;
- The extent to which it is possible for the client to modify the source code of the underlying software to include additional modules (i.e., modifications) to the base software, or to make direct changes to data;
- The nature and extent of modifications that have been made to the software. Although an entity may not be able to modify the source code of the underlying software, many software packages allow for configuration (e.g., setting or amending reporting parameters). These do not usually involve modifications to source code; however, the auditor may consider the extent to which the client is able to configure the software when considering the completeness and accuracy of information produced by the software that is used as audit evidence; and
- The extent to which data related to the preparation of the financial statements can be directly accessed (i.e., direct access to the database without using the IT application) and the volume of data that is processed. The greater the volume of data, the more likely the client may need controls that address maintaining the integrity of the data, which may include general IT controls over unauthorised access and changes to the data e.g. password controls.

ISA (UK) 315 provides two examples where a more complex environment may arise:

1. Entities with multiple legacy IT systems in diverse businesses that are not well integrated resulting in a complex IT environment.

Insight – multiple legacy IT systems

A legacy system is an outdated software or hardware, which is nonetheless still in use. Over time businesses evolve and adapt, which results in legacy systems that may be cost-prohibitive to update and are retained as they still do what they are required, albeit without the capacity for growth and technological advancements towards the latest capabilities and services.

Legacy systems may have been built with obsolete programming language or legacy code. This makes it challenging for data to be migrated, and there may be little documentation about the system or staff/ developers who retain knowledge of its functions. Different specifications of hardware and software may cause problems such as compatibility issues and challenges with upgrading systems. Data security measures may be weak and vulnerable to risk, for example they may use set or unchangeable passwords that leave them susceptible to attackers or knowledgeable insiders.

Where an entity has multiple legacy systems that are poorly integrated and are relied upon as part of the entity's business activities, this exposes the IT environment to risks in relation to security and the stability of the systems, especially if systems are poorly understood and there are outdated security features.

Whilst such an IT environment may be complex, the legacy systems may also be well designed, stable and supported by adequate IT support and controls that address the associated risks. Depending on the extent of the legacy systems and their relevance to the audit, understanding the systems and assessing risks is likely to require the input of IT expertise on the audit.

2. Entities using external or internal service providers for aspects of the IT environment (e.g., outsourcing the hosting of its IT environment to a third party or using a shared service center for central management of IT processes in a group).

Insight – external or internal service providers

Where an entity has ‘outsourced’ aspects of their IT environment, this introduces further complexity into the environment and potential risk. Put simply, by granting third-party access the entity’s data, security, and operations the entity has effectively extended its system of control across to the third party. This may increase the level of inherent risk that the organisation will have to mitigate.

The nature of the IT outsourcing arrangement may range from a fully managed solution with very little setup or maintenance on the entity’s part, to an unmanaged service, where the entity users decide on how to manage the service using the infrastructure provided.

The auditor needs to understand both the nature of the outsourcing, the oversight and controls that apply to the outsourced arrangement, to get a full picture of the IT environment, how it operates and to identify any risks to the audit.

There are also the associated contractual and relationship considerations that will need appropriate management from the entity. Auditors also need to consider ISA (UK) 402 regarding the use of service organisations and how it impacts the audit - for further information see Service organisations.

IT systems and processes

The following areas are required to be documented and reviewed in accordance with ISA (UK) 315 and are likely to include IT.

Information flows and processing

In relation to the significant classes of transactions, account balances and disclosures, auditors need to understand the entity’s information processing activities, including its data and information, the resources used in these activities and any policies that define them. This includes how information flows through the information system e.g., employee expenses

Transactions - How are they initiated? How is information about the transaction recorded, processed, and corrected as necessary? How is this then incorporated into the general ledger and reported in the financial statements?

Other relevant information - How is information about events and conditions other than transactions captured, processed, and disclosed in the financial statements?

Flows of information - The accounting records, specific accounts in the financial statements and other supporting records that relate to the flows of information in the information system

Financial reporting process - The financial reporting process used to prepare the entity’s financial statements, including disclosures, and any accounting software or data services that provide input into the financial reporting.

Resources (including IT environment) - In relation to the above information processing activities, the auditor needs to understand the entity’s resources, including the IT environment, as relevant. The above activities may or may not involve IT, but for entities that are in scope of a financial statement audit it is likely that IT will be a key component of the information flows and the information system. The associated IT environment, relevant controls, IT applications, any related IT risks and the general IT controls to address those risks should be appropriately document understood.

Communication of significant matters

Auditors need to understand and identify how the entity communicates significant matters that support the preparation of the financial statements and related reporting responsibilities in the information system and other components of the system of internal control:

- between people within the entity, including how financial reporting roles and responsibilities are communicated;
- between management and those charged with governance; and
- with external parties, such as those with regulatory authorities;

In larger/more complex entities, this communication may be in the form of formal policy and financial reporting manuals, whereas in smaller entities this may not be the case due to easier manager supervision.

Where IT is a key feature in the communication of significant matters that impact the financial statements, the auditor will need to understand the functioning of the associated IT environment.

Insight: documenting IT systems and processes

During planning auditors need to obtain sufficient understanding of the details of the client's systems in relation to the financial statements. In practice, this will be done through detailed system notes or flowcharts of areas such as purchase to pay, journals, sales, stock, payroll, significant areas and any other aspects of information relevant to the audit.

Where IT systems are involved, flowcharts and diagrams may be more useful to accurately map the flow of information through the systems end to end and identify the components of the system. A 'big picture' system and process mapping exercise should help to clarify exactly how information and data is collected within the system, how it is processed and transmitted and eventually captured in the financial statements. The level of detail required in the audit file will depend on the complexity of the information systems and processes of the client.

It is more efficient to start with the financial statements and work backwards, tracing the flow of the transactions back to source and the IT components that assist with the flow and processing of information through the system. Clients may also have existing process notes and internal process mapping, which auditors can then map to the financial statements and verify through the risk assessment procedures and inquiries. Auditors may also create their own documentation using readily available applications such as Microsoft Visio. Where systems are not already documented or are significant and complex, this is likely to increase the level of resourcing required at the planning stage of the audit and the need to obtain specialist IT input and expertise.

Understanding and documenting the client's systems for information processing forms the basis of the risk assessment and it is important to complete this step in a timely manner, to identify risks and the relevant controls that may be relevant throughout the audit.

Once the relevant systems have been documented, it is important that the auditor updates this information each year to confirm if there have been any changes in the way that the client is processing its data and information, or the associated policies and processes. This would include changes to the relevant personnel and their roles.

Where significant changes have been introduced after the planning and risk assessment stage, the auditor needs to revise their understanding, to assess the impact on the risk assessment and the need for any revisions. Depending on the nature and extent of change an IT expert may be required to help evaluate the impact on the audit.

Identifying IT risks

Under ISA (UK) 315 the auditor needs to obtain an understanding of control activities, through performing risk assessment procedures that address risks of material misstatement at the assertion level – guidance on this is available in Accounting systems, processes and controls. This is also the basis for identifying IT risks.

Based on the control activities that have been identified, the auditor also needs to identify the following that may be subject to risks arising from the use of IT:

1. IT applications
2. Other aspects of the IT environment

Following the above, the auditor also needs to identify:

a. the related risks arising from the use of IT; and

b. the entity's general IT controls (GITC) that address such risks.

ISA (UK) 315 Appendix 5:18 explains risks arising from the use of IT as related to inappropriate reliance on IT applications that are incorrectly processing data such as:

- unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database;
- the possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties;
- unauthorised changes to data in master files;
- unauthorised changes to IT applications or other aspects of the IT environment;
- failure to make necessary changes to IT applications or other aspects of the IT environment;
- inappropriate manual intervention; and
- potential loss of data or inability to access data as required.

Laws and regulations

In addition to IT risks, laws and regulations that may have a direct or indirect effect on the entity's financial statements may include data protection legislation e.g. Data Protection Act. In accordance with ISA (UK) 250 Section A - Consideration of Laws and Regulations in an Audit of Financial Statements considering compliance with such laws or regulations may involve understanding the entity's IT processes and general IT controls that address the relevant laws or regulations.

IT applications and systems

Under ISA (UK) 315, the auditor needs to gather information about the nature and characteristics of the IT applications used, as well as the related supporting IT infrastructure and IT, to assess for risks relevant to the flows of transactions and information processing in the information system.

ISA (UK) 315 sets out some of the matters that the auditor may consider and typical characteristics of IT environments, based on the complexity of IT applications. The guidance covers:

1 Automation and use of data

2 IT applications and infrastructure

3 IT processes

Appendix 5 of ISA (UK) 315 sets out how complex IT environments may include highly-customised or highly-integrated IT applications and may therefore require more effort to understand. Financial reporting processes or IT applications may be integrated with other IT applications. Such integration may involve IT applications that are used in the entity's business operations and that provide information to the IT applications relevant to the flows of transactions and information processing in the information system.

In such circumstances, certain IT applications used in business operations may also be relevant to the preparation of the financial statements. Complex IT environments also may require dedicated IT departments that have structured IT processes supported by personnel that have software development and IT environment maintenance skills. In other cases, an entity may use internal or external service providers to manage certain aspects of, or IT processes within, its IT environment (e.g., third-party hosting).

Automation and use of data

Where the entity is using automated procedures to process data, auditors need to assess the extent to which this applies to consider the level of complexity and risk. The ISA (UK) 315 application guidance sets out that large or complex IT applications (such as Enterprise Resource Planning 'ERP' systems) will typically have the following characteristics:

- extensive and/ or often complex automated procedures
- highly automated, paperless processing

System generated reports

Where an entity relies on system generated reports, the extent to which this introduces risk will depend on the type of logic, including customisation. Complex automated report logic or report-writer software may introduce a greater degree of risk, whereas simple automated logic is more likely in a non-complex setting.

Data entry

Manual data inputs may mean there is less IT risk and complexity, however the greater the number of data inputs and interfaces, the more likely the system is complex.

Interfaces

Auditors should consider how IT facilitates communications between the applications, databases, or other aspects of the IT environment. This includes both internally and externally, as appropriate, through system interfaces. Where there are no automated interfaces and only manual inputs, this would indicate a less complex environment. The greater the number of data inputs and complex interfaces, the more likely this will introduce IT related risks.

Volume and complexity of data

The volume and complexity of data in digital form being processed by the information system is also important to consider. This includes if the accounting records, or other information, are stored in digital form, and the location of this data. Lesser complex entities may have a low volume of data that can be verified manually and is available locally. The more complex and large IT systems will involve a large volume of data or complex data, use of data warehouses, and internal or external IT services providers such as third-party storage or hosting of data.

Insight: Identifying risks in IT applications

Typically, an entity that uses off the shelf IT products and accounting software and has no interfaces or integration between the different IT applications, nor any bespoke report writing abilities, has a non-complex system. In such instances, auditors are nonetheless required to document their understanding of the system as part of the risk assessment process, to confirm there are no relevant risks to the audit.

For example, in non-complex IT environments users may share a single log-on to the journal entry system or receive approvals for manual journals offline. This will impact the reliance that can be placed on IT controls for manual journals, which may be used as a risk factor in journal testing – as such the auditor will need to consider whether other procedures are required.

IT applications and infrastructure

Appendix 5 of ISA (UK) 315 sets out qualities of applications and infrastructure that are useful for auditors to understand and consider as part of the audit risk assessment.

Customised applications

The degree of customisation an application has will determine the degree of complexity. A purchased application with little or no customisation is typically non-complex and depending on the degree of integration with applications and customisation, can lean towards greater complexity. Custom developed applications or more complex Enterprise Resource Planning ‘ERP’ systems with significant customisation are likely to be on the larger and more complex end.

Emerging technologies

Where an entity is using emerging technologies (e.g., blockchain, robotics or artificial intelligence), auditors should understand whether these impact its financial reporting and how they are operating. Generally, the use of emerging technologies indicates a more complex environment that may be subject to risks arising from use of IT.

IT infrastructure

Auditors should ensure they understand the complexity of the nature of the IT application and underlying IT infrastructure. A small, simple laptop or client server-based solution will indicate a less complex infrastructure. Mature or stable ‘mainframes’, small or simple client servers, or software as service (SaaS) cloud solutions can indicate greater complexity and may involve larger or complex IT infrastructures.

Third-party hosting / outsourcing

Third-party hosting or outsourcing of IT is important to consider when obtaining an understanding of the client’s IT system. Where there is third-party hosting or outsourcing of IT, auditors should consider the extent to which the provider is competent, mature and proven, which is likely to reduce risks overall. The use of a new or start-up provider for certain applications may introduce further complexity and risks within the IT system.

Example – evaluating IT risks

It can be challenging for auditors to interpret whether a client's IT applications and infrastructure are less complex, and whether there is a need for further IT expertise to assess IT risk. Assessment on a case-by-case basis will be required, and to assist with this ISA (UK) 315 provides suggestions of risks which are detailed in the next section of this guide.

For illustration purposes, consider an example scenario of a lower complexity client, a small to medium sized company based primarily in the UK. Operating as a small group, a single set of IT systems are applied across sites with simple servers and infrastructure located in the UK. This inherently limits the level of scale, risk and complexity in the IT environment of the client. The auditors confirm that accounting estimates and simple models are produced on end-user computing tools such as spreadsheet software, without the use of complex or automated applications.

As this client uses only off the shelf applications with very little customisation it is evaluated as unlikely to have complexity or risk in its applications e.g., an off the shelf finance system, payroll system, expenses system and customer relationship management system. The audit team at planning documented and verified details of the relevant systems and the extent of customisation to ensure this was the case, through inquiries, verification and inspection of specification details and detailed walkthroughs with the IT department.

This client's IT infrastructure includes some software interfaces such as between the payroll and HR system to import and export data, but on understanding the use of IT auditors found that it operated manually rather than via an automated process. They also established that the output of all system reports relevant to financial reporting are manually checked and reconciled back to source documentation at month end, to ensure the accuracy of the data in the system, limiting the level of exposure to IT related risk. IT controls were not identified as relevant as reliance is not placed on automated or bespoke reports to feed into the integrity of the data in the financial statements, but the auditors have considered the design and implementation of relevant processes and controls in place and the functioning of the control environment.

Although the audit team noted that the client's use of IT applications for core functions was relevant to the audit, IT risks were not identified because the applications were from known and established providers, without novel technologies. The audit team found that the IT applications were compliant with relevant information management and security standards, and where the client was using outsourcing the IT team also had contracts with statements of assurance and oversight arrangements.

In the above scenario it is unlikely the audit team would identify risks in relation to IT, for the reasons noted. This conclusion would need to be supported by sufficient appropriate audit evidence and evaluated as part of risk assessment procedures.

System generated reports

System-generated reports that the auditor may intend to use as audit evidence may include a trade receivable aging report, inventory valuation reports and other relevant reports. For such reports, the auditor may obtain audit evidence about the completeness and accuracy of the reports by substantively testing the inputs and outputs of the report. In other cases, the auditor may plan to test the operating effectiveness of the controls over the preparation and maintenance of the report, in which case the IT application from which it is produced is likely to be subject to risks arising from the use of IT.

In addition to testing the completeness and accuracy of the report, the auditor may plan to test the operating effectiveness of general IT controls that address risks related to inappropriate or unauthorised program changes to, or data changes in, the report.

Some IT applications may include report-writing functionality within them while some entities may also use separate report-writing applications (i.e., report-writers). In such cases, the auditor may need to determine the sources of system-generated reports (i.e., the application that prepares the report and the data sources used by the report) to determine the IT applications subject to risks arising from the use of IT.

End-user computing outputs

Although audit evidence may also come in the form of system-generated output that is used in a calculation performed in an end-user computing tool (e.g., spreadsheet software or simple databases), ISA (UK) 315 Appendix 5:14 confirms that such tools are not identified as IT applications. However, there may be situations where the spreadsheet qualifies as a complex model, and the relevant controls and inputs will need to be assessed, particularly for complex accounting estimates. Further guidance can be found in Accounting systems, processes and controls and Auditing accounting estimates.

Example risks from IT applications

ISA (UK) 315 sets out useful examples of situations where IT applications are unlikely and likely to be subject to risks arising from IT. It is important to note that all examples are for guidance purposes only, as such characteristics are directional and may differ depending on the nature of the specific IT applications in use by an entity.

Unlikely to be subject to risks:

(a) Standalone applications

If applications are standalone, management is not likely to be relying on general IT controls to process or maintain data, which reduces the scope for IT related risk.

By contrast where applications are interfaced management may be relying on the application system to perform certain automated tasks that the auditor has also identified as relevant.

(b) Volume of data (transactions) is not significant

Where the volume of data is non-significant management is unlikely to place overall reliance on IT controls and this reduces the likelihood of risks arising from IT.

However, if the volume of data is significant, management's reliance on the application to process or maintain data is likely to be significant.

(c) Application functionality is not complex

In this situation, management does not rely on automated controls or other automated functionality. Providing the auditor also has not identified automated controls, the application is unlikely to be subject to IT related risks.

In complex instances, an application may automatically initiate transactions. There may be a variety of complex calculations underlying automated entries.

(d) Each transaction is supported by original hard copy documentation

IT related risk is unlikely where management uses system-generated reports but does not rely on them. If management reconciles reports to hard copy documentation and verifies calculations in reports, this supports the lack of IT related risk. The auditor will directly test the information produced by the entity as audit evidence, rather than the IT application.

IT processes

As part of the risk assessment, auditors should consider the IT processes in place at their client, which is covered in the guidance of Appendix 5 of ISA (UK) 315 and summarised below.

Personnel

The personnel involved in maintaining the IT environment e.g., the number and skill level of IT support managing security and changes to the IT environment are relevant to assessing the level of risk and complexity. Smaller, non-complex environments will typically have few personnel with limited IT knowledge to process vendor upgrades and manage access.

Access rights

The degree to which there are processes to manage access rights is another area to understand. Entities with a single individual with administrative access who manages access rights could be considered non-complex or small. The greater the number of individuals and complexity of processes managed in relation to access rights, the higher the likelihood of large or complex systems that introduce further IT related risks.

Security

The level of complexity in the security over the IT environment, including the vulnerability of applications, databases, and other aspects to cyber risks, is indicative of the scale and complexity of IT risks. Particularly where there are web-based transactions involving external interfaces, auditors should consider the associated risks. A simple on-premise access process with no external web-facing elements is likely to be low in complexity, which will increase depending on the number of web-based applications and the degree to which complex security models are associated. Physical controls will need to be considered too e.g., server rooms being securely locked.

Program changes

Auditors should consider what program changes have been made to the way information is processed in the system, the extent of changes in the period and the way change requests are documented. A non-complex situation would involve commercial software with no source code installed, limiting scope for underlying software program changes. Larger and more complex situations would include changes and development cycles, of a greater magnitude and frequency.

Extent of change in IT environment

The extent of change in the IT environment is important to understand, to identify new aspects of the IT environment, significant changes in IT applications or underlying IT infrastructure. Changes that suggest lower risk and complexity may be limited to version upgrades of commercial software only. Where changes consist of commercial software upgrades, ERP system upgrades or legacy enhancements, these will introduce greater complexity and risk. At the complex end of the spectrum are new and many complex changes, several development cycles each year and heavy ERP customisation.

Changes in systems and data

Where there was a major change, such as data conversion /data migration during the period, auditors should understand the nature and significance of changes made and how the conversion was undertaken. In a non-complex scenario this may have involved software upgrades provided by a vendor and no data conversion features for upgrade. In a moderately complex scenario, the client may have had minor version upgrades for commercial software applications and limited data conversion. In a large or complex scenario, the client will have had a major version upgrade, a new release or have changed platform.

Insight – Evaluating change

Changes to the IT environment and systems during the period do not necessarily mean the engagement is subject to additional IT risks, but it is important to assess the extent of change and the relevance to the financial statements. As the Appendix 5 of ISA (UK) 315 outlines, an off the shelf package undergoing a version upgrade, which does not involve customisation, is unlikely to be deemed complex or risky. However, version upgrades to a non-complex IT system may still pose IT related risks to the audit, as it may have an unintended impact on the function of the finance system or accounts production processes, particularly where it involves major data conversions/ migrations or program changes.

Other aspects of the IT environment

ISA (UK) 315 Appendix 5:16 explains that when the auditor identifies IT applications that are subject to risks arising from the use of IT, other aspects of the IT environment are also typically subject to risks arising from the use of IT.

Other aspects of the IT environment that may be subject to risks arising from the use of IT are:

- databases;
- the operating system;
- the network; and
- in certain circumstances, interfaces between IT applications.

The IT infrastructure includes the databases, operating system, and network.

Databases store the data used by IT applications and may consist of many interrelated data tables. Data in databases may also be accessed directly through database management systems by IT or other personnel with database administration privileges.

The operating system is responsible for managing communications between hardware, IT applications, and other software used in the network. As such, IT applications and databases may be directly accessed through the operating system.

A network is used in the IT infrastructure to transmit data and to share information, resources and services through a common communications link. The network also typically establishes a layer of logical security (enabled through the operating system) for access to the underlying resources.

When IT applications are identified by the auditor to be subject to risks arising from IT, the database(s) that stores the data processed by an identified IT application is typically also identified.

Similarly, because an IT application's ability to operate is often dependent on the operating system and IT applications and databases may be directly accessed from the operating system, the operating system is typically subject to risks arising from the use of IT.

The network may be identified when it is a central point of access to the identified IT applications and related databases or when an IT application interacts with vendors or external parties through the internet, or when web-facing IT applications are identified by the auditor.

Insight – other aspects of the IT environment

As outlined in ISA (UK) 315:A172 sets out that if the auditor has identified IT applications that are subject to risks arising from IT, other aspects of the IT environment (e.g., database, operating system, network) are likely to be identified because such aspects support and interact with the identified IT applications.

Where further IT risks are identified, it will be important to consider if there are general IT controls in place to address the risks across the IT environment, which is outlined in the section on IT controls.

Cybersecurity risk

The auditor's consideration of unauthorised access may include risks related to unauthorised access by internal or external parties (often referred to as cybersecurity risks). Such risks may not necessarily affect financial reporting, as an entity's IT environment may also include IT applications and related data that address operational or compliance needs. It is important to note that cyber incidents usually first occur through what are known as the 'perimeter' and 'internal network' layers (see definitions). These tend to be further removed from the IT application, database and operating systems that affect the preparation of the financial statements.

Accordingly, if information about a security breach has been identified, the auditor ordinarily considers the extent to which such a breach had the potential to affect financial reporting. If financial reporting may be affected, the auditor may decide to understand, and test the related controls to determine the possible impact or scope of potential misstatements in the financial statements or may determine that the entity has provided adequate disclosures in relation to such a security breach.

IT controls

Where risks have been identified, auditors should consider if there are any relevant controls that can be relied upon to address the associated risks. In relation to IT risks, these are typically understood as two different types of controls:

(1) application controls; and

(2) general information technology controls (GITCs).

Application controls are also known as information processing controls, as they apply to the processing of individual applications, and help ensure that transactions occur, are authorised, and are completely and accurately recorded and processed. Examples include checking the arithmetical accuracy of records, numerical sequence checks, and manual follow-up of exception reports.

Circumstances when an application control may address a risk arising from the use of IT may include when the information that may be affected by the general IT control deficiency can be reconciled to external sources (e.g., a bank statement) or internal sources not affected by the general IT control deficiency (e.g., a separate IT application or data source).

GITCs are controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information (i.e., the completeness, accuracy and validity of information) in the entity's information system. ISA (UK) 315 Appendix 5:21 explains that general IT controls are implemented to address risks arising from the use of IT.

Accordingly, the auditor uses the understanding obtained about the identified IT applications and other aspects of the IT environment and the applicable risks arising from the use of IT in determining the general IT controls to identify.

Insight – GITCs versus application controls

It is important to note the distinction between General IT controls (GITCs) and application controls. GITCs are controls over the IT environment, computer operations, access to programs and data, program development and program changes. Example GITCs are provided in Appendix 6 of ISA (UK) 315 and detailed further in the guidance section on General IT Controls.

Information processing controls (IT application controls) do not directly address risks relating to IT. They often involve manual checks between the IT and other sources, e.g.

- Input authorisation – ensuring that data has been properly authorised to input into the application system. For example, signatures on batch forms, online access controls, unique passwords, workstation identification and source documents;
- Batch controls and balancing – looking at the total monetary amount and items and comparing, to ensure that the manual totals agree with computer totals; and
- Data validation and editing procedures – identifying errors, incomplete or missing data and inconsistencies among related data items through checks such as table lookups, existence checks and duplicate checks.

Where end-user computing tools are used such as spreadsheets, designing and implementing controls around access and change to end-user computing tools may be challenging, and such controls are rarely equivalent to, or as effective as, general IT controls. Rather, the auditor may consider a combination of information processing controls, considering the purpose and complexity of the end-user computing involved, such as:

- Information processing controls over the initiation and processing of the source data, including relevant automated or interface controls to the point from which the data is extracted (i.e., the data warehouse);
- Controls to check that the logic is functioning as intended, for example, controls which 'prove' the extraction of data, such as reconciling the report to the data from which it was derived, comparing the individual data from the report to the source and vice versa, and controls which check the formulas or macros; or
- Use of validation software tools, which systematically check formulas or macros, such as spreadsheet integrity tools

Information processing controls rely on similar principles to non IT related controls - further guidance is available in Accounting systems, processes and controls.

Documenting IT processes and controls

When attempting to document the IT processes and controls of a client, the easiest way to do this is to start from the final figures included within the financial statements, and work back to the initiating transaction. This corresponds with understanding the IT systems and processes as relevant to the financial statements.

It is important to accurately obtain and record the relevant details of each application or system to verify details that impact the risk assessment, such as:

- IT system / application name
- Specification – edition, version number or manufacturer

- Data storage details – cloud based or server based and location

Narrative notes are usually sufficient for smaller, more straightforward systems. When completing a manual record of the accounting system, the auditor's notes will need to include:

- a brief description of the key business processes;
- a description of the controls at each stage of the process; and
- a walk-through or other testing to confirm the auditor's understanding (see also Assessing the design and implementation of controls).

The notes should be clear and concise, easy to review and laid out in a logical manner.

Further guidance is available in Accounting systems, processes and controls.

Flowcharts

Flowcharts can be a useful cost-effective approach to documenting a system, particularly for larger or more complicated IT processes. The same points will need to be considered as for narrative notes, as follows:

- the chart should be clear and concise;
- a key should be provided to explain the symbols, especially if the standard symbols are not used;
- controls should be identified and commented upon; and
- the chart needs to be easy to review.

Flowcharts can give a good overview of how the system works, particularly for the person performing the review, and a combination of narrative notes and flowcharts for more complicated areas can be very effective. In practice, these can be produced in Excel or with specific flowcharting software packages.

Questionnaires

Some firms may use questionnaires, which can be useful in helping the auditor gain an understanding of the overall system. However, where questionnaires are used, these should be used as an aide memoire and the auditor should ensure that sufficient thought is put into their completion, with care being taken to ensure that all aspects of the client's key business processes and controls are covered. This may require the auditor making additions and amendments to the standard questions.

Use of experts and specialists

As noted throughout this guidance the entity's use of IT, data analytical techniques, or the nature and extent of changes in the IT environment may be such that specialist skills are needed on the audit, to assist with obtaining the required understanding.

Depending on the client, auditors will need to consider if they can place reliance on the client's own IT department or specialists to obtain the relevant information. However, where assessing complex IT environments, GITCs and IT risks, an auditor's specialist or an IT auditor should be considered, who is sufficiently independent and qualified to make judgements.

For further guidance see Using the work of experts.

Current issues and further resources

Current issues

Emerging technologies

Entities may use emerging technologies (e.g., blockchain, robotics or artificial intelligence) because such technologies may present specific opportunities to increase operational efficiencies or enhance financial reporting. Emerging technologies by their nature are less established and may introduce further complexity into the audit.

When emerging technologies are relevant to the preparation of the financial statements, the auditor may include such technologies in the identification of IT applications and other aspects of the IT environment that are subject to risks arising from the use of IT. Appropriate expertise on emerging technologies will often be appropriate and necessary to identify any associated risks, and to design and perform relevant audit procedures.

While emerging technologies may be seen to be more sophisticated or more complex compared to existing technologies, the auditor is still required to develop an appropriate understanding of the impact on the audit, including identifying IT systems, risks and controls.

2.8 General IT controls

Quick overview

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

This section covers the general IT controls (GITCs) element of this requirement.

The process of understanding the system of internal controls is covered in Accounting systems, processes and controls.

The process of identifying IT related systems, risks and controls is covered in IT systems, risks and controls.

This section relates to section **C7.2 and C7.3** in the PCAS-based audit tools.

Scope and definitions

Scope

ISA (UK) 315 deals specifically with the process of obtaining an understanding of the entity's information systems, identifying and assessing IT related risks and designing and implementing appropriate audit responses.

GITCs are controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information (i.e., the completeness, accuracy and validity of information) in the entity's information system.

Having first identified the IT risks and information processing controls relevant to the audit (see IT systems, risks and controls and Accounting systems, processes and controls) the auditor is then required to identify **the related risks arising from the use of IT and the entity's GITCs that address such risk**. Documentation of the design and implementation is required for any identified GITCs.

ISA (UK) 315 Appendix 5:21 explains that GITCs are implemented to address risks arising from the use of IT. Accordingly, the auditor uses the understanding obtained about the identified IT applications and other aspects of the IT environment and the applicable risks arising from the use of IT, in determining the general IT controls to identify.

Further background on the relevance of IT to audits and guidance on identifying IT related risks is available in IT systems, risks and controls.

Key definitions

Term	Definition

General information technology controls (GITCs)

Controls over the entity’s IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information (i.e., the completeness, accuracy, and validity of information) in the entity’s information system. Also see the definition of *IT environment*.

IT environment

The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies.

IT application

An IT application is a program or a set of programs that is used in the initiation, processing, recording and reporting of transactions or information. IT applications include data warehouses and report writers.

IT infrastructure

The IT infrastructure comprises the network, operating systems, and databases and their related hardware and software.

IT processes

The IT processes are the entity’s processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations.

Information processing controls

Controls relating to the processing of information in IT applications or manual information processes in the entity’s information system that directly address risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information). Information processing controls may be automated (i.e., embedded in IT applications) or manual (e.g., input or output controls) and may rely on other controls, including other information processing controls or general IT controls.

Also known as ‘IT application controls’ or ‘input-processing-output controls’.

Risks arising from the use of IT

Susceptibility of information processing controls to ineffective design or operation, or risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information) in the entity’s information system, due to ineffective design or operation of controls in the entity’s IT processes (see IT environment).

Information policies

Information policies are policies that define the information flows, records and reporting processes in the entity’s information system. Risks to the integrity of information arise from susceptibility to ineffective implementation of the entity’s information policies.

Risk assessment procedures

The audit procedures performed to obtain an understanding of the entity and its environment, including the entity’s internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Significant risk

An identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement

	should that misstatement occur; or that is to be treated as a significant risk in accordance with the requirements of other ISAs (UK).
Databases	Databases store data that is used by the IT applications and interrelated data tables. This data may be accessed directly through database management systems by personnel with the relevant administration privileges.
Operating system	The operating system manages the communications between hardware, IT applications and other software in the network. IT applications and databases may be directly accessed through the operating system.
Network	Networks are used to transmit data and share information, resources and services through common communications links. Typically the network established the layer of logical security (enabled through the operating system) to access underlying resources.
Internal controls over financial reporting (ICFR)	Controls specifically designed to address risks related to financial reporting.

Source: ISA (UK) 315

Further definitions relevant to this subject are available in IT systems, risks and controls.

General IT controls

General IT controls (GITCs) are indirect controls that support IT applications and other aspects of the IT environment. A general IT control alone is typically not sufficient to address a risk of material misstatement at the assertion level, as by their nature the GITC supports the continued effective functioning of the systems and information processing.

The following are examples of how GITCs can apply:

- there are controls to prevent unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. (Note - Particular risks may arise where multiple users access a common database);
- personnel cannot gain access privileges to systems beyond those necessary to perform their assigned duties and without breaking down segregation of duties;
- controls prevent unauthorised changes to data in master files;
- controls prevent unauthorised changes to systems or programs;
- all necessary changes to systems or programs are made on a timely basis;
- there are controls to prevent inappropriate manual intervention;
- controls prevent cyber-attacks and the potential loss of data or inability to access data as required; and

- appropriate back-up and disaster recovery systems are in place.

The nature of the GITCs typically implemented for each of the aspects of the IT environment is also set out in ISA (UK) 315 *Appendix 6 Considerations for Understanding General IT Controls* . A client may use common IT processes across its IT environment or across certain IT applications, in which case common risks arising from the use of IT and common GITCs may be identified.

(a) Applications

GITCs for IT applications will correlate to the nature and extent of application functionality and the access paths allowed in the technology. For example, more controls will be relevant for highly integrated IT applications with complex security options than a legacy IT application supporting a small number of account balances with access methods only through transactions.

(b) Database

GITCs for databases typically address IT risks related to unauthorised updates to financial reporting information in the database through direct database access or execution of a script or program.

(c) Operating system

GITCs for an operating system typically address IT risks related to administrative access, which can facilitate the override of other controls. This includes actions such as compromising other user's credentials, adding new, unauthorised users, loading malware or executing scripts or other unauthorised programs.

(d) Network

GITCs for the network typically address risks related to network segmentation (preventing access to , remote access, and authentication. Network controls may be relevant when an entity has web-facing applications used in financial reporting. Network controls are also may be relevant when the entity has significant business partner relationships or third-party outsourcing, which may increase data transmissions and the need for remote access

GITCs and audit approach

The auditor's understanding of IT risks and GITCs implemented by the entity to address those risks may affect the audit approach in the following ways:

Audit approach	**GITC considerations**
Whether to test the operating effectiveness of controls to address risks of material misstatement at the assertion level;	The ongoing operating effectiveness of an information processing control may depend on certain GITCs that prevent or detect unauthorised program changes to the IT information processing control (i.e., change controls over the related IT application). In such circumstances, the expected operating effectiveness (or lack thereof) of the GITC may affect the auditor's assessment of control risk (e.g., control risk may be higher when such GITCs are expected to be ineffective or if the auditor does not plan to test the GITCs).
The auditor's strategy for testing information produced by the entity that is produced by or involves	When information produced by the entity to be used as audit evidence is produced by IT applications, the auditor may determine to test controls over system-generated reports, including identification and testing of the GITCs that address

information from the entity's IT applications;	risks of inappropriate or unauthorised program changes, or direct data changes to the reports.
The auditor's assessment of inherent risk at the assertion level;	When there are significant or extensive programming changes to an IT application to address new or revised reporting requirements of the applicable financial reporting framework, this may be an indicator of the complexity of the new requirements and their effect on the entity's financial statements. When such extensive programming or data changes occur, the IT application may present risks and GITCs should be considered.
The design of further audit procedures.	If information processing controls depend on GITCs, the auditor may determine to test the operating effectiveness of the GITCs, which will then require the design of tests of controls for such GITCs. If, in the same circumstances, the auditor determines not to test the operating effectiveness of the GITCs, or the GITCs are expected to be ineffective, the associated risks may need to be addressed through the design of substantive procedures. However, the risks may not be able to be addressed when they relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. **In such circumstances, the auditor may need to consider the implications for the audit opinion.**

Example IT risks and GITCs

In ISA (UK) 315, *Appendix 6 Considerations for Understanding General IT Controls* sets out some examples of GITCs that may exist, organised by IT process and the aspects of the environment they apply to. It is important to note that all examples are for guidance purposes only, as such characteristics are directional and may differ depending on the nature of the specific IT applications in use by an entity.

IT operations:

Example Risk	**Example GITC**
Network: The network does not adequately prevent unauthorised users from gaining inappropriate access to information systems.	• Access is authenticated through unique user IDs and passwords or other methods as a mechanism for validating that user are authorised to gain access to the system. Password parameters meet company or professional policies and standards (e.g., password minimum length and complexity, expiration, account lockout) • Network is designed to segment web facing applications from the internal network, where internal controls over financial reporting (ICFR) relevant applications are accessed

	• On a periodic basis, vulnerability scans are performed by the network management team, which also investigates potential vulnerabilities • On a periodic basis, alerts are generated to provide notification of threats identified by the intrusion detection systems. These threats are investigated by the network management team
Data backup and recovery: Financial data cannot be recovered or accessed in a timely manner when there is a loss of data.	• Financial data is backed up on a regular basis according to an established schedule and frequency
Job scheduling: Production systems, programs, or jobs result in inaccurate, incomplete, or unauthorised processing of data.	• Only authorised users have access to update the batch jobs (including interface jobs) in the job scheduling software • Critical systems, programs, or jobs are monitored, and processing errors are corrected to ensure successful completion.

Manage access:

Example Risk	**Example GITC**
User-access privileges: Users have access privileges beyond those necessary to perform their assigned duties, which may create improper segregation of duties.	• Management approves the nature and extent of user-access privileges for new and modified user access, including standard application profiles/roles, critical financial reporting transactions, and segregation of duties. • Access for terminated or transferred users is removed or modified in a timely manner • User access is periodically reviewed • Segregation of duties is monitored and conflicting access is either removed or mapped to mitigating controls, which are documented and tested • Privileged-level access (e.g., configuration, data and security administrators) is authorised and appropriately restricted
Direct data access: Inappropriate changes are made directly to financial data through means other than application transactions.	• Access to application data files or database objects/tables/data is limited to authorised personnel, based on their job responsibilities and assigned role, and such access is approved by management

System settings: Systems are not adequately configured or updated to restrict system access to properly authorised and appropriate users. Production systems, programs, or jobs result in inaccurate, incomplete, or unauthorised processing of data.	• Access is authenticated through unique user IDs and passwords or other methods as a mechanism for validating that users are authorised to gain access to the system. Password parameters meet company or industry standards (e.g., password minimum length and complexity, expiration, account lockout) • The key attributes of the security configuration are appropriately implemented
Application changes: Inappropriate changes are made to application systems or programs that contain relevant automated controls (i.e., configurable settings, automated algorithms, automated calculations, and automated data extraction) or report logic.	• Application changes are appropriately tested and approved before being moved into the production environment • Access to implement changes into the application production environment is appropriately restricted and segregated from the development environment
Database changes: Inappropriate changes are made to the database structure and relationships between the data.	• Database changes are appropriately tested and approved before being moved into the production environment
System software changes: Inappropriate changes are made to system software (e.g., operating system, network, change-management software, access-control software).	• System software changes are appropriately tested and approved before being moved to production
Data conversion: Data converted from legacy systems or previous versions introduces data errors if the conversion transfers incomplete, redundant, obsolete, or inaccurate data.	• Management approves the results of the conversion of data (e.g., balancing and reconciliation activities) from the old application system or data structure to the new application system or data structure and monitors that the conversion is performed in accordance with established conversion policies and procedures

Automated controls

Automated controls are a type of information processing control that may include automated calculations or input, processing and output controls, such as a three-way match of a purchase order, vendor shipping document, and vendor invoice.

The greater the extent of automated controls, or controls involving automated aspects, that management uses and relies on in relation to its financial reporting, the more important it may become for the entity to implement general IT controls that address the continued functioning of the automated aspects of information processing controls. Auditors need to use the understanding obtained about the identified IT applications and other aspects of the IT environment, and the applicable risks arising from the use of IT, to determine the general IT controls to identify.

When the auditor plans to test the operating effectiveness of an automated control, the auditor may also plan to test the operating effectiveness of the relevant general IT controls that support the continued functioning of that automated control to address the risks arising from the use of IT, and to provide a basis for the auditor's expectation that the automated control operated effectively throughout the period.

Example – reliance on IT controls

The auditor may have identified a risk for which substantive procedures alone are not sufficient because of the entity's use of highly-automated and paperless processing of transactions, which may involve multiple integrated IT applications. In such circumstances, the controls identified by the auditor are likely to include automated controls. The entity may be relying on general IT controls to maintain the integrity of the transactions processed and other information used in processing. In such cases, the IT applications involved in the processing and the storage of the information are likely subject to risks arising from the use of IT.

Ineffective GITCs

When the auditor expects GITCs to be ineffective or they are found to be deficient, this determination may affect the auditor's assessment of control risk at the assertion level. Further procedures may address determining whether:

- the related risk(s) arising from IT has occurred. For example, if users have unauthorised access to an IT application (but cannot access or modify the system logs that track access), the auditor may inspect the system logs to obtain audit evidence that those users did not access the IT application during the period;
- there are any alternate or redundant general IT controls, or any other controls, that address the related risk(s) arising from the use of IT. If so, the auditor may identify such controls (if not already identified) and therefore evaluate their design, determine that they have been implemented and perform tests of their operating effectiveness. For example, if a general IT control related to user access is deficient, the entity may have an alternate control whereby IT management reviews end user access reports on a timely basis. Circumstances when an application control may address an IT risk, may include when the information that may be affected by the general IT control deficiency can be reconciled to external sources (e.g., a bank statement) or internal sources not affected by the general IT control deficiency (e.g., a separate IT application or data source).

If related controls cannot be considered, an auditor's further audit procedures may need to include substantive procedures to address the applicable risks arising from the use of IT. Further guidance about the procedures that the auditor may perform in these circumstances is provided in ISA (UK) 330 and Assessing risk.

In circumstances where the risks relate to IT and they cannot be addressed by substantive procedures alone (e.g. when the entity conducts business using IT and no documentation of transactions is produced or maintained other than the IT system), the auditor should consider the impact of the deficiency of GITCs on the audit opinion (see Drafting the audit report).

Documenting GITCs

When attempting to document the GITCs, IT processes and controls of a client, the easiest way to do this is to start from the final figures included within the financial statements, and work back to the initiating transaction. This corresponds with understanding the IT systems and processes as relevant to the financial statements. The notes should be clear and concise, easy to review and laid out in a logical manner.

Further guidance is available in Accounting systems, processes and controls.

Flowcharts

Flowcharts can be a useful cost-effective approach to documenting a system, particularly for larger or more complicated IT processes. The same points will need to be considered as for narrative notes, as follows:

- the chart should be clear and concise;
- a key should be provided to explain the symbols, especially if the standard symbols are not used;
- controls should be identified and commented upon; and
- the chart needs to be easy to review.

Flowcharts can give a good overview of how the system works, particularly for the person performing the review, and a combination of narrative notes and flowcharts for more complicated areas can be very effective. In practice, these can be produced in Excel or with specific flowcharting software packages.

Questionnaires

Some firms may use questionnaires, which can be useful in helping the auditor gain an understanding of the overall system. However, where questionnaires are used, these should be used as an aide memoire and the auditor should ensure that sufficient thought is put into their completion, with care being taken to ensure that all aspects of the client's key business processes and controls are covered. This may require the auditor making additions and amendments to the standard questions.

Design and implementation of GITCs

Where IT risks have been identified and there are corresponding GITCs to address them, an assessment of the design and implementation of the GITCs is required.

ISA (UK) 315:A177 is explicit in stating that inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented. Therefore wherever inquiries are made of the client's staff in connection with the design and implementation of controls, additional audit procedures must be undertaken as well. Further guidance is provided in Accounting systems, processes and controls.

Schedule **C7.4** is provided *as a template* in the audit tools for the review of the design and implementation of controls relevant to the audit. This form should be completed on every audit as a review of the design and implementation of controls relevant to the audit is required on every audit, even where a substantive approach is being adopted.

Operational effectiveness of GITCs

Under certain circumstances, the auditor may decide to try to place reliance on the GITCs operating over the client's systems. GITCs that are typically identified can support the operating effectiveness of other information processing or automated controls that are relied upon, or they play a role in maintaining the integrity of information used in financial reporting, such as system-generated reports.

ISA (UK) 330:8 notes that assessing the operational effectiveness of controls is mandatory if:

- the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level (for example, this may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system). For further guidance see Determining the audit approach.

Further guidance on testing for operational effectiveness is provided in Accounting systems, processes and controls.

In PCAS tools, all work on testing the operational effectiveness of controls is recorded in the S section. If a wholly substantive approach is applied then the S section is not required. Review of the design and implementation of controls that is required on every audit is recorded in the C section.

Use of experts and specialists

GITCs and the complexity in the IT environment may be such that specialist skills are needed on the audit, to assist with obtaining the required understanding.

Depending on the client, auditors will need to consider if they can place reliance on the client's own IT department or specialists to obtain the relevant information. However, where assessing complex IT environments, GITCs and IT risks, an auditor's specialist or an IT auditor should be considered, who is sufficiently independent and qualified to make judgements.

For further guidance see Using the work of experts.

2.9 Preliminary analytical procedures

Quick overview

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to the preliminary analytical procedures (C5) schedule in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* details the types of audit risk assessment procedures, including analytical procedures.

ISA (UK) 520 (Updated May 2022) *Analytical Procedures* provides guidance on analytical procedures at all stages of the audit.

This guidance focuses on preliminary analytical procedures, which are analytical procedures conducted as part of the audit risk assessment at the planning stage of the audit. The remaining risk assessment process can be found in Assessing risk. Analytical procedures performed to obtain evidence during the execution stage of the audit are covered in Substantive analytical procedures and final analytical procedures at the completion stage of the audit are covered in Preparing the file for review.

This section looks at:

- why analytical procedures are performed as a risk assessment procedure; and
- the types of analytical procedures the auditor can use.

Key definitions

Term	**Definition**
Analytical procedures	Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.
Data analytics	Analytical procedures can be performed using a number of tools or techniques, which may be automated. Applying automated analytical procedures to the data may be referred to as data analytics.

Risk assessment procedures	The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Source: ISA (UK) 520 , ISA (UK) 315

Why analytical procedures are performed as a risk assessment procedure

Essentially, application of analytical procedures at the planning stage leads to a more effective audit plan.

Such procedures enable the auditor to identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that indicate matters that may have audit implications. Analytical procedures are performed after the understanding the entity process to ensure inconsistencies can be identified appropriately. This will be done through reviewing the information available, identifying particular areas within the financial statements that have changed significantly since the previous year and those areas that are not meeting expectations.

The matters identified during this process will assist the auditors in identifying and assessing the risks of material misstatement. This could mean that these become potentially higher risk areas or areas of the audit to which the auditor will want to pay particular attention. The use of analytical procedures at the planning stage may also indicate aspects of the business of which the auditor is unaware as well as aiding an understanding of how inherent risk factors, such as change, affect susceptibility of assertions to misstatement.

It is important to discuss the results of the preliminary analytical procedures with the client and to obtain any explanations for significant changes that were unexpected. The auditor should substantiate these explanations as part of the audit process and these should be borne in mind when assessing risk. Finally, there should be a conclusion on the preliminary analytical review section of the audit file that addresses whether all unexplained fluctuations have been added to the risk assessment or detailed work programmes or alternatively that there were no such items.

Developing expectations

The main reason for conducting analytical procedures at the planning stage is to identify the figures and ratios that have changed significantly since the previous accounting period. Situations where the auditor would have expected certain figures and ratios to have changed, but where in fact they have not, should also be identified. Therefore, the starting point for an auditor is to ascertain, through personal knowledge of and discussion with the client, what the expectations are for the period in question. Actual performance in key areas can then be compared with those expectations.

Example - Expectations

A typical example would be a company where the auditor knows that an additional site is being used to sell its goods, but where there has been no corresponding increase in the stock figure. This would be an area that should be specifically targeted for investigation during the main audit fieldwork.

As already noted, the benefit from preliminary analytical procedures derives from interpretation of the information available, so that problems and higher risk areas are identified and audit work directed to these more effectively. It is therefore important that consideration around any inconsistencies, ratios or transactions have been documented and professional judgement applied.

Data limitations

Analytical procedures at the planning stage provide a comprehensive assessment when the client produces draft accounts or a reasonably accurate trial balance to audit. Due to clients using accounting software as a standard practice, obtaining this data to perform analytical procedures is achievable. However, draft statutory accounts may not always be available at the planning stage of an audit. In such circumstances, the auditor could look at the client's management accounts instead. The vast majority of audit clients should prepare some sort of management accounts, probably monthly or quarterly.

However, many management accounts are not prepared on the same basis as the statutory accounts, for example:

- some entities only calculate depreciation charges for year-end statutory purposes;
- corporation tax may not have been taken into account for the current period;
- accruals and prepayments may not be calculated, or may be rough estimates only; and
- stock, debtor and warranty provisions may not always be fully updated.

The auditor should therefore determine the basis on which any management accounts have been drawn up, so as to take into account any limitations such as those noted above when analysing the financial performance and position of the entity.

For smaller entities, budgets and management accounts may not be extensive, and performance may be monitored and controlled by less formal means. In such cases, it is suggested that the auditor extracts information from the existing accounting records, such as VAT returns and bank statements, as well as any draft financial statements and then discusses variations with management. For example:

- by reviewing the bank statements, the auditor determines that the company appears to be trading at or around its overdraft limit, then this could indicate a potential going-concern problem; and
- a listing of sales invoices issued or a sales day book; in this instance, the auditor could assess whether or not the sales were on a seasonal basis, consistent with expectations and previous years.

Types of analytical procedures

Analytical procedures that could be performed as a risk assessment procedure include analysis of both financial and non-financial information that could use data aggregated at a high level.

Example – Financial vs non-financial

When comparing financial information, often the trial balance is obtained from the most recent accounting period and compared to the previous period. The expectations developed and assessed against the numbers to determine whether any movements are not in line with expectation. Non-financial information tends to include headcount, inventory days, starters and leavers, etc. Again, an expectation should be developed and then an assessment performed to determine if the data is in line with the company performance and issues for the period.

Insight – Less complex entities

During an audit, including those with less complex business models and processes, and a less complex information system, the auditor may perform a simple comparison of information, such as the change in interim or monthly account balances from balances in the prior periods, to obtain an indication of potentially higher risk areas.

Ratios

The main procedure adopted when conducting analytical procedures at the planning stage will be the calculation of ratios that are relevant to the particular client. Many standard accounts preparation or data analytics packages can present such figures, ratios and variance analysis, comparing them to prior periods and/or budget.

The auditor should aim to calculate key ratios, such as stock turnover and debtor days, as soon as the relevant information becomes available. If the figures and ratios vary significantly from previous periods and this cannot be adequately explained, the risk assessments relating to that particular area need to be revisited and revised wherever necessary.

The following table shows a list of ratios that could usefully be calculated.

Ratio	**How calculated**
Gross profit percentage	(Gross profit/turnover) × 100
Operating profit percentage	(Operating profit/turnover) × 100
Return on capital employed	(Profit after tax/shareholders' funds) × 100
Interest cover	Operating profit/interest payable
Debtor days*	(Trade debtors/credit sales) × 365†
Creditor days*	(Trade creditors/credit purchases) × 365†
Stock turnover	Trade purchases/closing stock
Current ratio	Current assets/current liabilities
Quick ratio	(Current assets – stock)/current liabilities
Gearing	Total borrowings/shareholders' funds

* Both figures should either include or exclude VAT.

† This should be adjusted accordingly where the accounting period is not a year.

It is important that only those ratios that are relevant to the particular business are calculated. Relevant ratios for other entity sectors may be different, e.g. for a property company, the loan to value ratio or the gross rental yield may be appropriate. One approach is to include any ratios that management use to assess the financial performance of the entity (see Performance measures used by management).

It should also be remembered that useful information can be obtained by comparing the results to industry statistics and other sources external to the business, as well as to internally prepared figures. Other procedures can involve the reconciliation of non-financial to financial data. For example, the average number of employees can be reviewed to assess whether or not the wages charge is reasonable.

Substantive analytical procedures

Preliminary analytical procedures may give an indication as to whether using substantive analytical procedures as part of the audit approach will be effective.

Insight – Reflection on approach

If the auditor is unable to understand the broad movement in the wages and salaries figure at the planning stage, a payroll proof in total may not be the most effective way to audit this figure at the fieldwork stage.

Note that preliminary analytical review procedures are not sufficient to be used as audit evidence. Substantive analytical procedures as explained in ISA (UK) 520 (Revised June 2016) and discussed in more detail in Substantive analytical procedures, are much more detailed. They need to be performed in addition to the preliminary procedures in order to reduce the sample sizes for substantive testing. The main objective at the preliminary stage is to help identify risks and direct audit work to the key areas.

Data analytics

Depending on the level of sophistication of the client’s accounting systems, and the expertise of the audit teams, the auditor may wish to make use of data analytics to perform some of these preliminary analytical procedures.

Insight – Appropriate data analytic methods

The auditor may use a spreadsheet to perform a comparison of actual recorded amounts to budgeted amounts, or may perform a more advanced procedure by extracting data from the entity’s information system, and further analysing this data using visualisation techniques to identify classes of transactions, account balances or disclosures for which further specific risk assessment procedures may be warranted.

2.10 Assessing materiality

Quick overview

The objective for the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

This section relates to *Materiality* schedule C6 in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

ISA (UK) 320 (Revised June 2016) (Updated May 2022) *Materiality in Planning and Performing an Audit* is effective for the audit of financial statements for periods commencing on or after 17 June 2016.

ISA (UK) 450 (Revised June 2016) (Updated May 2022) *Evaluation of Misstatements Identified during the Audit* is effective for periods commencing on or after 15 December 2017.

Materiality considerations in the context of a group audit engagement are also considered in ISA (UK) 600 (Revised November 2019) (Updated May 2022) *Special Considerations – Audits of Group Financial Statements* (see Consolidation and groups).

Key definitions

Term	Definition
Misstatement	A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgement, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.
Performance materiality	The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Source: ISA (UK) 320:9 and ISA (UK) 450:4

Purpose of materiality

Paragraph 11(a) of ISA (UK) 200 (Revised June 2016) (Updated May 2022) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)* states that the overall objectives of the auditor are:

‘To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.’

In order to consider whether the financial statements are free from material misstatement and whether they are in all material respects in accordance with an applicable accounting framework therefore requires some assessment as to what is material and what is not.

ISA (UK) 320:2 states:

‘Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgements about materiality are made in light of the surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both. Judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.’

This definition refers to users of the financial statements so we should also look at how materiality is defined in the FRS 102 glossary, which is very similar.

‘Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.’

It is therefore usually appropriate when assessing materiality to consider who, other than the addressees of the audit report (the members), will use the financial statements. For a private company, this might include the bank, providers of grant funding or HMRC.

In the planning flow chart in Planning overview, the initial assessment of materiality is shown at around the same time as the preliminary analytical procedures. This is in order to help judge the relative importance of figures, ratios and variances identified, as well as to judge the materiality of misstatements which may arise from the risks identified at the risk assessment stage, and hence the relative importance of those risks.

However, ISA (UK) 320 does not just require a single level of materiality for the financial statements as a whole, the auditor must also:

- set a level for performance materiality;
- set a level for what should be regarded as trivial;
- consider the need for specific levels of materiality for specific balances, classes of transaction or disclosure; and
- revise the materiality calculations above, if required.

Materiality in the audit

The concept of materiality is applied by the auditor in both planning and performing the audit and when evaluating the effect of identified misstatements on the audit as it progresses. Materiality judgements are also used when considering the effect of any uncorrected misstatements on the financial statements.

In planning the audit, the auditor makes judgements about misstatements that will be considered material. These judgements provide a basis for:

- determining the nature, timing and extent of risk assessment procedures;
- identifying and assessing the risks of material misstatement; and
- determining the nature, timing and extent of further audit procedures.

As well as quantitative misstatements, the auditor also needs to be aware of qualitative misstatements. For example, an inadequate description of an accounting policy which would mislead users of financial statements is material to those users. The auditor should remain alert for possible bias in management judgements, particularly in relation to the entity's accounting practices. A misstatement may also arise due to the omission of a disclosure needed for the financial statements to achieve a fair presentation beyond those disclosures specifically required by the accounting framework.

Similarly, an identified fraud or suspected fraud by a key member of management may be considered material even if the potential misstatement is less than materiality determined in quantitative terms for the financial statements as a whole.

Other relevant factors may include:

- the circumstances of the entity for the period (e.g. the entity may have undertaken a significant business combination during the period);
- the applicable financial reporting framework, including changes therein (e.g. a new financial reporting standard may require new qualitative disclosures that are significant to the entity); and
- qualitative disclosures that are important to users of the financial statements because of the nature of an entity (e.g. liquidity risk disclosures may be important to users of the financial statements for a financial institution).

Use of benchmarks in determining materiality

ISA (UK) 320 application material explains that determining materiality involves the exercise of professional judgement. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

The auditor should first carefully consider which is the most appropriate benchmark to use. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. If profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues. It may also be that gross assets is a more appropriate benchmark for an asset-based company such as a property investment company.

Factors that may affect the identification of an appropriate benchmark include the following:

- the elements of the financial statements (e.g. assets, liabilities, equity, revenue, expenses);
- whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (e.g. for the purpose of evaluating financial performance, users may tend to focus on profit, revenue or net assets);
- the nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;
- the entity's ownership structure and the way it is financed (e.g. if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- the relative volatility of the benchmark.

Adjustments can be made for smaller entities, e.g. when an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant. Charities' income can often fluctuate significantly year on year, so the gross expenses benchmark can be useful, as expenses are often a better indicator of the size and scale of a charity's operations.

Materiality for the financial statements as a whole

The auditor then needs to determine a percentage to be applied to a chosen benchmark. This involves the exercise of professional judgement. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider 5% of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider 1% of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances. The choice of an appropriate percentage is a matter of judgement and may be influenced by the auditor's understanding of the users. For example, a lower materiality percentage may be applied for a company whose shares are publicly traded than for an owner managed business with no external providers of finance.

The example given below ~~is used in the Private Company tool in *Navigate Audit*, however it~~ is not mandatory and firms are free to set their own levels for financial statement materiality but, in doing so, should take care not to set levels of materiality which are either too high or too low.

Measure	**Materiality percentage range**
Turnover	0.5–3%
Profit before tax from continuing operations	5–10%
Adjusted profit/loss	5–10%
Gross assets	1–3%

Net assets	3–10%

Even where the auditor does not have draft financial statements or management accounts available at the start of the audit, it is important that an initial materiality level is set on the basis of what the expected figures are going to be, and not just on last year's figures. Information can be gleaned from such things as the VAT returns, etc. to enable the auditor to set an appropriate level.

Whatever the percentage applied to the benchmark, it is important that the auditor documents why this percentage has been chosen and that they are prepared to adjust the percentage if considered necessary during the course of the audit.

Insight – Link between materiality and assessment of risk

Materiality for the financial statements as a whole is set by reference to the needs of users and the level of misstatement that would influence their decisions. It is therefore not influenced by the auditor's assessment of risk. The procedures performed by the auditor are however influenced by their assessment of the risk that material misstatements may exist which in turn depends on their assessment of materiality. The assessment of materiality helps the auditor to determine the type and extent of testing required to reduce audit risk (the risk that material misstatements exist and are not detected by the audit) to an acceptably low level.

Performance materiality

ISA (UK) 320 defines performance materiality as:

'... the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures,'

and requires the auditor to determine performance materiality at the planning stage.

The application material in ISA (UK) 320 notes that if an audit was planned so that only individually material misstatements were likely to be identified, then this would overlook the possibility of misstatements being material in aggregate. The idea of performance materiality is therefore to provide a margin of safety or buffer to ensure that the risk of the aggregate of both detected and undetected misstatements exceeding materiality is sufficiently low. Typically, it is in the range of 50%–75%, but it should be emphasised that the determination of performance materiality is not a simple mechanical calculation but involves the exercise of professional judgement.

Performance materiality may be set as a single figure for the financial statements as a whole or separately for some or all individual classes of transactions, account balances or disclosures.

Unlike materiality for the financial statements as a whole, performance materiality is directly affected by the auditor's assessment of risk. A high risk of misstatement means that the auditor has a greater expectation of finding errors and, in this situation, it is generally appropriate to use a performance materiality towards the lower end of the auditor's normal range. Conversely, where there is a low expectation of errors, a performance materiality towards the upper end of the range will still leave enough margin within the overall materiality level to allow for the possibility of aggregation risk.

ISA (UK) 530:A3 *Audit sampling* notes that tolerable misstatement (or error) is the application of performance materiality to a particular sampling procedure. Sampling is considered further in Sampling and misstatement evaluation. Many audit systems assess tolerable misstatement when sampling by multiplying materiality by a numerical risk factor which represents a combination of assertion level risk for the item being tested and other evidence obtained.

In the planning flow chart in Planning overview, the assessment of performance materiality is shown separately to the assessment of overall materiality, section-specific materiality and triviality, and at a much later stage in the planning process. This is because performance materiality can only be determined once the initial risk assessment has been completed.

In the case of first time audits, the auditor may set performance materiality lower than normal to allow for greater uncertainty regarding competence of management and the history of misstatements in prior periods.

Triviality

ISAs have always contained the concept of triviality, i.e. that there are some misstatements which are so small and insignificant that, even in aggregate, they will never influence users of the financial statements and hence never be material.

Misstatements classified as clearly trivial do not need to be reported to the client and also do not need to be recorded on a central list on the audit file. The assessment of what is and is not clearly trivial is a matter of professional judgement. ISA (UK) 450 requires the auditor to document the level at which misstatements are considered to be clearly trivial. This is best done at the planning stage.

This therefore raises the question as to what is considered trivial. ISA (UK) 450:A2 defines clearly that trivial matters as those that are ‘of a wholly different (smaller) order of magnitude than materiality’ and are ‘clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances’.

The most common approach is to apply a flat percentage to materiality for the financial statements as a whole. This is typically in the range of 0.5% to 5%, but it should be emphasised that this is a matter of professional judgement, and these ranges may not be applicable to all entities. The key word in the definition above is ‘aggregate’. What may seem insignificant individually may not be so if there are a number of similar sized misstatements which all have the same direction of impact on the profit and loss account. Some firms use a fixed amount for triviality rather than a percentage, which is also acceptable provided that the level set is appropriate.

ISA (UK) 450 goes on to clarify that where there is any uncertainty about whether an item is clearly trivial, the auditor should assume that it is not.

Insight – Clearly trivial

A number of firms have taken the view that it is safer to continue to aggregate all misstatements, regardless of size, on a central list in the first instance, and only then to judge what is and is not clearly trivial. This is a perfectly acceptable approach, but will still necessitate the formal assessment of clearly trivial for client reporting purposes.

Materiality for specific items (‘section-specific materiality’)

As well as requiring the auditor to set an overall level of materiality for the financial statements, ISA (UK) 320:10 permits the auditor to set a different (lower) level of materiality for specific balances, classes of transaction or disclosures. This may be considered necessary if there are items in the financial statements for which misstatements of less than materiality for the financial statements as a whole could reasonably be expected to influence users of the financial statements.

This requires the auditor to consider users and any particular focus they may have when reading the financial statements. The auditor should then judge whether, in that particular context, the user's view of the entity would be impacted if misstatements below the level of overall materiality were not adjusted for. If so, then materiality should be reduced in that area.

Factors that may indicate the need for a reduced materiality include the following:

- Whether users' expectations of an item's measurement/disclosure are affected by law, regulation or the applicable financial reporting framework.
  - For example, related party transactions, and the remuneration of management and those charged with governance, and sensitivity analysis for fair value accounting estimates with high estimation uncertainty.
- The key disclosures in relation to the industry in which the entity operates.
  - For example, research and development costs for a pharmaceutical company.
- Whether part of the entity's business that is separately disclosed in the financial statements attracts focus.
  - For example, disclosures about segments or a significant business combination.

Example – Borrowings secured over fixed assets

An example of 'section specific materiality' would be to reduce materiality for auditing fixed assets where bank borrowings are secured on them and the bank may be influenced by unadjusted misstatements smaller than overall materiality.

Example – Lower level of materiality for profit and loss account items

In a property investment company, where the balance sheet is vastly bigger than the profit and loss account, materiality for the financial statements as a whole would normally be based on gross assets. The auditor could then set a lower level of materiality for profit and loss account items, as often owners and other users are interested in this as well as the balance sheet, but may be less tolerant of misstatements here than in the balance sheet. A similar approach might also be relevant to the audit of a pension scheme.

ISA (UK) 320:A11 also notes that another factor to consider in relation to section-specific materiality is whether law, regulation or the applicable financial reporting framework affects users' expectations regarding the measurement or disclosure of certain items. Many auditors may have subconsciously been reducing materiality in certain areas for this reason for years. For example, there is generally an expectation that the disclosure of directors' remuneration will be virtually spot-on, rather than being accurate only to within the bounds of overall materiality. The auditor may now decide to formally apply a lower level of materiality to the audit of the directors' remuneration disclosure.

Whether or not to apply lower levels of materiality to specific items is a key decision requiring careful consideration, as this will generally increase the amount of audit work in such areas. It is important that the auditor's consideration of this issue is documented on the file. Many audit files leave this section of the audit documentation set blank because section-specific materiality is not being used, but this does not make clear that the issue has been properly considered.

Revision to materiality assessments

Materiality levels are often set initially based on incomplete or estimated figures which are adjusted during the course of the audit, either as part of the entity's normal procedures or as a result of identified misstatements.

ISA (UK) 320 sets out additional guidance in relation to revisions to materiality assessments. If information comes to light during the course of the audit which would have influenced the auditor's assessment of materiality had it been known when materiality was determined, the materiality level (or levels for particular classes of transactions, account balances or disclosures) should be adjusted. The amendment and the reason for it should be clearly documented on the audit file.

In any case, the auditor is required to reassess materiality levels at the conclusion of the audit in the context of the final financial statements.

If materiality levels are lowered, the auditor should consider whether performance materiality should also be decreased. In addition, where misstatements are found during the audit which exceed the auditor's initial expectations, consideration should be given to the need to reduce performance materiality.

Where revisions are made to materiality, the auditor should consider the implications for their audit approach and, if necessary, modify the nature, timing and extent of planned audit procedures. If the auditor's revised assessment results in a lower level of materiality, the auditor may find it necessary to carry out more audit work.

Regulatory findings

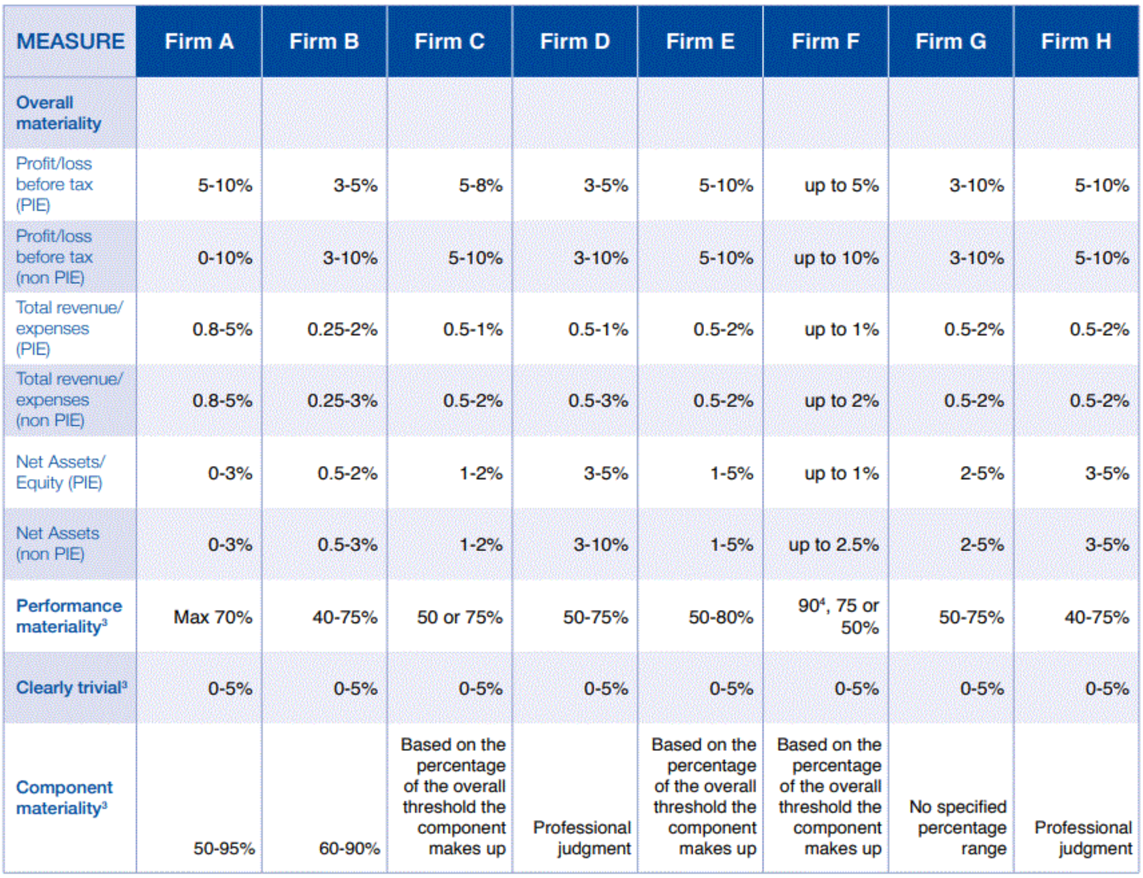
FRC thematic review

In December 2017, the Financial Reporting Council (FRC) issued Audit Quality Thematic Review: Materiality (2017). This followed on from a thematic review on the same topic issued in December 2013. Key points the FRC raised from the review are as follows:

- the FRC was pleased that the majority of the key messages for audit firms in its last report had been addressed by the firms. These included an increase in the emphasis within the firms' methodologies on the application of judgement when determining overall materiality and performance materiality; providing industry-specific guidance for many sectors; and demonstrating the consideration of risk in setting performance materiality;
- three of the audit firms had introduced guidance to encourage audit teams to reduce performance materiality to reflect the increased risk of first year audits;
- audit teams should ensure that if adjusted profit is used as a benchmark, it is a true reflection of the needs of users of the financial statements. If adjusted profit is used, auditors should explain why they have made the adjustments and how the benchmark selected better response to the need of users of the financial statements;
- audit firms should provide audit teams with guidance on setting component materiality including both how to address the relative sizes of components and the particular risks arising in certain components; and

- audit firms should consider how they can better explain the concept of performance materiality in their reports. As one of the influences on performance materiality is the auditor's view of the control environment at the entity, the difference between overall materiality and performance materiality can give investors some insight into this area.

The thematic review noted that most firms have a range of percentages that can be used for each benchmark. Some firms use ranges that are more prudent than others, as can be seen from the below table included in the report.



MEASURE	Firm A	Firm B	Firm C	Firm D	Firm E	Firm F	Firm G	Firm H
Overall materiality								
Profit/loss before tax (PIE)	5-10%	3-5%	5-8%	3-5%	5-10%	up to 5%	3-10%	5-10%
Profit/loss before tax (non PIE)	0-10%	3-10%	5-10%	3-10%	5-10%	up to 10%	3-10%	5-10%
Total revenue/ expenses (PIE)	0.8-5%	0.25-2%	0.5-1%	0.5-1%	0.5-2%	up to 1%	0.5-2%	0.5-2%
Total revenue/ expenses (non PIE)	0.8-5%	0.25-3%	0.5-2%	0.5-3%	0.5-2%	up to 2%	0.5-2%	0.5-2%
Net Assets/ Equity (PIE)	0-3%	0.5-2%	1-2%	3-5%	1-5%	up to 1%	2-5%	3-5%
Net Assets (non PIE)	0-3%	0.5-3%	1-2%	3-10%	1-5%	up to 2.5%	2-5%	3-5%
Performance materiality[3]	Max 70%	40-75%	50 or 75%	50-75%	50-80%	90[4], 75 or 50%	50-75%	40-75%
Clearly trivial[3]	0-5%	0-5%	0-5%	0-5%	0-5%	0-5%	0-5%	0-5%
Component materiality[3]	50-95%	60-90%	Based on the percentage of the overall threshold the component makes up	Professional judgment	Based on the percentage of the overall threshold the component makes up	Based on the percentage of the overall threshold the component makes up	No specified percentage range	Professional judgment

2.11 Fraud in the audit

Quick overview

Under ISA (UK) 240 (Revised May 2021) (Updated May 2022) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements,* the objectives of the auditor are:

- To obtain reasonable assurance that the financial statements as a whole are free from material misstatement due to fraud or error including:
  - identifying and assessing the risks of material misstatement of the financial statements due to fraud;
  - obtaining sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- to respond appropriately to fraud or suspected fraud identified during the audit.

Additionally, ISA (UK) 240 requires greater focus on professional scepticism and the auditor should therefore:

- make enquiries of management or those persons appointed to deal with such allegations whether any allegations of fraud have been raised by employees of other parties;
- be alert to audit evidence which may be contradictory or corroborative as well as for conditions which might indicate that audit evidence may not be authentic;
- consider whether responses from management or those charged with governance to the auditor's enquiries are inconsistent or implausible; and
- stand back, before the final audit conclusion is reached, and evaluate whether sufficient and appropriate audit evidence has been obtained.

This section covers these responsibilities, with specific requirements relating to certain stages of the audit covered in the relevant sections as well as providing links to how ISA (UK) 315 and ISA (UK) 330 are to be applied when assessing risks of material misstatement due to fraud.

The auditor should also assess whether they require specialised skills or knowledge in order to perform the audit.

This section relates to schedules **C9-9.4** and **C10** in the ~~*Navigate*~~ *Audit* tools *incorporated in Checklists, Inherent risk questions, Identified risks and templates within Audit Automation.*

Scope and definitions

Scope

This section covers the responsibilities of the auditor in relation to fraud. Compliance with law and regulations is covered in Consideration of laws and regulations.

ISA (UK) 240 is effective for the audit of financial statements for periods commencing on or after 15 December 2021, early adoption is permitted.

In this ISA (UK) 240 section, the following areas are covered:

- the definition of fraud;
- the responsibilities of those charged with governance;
- the auditor's responsibilities;
- risk assessment procedures;
- identification and assessment of the risks of material misstatement due to fraud;
- responses to the assessed risks of material misstatement due to fraud risk;
- evaluating audit evidence including considerations if the auditor is unable to continue the engagement;
- auditor's reports;
- management representations;
- communication with management and those charged with governance;
- communication with the authorities; and
- documentation.

The May 2022 update to ISA (UK) 240 includes conforming amendments related to ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement.*

ISA (UK) 700 (Revised November 2019) *Forming an Opinion and Reporting on Financial Statements* (Updated January 2020) applies for audits of financial statements for periods commencing on or after 15 December 2019 and includes a requirement for the auditor's report to explain to what extent the audit was considered capable of detecting irregularities, including fraud. 'Irregularity' is not defined, but is deemed to correspond to the definition in ISA (UK) 250A (Revised November 2019) (updated May 2022) Section A - *Consideration of Laws and Regulations in an Audit of Financial Statements* of non-compliance and is therefore broadly based. This requirement previously only applied to auditors' reports in respect of public interest entities but now applies to all audit reports. This is covered in Auditor's reports below ~~and further details can be found in *Navigate Audit* – Audit reports.~~

Key definitions

Term	**Definition**
Fraud	An intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage
Fraud risk factors	Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud

Source: ISA (UK) 240:12

Fraud vs error

The auditor should plan and perform audit procedures to reduce audit risk to an acceptably low level. As part of this process, ISA (UK) 240 requires the auditor to consider the risk of material misstatement in the financial statements due to fraud.

Misstatements can arise from either fraud or error. The main difference between fraud and error is whether the action that resulted in the misstatement was unintentional or whether it was intentional and involves deception.

Fraud

Fraud is an intentional act by one or more individuals amongst management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Although fraud has a wide legal definition, for the purpose of ISA (UK) 240, the auditor is only concerned with fraud that causes a **material misstatement** in the financial statements. These misstatements arise either from fraudulent financial reporting or from misappropriation of assets and can involve both qualitative and quantitative considerations.

Fraudulent financial reporting involves intentional misstatements in financial statements to deceive the users of those financial statements. This type of fraud often involves an incentive or pressure to commit fraud, a perceived opportunity to do so or a rationalisation of the fraudulent act and may be perpetrated through:

- falsification or alteration of records and documents;
- suppression or omission of the effects of transactions from records or documents;
- recording fictitious transactions;
- wilful misrepresentation of transactions or of an entity's state of affairs; or
- intentional misapplication of accounting policies.

Fraud often involves management override of controls by intentionally using such techniques as:

- recording fictitious journal entries, particularly close to the end of the accounting period;
- adjusting certain assumptions made and changing judgements used when performing accounting estimates;
- omitting, advancing or delaying recognition of items in the financial statements;
- omitting, obscuring or misstating disclosures required by the applicable financial reporting framework or disclosures that are necessary to achieve fair presentation;
- concealing facts that could affect amounts recorded in the financial statements;
- engaging in complex transactions which aim to misrepresent the financial position or performance of the entity;
- altering records and/or terms related to significant and unusual transactions;

- altering reports that would highlight inappropriate activity or transactions;
- exploiting inadequate IT process controls over IT applications; or
- exploiting inadequate automated controls over IT applications.

Misappropriation of assets is often perpetrated by employees and management through:

- embezzlement of receipts;
- theft of physical assets or intellectual property;
- arranging for the entity to pay for goods or services not actually received; and
- use of the entity's assets for personal use.

Generally, misappropriation of assets will entail fraudulent or misleading documentation to conceal the missing assets or the fact that assets have been inappropriately used without proper approval or authorisation.

Error

Error is distinguished separately from fraud and is defined as unintentional mistakes in the financial statements. Errors may arise due to:

- mathematical or clerical mistakes in the underlying records and accounting data;
- oversight or misinterpretation of facts; or
- unintentional misapplication of accounting policies.

As part of the auditor's assessment of an error, they should decide its cause and whether it was intentional or unintentional.

Indications of fraud

Appendix 3 to ISA (UK) 240 provides the following examples of circumstances that may indicate the possibility that the financial statements may contain material misstatements resulting from fraud.

Example – Circumstances that may be indicative of fraud

Discrepancies in the accounting records may be indicative of fraud, such as:

- transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy;
- unsupported or unauthorized balances or transactions;
- last-minute adjustments that significantly affect financial results;
- evidence of employees' or contractors' access to systems and records inconsistent with that necessary to perform their authorised duties;
- evidence of unauthorized third party access to the IT environment; and
- tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence may be indicative of fraud, such as:

- missing documents;
- documents that appear to have been altered;
- unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist;
- significant unexplained items on reconciliations;
- unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships – e.g. receivables growing faster than revenues;
- inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures;
- unusual discrepancies between the entity's records and confirmation replies;
- large numbers of credit entries and other adjustments made to accounts receivable records;
- unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger;
- missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement;
- missing inventory or physical assets of significant magnitude;
- unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies;
- fewer responses to confirmations than anticipated or a greater number of responses than anticipated; and
- inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management may be indicative of fraud, such as:

- denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought;
- undue time pressures imposed by management to resolve complex or contentious issues;
- complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management;
- unusual delays by the entity in providing requested information;
- unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques;

- denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel;
- an unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable; and
- an unwillingness to address identified deficiencies in internal control on a timely basis.

Other circumstances which may be indicative of fraud include:

- an unwillingness by management to permit the auditor to meet privately with those charged with governance;
- accounting policies that appear to be at variance with industry norms;
- frequent changes in accounting estimates that do not appear to result from changed circumstances;
- tolerance of violations of the entity's code of conduct; and
- the entity's performance is out of line with industry trends and competitors.

Responsibilities of those charged with governance

As stewards of the company, both those charged with governance and management have a fiduciary duty towards the owners of the company.

Specifically, those charged with governance:

- have a statutory duty to maintain adequate accounting records;
- are required to prepare financial statements that give a ‘true and fair view’; and
- are responsible for the prevention and detection of fraud and error.

It is not possible to achieve absolute assurance against fraud and error, but the implementation and continued operation of adequate accounting and internal control systems may reduce the likelihood of such occurrences.

An additional responsibility is that, under the *Companies Act* 2006, s. 501, it is a criminal offence to give auditors information or explanations which are misleading, false or deceptive.

Those charged with governance should take steps to prevent and detect fraud in the entity, and these may include:

- creating a culture of honesty and ethical behaviour, including setting an appropriate ‘tone from the top’;
- developing an appropriate control environment;
- hiring, training and promoting appropriate employees; and
- requiring periodic confirmation by employees of their responsibilities in relation to fraud and taking appropriate action in response to actual, suspected or alleged fraud.

Insight – Whistleblowing

Entities may have whistleblowing policies in place to provide guidance for employees, or other parties, when disclosing concerns about actual or suspected wrongdoing, including fraud.

In cases where the entity has in place such a person who would deal with allegations of fraud and to whom employees are able to turn to speak about these types of concerns, the auditor should speak directly with them to enquire about any allegations of fraud raised by employees.

Responsibilities of the auditor

The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected even though the audit is properly planned and performed in accordance with the relevant ISAs (UK).

Insight – FRC Position Paper – audit reform

Following the BEIS paper issued for consultation in March 2021 *Restoring trust in audit and corporate governance* , the FRC issued a Position Paper in July 2022 to set out the next steps to reform the UK's audit and corporate governance framework, in particular relating to the detection and prevention of material fraud.

ISA (UK) 240 expects the auditor, when planning their work and when evaluating and reporting their findings, to recognise that **fraud or error** may materially affect the financial statements. ISA (UK) 240 requires that further audit work be undertaken where required but in such a manner that the audit team are not biased towards obtaining audit evidence that corroborates the risk assessment. Equally, auditors should not be biased towards *excluding* audit evidence which may contradict the risk assessment. As part of the increased focus on professional scepticism in ISA (UK) 240, auditors should be vigilant when assessing the authenticity of audit evidence obtained.

Compliance with auditing standards cannot guarantee that the financial statements will be free from material misstatement. The risk of undetected misstatement will be higher with regard to those resulting from fraud or error due to:

- the inherent limitations of the accounting and internal control systems and the use of audit sampling to test them;
- the persuasive, rather than conclusive, nature of the evidence generally obtained by auditors;
- frauds sometimes taking place over a number of years but only being discovered when they become material;
- the possibility that audit procedures which are planned to detect error may not be appropriate to detect fraud which does not immediately affect the financial statements; and
- frauds often involving collusion or intentional misrepresentations to the auditor.

Auditors are often less likely to detect fraud perpetrated by management than fraud perpetrated by employees because management are usually in a position to directly or indirectly manipulate accounting records or override control procedures.

ISA (UK) 240:7-1 sets out a new requirement that, while the risk of not detecting a material misstatement due to management fraud may be higher than the risk of not detecting one resulting from error, the auditor should still plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatement due to fraud.

When obtaining reasonable assurance that the financial statements are free from material misstatement due to fraud or error, the auditor should also consider the potential for management override of controls and recognize the fact that audit procedures which are effective for detecting error may not be effective in detecting fraud.

Where fraud or errors are subsequently discovered which were not detected by the audit, this does not automatically mean that the audit was defective. The guidance stresses that although auditors cannot prevent fraud and error, the very fact that an annual audit will be carried out may act as a deterrent.

Law, regulation or relevant ethical requirements may require the auditor to perform additional procedures and take further actions specific to those particular requirements. The objectives of the auditor under ISA (UK) 250A include responding appropriately to identified or suspected non-compliance with laws and regulations identified during the audit.

Insight – Duty to report suspected non-compliance with laws and regulations

ISA (UK) 250B addresses the auditor's statutory right and duty to report to regulators of public interest entities and regulators of other entities in the financial sector.

It identifies that **speed** of reporting is essential where the circumstances cause the auditor no longer to have confidence in the integrity of those charged with governance, for example where the auditor believes that a fraud or other irregularity may have been committed by, or with the knowledge of, those charged with governance, or have evidence of the intention of those charged with governance to commit or condone a suspected fraud or other irregularity.

Additionally, auditors in the UK are subject to **ethical requirements** from two sources: the FRC's Ethical Standard concerning the integrity, objectivity and independence of the auditor, and the ethical pronouncements established by the auditor's relevant professional body.

Law, regulation and other ethical considerations – additional responsibilities

The auditor may have additional responsibilities under law, regulation or other ethical requirements particularly as these relate to the entity’s potential (or actual) non-compliance with laws and regulations, including fraud, such as:

(a) Responding to identified or suspected non-compliance with laws and regulations, including requirements in relation to specific communications with management and those charged with governance, assessing the appropriateness of their response to non-compliance and determining whether further action is needed

(b) Communicating identified or suspected non-compliance with laws and regulations to other auditors (e.g. in an audit of group financial statements); and

(c) Documentation requirements regarding identified or suspected non-compliance with laws and regulations.

In complying with any additional responsibilities, further information may come to light which may be relevant to the audit.

Professional scepticism

Auditors should maintain a high level of professional scepticism throughout the audit, particularly when considering the risks of material misstatement due to fraud. Professional scepticism often entails a critical and ongoing questioning of the audit evidence, and the audit team should ensure that they are not biased towards obtaining audit evidence which is corroborative of the risk assessment or exclude audit evidence which may contradict the risk assessment.

Insight – Audit evidence from multiple sources

ISA 240:A8-1 points out that audit evidence should comprise information that both supports and corroborates management's assertions, as well as any information that contradicts such assertions. Obtaining audit evidence in an unbiased manner may therefore involve obtaining evidence from **multiple sources** within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence.

Since auditors are not trained to be experts in the authentication of documents, they will generally accept records and documents as being genuine so long as there is no evidence to the contrary. However, ISA (UK) 240 does require auditors to remain alert for conditions identified during the audit which might indicate that a document may **not be authentic**. In these cases, or where it would appear that terms in a document have been modified but not disclosed to the auditor, the auditor should investigate further.

Example – Conditions that indicate a document may not be authentic

ISA (UK) 240:A10-1 provides examples of conditions that indicate a document is not authentic or has been tampered with, including:

- unexplained alterations to documents received from external sources;
- serial numbers used out of sequence or duplicated;
- addresses and company emblems not as expected;
- document style different to others of the same type from the same source (e.g. changes in fonts and formatting);
- information that would be expected to be included is absent;
- invoice references that differ from others;
- unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms (for example, purchase costs that appear unreasonable for the goods or services being charged for);
- information that appears implausible or inconsistent with the auditor's understanding and knowledge;
- a change from authorised signatory;
- 'copy' documents presented rather than originals; and
- electronic documents with a last edited date that is after the date they were represented as finalised.

ISA (UK) 240:A10 sets out examples of additional procedures to determine the authenticity of audit evidence.

Even when management and those charged with governance have been found previously to be honest and trustworthy, a sceptical view should be maintained throughout the audit. Where responses to enquiries made of management or those charged with governance are inconsistent or appear implausible, the auditor should investigate these inconsistencies. Further details and guidance on professional scepticism are available in Audit team planning meeting.

Insight – Inconsistencies identified

ISA (UK) 240:46-1 states that, as required by ISA (UK) 230:14, if the auditor identifies information that is inconsistent with their final conclusion regarding a significant matter, the auditor shall document how they addressed the inconsistency. Further details are available in Documentation.

This section relates to schedule **B4** in the ~~*Navigate*~~ *Audit* tools.

Engagement team discussion

ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement through Understanding of the Entity and its Environment* requires the engagement partner and key engagement team members to discuss any susceptibilities of the financial statements to material misstatement (see Audit team planning meeting for further details). ISA (UK) 240 requires this discussion to include particular emphasis on those risks arising from fraud and also deciding whether further discussions are needed to deal with fraud risks factors which may have been identified during the course of the audit

The engagement team discussion(s) should ideally set aside any beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. Engagement team meetings should include the engagement partner and key staff and encourage a free exchange of ideas by all team members about potential fraud risk factors.

The engagement partner has a responsibility to ensure that those engagement team members not present at the discussion are informed of matters relevant to their work. Areas that the discussion would normally consider are set out in Audit team planning meeting.

After the initial discussion, it is important that the engagement team members continue to communicate and discuss their findings, particularly if fraud risk factors are identified during the course of the audit so that any implications on the audit can be discussed and further audit procedures agreed upon where required. Where **allegations of fraud** come to their attention, the audit team should discuss how to investigate and respond to these allegations.

For a **group audit**, discussions among the group engagement team should include fraud risk areas.

Where a **small audit** is being carried out entirely by the engagement partner, that partner must consider the susceptibility of the entity to fraud during the planning and execution of the work and remain vigilant for instances of fraud during the course of their audit work.

Risk assessment procedures

ISA (UK) 315 deals with identifying and assessing the risks of material misstatement and further guidance on the ISA (UK) 315 requirements may be found here.

ISA (UK) 240 specifically requires an assessment of the risk that **fraud or error** may lead to misstatement and sets out the following areas for consideration.

Management and others within the entity

The auditor should obtain an understanding of, and enquire of management's:

- assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;
- controls that are in place to prevent and detect fraud;
- process for identifying and responding to the risks of fraud in the entity including any specific risks of fraud that have been identified, or brought to its attention, or account balances, classes of transactions or disclosures for which a risk of fraud is likely to exist;
- communication, if any, with those charged with governance regarding its fraud risk identification procedures; and
- communication, if any, to employees regarding its views on business practices and ethical behaviour.

The auditor should bear in mind that although the entity's control environment may provide an appropriate foundation for the system of internal control and may help reduce the risk of fraud, an appropriate control environment is not necessarily an effective deterrent to fraud. Additionally, the auditor's enquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such enquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud.

The auditor should ask those charged with governance, management and the internal audit function about any actual, suspected or alleged fraud affecting the entity. This includes making enquiries whether any employees or other parties have raised allegations of fraud.

Where there is an internal audit function, the auditor should ask appropriate individuals within the function about the risk of fraud, whether the internal audit function has performed any procedures to detect fraud in the period and whether management and those charged with governance have responded satisfactorily to any findings resulting from those procedures.

Others to whom the auditor may direct enquiries about fraud include:

- operating personnel not directly involved in the financial reporting process;
- employees with different levels of authority;
- employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees;
- in-house legal counsel;
- chief ethics officer or equivalent; and
- the person(s) who deal with allegations of fraud.

In obtaining audit evidence, the auditor should also comply with the relevant requirements in relation to related parties in ISA (UK) 550 and covered in Related party transactions.

Those charged with governance

Those charged with governance have a **duty to oversee** the systems for monitoring risk, financial control and compliance with the law.

Unless those charged with governance are involved in managing the entity, the auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity as well as the controls management has put in place to mitigate these risks.

Further guidance on procedures to obtain an understanding of the oversight exercised by those charged with governance may be found in ISA (UK) 240:A20-A21-1.

The auditor should also make enquiries of those charged with governance whether they have any knowledge of fraud affecting the entity. This should include discussions about the risks of fraud in the entity, in particular those that are specific to the entity's business sector and should include the entity's assessment of the risks of fraud and controls put in place to mitigate specific risks of fraud that have been identified.

The auditor should assess the responses by those charged with governance and determine whether these are **consistent** with the responses provided by management as this may give insight into the adequacy of internal control and the competence and integrity of management.

Insight – Considerations for smaller entities

In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

Unusual or unexpected relationships

Any unusual or unexpected results obtained during analytical procedures, particularly automated analytical procedures (data analytics), required by ISA (UK) 315 should be evaluated by the auditor in order to consider the possibility of fraudulent financial reporting.

Other information

Any other information that comes to the auditor's attention during the course of the audit should be considered as a possible indicator of fraudulent financial reporting.

The engagement team discussion may be particularly useful in this respect to encourage all members of the audit team to raise possible areas of concern, particularly when further engagement team discussions are held.

In addition, work performed as part of acceptance or reacceptance procedures and work done for the entity in other capacities may be of use.

Fraud risk factors

After their work on understanding the entity and its environment is complete, which will include consideration of ISA 240:15-1 in relation to related parties, the auditor should consider whether there are any indications that one or more fraud risk factors is present. Examples include:

- the need to meet expectations of third parties to obtain additional equity or other financing; or
- the granting of significant bonuses if hard to reach or unrealistic profit targets are met; and
- a control environment that is not effective.

Further examples of fraud risk factors may be found here.

Insight – Consideration of the risks of material misstatement at the financial statement level

Following enquiries of management, the auditor may be led to understand that the entity's financial statements are to be used in discussions with lenders in order to secure further financing to maintain working capital. The auditor may therefore determine that there is a greater susceptibility to misstatement due to fraud risk factors that affect inherent risk (i.e., the susceptibility of the financial statements to material misstatement because of the risk of fraudulent financial reporting, such as overstatement of assets and revenue and under-statement of liabilities and expenses to ensure that financing will be obtained). (ISA (UK) 315:A197)

Fraud risk factors may not necessarily indicate that a fraud has occurred or is likely to occur and the auditor should use professional judgement to assess whether the existence of a fraud risk factor does indeed affect the risk of material misstatement of the financial statements. When obtaining audit evidence in relation to the risk of material misstatement due to fraud, the auditor should also comply with the requirements of ISA (UK) 550 in relation to related parties.

Fraud risk factors are generally classified as:

- an incentive or pressure to commit fraud, e.g. profitability being threatened by changes in the market;
- a perceived opportunity to commit fraud, e.g. the handling of large amounts of cash; and
- attitudes or an ability to rationalise the fraudulent action, e.g. a known history of violations against laws and regulations.

Fraud risk factors cannot easily be ranked in order of importance because the significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgement.

Auditors are encouraged to increase their focus on identifying fraud risk factors when assessing the risks of the financial statements being materially misstated due to fraud and they should ensure their approach is tailored to the entity they are auditing. Specifically, auditors should evaluate whether the engagement team requires **experts** or **other specialists** in order to perform the audit (ISA (UK) 240:A28-1).

ISA (UK) 240:A27 provides further guidance on the consideration of relevant fraud risks where size, complexity and ownership of the entity have a significant influence when assessing fraud risks.

Insight – other fraud risk considerations

In some entities, particularly **smaller entities**, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets. ISA (UK) 240:A28 provides further guidance on considerations specific to smaller entities when evaluating fraud risk factors.

In the case of entities with **multiple locations**, management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

Further guidance may be found in System Processes.

Identification and assessment of fraud risk

As part of their work in identifying and assessing the risk of material misstatement at the financial statement and assertion level, the auditor should assess the risks of material misstatement due to fraud. Fraud risks will automatically be significant risks (see Significant risks for more details) and, therefore, the auditor should evaluate the design of the related controls and determine whether they have been implemented.

The assessment of fraud risk is a three-stage process. The auditor uses professional judgement to:

- identify risks of fraud through risk assessment procedures;
- relate the risks of fraud to the assertions; and
- consider the likely size of the potential misstatement and the likelihood of the risk occurring.

Not all fraud risks will have related controls as the entity’s management and those charged with governance may believe that some risks are so remote that the implementation of controls to mitigate them is not necessary.

Revenue recognition

As material misstatement due to fraud often results in an understatement or overstatement of revenue, ISA (UK) 240 states that the auditor should presume that there are risks of fraud in revenue recognition. This means that these risks will be **significant risks** and the three-stage assessment noted above should be followed, together with consideration of associated controls.

The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year-over-year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.

Example – Circumvention of controls to manipulate revenue recognition

Controls can be circumvented by the collusion of two or more people or inappropriate management override of controls. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity’s standard sales contracts, which may result in improper revenue recognition. Edit checks in an IT application that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled to manipulate revenue recognition. (ISA (UK) 315:23)

When identifying and assessing the risks of fraud in revenue recognition, ISA (UK) 240:27 requires the auditor to evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

The assumption that there are risks of fraud in revenue recognition may be rebutted, for example where there is a single type of simple revenue transaction, such as leasehold revenue from a single unit rental property (ISA (UK) 240:A31). The auditor should always document the reason(s) for the conclusion that there is no risk to material misstatement due to fraud related to revenue recognition.

Responses to fraud risk

Overall responses

Where the risk of material misstatement in the financial statements due to fraud has been identified, the auditor should respond in ways that have an overall effect on how the audit is conducted. This means that professional scepticism should be increased in all areas, which may lead to an increased need to corroborate explanations and representations, as well as taking greater care when examining documentation in relation to material matters.

Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional scepticism, for example, through:

- increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions; and
- increased recognition of the need to corroborate management explanations or representations concerning material matters.

When seeking other information that relates to management's explanations or representations, the auditor should do so in a manner that is **not biased** towards excluding audit evidence that may be contradictory and should involve more general considerations apart from the specific procedures otherwise planned.

In their overall response to the risk of material misstatement due to fraud, the auditor is required by ISA (UK) 240 to pay particular attention to:

- the assignment and supervision of suitably experienced personnel and experts;
- the accounting policies used by the entity, particularly those related to subjective and complex areas; and
- the selection, nature and timing of audit procedures, including incorporating an element of unpredictability in the audit plan.

Further guidance on these areas is available in ISA (UK) 240: A35-A41.

Responses at the assertion level

The auditor’s responses to the risk of material misstatement due to fraud at the assertion level may include changing the nature, extent and timing of tests planned. The auditor will aim to obtain more relevant and reliable audit evidence as well as additional corroborative evidence.

This may include a greater reliance on observation and inspection procedures or, where relevant, Computer Assisted Audit Techniques (CAATs). The auditor may conclude that better quality evidence will be obtained by performing more, or all, of their procedures at the period end, rather than during an interim visit, unless the fraud risk has arisen from improper revenue recognition during an interim period and which may be best investigated earlier in the audit process. More extensive testing may also be suitable in response to the increased risk assessment.

Example audit procedures to address the assessed risks of material misstatement due to fraud are set out in the box below.

Example Audit procedures to address the assessed risks of material misstatement due to fraud

- visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis;
- requesting that inventory be counted at the end of the reporting period or on a date closer to period end to minimise the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period;
- altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmations, sending confirmation requests to a specific party within an organisation, or seeking more or different information;
- performing a detailed review of the entity’s year end adjusting entries and investigating any that appear unusual as to nature or amount;
- for significant and unusual transactions, particularly those occurring at or near year end, investigating the possibility of related parties and the sources of financial resources supporting the transactions;
- performing substantive analytical procedures using disaggregated data. For example, comparing sales and costs of sales by location, line of business or month to expectations developed by the auditor;
- conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk;
- when other independent auditors are auditing the financial statements of one or more subsidiaries, division or branches, discussing with them the extent of work necessary to be performed to address the risk of material misstatement due to fraud resulting from transactions and activities among these components;
- if the work of an expert becomes particularly significant with respect to a financial statement item for which the risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the

expert’s assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose;

- performing audit procedures to analyse selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgements, e.g. a provision for sales returns, were resolved with the benefit of hindsight;
- performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods;
- using automated tools and techniques, such as data mining, to test for anomalies in a population;
- testing the integrity of computer-produced records and transactions;
- seeking external confirmations to confirm or request information, such as outstanding amounts, the details of sales agreements, such as date, any rights of return and delivery terms etc.; and
- seeking additional audit evidence from sources outside of the entity being audited.

Responses to management override of controls

Management are usually in a unique position to perpetrate fraud largely due to their ability to manipulate accounting records and to prepare fraudulent financial statements by overriding controls which would otherwise appear to be performing effectively.

The extent of the risk that management may use their position to override controls to manipulate accounting records and prepare fraudulent financial statements will vary from entity to entity. However, since there will be some risk in all entities the ISA deems this to be a significant risk (see Significant risks for more details). Therefore, in accordance with ISA (UK) 315, specific procedures should be planned and performed to address this risk. Further guidance may be found in Determining the audit approach.

It is therefore important that the auditor obtains an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In identifying the controls that address the risks of material misstatement due to fraud, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. If so, the auditor should take account of that management position when identifying and assessing risks of material misstatement.

Information from identifying these controls and evaluating their design and determining whether they have been implemented, may also be useful in **identifying fraud risks factors** that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

ISA (UK) 240 also requires the auditor to:

- test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements;

- review accounting estimates for biases that could result in material misstatement due to fraud; and
- obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment.

In the ~~*Navigate*~~ *Audit* tools, these steps are included in schedules V (journals), C8 (accounting estimates) and X (related party transactions).

Further audit procedures in relation to journal entries and other adjustments may be found in ISA (UK) 240:A42-A45.

The auditor's assessment of the risk of material misstatement relating to management override of controls may lead them to perform procedures in addition to those set out in this section.

Journal entries

The financial reporting process is often manipulated by the recording of inappropriate or unauthorised journal entries or other adjustments. When determining which journals or adjustments to test, the auditor should consider:

- their assessment of the risks of material misstatement, which may indicate a type of class or adjustments for testing;
- whether there are effective controls over journal entries and adjustments;
- the nature of evidence that can be obtained, particularly when journal entries are made electronically;
- the typical characteristics of fraudulent journal entries, including entries:

- made to unrelated, unusual or seldom used accounts;
- journals made to accounts which are high risk or contain complex accounting or estimates;
- made by individuals who do not usually make journal entries;
- recorded at the end of the period or as post-closing entries that have little or no explanation or description;
- made either before or during the preparation of the financial statements that do not have account numbers;
- journal descriptions appearing to relate to transactions outside the normal course of business; or
- containing round numbers or consistent ending numbers;

- the nature and complexity of the accounts involved, as fraudulent entries may be made to accounts that:

- contain transactions that are complex or unusual in nature;
- contain significant estimates and period end adjustments;
- have been prone to misstatements in the past;

- have not been reconciled on a timely basis or contain unreconciled differences;
- contain intercompany transactions; or
- are otherwise associated with an identified risk of material misstatement due to fraud; and
  - those journals processed outside the normal course of business.

Accounting estimates

Fraudulent financial reporting is often performed through intentional misstatement of accounting estimates. Therefore, the ISA requires that, when the auditor is reviewing accounting estimates, they consider whether the estimates indicate a bias on the part of the entity's management. The auditor shall also perform a retrospective review of management judgements and assumptions in the prior year to see if any bias is indicated in the current period.

If a bias is indicated, the auditor should consider whether the circumstances represent a risk of material misstatement due to fraud.

Insight – Compliance with ISA (UK) 540 Auditing Accounting Estimates and Related Disclosures

ISA 240:33-1 specifically highlights that when the auditor obtains and evaluates audit evidence regarding possible management bias in making accounting estimates, they should comply with the relevant requirements in ISA (UK) 540.

Insight – Retrospective reviews

ISA (UK) 240:33(b)(ii) and ISA (UK) 540 require a **retrospective review** of management's judgements and assumptions in respect of significant accounting estimates.

This review forms part of the risk assessment procedures to obtain information regarding the effectiveness of management's previous accounting estimates, audit evidence about the outcome, or where applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatements in the current period, and audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

In so doing, the auditor should determine whether there is an indication of possible bias on the part of management.

Business rationale of transactions

The auditor should aim to understand the rationale of unusual business transactions in order to consider whether the transactions have been entered into to conceal fraudulent financial reporting or misappropriation of assets. The auditor should consider whether:

- the transaction appears overly complex;
- management has not discussed the nature of, and accounting for, the transaction with those charged with governance;
- management is placing emphasis on the need for a particular accounting treatment rather than the underlying economics of the transaction;
- transactions involving non-consolidated related parties, including special purpose entities, have not been properly reviewed and approved by those charged with governance; and

- the transaction involves previously unidentified related parties or parties that do not have the substance to support the transaction without the assistance of the entity being audited.

Automated tools and techniques may assist the auditor in identifying transactions outside the normal course of business.

Evaluating audit evidence

In accordance with ISA (UK) 330 (Revised July 2017) *The Auditor's Responses to Assessed Risks*, once all audit procedures have been undertaken and audit evidence obtained, the auditor should, before the final conclusion of the audit is reached, revisit their assessment of the risk of material misstatement, including the risk of material misstatement due to fraud, and consider whether this remain valid or requires amendment.

When evaluating the audit evidence in order to reach a conclusion whether the financial statements are consistent with their understanding of the entity, the audit should consider, where analytical procedures are performed near the end of the audit, whether these might indicate a previously unrecognised risk of material misstatement due to fraud.

The auditor should also determine whether the audit evidence obtained is **sufficient and appropriate** in order to conclude whether the financial statements are materially misstated due to fraud and, during this evaluation, consider all audit evidence obtained whether corroborative or contradictory.

If it becomes clear during this 'stand back' that the risk assessment does require amendment, then further audit procedures may be needed.

Insight – 'Stand back' considerations

The auditor's overall analytical review procedures at the end of the audit should include consideration of whether there is any indication of a previously unrecognised risk of material misstatement due to fraud. For example, uncharacteristically large amounts of income being reported in the last few weeks of the accounting period may indicate fraudulent activity.

Any misstatements discovered during the audit process should also be considered as possible indicators of fraud. If fraud is indicated, the auditor should evaluate the implications of the misstatement on **other aspects** of the audit, in particular reconsidering the reliability of management representations. As part of these considerations, the auditor will need to decide whether an expert or other specialist is required to assist with further investigation of the matter.

If the auditor identifies a misstatement, they should obtain an understanding of how this misstatement arose and evaluate whether it is indicative of fraud. However, regardless of whether the misstatement is material or not, if the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.

Further considerations of identified misstatements may be found in ISA (UK) 240:A52-A54.

Insight - Severity of fraud

The auditor must consider the severity of the fraud and its impact on the audit report. Where a suspected fraud has caused a misstatement that is not material to the financial statements, the auditor should consider its implications on the rest of the audit evidence. For example, a petty cash fraud perpetrated by a clerk is not likely to impact the auditor's opinions. However, if the same fraud was perpetrated by management, the auditor may consider that it is indicative of a more pervasive problem with the integrity of management.

When performing analytical procedures near the end of the audit in order to evaluate audit evidence and form an overall conclusion, determining which particular trends and relationships may indicate a risk of material misstatement due to fraud will require professional judgement. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example:

- uncharacteristically large amounts of income being reported in the last few weeks of the reporting period;
- unusual transactions;
- income that is inconsistent with trends in cash flow from operations;
- uncharacteristically low amounts of revenue at the start of the subsequent period; or
- uncharacteristically high levels of refunds or credit notes.

Automated tools and techniques may assist identifying trends and relationships that may indicate a risk of material misstatement.

If the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor shall evaluate the implications for the audit and their audit report. ISA (UK) 240 Appendix 3 sets out examples of circumstances that might indicate the possibility of fraud.

Additionally, ISA (UK) 240:A62 states that, when the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the **attention of the appropriate level** of management as soon as practicable. This should take place even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organisation). The determination of which level of management is the appropriate one is a matter of professional judgement and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard (ISA (UK) 240:A64).

Insight – Reporting fraud to an appropriate authority outside the entity

ISA (UK) 250A provides further guidance with respect to the auditor's determination of whether reporting identified or suspected non-compliance with laws or regulations to an appropriate authority outside the entity is required or appropriate in the circumstances, including consideration of the auditor's duty of confidentiality.

If the auditor has identified or suspects a fraud, the auditor shall determine what reporting requirements may be needed to comply with the law, regulation or relevant ethical requirements. This determination may involve complex considerations and professional judgements and accordingly, the auditor may consider consulting internally (for example, within the firm or a network firm) or on a confidential basis with a regulator or professional body (unless doing so is prohibited by law or regulation or would breach the duty of confidentiality). The auditor may also consider obtaining legal advice to understand the auditor's options and the professional or legal implications of taking any particular course of action (ISA (UK) 240:44, A67-A68).

Auditor unable to continue the engagement

ISA (UK) 240 states that there may be situations where the auditor is required to question their ability to continue performing an audit. These may include where:

- the entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even where the fraud is not material to the financial statements;
- the auditor's consideration of the risk of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
- the auditor has significant concerns about the competence or integrity of management or those charged with governance.

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

(c) if the auditor decides they need to withdraw, they should:

(i) discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Because of the variety of circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity. Further guidance on withdrawal from the engagement is available in ISA (UK) 240 A56-1 to A58.

Auditor's report

ISA (UK) 700 (Revised November 2019) (Updated May 2022) includes a requirement for the auditor's report to explain to what extent the audit was considered capable of detecting irregularities, including **fraud**.

Application guidance to ISA (UK) 700 notes that the explanation should relate to the specific circumstances of the entity and should not simply refer to generic or abstract matters expressed in standardized or boilerplate language. Matters should be described in a way that enables a user to understand their significance in the context of the audit of financial statements as a whole. The auditor may explain the extent to which aspects of the auditor's work addressed the detection of irregularities including, 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; and
- the auditor's assessment of the susceptibility of the entity's financial statements to material misstatement.

Further details of ISA (UK) 700 are given in Audit reports and Templates and Letters including an example explanation as to what extent the audit was considered capable of detecting irregularities, including fraud.

Management representations

ISA (UK) 240 requires the auditor to obtain a letter of representation *(template available)* from management and those charged with governance that:

- they acknowledge their responsibility for the design, implementation and maintenance of internal controls to prevent and detect fraud and that they believe they have appropriately fulfilled those responsibilities;
- they have disclosed to the auditor the results of their assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- they have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving:
  - management;
  - employees who have significant roles in internal control; or
  - others where the fraud could have a material effect on the financial statements; and
- they have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements, communicated by employees, former employees, analysts, regulators or others.

ISA (UK) 580 establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. In addition to acknowledging that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

Insight – Written representations

ISA (UK) 240:A60 states that, because of the nature of fraud and the difficulties that may be encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

(a) the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and

(b) their knowledge of actual, suspected or alleged fraud affecting the entity.

Communication with management and those charged with governance

Where the auditor has identified a fraud, or has obtained indications that a fraud may exist, unless prohibited by law or regulation, this should be communicated, even if the matter might be considered inconsequential, to an appropriate level of management as soon as possible.

If fraud is identified involving:

- management;
- employees who have significant roles in internal control; or
- others where the fraud could have a material effect on the financial statements,

the auditor should communicate with those charged with governance as soon as practicable. Such communications with those charged with governance are required, unless the communication is prohibited by law or regulation.

Insight – “Tipping off”

In the UK, laws or regulations may prohibit alerting (‘tipping off’) the entity when, for example, the auditor is required to report the non-compliance to an appropriate authority pursuant to anti-money laundering legislation. (ISA (UK) 240:A61-1)

~~Detailed guidance on ‘tipping off’ is provided in the Anti-money laundering area of *Navigate Practice Management*.~~

Communication may be oral or in writing, but where fraud involves senior management or results in material misstatement of the financial statements, the nature and sensitivity of such matters may be such that the auditor considers it appropriate to report in writing.

If the integrity or honesty of management or those charged with governance is doubted, the auditor may consider seeking legal advice before deciding on an appropriate course of action.

In addition, the auditor should inform those charged with governance about any significant deficiencies in the design and implementation of internal controls to prevent and detect fraud, or other matters related to fraud which may have come to their attention.

The auditor should also communicate with those charged with governance, unless prohibited by law or regulation, any other matters related to fraud that are, in the auditor’s judgement, relevant to their responsibilities. The auditor should consider the matters to communicate regarding management’s process for identifying and responding to the risks of fraud in the entity and the auditor's assessment of the risks of material misstatement due to fraud. (ISA (UK) 240:A66).

Public interest entities

For public interest entities, when the auditor suspects, or has reasonable grounds to suspect, that irregularities, including fraud with regard to the financial statements of the entity, may occur or have occurred, they should inform the entity, unless prohibited by law or regulation, and ask it to investigate the matter and take appropriate measures to deal with the issue and to prevent any recurrence. Where the entity does not investigate these matters, the auditor should inform the relevant authorities (see Communication with the authorities). Further guidance on considerations in relation to Public Sector Entities may be found in ISA (UK) 240:A65-1 and A69.

If the entity investigates the matter but does not, in the auditor's judgement, take appropriate measures to deal with any fraud and prevent future occurrences, the auditor should consider whether they need to take further action.

Communication with the authorities

If the auditor has identified or suspects fraud, then the auditor will need to consider whether law, regulation or relevant ethical requirements will require them to report this to the appropriate authority outside the entity or whether this will establish responsibilities under which reporting to an appropriate authority outside the entity is appropriate in the circumstances.

The auditor's duty of confidentiality will be overridden by the requirements of anti-money laundering legislation including the *Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations* 2017 (SI 2017/692), the *Proceeds of Crime Act* 2002 and the *Terrorism Act* 2000 which impose a duty on the auditor to report knowledge or suspicions of criminal activity gained in the course of their work. ~~Further details are given in the Anti-money laundering area of *Navigate Practice Management*.~~

Public interest entities

The disclosure in good faith to the relevant authorities, by the auditor, of any irregularities referred to in Communication with management and those charged with governance does not constitute a breach of any contractual or legal restriction on disclosure of information in accordance with the Audit Regulation. Further guidance on considerations in relation to Public Sector Entities may be found in ISA (UK) 240:A65-1 and A69.

Documentation

As part of the auditor's understanding of the entity as required by ISA (UK) 315, the auditor should document:

- the significant decisions reached during the engagement team discussion about the susceptibility of the entity's financial statements to material misstatement due to fraud;

- the fraud risk factors and the identified and assessed risks of material misstatement due to fraud at the financial statements level and at the assertion level; and
- the identified controls in the control activities component that address assessed risks of material misstatement due to fraud.

Insight – Recording inconsistencies

As required by ISA (UK) 230, if the auditor identifies inconsistencies between information obtained in relation to significant matters and their final conclusion then they should document how this inconsistency was addressed.

Within the ~~*Navigate*~~ *Audit* tools, schedule **B4** *(available in the templates)* provides an opportunity to document inconsistencies identified during the audit.

The auditor should also document:

- their planned responses to the assessed risk of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures planned, with those procedures linked back to the assessed risks of material misstatement due to fraud at the assertion level;
- the results from the procedures planned, including those designed to address the risk of management override of controls;
- communications about fraud made to management, those charged with governance, regulators and others; and
- if they have assessed that there is no risk of material misstatement due to fraud related to revenue recognition, their reasons for this conclusion.

Guidance on considerations to be taken into account on an audit, particularly in relation to the first time implementation of ISA (UK) 315 was issued by the International Auditing and Assurance Standards Board (IAASB) in July 2022.

Current issues and further resources

Current issues

Covid-19 support fraud

The number of fraudulent claims due to exploitation of the Coronavirus Job Retention Scheme ('furlough fraud') became a significant government threat during the pandemic. The National Crime Agency (NCA) also reported large increases in Suspicious Activity Reports (SARs) in relation to the Bounce Back Loan Scheme and the Self-Employed Income Support Scheme (SEISS).

The government set out that the following actions constituted an overclaimed furlough grant, and thus could amount to furlough fraud:

- any amount the employer was not entitled to receive; or
- any amount the employer was no longer entitled to receive after a change in circumstances, e.g. an employee whose monthly wages were being claimed for under

the scheme and was no longer employed by the employer but claims were still made for said employee.

The government introduced legislation to aid in the recovery of overpaid monies. One of HMRC's concerns is to address non-compliance with the Coronavirus schemes but they are not obliged to look into 'innocent errors' in their approach to tackling this issue. However, employers will not be charged a penalty if they did not know of the overpayment at the time it was received, or at the time that their circumstances changed, and if it was repaid within the following time period:

- companies have until 12 months from when their accounting period ends to rectify errors; and
- sole traders or partners had until 31 January 2022.

Auditors would need to be on the alert during the course of their audit of an entity for any indications that fraud has taken place in relation to any of the above Coronavirus schemes which the entity might have applied for.

Conflict in Ukraine considerations

A number of UK sanctions were already in force against Russia and its interests before the invasion of Ukraine took place in February 2022. These sanctions were significantly scaled up when the invasion took place.

As the number of individuals, entities and activities which are subject to UK sanctions increases, the risk that auditors may have clients, or prospective clients, which are subject to sanctions also increases.

The likelihood that clients and potential clients might seek to obscure their identities, or the provenance of their assets is likely to be heightened under the current conditions, potentially necessitating more searching assessment of risks, and more consideration to the risk of misstatements due to fraud.

Auditors will need to be alert to any instances of suspected or actual fraud in relation to entities or individuals seeking to take advantage of the conflict in Ukraine and using it as smoke screen to conceal these types of activities.

Further resources

Related guidance

The FRC Bulletin: Guidance for Auditors and Matters to Consider Where Engagements are Affected by Coronavirus considers a number of issues relating to Covid-19 including fraud.

2.12 Consideration of laws and regulations

Quick overview

The objectives of the auditor are:

- to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;
- to perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and
- to respond appropriately to identified or suspected non-compliance with laws and regulations identified during the audit.

This section covers these responsibilities. It does not cover fraud and error, which is covered in Fraud in the audit, or money laundering~~, which is covered in the Anti-money laundering area of *Navigate Practice Managment*.~~

This section relates to schedules C4 and PAF05 *(within the Background information)* in the PCAS-based audit tools.

Scope and definition

Scope

ISA (UK) 250 Section A (Revised November 2019) *Consideration of Laws and Regulations in an Audit of Financial Statements* is effective for periods beginning on or after 15 December 2019. The latest revised ISA (UK) includes a specific requirement to consider whether there are any indications of non-compliance with laws and regulations when performing risk assessment procedures, as well as a number of new paragraphs of application material.

Further guidance on the auditor's responsibility to report to regulators of public interest entities and entities in the financial sector is contained in ISA (UK) 250 Section B (Revised November 2019) *The Auditor's Statutory Right and Duty to Report to Regulators of Public Interest Entities and Regulators of Other Entities in the Financial Sector.*

ISA (UK) 700 (Revised November 2019) (Updated January 2020) applies for audits of financial statements for periods commencing on or after 15 December 2019 and includes a requirement for the auditor's report to explain to what extent the audit was considered capable of detecting irregularities, including fraud. 'Irregularity' is not defined, but is deemed to correspond to the definition in ISA (UK) 250A (Revised November 2019) of non-compliance and therefore broadly based. Application guidance to ISA (UK) 700 notes that the audit report should relate to the specific circumstances of the entity and may explain the extent to which aspects of the auditor's work addressed the detection of irregularities. Further detail is in the section below on Reporting~~ and in the Audit reports area of *Navigate Audit*.~~

Key definitions

Term	Definition
Non-compliance	Acts of omission or commission intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity, which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity.

Source: ISA (UK) 250A:12

Legal and regulatory framework

An entity's legal and regulatory framework is the laws and regulations to which it is subjected. The legal and regulatory framework will vary from entity to entity. Some laws and regulations will have a direct effect on the financial statements as they determine the amounts to be reported and disclosures in the financial statements. Examples of such laws and regulations include those governing taxation and pension rights.

Other laws and regulations do not have a direct effect on the amounts in the financial statements, but compliance with them is fundamental to the ability of the business to operate. These include compliance with the terms of an operating licence, compliance with regulatory solvency requirements or compliance with environmental regulations. Non-compliance with these laws and regulations may result in fines, litigation, adverse publicity or regulatory action affecting the ability of the business to operate and may have a material effect on the financial statements.

The amount of law and regulation that an entity is governed by will depend on the industry it operates in and its constitution. For example, some sectors are heavily regulated, such as banks or pharmaceutical companies, whilst others are only subject to 'general' laws such as health and safety regulations.

Management responsibility

It is management's responsibility to ensure that the entity complies with laws and regulations and to establish procedures to prevent and detect non-compliance. Management would normally be expected to have procedures that enable them to:

- maintain a register of significant laws and regulations as they affect the entity;
- monitor relevant legal requirements and ensure operating procedures and conditions meet them;
- institute and operate an appropriate system of internal control;
- develop and publish within the entity relevant codes of conduct;
- ensure employees are properly trained and understand the relevant codes of conduct;
- monitor compliance with the code;

- engage legal advisers to assist in monitoring; and
- maintain a record of complaints.

In larger entities, particular responsibilities may be assigned to:

- an internal audit function;
- a compliance department; or
- an audit committee.

In certain industries, such as the financial sector, certain compliance procedures and functions may be mandated by regulations.

Non-compliance with laws and regulations may lead to financial penalties being imposed on an entity or a loss of its business. Therefore, the implications of any non-compliance, either suspected or actual, should be assessed under the applicable financial reporting framework with regard to the possible inclusion and/or disclosure in the financial statements of liabilities, provisions, contingent liabilities or other relevant information. In serious cases, this may also affect the directors' consideration of going concern.

Responsibility of the auditor

The auditor is responsible for obtaining reasonable assurance that the financial statements are free from material misstatement whether due to fraud or error. In carrying out the audit, the auditor takes account of the legal and regulatory framework within which the entity operates but, with some limited exceptions, they have no direct responsibility for the detection of non-compliance with laws or regulations.

ISA (UK) 250 Section A distinguishes between laws and regulations that have a direct effect on the preparation of the financial statements and the determination or presentation of items within them, and those other laws and regulations which, whilst not directly related to the financial statements, are such that non-compliance could have a material impact on the financial statements. The ISA specifies different approaches to be taken by the auditor in respect of possible non-compliance in these two categories.

The objectives of the auditor are to obtain evidence regarding compliance with those laws and regulations that directly affect the financial statements, to carry out procedures to help identify instances of non-compliance with other laws or regulations where this could have material effect on the financial statements and, where non-compliance is identified or suspected, to respond appropriately including reporting to management, those charged with governance or external authorities.

As part of the planning process, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the client and its industry. The auditor should also consider the procedures the entity follows to ensure that it complies with this framework. Procedures may include:

- using and updating existing knowledge of the entity's industry, regulatory and other external factors;
- enquiring of those charged with governance about the entity's policies and procedures for complying with laws and regulations;
- enquiring of those charged with governance as to the regulations that may be expected to have a fundamental effect on the operations of the entity;
- discussing the policies for identifying, evaluating and accounting for litigation claims with those charged with governance; and

- discussing the legal and regulatory framework with auditors of subsidiaries in other countries.

When performing their risk assessment procedures, the auditor also needs to consider whether there are any indications of non-compliance with laws and regulations.

During the audit, the auditor may also become aware of non-compliance with laws or regulations which do not materially affect the financial statements. In these situations, the auditor is mindful of the 'Professional conduct in relation to defaults or unlawful acts guidance' attached to the ICAEW Code of Ethics and of the auditor's obligations to report potential money laundering offences and certain other activities to an appropriate authority.

Consideration of compliance

Laws with a direct effect on the financial statements

Where laws and regulations are generally recognised to have a direct effect on material amounts and disclosures in the financial statements, the ISA requires that the auditor should obtain sufficient appropriate evidence of compliance. Examples of such laws are:

- those which determine the form and content of an entity's financial statements, e.g. the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) or the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409);
- those which determine when a company is prohibited from making a distribution, e.g. the *Companies Act* 2006, s. 830;
- those which oblige the auditor to report in accordance with specific statutory requirements, e.g. failure of a company to maintain adequate accounting records or disclosure of directors' remuneration; and
- financial reporting requirements for specific industry sectors.

The auditor's responsibility to express an opinion on financial statements does not extend to determining whether the entity has complied with every aspect of applicable tax legislation. The auditor needs only to obtain sufficient appropriate evidence to give reasonable assurance that the amounts included in the financial statements and related disclosures are not materially misstated.

Other laws and regulations

Other laws and regulations may also have a material effect on the financial statements. Such laws and regulations include those that have a fundamental effect on the operations of the entity or its ability to continue as a going concern. For example, non-compliance with the terms of a licence or other entitlement to perform operations (such as a failure by a bank to comply with capital maintenance requirements) may not directly affect the financial statements but may give rise to penalties or withdrawal of the licence to operate.

To identify instances of non-compliance with other laws and regulations which have a material effect on the financial statements, the ISA requires the auditor to:

- review correspondence with relevant authorities; and

- make enquiries of management and those charged with governance as to whether the entity is in compliance with such laws and regulations.

Other laws and regulations may be considered to be general business laws and regulations or other laws and regulations.

General business laws and regulations

This might include things such as health and safety, employment legislation and planning regulations. The extent to which these may present significant risks may depend on the type of sector the client is in, for example.

- Health and safety might be a minor issue in an office, but a significant risk in a factory where heavy machinery is operated or toxic chemicals are used. A serious breach of health and safety legislation can lead to large fines for the entity, possible legal action and a loss of reputation.
- Employment legislation has become increasingly complex in recent years and a failure to comply can have a significant effect on entities of all sizes, e.g. unfair dismissal claims in employment tribunals. Certain industry sectors are also more at risk from the working time or minimum wage regulations, where non-compliance can result in heavy fines.
- Obtaining planning permission is a critical issue for many businesses such as housebuilders, supermarkets, etc.

Other specific laws and regulations

The auditor should also ascertain details of specific laws and regulations which could have an impact on the business, for example:

- Financial Services and Markets Act for financial services businesses;
- food hygiene regulations and licensing laws for restaurants and pubs; and
- child protection legislation for schools, charities, etc.

It is not sufficient just to list the relevant Acts or regulations. The auditor should then consider whether, as a result of non-compliance with any laws or regulations, there are any potential contingent liabilities (e.g. warranty claims, legal action, fines or penalties, etc.) or any issues that would have a material impact on the financial statements, in particular the client’s ability to continue as a going concern, e.g. bad publicity leading to a critical loss of customer and/or supplier goodwill.

Many small entities are only governed by general business regulations, which would not have a significant impact on their ability to continue as a going concern, nor would they result in material contingent liabilities should they not comply. However, a significant minority of such entities will be governed by additional laws and regulations, which could have a significant impact on the entity’s operations. Where this is the case, it is essential that the auditor has an understanding of such laws and regulations. The auditor does not need to become a legal expert, but some understanding is necessary to ascertain the nature of the relevant laws and regulations and to determine, through investigation and discussion with the client, the types of situation that could result in significant risks.

When seeking to determine whether there are any specific laws and regulations which could have a significant impact on the client, the auditor should consider the following questions:

- Does the entity make payments or returns to a separate licensing agency?

- Is the entity subject to regular or potential reviews of its operations by an external agency?
- Does the entity deal with hazardous material or machinery?

Answering yes to one or more of the questions above is an indicator that there could be laws or regulations that could have a significant impact on the client if they are not complied with.

Other procedures and written representations

The auditor should remain alert during the audit to the possibility that other audit procedures may indicate non-compliance with laws or regulations.

In all cases, the auditor should obtain a letter of representation *(template available)* from those charged with governance that they have disclosed to the auditor all known or suspected instances of non-compliance where this may have an effect on the financial statements.

Unless the auditor becomes aware of, or suspects, non-compliance, they are not required to carry out procedures regarding the entity's compliance with laws or regulations other than those set out in this section.

Money laundering and tipping off

The auditor should be aware that instances of possible or actual non-compliance with laws and regulations discovered during the audit may result in obligations for partners and staff to report to the authorities.

When considering actual or suspected non-compliance with laws or regulations, the auditor needs to be mindful of the requirements of anti-money laundering legislation and other similar legal obligations to report suspicious activity to an appropriate authority. In particular, the auditor needs to be mindful of 'tipping off' rules under the *Proceeds of Crime Act* 2002 which may restrict the auditor's ability to discuss matters with management or those charged with governance or carry out further investigations.

~~Further guidance is given in the Anti-money laundering area of *Navigate Practice Managment*.~~

Non-compliance

Information that may alert the auditor to the possibility of non-compliance may include, for example:

- evidence of investigation by government departments;
- payment of fines or penalties;
- large payments for unspecified services or loans to consultants;
- excessive sales commissions;
- purchasing at prices significantly above or below market price;
- unusual payments in cash, cheques payable to bearer or transfers to numbered bank accounts;
- unusual transactions with companies registered in tax havens;

- payments for goods or services made to a country other than that where goods originated;
- existence of an accounting system or part of one which fails, whether by design or accident, to give an adequate audit trail;
- unauthorised or improperly recorded transactions; or
- media comment.

When the auditor becomes aware of or suspects non-compliance, they should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect in the financial statements.

Evaluating the effect on the financial statements involves considering:

- the potential financial consequences of non-compliance including fines, compensation, penalties, damages, expropriation of assets, forced discontinuance of operations and litigation;
- whether the potential financial consequences require recognition of liabilities or disclosure in the financial statements;
- whether the going concern assumption remains appropriate; and
- whether potential consequences are so serious as to call into question the presentation of the financial statements or otherwise make them misleading.

If the auditor suspects non-compliance, they should, unless prohibited by law or regulation (i.e. Money laundering and tipping off), discuss the matter with management and, where appropriate, those charged with governance. Where management does not provide sufficient information about the suspected non-compliance and, in the auditor's judgement, the effect of the suspected non-compliance may be material to the financial statements either quantitatively or qualitatively, and where there is more than one occurrence both individually and in aggregate, the auditor should consider taking legal advice. If there is still insufficient information concerning the non-compliance, then the auditor should consider the implications for their audit opinion.

However, it is not just the effect on the audit report that should be considered. The auditor needs to assess the impact on other areas of the audit including the risk assessment, the reliability of management representations and the integrity of management and those charged with governance. This may be particularly important where the non-compliance includes:

- an apparent failure of specific control procedures;
- involvement of management; and
- any concealment of the act.

Reporting

Reporting to management and those charged with governance

The discovery of non-compliance should, unless prohibited by law or regulation, be reported to those charged with governance unless clearly inconsequential. Where the non-compliance is believed to be intentional and material, this report should be made as soon as is practicable.

Where it is suspected that management or those charged with governance are involved in the non-compliance, the matter should be reported to the next higher level of management who are not suspected of being involved. Legal advice may be required if the auditor believes that no higher authority exists or that their report may not be acted on. If money laundering or some other reportable event is suspected, the auditor may be prevented by 'tipping off rules' from communicating with management and it may be appropriate to report suspicions directly to the relevant authority.

Specific requirements apply in the case of audits of public interest entities.

Reporting in the auditor's report

Where a non-compliance has a material effect on the financial statements, and it has not been adequately reflected in those financial statements, the auditor should issue a qualified or adverse opinion on the financial statements.

If management or those charged with governance have failed to provide sufficient appropriate evidence for the auditor to form a conclusion as to whether non-compliance may be material to the financial statements, a limitation of scope opinion should be given. This will be either a disclaimer of opinion or a qualified opinion depending on the severity of the limitation.

If the auditor is unable to determine whether a non-compliance has occurred as a result of circumstances other than management intervention, a limitation of scope opinion will also be suitable.

In all these situations, and where there is the suspicion of money laundering, the auditor must consider whether issuing the audit report would be considered to be ' tipping off'. In such a situation, the auditor should obtain specialist legal advice.

The auditor should not refrain from qualifying their report or omitting an explanatory paragraph simply because the matter has since been corrected. The auditor should base their assessment on the adequacy of the view given by the financial statements.

In considering the implications of non-compliance on the financial statements, the auditor should consider the requirements of the accounting framework, bearing in mind that although immediate financial consequences may not be material, there may be future material consequences arising from, e.g. fines, civil litigation, criminal proceedings or loss of business.

Reporting to third parties

Where the auditor becomes aware of an actual or suspected non-compliance which gives rise to a statutory duty or right to report, they should do so to the appropriate authority without delay.

ISA (UK) 250 Section B covers reporting to regulators of public interest entities and other entities in the financial sector. ISA (UK) 250 Section B may also be adapted for situations in which the auditor of other entities identifies an instance of non-compliance with law or regulations which they are under a statutory duty to report.

In addition to those circumstances in which the auditor has a statutory duty to report, the application material in ISA (UK) 250 Section A requires the auditor who becomes aware of suspected or actual non-compliance to:

- consider if the matter should be reported to 'an appropriate authority in the public interest'; and where this is the case
- discuss the matter with the board and the audit committee, except in cases where they no longer have confidence in the integrity of the directors.

Once they have reached a decision, the auditor should then notify the directors in writing that they are of the opinion that the matter is reportable. If the directors do not report the matter themselves, or do not provide evidence that they have already reported the matter, the auditor should report directly. The auditor may take legal advice before making a decision on whether the matter needs to be reported.

Where the auditor has lost confidence in the integrity of the directors as a result of the suspected or actual non-compliance, they may report extreme cases directly to the proper authority in the public interest, without discussing the matter with the board.

Reporting to third parties may lead to some concerns regarding the apparent breach of confidentiality and what is meant by the public interest. The guidance in the ISA considers both in detail.

Public interest entities

For public interest entities, ISA (UK) 250 Section A requires that when the auditor suspects that irregularities, including fraud with regard to the financial statements, may occur or have occurred, the auditor informs the entity and asks it to investigate the matter and take appropriate measures to deal with the issue and to prevent any recurrence. Where the entity does not investigate these matters, the auditor is required to inform the relevant authorities.

The disclosure in good faith to the relevant authorities, by the auditor, of any such irregularities does not constitute a breach of any contractual or legal restriction on disclosure of information in accordance with the Audit Regulation.

The auditor considers whether to take further action when the entity investigates the matter but where the measures taken by management or those charged with governance, in the auditor's judgement, were not appropriate to deal with the actual or potential risks of fraud identified or would fail to prevent future occurrences of fraud or other irregularities.

Auditor resignation

The guidance suggests that as a last resort, where the auditor cannot obtain the necessary information, or where management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances, or the auditor wishes to inform the shareholders and creditors of their concerns but has no immediate opportunity to do so, or where management refuse to issue financial statements, then the auditor should consider withdrawing from the engagement.

Documentation

The ISA (UK) requires the auditor to include in the audit documentation all identified or suspected non-compliance with laws and regulations and:

- the audit procedures performed, the significant professional judgements made and the conclusions reached thereon; and
- the discussions of significant matters related to the non-compliance with management, those charged with governance and others, including how management and, where applicable, those charged with governance have responded to the matter.

In the PCAS audit tools, schedules C4 and PAF05 *(within the Background information)* provide space to document these matters.

Current issues and further resources

Current issues

Due to the political situation in Russia, Ukraine and surrounding countries, compliance with laws and regulations is likely to prove a difficult area for management and auditors alike. With frequent changes to sanctions and connected restrictions, it will often be difficult for management to ensure that they have complied with laws and regulations. Demonstrating to auditors how they have complied may be even more difficult.

In addition, auditors fulfilling their responsibilities under ISAs with respect to laws and regulations, including the requirement to report on the extent to which the audit was able to detect irregularities, including fraud, will be auditing and reporting in a constantly changing situation. This may be the case right up to the point of signing the auditor's report, depending on the period end of the entity and timing of the audit. Auditors will need to maintain regular communication with management, in order to monitor non-compliance with laws and regulation right up to the date the auditor's report is signed.

2.13 Determining the audit approach

Quick Overview

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Having identified and assessed risks in Assessing risk this section covers designing an appropriate audit approach.

This section relates to the planning schedules (Section C) in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

Three ISAs deal specifically with the process of obtaining an understanding of the entity, identifying and assessing risks and designing and implementing appropriate audit responses. These are:

(1) ISA (UK) 315 (Revised July 2020) Identifying and Assessing the Risks of Material Misstatement;

(2) ISA (UK) 330 (Revised July 2017) (Updated May 2022) *The Auditor's Responses to Assessed Risk*s; and

(3) ISA (UK) 240 (Revised May 2021) (Updated May 2022) The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.

ISA (UK) 315 requires the auditor to identify and assess risks of material misstatement, which forms the basis of determining the audit approach. Guidance is available in the section on Assessing Risk.

ISA (UK) 330:5 requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level and covers:

- adequacy of presentation of the financial statements;
- evaluating the sufficiency and appropriateness of audit evidence; and
- documentation.

Guidance is available within this section.

ISA (UK) 240 covers the auditor's procedures in relation to fraud, including responses to assessed risks of material misstatement due to fraud. Guidance is available in the section on Fraud in the audit.

Key definitions

Term	Definition
Substantive procedure	An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

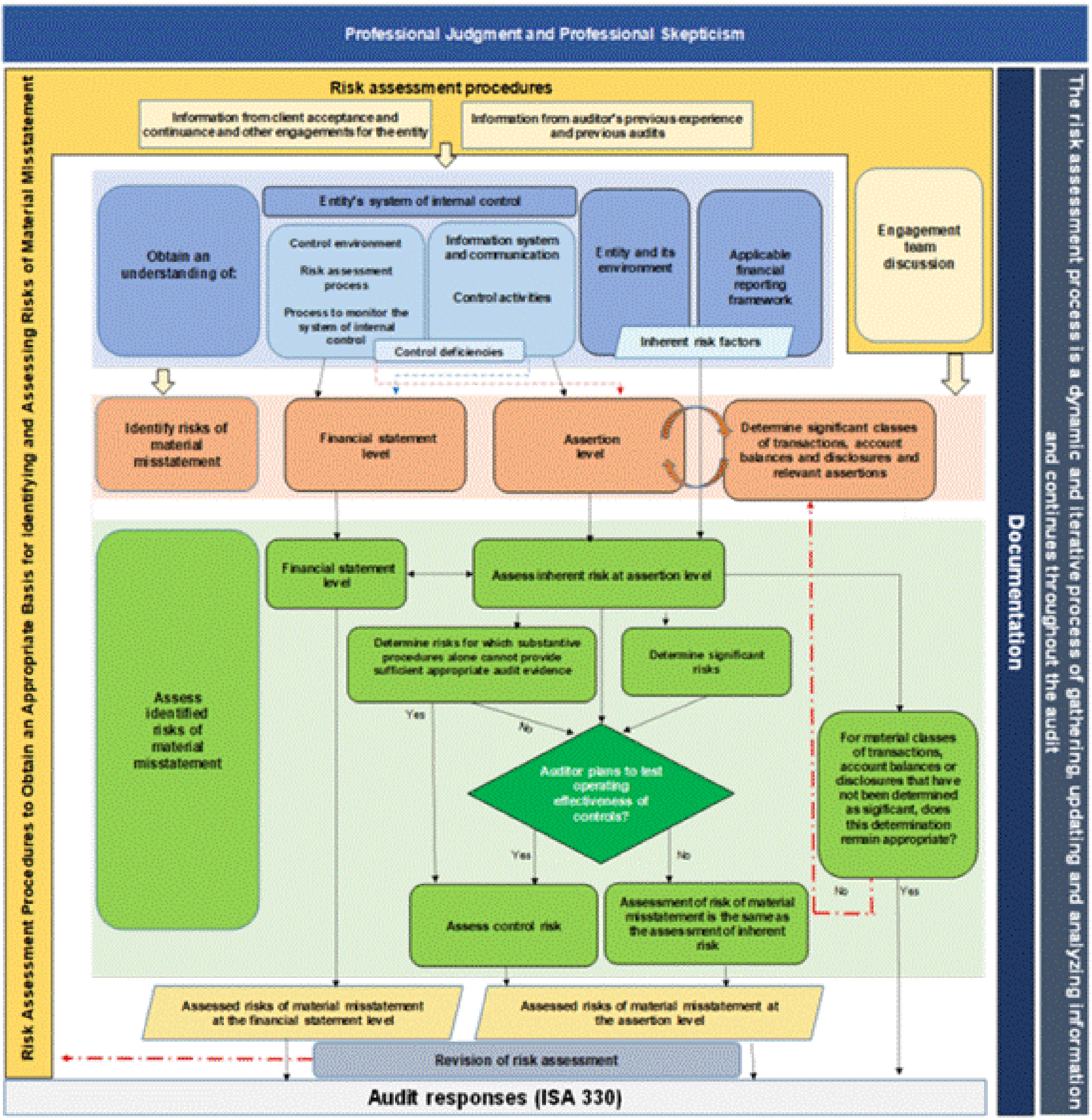
- Tests of details (of classes of transactions, account balances, and disclosures); and
- Substantive analytical procedures.

Test of controls — An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Source: ISA (UK) 330:4

Response to risk

As discussed in Assessing risk, auditors are required to approach the assessment of risk at the financial statement level and assertion level as illustrated in the following diagram:


Professional Judgment and Professional Skepticism
Risk Assessment Procedures to Obtain an Appropriate Basis for Identifying and Assessing Risks of Material Misstatement
Risk assessment procedures
Information from client acceptance and continuance and other engagements for the entity
Information from auditor's previous experience and previous audits
Obtain an understanding of:
Entity's system of internal control
Control environment
Risk assessment process
Process to monitor the system of internal control
Information system and communication
Control activities
Control deficiencies
Entity and its environment
Applicable financial reporting framework
Inherent risk factors
Engagement team discussion
Identify risks of material misstatement
Financial statement level
Assertion level
Determine significant classes of transactions, account balances and disclosures and relevant assertions
Assess identified risks of material misstatement
Financial statement level
Assess inherent risk at assertion level
Determine risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence
Determine significant risks
Yes
No
Auditor plans to test operating effectiveness of controls?
Yes
No
For material classes of transactions, account balances or disclosures that have not been determined as sigificant, does this determination remain appropriate?
No
Yes
Assess control risk
Assessment of risk of material misstatement is the same as the assessment of inherent risk
Assessed risks of material misstatement at the financial statement level
Assessed risks of material misstatement at the assertion level
Revision of risk assessment
Audit responses (ISA 330)
Documentation
The risk assessment process is a dynamic and iterative process of gathering, updating and analyzing information and continues throughout the audit

Source: IAASB ISA 315 First Time Implementation Guide

The auditor’s response to those assessed risks is guided by ISA (UK) 330.

Where further audit procedures are required, they need to be responsive to the reasons for the assessed risk of material misstatement. The higher the assessed risk, the more persuasive the audit evidence needs to be. The linkage of the further audit procedures with the assessed risk and the reasons for the assessment also needs to be documented.

General approach considerations

The nature, timing and extent of the risks identified will impact the approach taken and design of procedures.

Nature of procedures

The nature of an audit procedure refers to its **purpose** (i.e., test of controls or substantive procedures) and its **type** (that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedures).

The purpose and type of testing can be tailored to the circumstances or in some circumstances is a prescribed requirement of the ISAs.

Purpose

Depending on the circumstances, the auditor may determine that:

- performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls;
- only tests of details are appropriate; or
- a combination of substantive analytical procedures and tests of detail is most responsive to the assessed risks.

In practice, the majority of audits involve a mix of testing purposes across substantive procedures and tests of controls, tailored to the particular risks on the audit. However, some approaches are specifically required under the ISAs.

The following table summarises the requirements of ISA (UK) 330 around the purpose of the procedure. The purpose of the procedure should be responsive and closely aligned to the information about risks obtained during the risk assessment stage (see Assessing risk).

Purpose	ISA (UK) 330 requirements and guidance
Substantive procedures (either tests of detail or substantive analytical procedures)	• Irrespective of the assessed risks of material misstatement, the auditor must design and perform substantive procedures for each material class of transactions, account balance, and disclosure;

	• Agreeing or reconciling information in the financial statements with the underlying accounting records is required, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers; • Examining material journal entries and other adjustments made during the course of preparing the financial statements; • If the auditor has determined that an assessed risk of material misstatement is a significant risk, the auditor must perform substantive procedures that are specifically responsive to that risk; • For very small entities it may be more efficient to perform further audit procedures that are primarily substantive procedures. This is because there may not be many controls that could be identified by the auditor, or documentation by the entity may be limited.
Tests of detail	• When the approach to a significant risk consists only of substantive procedures, those procedures must include tests of detail; • As noted above, for very small entities it may be more efficient to perform further audit procedures that are primarily substantive procedures. This is because there may not be many controls that could be identified by the auditor, or documentation by the entity may be limited.
Tests of controls	• If the auditor intends to rely on controls over a significant risk, they must test those controls in the current period; • Where substantive procedures alone cannot provide sufficient appropriate audit evidence, tests of controls will be required. For example, where an entity conducts its business primarily through IT and no documentation of transactions is produced and maintained other than through the IT system (most commonly in the technology or telecommunications industries);

	• To address risks where it is expected that controls are operating effectively over those risks; • Tests of general IT controls to address risks of misstatement related to the integrity of data, where an entity relies on such data for the financial statements.
Combined approach (mix of substantive and controls testing)	• Generally effective for most audit areas unless there are weaknesses in the control environment, controls do not apply or are not operating effectively; • Controls have an inherent risk of failure and management override, so a combined approach of tests of controls and substantive procedures is necessary to obtain reasonable assurance (i.e. a purely controls based approach to an audit without any substantive procedures would not suffice).

Insight – dual purpose tests

An auditor may design a test of controls to be performed concurrently with a test of detail on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of detail, both may be accomplished concurrently by performing a test of controls and a test of detail on the same transaction, also known as a dual-purpose test.

For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

Type

The assessment of the risk or the nature of the assertion is relevant to the type of testing to deploy. A combination of testing types may be necessary to obtain sufficient appropriate audit evidence.

Tests of detail will usually involve a combination of inspection, observation, confirmation, recalculation and reperformance, in order to focus on a particular risk at the assertion level and agree items back to underlying records and calculations. They may also involve an element of inquiry, for example to establish circumstances surrounding a particular transaction within a sample test, but the main types of testing will be detailed and performed at the individual item level.

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. They generally involve analytical procedures or elements of reperformance and recalculation. ISA (UK) 520 establishes requirements and provides guidance on the application of analytical procedures during an audit. Further guidance is available in Substantive analytical procedures.

For controls, inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are usually performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

The details supporting the control also influence the type of procedure required to confirm if the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of the operation may not exist for some factors in the control environment, such as an assignment of authority and responsibility, or for some types of controls, such as automated controls. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs (data analytics).

Further guidance on controls testing is available in Accounting systems, processes and controls and General IT controls.

Timing of procedures

Timing of an audit procedure relates to when it is performed, or the period or date to which the audit evidence applies.

In general, the higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer, or at, the period end rather than at an earlier date, and so the timing of the audit work should be carefully considered at the planning stage.

A disadvantage of performing all procedures at the period end is that the auditor may lose the ability to identify and address significant matters at an early stage. Another strategy might be to perform procedures unannounced or at unpredictable times.

In considering when to perform their procedures, the auditor should take into account:

- the control environment;
- when information is available;
- the nature of the risk, for example risks relating to the state of work in progress would be performed at the period end;
- the period or date to which the audit evidence relates; and
- the timing of the preparation of the financial statements, particularly for those disclosures that provide further explanation about amounts recorded in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.

Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, particularly on balance sheet items - for example, when testing controls over the entity's physical inventory counting at the period end.

If the auditor intends to rely on a control throughout the period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are necessary. This may include tests of controls for the entity's process to monitor the system of internal control, which can support that the control was operating throughout the period in question.

Audit procedures at end or after period

Certain audit procedures can be performed only at or after the period end, for example:

- agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers;
- examining adjustments made during the course of preparing the financial statements; and
- procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalised.

Extent of procedures

The extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control.

The extent of any audit procedure is a matter of judgement based on the materiality, the assessed risk and the degree of assurance the auditor plans to obtain. The use of data analytics may allow more extensive testing of a population of transactions and account balances.

The higher the auditor’s assessment of risk, the more reliable and relevant the audit evidence must be. This will affect both the types of audit procedures performed and their mix. Where the auditor has considered related controls in their assessment of material misstatement, they should test the effective operation of those controls.

Where the auditor uses information produced by the entity’s information system in their testing, the accuracy and completeness of that information should be verified. For example, if analytical procedures include comparisons to budget data, the accuracy and completeness of the budget data should be considered.

Response to financial statement level risk

ISA (UK) 330:5 requires the auditor to determine overall responses to address the risks of material misstatement at the financial statement level. Such responses may include:

- emphasising to the audit team the need to maintain professional scepticism in gathering and evaluating audit evidence;
- assigning more experienced staff or those with specialist skills or using experts;
- providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed; and
- making general changes to the nature, timing, or extent of audit procedures as an overall response.

The auditor may also decide to perform all audit procedures at the period end date rather than during any interim visit. Only if the auditor has confidence in the effectiveness of the control environment may some audit procedures be performed at an interim date.

Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud (see Fraud in the audit).

Where there are concerns about the control environment, the auditor is also likely to use a wholly substantive approach, rather than a combined approach which also relies on tests of controls.

Insight – Control environment

The assessment of the risks of material misstatement at the financial statement level is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end.

Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- conducting more audit procedures as of the period end rather than at an interim date;
- obtaining more extensive audit evidence from substantive procedures; or
- increasing the number of locations to be included in the audit scope.

Further guidance is available in Understanding the entity.

Response to assertion level risk

ISA (UK) 330:6 requires the auditor to determine overall responses to address the risks of material misstatement at the assertion level. The auditor should plan procedures that directly address and target the risk assessment, and should consider:

- the significance of the risk;
- the likelihood that a material misstatement will occur;
- the magnitude of the potential misstatement should it occur;
- the characteristics of the class of transactions, account balance or disclosure involved;
- the nature of the specific controls used by the entity and in particular whether they are manual or automated; and
- whether the auditor expects to obtain audit evidence about related controls.

The assessment of assertion level risk often has a direct impact on the sample sizes for all substantive testing – therefore: the higher the risk, the larger the samples should be. This is looked at in more detail in Sampling and misstatement evaluation.

Example – Responses to assertion level risks

When designing tests of detail to detect material misstatement at the assertion level, the exact nature of the testing will be tailored to the nature of the assertion. Tests of detail related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of detail related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

Certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of the completeness assertion, to respond to the need to identify a reciprocal population outside of the accounting system and hence there may be corresponding controls to ensure the completeness of income. Whereas substantive procedures may be most responsive to the assessed risk of the occurrence assertion, as the testing is focused on detecting misstatements within income recorded within the accounting system.

Detailed guidance on Substantive analytical review and tests of detail is in Substantive analytical procedures and guidance on tests of controls can be found in Accounting systems, processes and controls.

Significant risks

As noted in Assessing risk, some of the risks identified may be determined by the auditor as being significant. Significant risks are required to receive special audit attention under the ISAs including ISA (UK) 330:21.

Firstly, the auditor must perform some substantive procedures specifically in response to each significant risk. In other words, a wholly controls-based approach would not be suitable or appropriate in response to a significant risk.

Secondly, ISA (UK) 315 requires the auditor to obtain an understanding of the entity's controls, including controls within the control activities component, relevant to that risk. This means that the design and implementation of those controls must also be assessed.

Where the auditor plans to go further and rely on the operational effectiveness of controls intended to mitigate a significant risk, the auditor should obtain audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period. This rules out reliance on controls testing performed in previous years under the 'three-year cycle' principle described in Impact of testing results and requires the auditor to test such controls in the current period.

Finally, if the auditor plans to rely solely on substantive procedures, those procedures must include tests of detail. In other words, the audit approach cannot consist solely of substantive analytical procedures.

ISAs also stipulate a number of mandatory procedures to be performed in response to significant risks in respect of certain balances, transactions and disclosures. Those relating to management override of controls are discussed in detail in Specifically identified risks; the rest are detailed in Substantive analytical procedures onwards.

It is therefore vital that both the assessment of, and response to, significant risks must be carefully considered and planned.

Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist with obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error.

Revenue

When identifying and assessing the risks of material misstatement due to fraud, there is a presumption under ISA (UK) 240 that there are risks of fraud in revenue recognition and therefore auditors must evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

ISA (UK) 240:47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud.

Fraud in revenue recognition should therefore be a significant risk on the vast majority of audits (due to the presumption of the risk of fraud in revenue recognition outlined above, and limited exemptions permitted for rebuttal of this).

The requirement for tests of details when auditing significant risks without controls testing can create problems when auditing revenue, if auditors do not recognise the significant nature of revenue recognition risk and do not plan any tests of details. The implication is that insufficient audit evidence will be obtained and that the audit opinion will not be fully supported.

It is therefore vital that the risk assessment and response to fraud in revenue risk is carefully considered and planned.

See Fraud in the audit and Income for more guidance.

Material areas

ISA (UK) 330:18 states: 'Irrespective of the assessed risk of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.' This reflects the fact that:

- the auditor's assessment of risk is judgemental and so not all risks of material misstatement may have been identified; and
- there are inherent limitations to internal control, including the risk of management override.

Accordingly, even if the auditor determines that the risk of material misstatement may be reduced to an acceptably low level by performing only tests of controls for a particular assertion, additional substantive procedures must still be performed. It is worth remembering that analytical procedures are a form of substantive test and these may give sufficient audit evidence in conjunction with controls testing.

ISA (UK) 330:20 also requires the auditor specifically to:

(a) agree or reconcile the financial statements with the underlying accounting records; and

(b) examine material journal entries and other adjustments made during the course of preparing the financial statements.

Stocktakes

When determining the audit approach some consideration will need to be given whether stock is assessed as being a material area (and therefore a stocktake will be required) and if so, how this will be factored into the audit.

Where stock is material, the auditor's risk response will usually include attendance at the stocktake. Audit procedures at stocktakes are covered in Inventory. However, some thought should go into the planning of the auditor's attendance, as the timing is critical, particularly as ISA (UK) 501 requires the auditor to attend during the stocktake and not afterwards.

The auditor should liaise closely with the client before the year end to determine the likely quantities of inventories that will be held at the year end and their location(s) and the timing of the stocktakes in order to be able to schedule attendance by a member of the audit team.

Management override of controls

ISA (UK) 240 points out that management personnel are in a unique position to perpetrate fraud because of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. ISA (UK) 240 recognises that although the level of risk of management override of controls will vary from client to client, the risk is nevertheless present in all clients to some extent. Due to the unpredictable way in which such override could occur, management override is a fraud risk and therefore is automatically designated as significant under the ISAs.

This means that management override of controls should appear as a significant risk in the risk assessment of every audit. In practice however this is often overlooked as a risk. Sometimes management override of controls is identified as a risk, but the fraud aspect and hence the significant nature of the risk is not.

The risk of management override of controls would typically be so pervasive it would be considered as a financial statement level risk, but there could also be specific assertion risks the audit team can identify.

The general implications of designating a risk as significant are considered further in Significant risks. However, this particular risk is unusual in that ISA (UK) 240:33 requires the auditor, irrespective of their assessment of the risks of management override of controls, to design and perform three specific audit procedures:

‘ **Review journals** – The auditor must test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements. This involves speaking to members of the client’s staff about any inappropriate or unusual activity relating to the posting of journals and other year-end adjustments, as well as reviewing such entries in the ledger. The ISA also requires the auditor to consider reviewing journals throughout the rest of the accounting period. It is likely that this will only be needed to be done where the risk of management override is considered to be high.

Review accounting estimates for bias – This requires the auditor to consider the assumptions and judgements made by management in determining estimates, and considering whether, even if reasonable on an individual basis, they may give rise to bias when considered together in aggregate. If this appears to be the case, the auditor must go further and re-evaluate all accounting estimates as a whole. The auditor is also required to perform a retrospective review of estimate assumptions made in the prior year (see Auditing accounting estimates).

Understand the business rationale of significant transactions outside the normal course of business – This requires the auditor to use their understanding of the entity and its environment to identify such transactions, and to then consider whether these may indicate fraudulent financial reporting or an attempt to conceal the theft of assets (see Understanding the entity).’

Most firms should have these procedures included as standard in their audit programmes so that documenting the auditor’s response to the risk of management override of controls should simply be a case of cross-referencing to them.

In the private company-based audit tools (PCAS) the above procedures are covered in

- Journals (V Section)
- Review of accounting estimates and related disclosures (C8.1 *in templates*)
- Related party transactions - Audit programme (X2)

It is important that these procedures are performed. Fraud is not limited only to large or listed clients and these procedures form a key part of the auditor's attention to potential fraud and compliance with ISAs (See Fraud in the audit). ISA (UK) 240 additionally requires that the auditor considers whether, in order to respond to the identified risks of management override of controls, they need to perform other audit procedures in addition to the three listed above.

External confirmations

The practicalities of obtaining external confirmations are considered in more detail in other audit Execution sections ~~of *Navigate Audit*.~~ ISA (UK) 505 *External Confirmations* also sets out the key requirements for the audit.

However, they are worth noting at the planning stage since ISA (UK) 330:19 requires the auditor to consider whether external confirmations should be used to obtain substantive audit evidence. This is easiest to address while planning the response to risk and designing the audit programmes.

Another reason to consider external confirmations at the planning stage is that the timing of confirmation requests is often crucial in maximising the response rate and obtaining the best quantity and quality of audit evidence.

There are a number of issues to consider at the planning stage when considering the use of external confirmations:

- Management may refuse to allow the auditor to send a confirmation request. This is probably most common when circularising trade debtors (see Debtors circularisation), usually on the grounds that 'the customer will get upset/will be confused/won't reply anyway'. In such circumstances ISA (UK) 505 *External confirmations* requires the auditor to seek audit evidence as to the validity and reasonableness of the reasons given, which can be difficult or even impossible to do.

- If there are a high number of non-responses, alternative procedures must be performed (substantive procedures or tests of controls as appropriate).

- If a low response rate is anticipated, there may be little point in even attempting external confirmation and alternative procedures should be designed and performed to address the risk.

- The information to be confirmed may be time-critical, i.e. it may not be easy for a respondent to obtain information after a certain date. This is often true with 'real time' systems, and so the timing of sending the initial request may be crucial.

External confirmations can be a fairly lengthy process, and so the relative efficiency of this approach must also be considered. Auditors need to stay in control of the process, including:

- determining the information to confirm;

- selecting the confirming parties;

- checking the confirmation emails or letters and posting them out;

- asking respondents to send their replies directly to the auditor and not the client; and

- sending any follow-up requests as necessary.

Insight – external confirmations

The assertions covered by external confirmations will vary. For example, in the case of goods held on consignment, evidence will be obtained about existence and rights and obligations assertions, but not about the value. Confirmation about the completeness assertion can be obtained by contacting certain parties. For example, evidence about completeness of accounts payable balances can be obtained by circularising suppliers with a nil balance at the year end to determine whether all liabilities to them have been recorded. This means that external confirmation requests must be tailored to the specific audit objective.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with ISA (UK) 260 (Revised June 2016) (Updated May 2022) *Communication With Those Charged With Governance*. The auditor shall also determine the implications for the audit and the auditor's opinion in accordance with ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report*.

Similarly, where no response is obtained from a positive confirmation or where the response has not provided sufficient reliable evidence, the auditor should perform alternative procedures. Where no response has been obtained by the stated deadline, the auditor would normally first attempt to contact the recipient of the confirmation to elicit a response, before identifying alternative procedures.

If adequate responses for external confirmation are not obtained, ISA (UK) 505:10 states that:

- If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts;
- If it is not possible to resolve those doubts then the implications for the risk assessment (including the risk of fraud) must be considered together with the impact on the nature, timing and extent of other audit procedures;
- Doubts about the reliability of a response may arise because it was not received by the auditor directly or appeared not to come from the original intended confirming party. If a confirming party uses a third party to coordinate its response, the auditor should perform procedures to confirm that the respondent was indeed authorised to respond on behalf of the original contact; and
- Once any alternative procedures have been performed, the auditor should evaluate whether the results in total have provided sufficient appropriate audit evidence and, where this is not the case, the auditor should consider the implications for the audit report.

Negative and positive confirmations

A negative confirmation is defined by ISA (UK) 505 as, 'a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request'. Positive confirmations ask respondents to reply and either confirm information or provide data themselves.

Negative confirmations provide less persuasive audit evidence than positive confirmations, however they can still be useful.

By their very nature, negative confirmations provide less persuasive audit evidence than positive confirmations, which is one reason why they are rarely used in practise. There is an additional risk with negative confirmations that the auditor will assume that information was correct when the respondent simply chooses not to respond.

The auditor should not use negative confirmations as the sole substantive audit procedure to address an assessed risk of material misstatement unless:

(a) the risk of material misstatement has been assessed as low and the operating effectiveness of relevant controls has been successfully tested;

(b) the population of items to be tested comprises a large number of small, homogeneous, account balances, transactions or conditions;

(c) a very low exception rate is expected; and

(d) the auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

With positive confirmations, the response rate tends to be lower the more information the auditor requests from the party. However, by requesting information from respondents, the value of audit evidence is greater than where they are asked only to confirm a balance included in the request. In order to obtain good quality responses, the auditor should consider to whom the confirmation request is addressed.

Example – Audit evidence from external confirmations

If the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognising revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment.

In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms.

In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

Interim audits

An interim audit is often used where the reporting timetable is particularly tight, as it enables the auditor to bring forward much of the detailed audit work to an earlier date, usually before the year end. This approach can be effective – for example, by assisting the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.

If use is made of an interim audit, the auditor must consider what audit evidence is required for the remaining period. ISA (UK) 330:22 requires the auditor to carry out further substantive procedures (and, where relevant, tests of control) to cover this period to provide sufficient audit evidence to support a conclusion on the whole accounting period.

A common problem when performing an interim audit is inefficiency. Many auditors do not spend enough time upfront planning the work needed at the interim and final stages, which increases the risk of duplicating audit work unnecessarily.

Profit and loss account testing can be mostly completed at the interim stage, particularly if a significant population has been tested and results have been satisfactory. At the final stage, if samples have been apportioned between the two periods, the substantive testing still to be done can be limited and use can be made of analytical procedures to provide additional audit evidence needed.

Balance sheet interim audit work can be rolled forward and updated for the remaining period, although sufficient work must be performed to ensure the figures as at the balance sheet date are not materially misstated.

Prior periods

Determining the audit approach may involve assessing information from previous periods and audits.

In certain circumstances, the auditor performs audit procedures to establish the continuing relevance and reliability of audit evidence from a prior period. This is generally the case with reliance on prior year assessments of controls. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period.

There are, however, exceptions, for example, a legal opinion obtained in a previous audit related to the structure of a securitisation to which no changes have occurred, may be relevant in the current period. In such cases it may be appropriate to use the evidence from the prior period, if the evidence and the related subject matter have not fundamentally changed and audit procedures have been performed during the current period to establish its continuing relevance.

Controls

Specifically where relying on evidence about controls in previous years, the continuing relevance and reliability of the prior period evidence should be understood, including if significant changes in those controls have occurred subsequent to the previous audit.

Changes may affect the relevance and reliability of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor should test the controls in the current audit.

If there have not been such changes, the auditor should test the controls at least once in every third audit. They should also test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period, with no testing of controls in the subsequent two audit periods. Whilst the length of time between testing controls is a matter of professional judgement, ISA (UK) 330:14b requires testing to be performed every three years.

As noted in the section of Significant risks, where the controls being relied upon relate to significant risks they must be tested within the period: the three-year time period does not apply.

Example

In performing a previous audit, the auditor may have determined that an automated control was functioning as intended. In the current period the auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the audit evidence in the current period about the operating effectiveness of the controls.

Designing and performing procedures

The planned audit work needs to be responsive to and directly address the audit risk assessment. This is key to designing and performing appropriate procedures, as well as overall audit efficiency and quality. In the PCAS-based audit tools, the Risk assessment summary for financial statement level risks (~~C9.3~~ *Area risk assessment and Identified Risks*) and assertion level risks (~~C9.4~~ *Area risk assessment and Identified Risks*) supports this linkage as it covers both the risk assessment and the audit approach, with a cross-reference to the relevant work programme. Such a schedule provides the auditor with an overview of all the financial statement areas and allows the audit approach to be planned for each area, as well as down to the assertion level. It also provides the opportunity to determine and document whether a section is not significant, and what specific approach is needed.

This is vital in planning an efficient and effective audit, yet it is one area where many auditors do not spend enough time. Time spent here can mean that a significant amount of unnecessary audit fieldwork is avoided later on.

One of the most common reasons for over-auditing is that risk is assessed at the level of each financial statement area, and not down to the assertion level. For example, stock is designated as high risk, resulting in large sample sizes for all stock tests, whereas the real risk relates only to say the *valuation* of stock.

Documentation

ISA (UK) 330:28 requires the auditor to include in the audit documentation:

(a) the overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing, and extent of the further audit procedures performed;

(b) the linkage of those procedures with the assessed risks at the assertion level; and

(c) the results of the audit procedures, including the conclusions where these are not otherwise clear.

In the PCAS-based audit tools, responses to financial statement level risks are documented on *the Identified Risks* ~~C9.3 Risk assessment summary - financial statement level risks~~.

Responses to assertion level risks are documented on *the Identified Risks* ~~C9.4 Risk assessment summary – assertion level risks.~~

The purpose of these schedules is to document the risks identified and to provide a link between the risks assessed, the controls (if any) in those areas, the audit approach and the outcome of the work.

Many audit systems will contain a standard schedule to record in more detail the key risks identified at the assertion level by the risk assessment process and the auditor's proposed responses to them.

The advantage of this approach is that the auditor can draft bespoke audit procedures in response to specific risks. This also demonstrates the linkage referred to above that ISA (UK) 330 speaks of. Careful cross-referencing between planning and audit work is needed to ensure that the planned procedures are executed.

The PCAS-based audit tools *within Audit Automation* provide space to cross-reference risks identified to relevant audit procedures.

As noted throughout this guidance, the planned audit work should reflect the risk assessment. This is to ensure that sufficient work is undertaken to obtain sufficient appropriate audit evidence, and to be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

2.14 Audit team planning meeting

Quick overview

This section covers the requirements around holding an engagement team planning meeting.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.

This section relates to schedule C10 *available in the templates* in the *~~Navigate~~ Audit* tools.

Scope and definitions

Scope

ISA (UK) 240 (Revised May 2021) (Updated May 2022) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* is effective for the audit of financial statements for periods commencing on or after 15 December 2021, early adoption is permitted.

ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement (July 2020)* is effective for the audit of financial statements for periods commencing on or after 15 December 2021, early adoption is permitted.

Both ISA (UK) 240 and ISA (UK) 315 specifically require an audit team meeting at the planning stage, principally for matters such as sharing knowledge, discussing audit issues and risks, susceptibility to fraud, determining the overall audit approach and communicating relevant matters within the audit team.

Key definitions

Term	**Definition**
Engagement team	All partners and staff performing the engagement, and any other individuals who perform procedures on the engagement, excluding an external expert and internal auditors who provide direct assistance on an engagement.
Fraud	An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
Fraud risk factors	Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Source: ISQM (UK) 1 and ISA (UK) 240

Attendance

Both ISA (UK) 240 and ISA (UK) 315 specifically require an audit team meeting at the planning stage. ISA (UK) 315:17 requires the attendance of the 'engagement partner' and 'other key engagement team members' at this meeting.

Whilst the phrase 'other key engagement team members' is not defined, this is likely to include:

- the audit manager and the audit senior;
- component auditors of significant components; and
- relevant audit specialists such as IT audit, and the tax manager, where such services are provided.

However, there are benefits in all members of the audit team attending, including:

- communication is more effective as everyone is at the original discussion and does not need to be subsequently briefed;
- all team members have an opportunity to share knowledge and information about the client, for example junior staff working on the engagement in an earlier year often have detailed knowledge about the client's staff and accounting records;
- members of the team may be able to gain a better understanding of how the results of the work assigned to them affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures; and
- it can be a good opportunity for more junior staff to develop their professional judgement and audit skills by listening to the input of the partner and manager.

The presence of the engagement partner is not to be underestimated as they are key in setting the overall tone and direction of the audit and their knowledge and experience of the client, its industry and auditing in general will provide essential inputs to the risk assessment process.

ISA (UK) 315:18 also states: 'The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.' This might comprise members of staff who were unable to attend the meeting due to sickness, location of the meeting or working on another job.

Many smaller, less complex audits are carried out entirely by the engagement partner, who may be a sole practitioner. In such situations, having personally conducted the planning of the audit, the engagement partner should still consider the susceptibility of the entity's financial statements to material misstatement due to fraud, including in relation to related party transactions.

Matters to be discussed

The audit team planning meeting should cover the following:

- understanding and considering the susceptibility of the company's financial statements to material misstatement due to fraud or error, specifically including in relation to related party transactions;
- the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement, for example due to complex areas of accounting within the framework;

- considering the disclosure requirements of the applicable financial reporting framework to assist in identifying at an early stage where there may be risks of material misstatement in relation to disclosures;
- reviewing the audit approach to these risk areas (see Determining the audit approach);
- emphasising the need for professional scepticism when carrying out the audit and reviewing the test results; and
- sharing the insights of team members based on their knowledge of the entity, and exchanging information about business risks.

However, other relevant matters can also be discussed as the auditor considers appropriate.

Related Parties

ISA (UK) 550:13-14 *Related parties* also contains a specific requirement to discuss the risk of fraud or error that could result from the entity's related party relationships and transactions. The guidance material in the ISA gives suggestions of issues which could be discussed in connection with this:

- the nature and extent of the client's relationships and transactions with related parties;
- the importance of maintaining professional scepticism throughout the audit regarding related party relationships and transactions;
- circumstances or conditions that may indicate the existence of related party relationships or transactions that management has not identified or disclosed, e.g. a complex structure, use of special-purpose entities for off-balance sheet transactions, or an inadequate information system;
- those records or documents that may indicate the existence of related party relationships or transactions;
- the importance attached by the client to the identification, appropriate accounting for, and disclosure of related party relationships and transactions and the related risk of management override of relevant controls; and
- specific consideration of how related parties may be involved in fraud, e.g.:
    a. how special-purpose entities controlled by management might be used to facilitate earnings management; and
    b. how transactions between the client and a known business partner of a key member of management could be arranged to facilitate misappropriation of the client's assets.

In general terms, it is important that the audit team members approach the discussion with a questioning mind, setting aside any beliefs they may have that management and the directors are honest and have integrity. The meeting should be a wide-ranging, open exchange of ideas between team members, and should not be limited by any preconceived ideas about the client.

During the meeting new risks may be identified, and these should be taken into account in the risk assessment.

Fraud discussion

ISA (UK) 315 requires the auditor to discuss any susceptibilities of the financial statements to material misstatement and ISA (UK) 240 requires this discussion to include particular emphasis on those risks arising from fraud.

The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. It should include the engagement partner and key staff, and the engagement partner has a responsibility to ensure that those engagement team members not present at the discussion are informed of matters relevant to their work. Areas that the discussion would normally consider are:

- how and where the auditor believes the financial statements (including disclosures) may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting and how assets of the entity could be misappropriated;
- circumstances that might be indicative of earnings management and how earnings may be managed fraudulently;
- the risk that management may attempt to present disclosures in a manner that may obscure a proper understanding of the matters disclosed (e.g. by including too much immaterial information or by using unclear or ambiguous language);
- the known external and internal factors affecting the entity that may create an incentive for management or others to commit fraud;
- management’s involvement in overseeing employees with access to cash or other assets susceptible to misappropriation;
- any unusual or unexplained changes in behaviour or lifestyle of management or employees which have come to the attention of the engagement team;
- the importance of maintaining an attitude of professional scepticism;
- types of circumstances that might be indicative of fraud;
- how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed;
- the audit procedures selected to respond to the risk of fraud and whether some types of procedures are more effective than others;
- any allegations of fraud that have come to the auditor’s attention;
- the risk of management override of controls;
- for a group audit, matters to discuss with the component auditor of a significant component about the susceptibility of the component to material misstatement of the financial information of that component due to fraud; and

- if allegations of fraud come to the auditor's attention, the discussion shall include how to investigate and respond to those allegations.

The engagement partner shall determine whether further discussions among members of the engagement team need to be held at later stages in the audit to consider fraud risk factors that have been identified during the course of the audit and the implications for the audit.

Within the ~~*Navigate*~~ *Audit* tools, Notes of engagement team planning meeting (*template* **C10**) provides space to document the engagement team discussion.

See Fraud in the audit for detailed guidance on the auditor's responsibilities in relation to fraud.

Demonstrating professional scepticism

An important part of the team meeting is for the team to discuss the susceptibility of the financial statements to material misstatement. This could be due to fraud and/or error and the meeting is the opportunity to discuss both:

- the susceptibility of the financial statements to material misstatement; and
- how the financial statements could be materially misstated due to fraud or error.

It is not appropriate to rely on past experience concerning the honesty and integrity of clients as it shows a failing to maintain professional scepticism. The audit team should consider beyond their historical experiences of clients to reflect on risks in the current year audit.

During the audit team meeting, the team should discuss:

- how management could override internal controls to perhaps commit a fraud;
- how employees could manipulate weaknesses in internal controls for personal financial gain; and
- how related party relationships may give rise to a fraud risk factor.

These are some of the key points that should be discussed among the engagement team to demonstrate that professional scepticism is being applied. It may be the case that there is no fraud/error present but the idea of applying professional scepticism is for the auditor to remain alert to the possibility that there could be fraud/error (indeed fraud, by its very nature, is designed not to be detected).

As well as fraud issues, the team should also discuss how the financial statements could be materially misstated because of error.

The audit engagement partner should also demonstrate the application of professional scepticism when taking responsibility for:

- the direction, supervision and performance of the audit;
- reviews of work performed; and
- the engagement team undertaking appropriate consultation on difficult or contentious matters and considering the conclusions reached from such consultations.

Documenting the discussion

It is common to see a detailed planning memorandum prepared to supplement and draw together the content of the various standard planning forms. However, a planning memorandum drafted before the planning meeting can only ever be evidence of a briefing, it does not provide any evidence of the discussions that took place.

To document the discussions, it is therefore necessary to have a separate file note or minute of the meeting. Another option would be an updated version of the planning memorandum that includes notes taken at the meeting.

The notes taken at the meeting should record:

- who was present at the meeting. This is particularly important in evidencing that the discussions were led by the audit engagement principal; and
- the topics discussed, again ensuring that those matters required to be discussed by the ISAs are recorded.

In the ~~*Navigate*~~ *Audit* tools, the engagement team meeting can be documented ~~as part of the Planning memorandum (**C1**) or~~ on Notes of engagement team planning meeting (*template* **C10**). A checklist of fraud related issues that may be relevant to the engagement team discussion is included on Fraud risk factors (**C9.2**).

Timing of the discussions

Beyond the fact that the initial discussion should take place at the planning stage of the audit, neither ISA (UK) 315 nor ISA (UK) 240 gives any specific guidance as to when during the planning process the discussions should take place. The timing of the discussions is therefore at the discretion of the auditor, given the particular circumstances of the practice and client, the availability of the engagement partner and other members of the audit team, and the audit timetable as agreed with the client. The timing of the team meeting as shown in the planning flowchart in Planning overview is therefore a suggestion only.

Some partners prefer a first draft of the risk assessment and response thereto (see Determining the audit approach) to have already been prepared as a basis for the team discussion. Others favour a ‘blank canvas’ approach to team meetings, which can therefore be held earlier in the planning process and form the basis of the risk assessment and response process.

Either way, given that the discussions should yield a productive assessment of the risk of fraud and error, the meeting should take place before the risk assessments are finalised.

Many firms hold team planning meetings once the planning has been completed and approved, just before the team goes out to the client to start the detailed audit fieldwork. This is more of a team briefing, and while such meetings can be useful, this is not what is envisioned when ISAs refer to team discussions.

Further meetings may of course be held during the course of the engagement to allow team members to communicate and share information gained during the audit which may affect the risk assessment, or the audit procedures performed.

2.15 Service organisations

Quick overview

This section explains the auditor's responsibility when a user entity uses the services of one or more service organisations.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*~~.

This section relates to the Service organisations (**Sup4**) schedule *available as a template* in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

Service organisations

ISA (UK) 402 (Updated May 2022) *Audit Considerations Relating to an Entity using a Service Organisation* is effective for the audit of financial statements for periods commencing on or after 15 June 2010.

ISA (UK) 402 deals with the auditor's responsibility to obtain sufficient appropriate audit evidence when an entity uses the services of a service organisation. It expands on how the auditor applies ISA (UK) 315 (Revised July 2022) *Identifying and Assessing the Risks of Material Misstatement* and ISA (UK) 330 (Revised July 2017) (Updated May 2022) *The Auditor's Responses to Assessed Risks* in obtaining an understanding of the entity, including the entity's system of internal control relevant to the preparation of the financial statements,

ISA (UK) 402:9 requires the auditor, when gathering information to understand the entity, to consider any use of a service organisation and the effect on the entity's internal control. This is in order to identify and assess the risk of material misstatement and hence to design and perform further audit procedures in response to those risks.

A 'service organisation' is any entity that provides services to another, for example:

- information processing;
- maintenance of accounting records;
- facilities management;
- maintenance of safe custody of assets, such as investments; and
- initiation or execution of transactions on behalf of the other entity.

Use of service organisations is often referred to as 'outsourcing'.

It is important to note that it is not appropriate for an auditor to simply rely on reports and information provided by a service organisation. In the absence of any records kept by the entity itself, such reports should be treated as information produced by the entity and which therefore require auditing.

Guidance on issuing reports on service organisations is given in TECH 01/20 AAF AAF Assurance reports on internal controls of service organisations made available to third parties (2020) and ISAE 3402 Assurance Reports on Controls at a Third Party Service Organisation.

Key definitions

Term	**Definition**
Complementary user entity controls	Controls that the service organisation assumes, in the design of its service, will be implemented by user entities and which, if necessary to achieve control objectives, are identified in the description of its system.
Service auditor	An auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.
Service organisation	A third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.
Service organisation's system	The policies and procedures designed, implemented and maintained by the service organisation to provide user entities with the services covered by the service auditor's report.
Subservice organisation	A service organisation used by another service organisation to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.
Type 1 report	A report on the description and design of controls at a service organisation which comprises: • a description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date; and • a report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.
Type 2 report	A report on the description, design and operating effectiveness of controls at a service organisation, which comprises: • a description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and

implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and

- a report by the service auditor with the objective of conveying reasonable assurance that includes:
  - the service auditor’s opinion on the description of the service organisation’s system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
  - a description of the service auditor’s tests of the controls and the results thereof.

User auditor	An auditor who audits and reports on the financial statements of a user entity.
User entity	An entity that uses a service organisation and whose financial statements are being audited.

Source: ISA (UK) 402

Audit objectives and procedures

Where the reporting entity uses a service organisation, ISA (UK) 402 sets out requirements on the procedures necessary to assess the impact of the entity’s use of a service organisation, specifically around:

- obtaining an understanding of the services provided by a service organisation, including internal control;
- responding to the assessed risks of material misstatement (see Evaluate the impact on the audit);
- fraud, non-compliance with laws and regulations and uncorrected misstatements; and
- reporting by the user auditor.

The auditor may also need to consider the financial standing of service organisations used by the reporting entity in assessing the reporting entity’s status as a going concern (see Indemnities (going concern)).

In the PCAS based audit tools, there is a **service organisations work paper *template* (Sup4)** to assist in considering how a reporting entity’s use of a service organisation affects the entity’s internal controls, assessing the risk of material misstatement and the design of further audit procedures.

Obtain an understanding of the work performed by the service organisation

The auditor should obtain and document an understanding of how the user entity uses the services of service organisations in its operations, paying particular attention to:

- the nature of the services provided and the significance of the activities to the user entity, including on internal control;
- the nature and materiality of the transactions processed, or accounts or financial reporting processes affected;
- the degree of interaction between the activities of the service organisation and those of the user entity;
- the nature of the relationship between the user entity and the service organisation, including the contractual terms that apply to relevant activities undertaken;
- how the entity's use of a service organisation affects the user auditor's reporting responsibilities in relation to accounting records arising from laws or regulations; and
- the relevance of the activities to the audit – that is, the effect on risk, audit testing and any effect on how evidence will be obtained.

The auditor should also understand the way the user entity monitors the activities of the service organisation to ensure that it meets its fiduciary and other legal responsibilities. Further requirements relating to internal controls are covered in Obtain an understanding of relevant internal controls.

Identifying relevant activities

Not all outsourced activities have a significant effect on the reporting entity’s financial statements.

Services provided by a service organisation will be relevant when those services, and the controls over them, effectively form part of the entity’s information system relevant to financial reporting. Controls at the service organisation may be relevant to the audit, such as controls over the safeguarding of assets. A service organisation’s services will be part of the entity’s information system if those services affect any of the following:

- the classes of transactions that are significant to the user entity’s financial statements;
- the procedures by which the user entity’s transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- the related accounting records, supporting information and specific accounts in the user entity’s financial statements;
- how the user entity’s information system captures events and conditions, other than transactions, that are significant to the financial statements;
- the financial reporting process used to prepare the financial statements; and
- controls surrounding recurring and non-recurring journal entries.

Subservice organisations

If the service organisation itself outsources some of its activities to another service organisation, the auditor should consider whether those activities are relevant to the audit of the user entity's financial statements. If they are, the requirements of ISA (UK) 402 should be applied also to the operations of the other service organisations.

Characteristics of service organisations which may increase risk

Examples of ways in which different activities undertaken by service organisations can affect the risk of misstatement are given in the table below.

Outsourced accounting functions

Degree of risk	Characteristics	Examples
High	• Complex transactions. • Those undertaking accounting work need extensive business or specialist knowledge. • Delegated authority to initiate and execute transactions. • Effective controls only possible on 'real time' basis. • Reversal of outsourcing costly/difficult. • High cost of performance failure (e.g. misleading management reports leading to poor decision making). • High proportion of finance functions outsourced.	• Maintenance of both accounting records and preparation of budgets and reports control. • Accounting records of retail business.

Medium	• Some business knowledge needed but parameters for necessary judgements can be identified and agreed in advance. • Transactions can be initiated but execution requires approval from entity. • Execution of transactions on instruction from entity. • Analytical techniques insufficient for .adequate degree of control. • Discrete functions outsourced.	• Outsourcing of accounting records by a supplier of raw materials. • Credit control. • Leasing arrangements.
Low	• Little requirement for judgement in processing transactions. • Non-complex transactions. • Little business knowledge required. • Analytical control techniques effective. • Effects of failure can be contained. • Easy to rearrange/find alternative service organisations. • Low proportion of discrete functions outsourced.	• Processing salary payments. • Preparation of invoices. • Data entry.

Further considerations

Outsourced payroll

A common example of a service organisation is the outsourcing of payroll. Often this will be outsourced to the audit firm itself, which presents additional independence issues as described in Documentation of independence. There is no such exemption from the requirements of ISA (UK) 402 where the audit firm is acting as the service organisation. The same procedures and considerations should still be applied.

Outsourced accounting records

Outsourcing all or part of their accounting records does not diminish the responsibilities of those charged with governance in relation to those records. Therefore, for each material element of the accounting records maintained by a service organisation, the auditor should obtain and document an understanding of the way the accounting records are maintained and how those charged with governance ensure the accounting records meet any relevant legal obligations. Under UK company law, those charged with governance must retain ownership of the accounting records and allow the auditor to access them at any time.

ISA (UK) 402 requires that the auditor should assess whether the arrangements for maintaining all or part of the entity's accounting records by a service organisation have any effect on reporting responsibilities in relation to accounting records.

ISA (UK) 420:A11-3 notes that the wording of UK company law is such that it requires companies to keep records rather than cause them to be kept and thus the wording of the contract with the service organisation will need to be reviewed to determine whether the entity retains ownership of those records. It is suggested that the auditor may wish to seek legal advice where there is any doubt on this matter.

Obtain an understanding of relevant internal controls

Detailed guidance on understanding and documenting the entity's system of internal control can be found in Accounting systems, processes and controls.

The auditor must identify and document the relevant controls at the user entity that relate to the services performed by the service organisation, including those that are applied to the transactions processed by the service organisation.

When obtaining an understanding of internal control relevant to the preparation of the financial statements, the user auditor must evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation.

Example – Internal controls relevant to payroll processed by a service organisation

If a user entity uses a service organisation to process payroll, the user entity may establish controls over the submission and receipt of payroll information that could prevent, or detect, material misstatements. These controls may include:

- comparing the data submitted to the service organisation with reports received from the service organisation after the data has been processed;

- recomputing a sample of the payroll amounts for accuracy; and
- reviewing the total payroll amount for reasonableness.

In such a situation, the user auditor may perform tests of the user entity's controls over payroll processing that would provide a basis to conclude that the user entity's controls are operating effectively for the assertions related to payroll transactions.

The user auditor determines whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the financial reporting has been obtained to provide a basis for the identification and assessment of risks of material misstatement.

If the auditor is unable to ascertain sufficient information about the operation of controls at the service organisation from the user entity, ISA (UK) 402 requires the auditor to perform one or more of the following procedures:

- obtain a type 1 report on the description and design of controls or a type 2 report on the description and design of controls and their operating effectiveness, if available (see Using a type 1 or type 2 report);
- contact the service entity, through the user entity, to obtain specific information;
- visit the service organisation and perform procedures that will provide the necessary information about controls; or
- use another auditor to perform those procedures.

Using a type 1 or type 2 report

Type 1 and type 2 reports are prepared under International Standards on Assurance Engagements (ISAE) 3402 *Assurance Reports on Controls at a Third Party Service Organisation* with guidance from AAF 01/06 and are used to support the auditor's understanding of the service organisation. Type 1 and type 2 reports provide differing levels of assurance to the user auditor and, as a result, have different impacts on the remaining work to be carried out.

Type 1 report

A type 1 report is a report on the description and design of the controls at a service organisation and contains:

- the service organisation's description of its system;
- a written assertion by the service organisation that, in all material respects, and based on suitable criteria, the description fairly presents the service organisation's system as designed and implemented as at the specified date and the controls related to the control objectives stated in the service organisation's description of its system were suitably designed as at the specified date; and
- a service auditor's assurance report that gives reasonable assurance on the points above.

Type 2 report

A type 2 report is a report on the description and design and also operating effectiveness of the controls at a service organisation and contains:

- the service organisation's description of its system;
- a written assertion by the service organisation that, in all material respects, and based on suitable criteria, the description fairly presents the service organisation's system as designed and implemented throughout the specified period, the controls related to the control objectives stated in the service organisation's description of its system were suitably designed throughout the specified period and the controls operated effectively throughout the specified period; and
- a service auditor's assurance report that gives reasonable assurance on the points above and also includes a description of the tests of controls and the results thereof.

Sufficiency and appropriateness

In order to determine the sufficiency and appropriateness of the audit evidence provided by the type 1 or type 2 report, the auditor needs to be satisfied as to:

- the service auditor's professional competence and independence from the service organisation; and
- the adequacy of the standards under which the report was issued, particularly where the service auditor practices outside of the United Kingdom.

Using a type 1 or type 2 report as audit evidence to support understanding about the design and implementation of controls

Where the auditor plans to use a type 1 or type 2 report as audit evidence to support understanding about the design and implementation of controls at the service organisation, ISA (UK) 402 requires the auditor to:

- evaluate whether the description and design of controls at the service organisation is at a date or for a period that is appropriate for the auditor's purposes;
- evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal controls relevant to the preparation of the financial statements; and
- determine whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Evaluate the impact on the audit

Once the auditor has obtained an understanding of the services provided by service organisations, including the impact on the client's internal control, the auditor should evaluate the impact on the audit.

Responding to the assessed risks of material misstatement

ISA (UK) 402 requires the auditor to use their understanding of the arrangement to:

- assess whether sufficient appropriate audit evidence can be obtained on the relevant financial statement assertions from the records held at the reporting entity; and if not
- determine effective procedures to obtain audit evidence either by direct access to the records kept by the service organisation or through information obtained from the service organisation or its auditor.

Where the auditor requires evidence concerning balances representing assets held by or transactions undertaken by the service organisation, the auditor may consider the efficiency and effectiveness of the following procedures:

- inspecting records and documents held by the reporting entity;
- establishing the effectiveness of controls;
- obtaining representations to confirm balances and transactions from the service organisation;
- performing analytical review procedures on the records maintained by the reporting entity or the returns from the service organisation;
- inspecting records and documents held by the service organisation;
- requesting the service organisation auditor or the reporting entity's internal audit function to perform specified procedures; and
- reviewing information from the service organisation and its auditor concerning the design and operation of its controls systems.

Example – Client uses an investment manager

Investment managers are one of the most common examples of a service organisation. When auditing the financial statements for an entity with an externally managed investment portfolio, the report produced by the investment manager cannot be accepted unchallenged. This can be a particular issue where the investments consist of a unitised fund. The planning section should detail the audit work required – for example:

- reconciling contributions received by the investment manager to those paid by the company;
- checking the price of units to those published in the financial press; and
- reconciling the movement in the number of units by reperforming calculations for purchases and sales.

Testing the operating effectiveness of controls

When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the auditor obtains evidence about this from one or more of the following:

- obtaining a type 2 report;
- performing appropriate tests of control at the service organisation; or
- using another auditor to perform tests of control at the service organisation.

Where the auditor intends to use a type 2 report as audit evidence that controls at the service organisation are operating effectively, the auditor should:

- consider whether the description, design and operating effectiveness of controls at the service organisation is at a date or for a period that is appropriate;
- determine whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so:

- review the design and implementation of those controls; and
- test their operational effectiveness;

- evaluate the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and
- consider whether the tests of controls performed by the service auditor and the results thereof are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the firm's risk assessment.

In the PCAS based audit tools, there is a **testing the operational effectiveness of controls work paper (S4)** *available in the templates* for documenting the testing of the operating effectiveness of an internal control.

Fraud, error and non-compliance with laws and regulations

ISA (UK) 402 requires the auditor to enquire of management of the user entity whether the service organisation has reported to them any incidences of fraud, non-compliance with applicable laws and regulations and uncorrected misstatements affecting the financial statements of the user entity. Terms of the contract between the user entity and the service organisation may require that such disclosure is made.

If such incidents have been reported, the auditor should consider any impact they may have on the nature, timing and extent of audit procedures.

Indemnities (going concern)

The auditor should review the financial standing of the service organisation and the resources available to it insofar as it is considered necessary to rely on the operation of an indemnity from the service organisation in assessing the entity's status as a going concern.

Reporting by the user auditor

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation which are relevant to the audit of the financial statements, then the auditor's opinion should be modified in accordance with ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report*. Such a limitation on scope may arise where:

- the auditor is unable to obtain a sufficient understanding of the services provided by the service organisation and does not have a basis for the identification and assessment of the risks of material misstatement;
- the auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively but he is unable to obtain sufficient appropriate audit evidence about the operating effectiveness of these controls; or
- sufficient appropriate audit evidence is only available from records held at the service organisation and the auditor is unable to obtain direct access to those records.

Whether the auditor expresses a qualified opinion or disclaims an opinion depends on the individual situation and circumstances.

Where the auditor's report is not modified, it should not refer to the work of a service auditor.

If reference to the work of the service auditor is relevant to an understanding of a modification in the auditor's report, the report should make clear that the reference does not diminish the auditor's responsibility for the audit opinion. The auditor may also need to seek the consent of the service auditor before making such a reference.

Further guidance on modified opinions can be found in Drafting the audit report.

2.16 Using the work of internal auditors

Quick overview

This section explains the auditor's responsibility when undertaking audits of entities which have an internal audit function.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.

This section relates to the Using the work of internal audit (**Sup5**) schedule in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

Internal audit function

ISA (UK) 610 (Revised June 2013) (Updated May 2022) *Using the Work of Internal Auditors* is effective for the audit of financial statements for periods commencing on or after 15 June 2014.

The majority of smaller audit clients will not have any sort of internal audit function. However, very large private companies and charities and listed companies are likely to have an internal audit department. ISA (UK) 610:13 makes clear that where internal audit exists, the external auditor should consider the activities of the internal audit department and their effects, if any, on external audit procedures.

Even where the entity has an internal audit function, the auditor is not required to use its work to modify the nature or timing, or reduce the extent of audit procedures to be performed directly by the external audit team. Use of the internal audit function remains a decision of the auditor in establishing the overall audit strategy.

Key definitions

Term	Definition
Direct assistance	The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.
Internal audit function	A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

Source: ISA (UK) 610

Audit objectives and procedures

Regardless of whether the external auditor plans to use the work of the external audit function, the auditor should obtain a sufficient understanding of the activities of the internal audit function to identify and assess the risks of material misstatement of the financial statements and to design and perform further audit procedures (see Understanding the internal audit function).

Where the client has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, ISA (UK) 610 requires the auditor to:

- determine whether the work of the internal audit function can be used, and if so, in which areas and to what extent (see Determining the extent of use); and
- if using the work of the internal audit function, to determine whether that work is adequate for the purposes of the audit (see Using the work of the internal audit function).

ISA (UK) 610 also covers determining whether, in which areas, and to what extent an internal auditor can be used to provide direct assistance and then further detail on using the internal auditor to provide the direct assistance. However, this is prohibited under ISAs (UK) as explained in Direct assistance.

In the PCAS based audit tools, there is a work paper *programme* for **Using the work of internal audit (Sup5)** to address the procedures for using the work of the internal auditor.

Understanding the internal audit function

Regardless of whether the auditor plans to use the work of the internal audit function, where an internal audit function exists, in accordance with ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement*, the auditor must make enquiries of appropriate individuals within the internal audit function as part of the risk assessment.

The auditor must obtain an understanding of the internal audit function, including its:

- nature
- responsibilities; and
- activities.

The auditor’s understanding of the internal audit function should be documented as part of the understanding of the entity and its environment and its system of internal control (see Accounting systems, process and controls), and the identification and assessment of risks of material misstatement (see Assessing risk).

In the PCAS based audit tools, the Internal control aide-memoire (**C7.1**) is provided to assist with understanding the entity’s internal audit function.

Objectives and scope of the internal audit function

The scope and objectives of internal auditing vary widely and depend on the size, complexity and structure of the entity and the requirements of its management.

Ordinarily, internal auditing activities include one or more of the following:

- assessment of the governance process in its accomplishment of objectives on ethics and values, performance management and accountability;
- identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control;
- performing procedures to assist the entity in the detection of fraud;
- reviewing controls, evaluating their operation and recommending improvements;
- examination of financial and operating information;
- review of the economy, efficiency and effectiveness of operations; and
- review of the compliance with laws, regulations and other external requirements and with management policies and directives.

Depending on the responsibilities of the internal audit function, it may play an important role in the entity's monitoring of internal control over financial reporting. Equally, however, its responsibilities may be more focused on evaluating the efficiency and effectiveness of operations and, if so, its work may not relate directly to the entity's financial reporting.

Additionally, the level of precision that an internal auditor works to may also be higher than that of the external auditor who is primarily concerned with material misstatement in the financial statements, but some of the methods used will be common.

Some entities will sub-contract the internal audit function to a third party but as this is still within the control of the entity, the external auditor may consider its impact on the planned audit procedures.

Enquiries of the internal audit function

Making enquiries of appropriate individuals within the internal audit function will help the auditor to obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the function's audit plan for the period and discussing it with appropriate individuals in the function.

Appendix 4 to ISA (UK) 315 provides examples of reports of the internal audit function that may be relevant to the entity's financial reporting, including:

- the function's strategy and planning documents; and
- reports on the findings of the function's examinations that have been prepared for management or those charged with governance.

Appropriate individuals

Appropriate individuals with whom the auditor should make enquiries are those who the auditor considers to have the appropriate knowledge, experience and authority, for example, the chief internal audit executive.

The auditor should also consider holding periodic meetings with these individuals, if appropriate.

Impact on risk assessment and audit procedures

The auditor’s understanding of the entity's internal audit function, together with the information obtained from enquiries, may provide information relevant to the auditor’s risk assessment (see Assessing risk).

Note that if the internal audit function provides information regarding any actual, suspected or alleged fraud, this must be taken into consideration in the auditor’s risk assessment. Guidance on the auditor’s responsibilities in respect of fraud can be found in Fraud in the audit.

Based on the preliminary understanding of the internal audit function, the auditor may then determine whether to use the function’s work (see Determining the extent of use).

Where an internal audit function is effective, the extent of audit testing may be reduced. However, the auditor will not be able to rely solely on the work of the internal audit function to the extent of performing no additional testing. Additionally, if the internal audit function is effective, this may be a consideration in the external auditor’s assessment of the entity’s control environment and risk assessment.

Communication

The auditor should ensure that communications with the appropriate individuals in the internal audit function are established early on in the audit planning stage and are maintained throughout the engagement.

Establishing good communications with the function facilitates effective information sharing and creates an environment in which the auditor can be informed of significant matters that come to the attention of the function. The auditor is then able to take this information into account in their work and adapt the audit strategy as necessary.

Determining the extent of use

Evaluating the internal audit function

In order to determine whether, and to what extent, the work of the internal audit function can be used, the external auditor needs to firstly evaluate the internal audit function.

ISA (UK) 610:15–16 sets out the criteria the auditor should use to make this evaluation. The external auditor should concentrate on:

Criteria	**Auditor considerations**
The extent to which the function’s organisational status and relevant policies and procedures support the objectivity of the internal audit function.	The specific status of the internal audit department within the entity and the effect this has on its ability to be objective. Ideally, the internal auditors will report to the highest level of management and be free of any other operating responsibility. Any constraints or restrictions placed on them by management would need to be carefully considered. In particular, they will need to be free to communicate fully with the external auditor. Appraise the nature and extent of the internal audit work performed. The external auditor would also need to consider

	whether management acts on internal audit recommendations and how this is evidenced.
Technical competence of the persons performing the work.	Do the internal auditors have adequate technical training and proficiency? The external auditor may, for example, review the policies for hiring and training internal audit staff and their experience and professional qualifications.
Application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting the work of the internal audit function.	Examine whether internal audit work is properly planned, supervised, reviewed and documented. The existence of adequate audit manuals, work programmes and working papers would be considered.
Whether there is likely to be effective communication with the internal auditors.	Is there likely to be effective communication with the internal auditors? This might include holding regular meetings, the provision of access to relevant reports and prompt communication of significant matters arising.

The external auditor's evaluation of these criteria may indicate that the risks to the quality of the work of the function are too significant and that it is therefore not appropriate to use any of the work of the function as audit evidence. In making this evaluation, it is important to consider the factors in aggregate since an individual factor may in itself not lead the auditor to the same conclusion as if that factor were considered in the light of others.

Determining the nature and extent of the internal audit function that can be used

Having determined that the work of the internal audit function can be used for purposes of the audit, the external auditor should consider whether the planned nature and scope of the internal audit function's work is relevant to the overall audit strategy and audit plan.

Examples of work of the internal audit function that may be used by the auditor include:

- testing of the operating effectiveness of controls;
- substantive procedures involving limited judgement;
- observations of inventory counts;
- tracing transactions through the information system relevant to financial reporting;
- testing of compliance with regulatory requirements; and
- in some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group.

Even where using the work of the internal audit function, the external auditor must still make all the significant judgements in the engagement and should therefore ensure that there is no undue use of the work of the internal audit function that is incompatible with making all significant judgements in the audit engagement. The external auditor should consider reducing reliance where:

- more judgement is involved in planning and performing relevant audit procedures and evaluating the audit evidence gathered, for example, in evaluating significant accounting estimates;
- there is considered to be a higher risk of material misstatement or where significant risks have been identified;
- the organisational status and relevant policies and procedures of the function support their objectivity to a lesser degree; and
- the level of competence of the internal audit function is lower.

In the latter two situations, the auditor would need to consider carefully whether any reliance on the internal audit function was appropriate.

The auditor also needs to evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in sufficient involvement in the audit, given the sole responsibility for the audit opinion expressed. In making this evaluation, it is important to consider the factors in aggregate since an individual factor may, in itself, not lead the auditor to the same conclusion as if that factor were considered in the light of others.

The external auditor's evaluation of these criteria may indicate that the risks to the quality of the work of the function are too significant and that it is therefore not appropriate to use any of the work of the function as audit evidence.

In addition, as part of giving an overview of the planned scope and timing of the audit, the external auditor needs to communicate to those charged with governance how the work of the internal audit function is planned to be used.

Example – determining the extent of use

The example below sets out two scenarios and details the reliance that may be placed on the work of an internal audit function in each situation.

Example – Evaluating the work of the internal audit function

Case A

An internal audit function is staffed by a number of qualified accountants. Reports go to the audit committee. Their programme of work consists of, among other things, systems checks and periodic audits of branch returns. The external auditor receives reports as and when produced.

Case B

Internal audits are carried out on a part-time basis by the controller of one subsidiary. Work is mainly of an ad hoc nature, looking at problem areas both in terms of control and efficiency and producing reports for the finance director.

Extent of reliance

Based upon the facts set out here, the possible extent of reliance in Case A would appear to be far greater than in Case B. The auditor may seek to rely on work performed on the internal control systems by the internal audit function, together with some of the checks carried out during the audits of branch returns.

In contrast, in Case B, the opportunities for reliance on the internal audit function would be greatly reduced. Some reliance may be possible in areas reported on which have relevance to the external audit. However, because of the status of the internal audit function and its method of operation, there would probably be less reliance and a greater level of procedures in the relevant area.

Using the work of the internal audit function

Where the external auditor plans to use the work of the internal audit function, the auditor needs to:

- agree the timing, nature, extent of the work with the internal audit function as well as discussing materiality, sample methods, documentation and review and reporting procedures;
- read the reports of the internal audit function that relate to the work the auditor plans to use to obtain an understanding of the nature and extent of the audit procedures performed by the internal audit function and the related findings;
- perform sufficient audit procedures on the internal audit function's work to determine its adequacy for purposes of the audit, including whether:
  - the work of the function has been properly planned, performed, supervised, reviewed and documented;
  - sufficient appropriate audit evidence has been obtained to enable the function to draw reasonable conclusions; and
  - conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed;
- consider whether the nature and extent of the audit procedures were responsive to the evaluation of:
  - the amount of judgement involved;
  - the assessed risk of material misstatement; and
  - the level of competence of the function;
- reperform some of the internal audit function's work; and
- determine whether the initial evaluation of the internal audit function and the appropriateness of their work to the audit remains valid.

If the external auditor concludes that the internal audit function's work is not adequate for the purposes of the audit, the auditor should consider what additional procedures are necessary in order to have sufficient appropriate evidence to form an opinion.

Documentation

When the auditor uses the work of the internal audit function, documentation on the audit file needs to include:

- an evaluation of:

- whether the function's organisational status and relevant policies and procedures adequately support the objectivity of the internal auditor;
- the level of competence of the function; and
- whether the function applies a systematic and disciplined approach, including quality control;
    - the nature and extent of the work used and the basis for that decision; and
    - the audit procedures performed by the external auditor to evaluate the adequacy of the work used.

Where the auditor decides not to use the work of the internal audit function, the auditor's understanding of the internal audit function's responsibilities, its organisational status and the activities to be performed and the implications for the audit risk assessment should still be documented.

Direct assistance

Direct assistance is defined as the use of an internal auditor to perform audit procedures under the direction, supervision and review of the external auditor. Under the IAASB's ISA 610, direct assistance is permitted subject to certain restrictions.

However, the FRC has concluded that it is not appropriate to allow the use of direct assistance in audits under ISA (UK) 610. This is because those individuals providing the direct assistance would not be independent of the audited entity under the Ethical Standard, which would seem to compromise the independence of the audit engagement team employed by the audit firm. Further, the risk to audit quality is heightened by the use of direct assistance since the individual providing direct assistance would not be familiar with the external auditor's processes, including those for quality control.

Therefore, the FRC has concluded that direct assistance should be prohibited for audits conducted in accordance with ISAs (UK) and that this should be extended in a group audit to any component auditor whose work is relied upon by the group auditor, including for overseas components. This does not represent a divergence from the IAASB's ISA 610, since the IAASB makes clear that its requirements in this area will not be applicable in jurisdictions where direct assistance is prohibited.

2.17 Using the work of experts

Quick overview

This section examines situations where the auditor relies on other experts for part of the audit evidence. It covers reliance on both experts appointed by management and experts appointed by the auditor.

This section does not cover the procedures required when relying on a component auditor, these are covered in detail in Consolidation and groups.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas~~ of *Navigate Audit*.~~

This section relates to the following schedules in the Private Company (PCAS) based audit tools:

- Using the work of management's expert (*template* **Sup2**);
- Using the work of an auditor's expert (*template* **Sup3**).

Scope and definitions

Scope

Management's expert

ISA (UK) 500 (Updated May 2022) *Audit evidence* is effective for the audit of financial statements for periods commencing on or after 15 December 2019.

A management's expert is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

A management's expert is therefore someone appointed by management for the purpose of helping management prepare the financial statements. The scope of their work is defined by, and used by, management primarily; it is not designed for the auditor's use per se. Care must therefore be taken by auditors in making use of such work to ensure it is relevant, reliable and suitable for the purposes of the audit.

Some of the experts most frequently used by clients are:

- actuaries – to determine defined benefit pension scheme liabilities;
- surveyors – to value property;
- professional stocktakers – to count and value stocks (see Inventory); and
- language experts – to translate the financial statements of overseas branches and subsidiaries for inclusion in consolidated accounts.

Auditor's expert

ISA (UK) 620 (Revised November 2019) (Updated May 2022) *Using the Work of an Auditor's expert* is effective for the audit of financial statements for periods commencing on or after 15 December 2019.

An auditor's expert is an individual, or organisation, possessing expertise in a field other than accounting and auditing, whose work in that field is used by the auditor to assist in obtaining sufficient appropriate audit evidence. The auditor's expert may be either an auditor's internal expert (who belongs to the auditor's firm or network) or an auditor's external expert. They are often members of another profession such as surveyors, actuaries or engineers.

In the course of an audit, the auditor may need to obtain audit evidence from an expert, whether internal or external to the firm. This might be in the form of a report, opinion or valuation. Examples are:

- asset valuations (e.g. of land and buildings);
- determination of quantities or physical condition of assets (e.g. minerals stored in stockpiles);
- determination of amounts using specialised techniques or methods (e.g. an actuarial valuation of a defined benefit pension scheme);
- the measurement of work completed and to be completed on contracts in progress; and
- legal opinions concerning interpretations of agreements, statutes and regulations.

Although the work of an expert may be used, the auditor retains sole responsibility for the audit opinion.

Audit and accounting specialists

ISA (UK) 620 is restricted in scope to exclude audit and accounting knowledge. Therefore, where an engagement team requires specialised skills the individual will fall under the scope of ISA (UK) 220 (Revised November 2019) (Updated May 2022) *Quality Control for an Audit of Financial Statements* paragraph as an audit and accounting specialist.

Audit and accounting specialists are also called 'a member of the engagement team with expertise in a specialised area of accounting or auditing'. These individuals represent members of the audit team who complete audit testing on an area which requires specialist skills, e.g. IT audit or forensic audit skills. Although the individual is considered a member of the engagement team they may be engaged by the firm, rather than employed directly.

Where a specialist in one of these fields (whether internal or external) is to be used, the individual should be supervised in accordance with the requirements of ISA (UK) 220:A20 which suggests that the following matters should be considered:

- agreeing with members of staff the nature, scope and objectives of their work, and the respective roles of, and the nature, timing and extent of communication between them and other members of the engagement team; and
- evaluating the adequacy of their work including the relevance and reasonableness of their findings or conclusions and their consistency with other audit evidence.

In May 2021, a revision to ISA (UK) 220 was issued which is effective for audits of financial statements for periods commencing on or after 15 December 2021, although early adoption is permitted. At the time of writing, this version has not been included in detail here.

Component auditors

Special considerations apply in the audit of group financial statements where the group auditor relies on work performed by component auditors. This section does not cover the procedures required when relying on a component auditor, these are covered in detail in Consolidation and groups.

Key definitions

Term	**Definition**
Accounting records	The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as worksheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
Appropriateness (of audit evidence)	The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.
Audit evidence	Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and information obtained from other sources.
Auditor's expert	An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm) or an auditor's external expert.
External information source	An external individual or organisation that provides information that has been used by the entity in preparing the financial statements, or that has been obtained by the auditor as audit evidence, when such information is suitable for use by a broad range of users. When information has been provided by an individual or organisation acting in the capacity of a management's expert, service organisation or auditor's expert, the individual or organisation is not considered an external information source with respect to that particular information.
Expertise	Skills, knowledge and experience in a particular field.

Management's expert	An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.
Sufficiency (of audit evidence)	The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.
Engagement team	All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform audit procedures on the engagement. This excludes an auditor's external expert engaged by the firm or by a network firm.

Source: ISA (UK) 500 , ISA (UK) 620 , ISA (UK) 220

Using the work of management's expert

Audit objectives and procedures

The required audit procedures in this area are similar to those which apply when using an auditor's expert (see Using the work of an auditor's expert). The key procedures per ISA (UK) 500:8 are as follows:

- evaluate the competence, capabilities and objectivity of that expert;
- obtain an understanding of the work of that expert; and
- evaluate the appropriateness of management's expert's work as audit evidence for the relevant assertion.

The nature, timing and extent of audit procedures in relation to work performed by management's experts will be affected by many factors such as:

- the nature and complexity of the matter;
- the risks of material misstatement;
- the availability of alternative sources of evidence;
- the nature, scope and objectives of the management's expert's work;
- whether the management's expert is employed by the entity or is a party engaged by it to provide relevant services;
- the extent to which management can exercise control or influence over the work of the management's expert;
- whether the management's expert is subject to technical performance standards or other professional or industry requirements;
- the nature and extent of any controls over the management's expert's work;
- the auditor's knowledge and experience of the management's expert's field of expertise; and
- the auditor's previous experience of the work of that expert.

In *Audit Automation using* PCAS, there is a work paper *template* for **Using the work of management's expert (Sup2)** for use where information to be used as audit evidence has been prepared using the work of management's expert and that expert's work is significant to the audit.

Evaluate the competence, capabilities and objectivity of management's expert

In order to evaluate the competence, capabilities and objectivity of management's expert, the auditor will need to evaluate evidence from a variety of sources, such as:

- personal experience with previous work of that particular expert;
- discussions with the expert and with others familiar with the expert's work;
- knowledge of the expert's qualifications, membership of a professional body or industry association, licence to practice, etc.;
- published books or papers written by the expert;
- the resources and time available to the expert; and
- an auditor's expert, where used, who assists the auditor in obtaining sufficient appropriate audit evidence with respect to the information produced by the management's expert.

The auditor may also need to consider the relevance of the management's expert's competence for the matter in question. For example, a particular actuary used by management may specialise in property insurance but have limited expertise regarding pension calculations.

The auditor will need to consider the objectivity of the management's expert, which will normally be of greater importance when the expert has been appointed by management rather than the auditor. A broad range of circumstances may threaten objectivity, e.g. self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats and may be created either by external structures (e.g. the management's expert's profession, legislation or regulation) or by the management's expert's work environment (e.g. quality control policies and procedures). However, safeguards are unlikely to eliminate all threats to a management's expert's objectivity.

ISA (UK) 500:A43 suggests that it may be relevant to discuss with management and the expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- financial interests;
- business and personal relationships; and
- the provision of other services to the entity under audit.

Obtain an understanding of the work of management's expert

The auditor needs to obtain an understanding of the work of the management's expert, including an understanding of the relevant field of expertise. Aspects of the expert's field relevant to the auditors understanding may include:

- whether the expert's work has any areas of speciality within it that are relevant to the audit;
- whether any professional standards or regulatory requirements apply;
- what assumptions and methods are used by the management's expert and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes; and
- the nature of the internal and external data the expert uses.

Evaluating the terms of reference or other written instructions from the company to the expert may assist the auditor in determining the appropriateness of the following:

- the nature, scope and objectives of that expert's work;
- the respective roles and responsibilities of management and that expert; and
- the nature, timing and extent of communication between management and the expert, including in the form of any report to be provided by the expert.

Where such documentation is not available (e.g. where the expert is employed by the entity), inquiry of the expert and other members of management may be the most appropriate way for the auditor to gain the necessary understanding.

Evaluate the appropriateness of the management's expert's work

In order to evaluate the appropriateness of the management's expert's work as audit evidence, the auditor needs to consider:

- the relevance, completeness and accuracy of any source data used by the expert (consider both internal and external information sources);
- the relevance and reasonableness of any significant assumptions and methods used by the expert and their consistency with prior periods;
- the relevance and reasonableness of the expert's findings or conclusions;
- the consistency of the expert's findings or conclusions with other audit evidence;
- whether the expert's findings and conclusions are appropriately reflected in the financial statements; and
- the timing of work undertaken.

It should be remembered that the work was undertaken for management and not for the purposes of the audit and so its appropriateness as audit evidence should be carefully considered.

Using the work of an auditor's expert

Audit objectives and procedures

ISA (UK) 620 requires the auditor to:

- determine whether the use the work of an auditor's expert is necessary to obtain sufficient appropriate audit evidence (see Determine the need for an auditor's expert); and
- if using the work of an auditor's expert, to determine whether that work is adequate for the purposes of the audit.

To determine whether work performed by the auditor's expert is adequate for the purposes of the audit, the auditor must:

- evaluate the competence, capabilities and objectivity of the auditor's expert;
- obtain an understanding of the field of expertise of the auditor's expert;
- agree terms with the expert (see Agreement with the auditor's expert)
- evaluate the adequacy of the auditor's expert's work; and
- follow certain documentation requirements set out in ISA (UK) 620.

In *Audit Automation using* PCAS, there is a work paper *in the templates* for **Using the work of an auditor's expert (Sup3)** for use where information to be used as audit evidence has been prepared using the work of an auditor's expert and that expert's work is significant to the audit.

Determine the need for an auditor's expert

The auditor is required to determine whether it is necessary to use an auditor's expert to assist in obtaining appropriate audit evidence. When determining the need to use the work of an auditor's expert, the auditor may need to consider:

- whether those charged with governance have used an expert (management's expert) in preparing the financial statements;
- the nature and significance of the matter in the context of the audit (e.g. whether it relates to an area involving subjective and complex judgements);
- the risks of material misstatement in the matter;
- the expected nature of audit procedures planned to respond to identified risks, including:

- the engagement team's knowledge and previous experience of the matter being considered; and
- the quantity and quality of other audit evidence expected to be obtained.

Evaluate the competence, capabilities and objectivity of the auditor's expert

Once a decision has been made to use the work of an expert, the auditor should evaluate the expert's professional competence, capabilities and objectivity.

Competence and capabilities

'Competence' relates to the nature and level of expertise of the auditor's expert and 'capability' relates to the ability of the auditor's experts to exercise that competence in the circumstances of the engagement.

Evaluating competence and capabilities will involve considering information from a number of sources, including:

- knowledge of the expert's professional certification or licensing by, or membership of, an appropriate professional body;
- the expert's experience and reputation in the area of expertise in question;
- the resources available to the expert;
- personal experience with previous work of that expert;
- discussions with the expert;
- discussions with others who are familiar with the work of that expert; and
- the audit firm's quality control policies and procedures.

Objectivity

The objectivity of the expert should also be considered. Normally, an expert appointed by the auditor for the purpose of the audit will not have the same objectivity issues which may exist when the expert is employed by or related to the client (see Using the work of management's expert).

The evaluation of objectivity must include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.

The objectivity of the expert will be impaired if the expert is either employed by the entity or related to it in some way (e.g. they are a shareholder). ISA (UK) 620:A19 states that where 'a proposed auditor's expert is an individual who has played a significant role in preparing the information that is being audited, that is, if the auditor's expert is a management's expert', there are no safeguards that can be applied to reduce the threats to objectivity to an acceptable level.

Where the expert is an employee of the auditor or the auditor's firm, the auditor will still need to assess aspects of the expert's work and results as if the expert was a third party, although the expert's skills and competence may not need to be considered for each assignment. The auditor, however, needs to have regard to the related ethical guidance when deciding if employees of the firm can be used as experts on an audit assignment. The auditor must ensure that their objectivity and independence is not impaired, which would be the case where 'in house' experts have performed a valuation of an asset or liability of the client for inclusion in its balance sheet.

Public interest entities

For public interest entities, where the auditor has used the work of an auditor's external expert, confirmation needs to be obtained from that external expert regarding the expert's independence. In addition, ISA (UK) 260 (Revised November 2019) (Updated May 2020) *Communication with those Charged with Governance* requires the auditor to communicate in the additional report to the audit committee when the work of an external expert has been used and to confirm that confirmation from the external expert regarding independence has been obtained.

Obtain an understanding of the field of expertise of the auditor's expert

Before using the work of an expert, a sufficient understanding of the field of expertise of the expert needs to be obtained to enable the auditor to:

- determine the nature, scope and objectivity of the expert's work for purposes of the audit; and
- evaluate the adequacy of that work.

This includes understanding:

- whether the expert's field has areas of speciality that are relevant to the audit;
- whether any professional, legal or regulatory requirements apply;
- what assumptions and methods, including models where applicable, will be used by the expert;
- whether they are generally accepted within the field and appropriate for financial reporting purposes; and
- the nature of internal and external data or information that will be used by the expert.

Agreement with the auditor's expert

The nature, scope and objectives of the auditor's expert's work may vary considerably depending on the circumstances. Therefore, these matters should be agreed before the expert commences work and may be best clarified in writing.

The letter of instruction should contain details of:

- the nature, scope and objectives of the expert's work;
- the respective roles and responsibilities of the auditor and the expert;
- the nature, timing and extent of communication between the expert and the auditor (including the form of any report to be provided by that expert); and
- the need for the expert to observe confidentiality requirements.

The letter of instruction may also contain details regarding access to, and retention of, each other's working papers and the expected method and frequency of communication between the auditor and the expert.

Evaluate the adequacy of the auditor's expert's work

The auditor should assess the adequacy of the expert's report as audit evidence regarding the financial statement assertions being considered. This will involve assessment of:

- the relevance and reasonableness of the expert's findings and their consistency with other audit evidence;
- any assumptions and methods used and their relevance and reasonableness in the circumstances; and

- any source data used and its relevance, completeness and accuracy.

Where the expert's role is to evaluate assumptions and methods used by management in developing an accounting estimate, including any models used, the auditor's procedures are likely to focus on whether the auditor's expert has adequately reviewed those assumptions and methods. Where the expert is primarily involved in developing an auditor's estimate for comparison with that used by management, the auditor's procedures may be primarily directed to evaluating the assumptions and methods used by the expert.

In evaluating significant assumptions and methods used by the expert, the auditor may consider whether they are:

- generally accepted within the auditor's expert's field;
- consistent with the requirements of the applicable financial reporting framework;
- dependent on the use of specialised models; and
- consistent with those of management, and if not, the reason for, and effects of, the differences.

The auditor should ensure that the data used by the expert is sufficient, relevant and reliable and may consider reviewing or testing this data for example by verifying the origin of the data, including obtaining an understanding of, and where applicable testing, the internal controls over the data and reviewing or testing the data for completeness and internal consistency.

Where the work of the expert is not considered adequate for the auditor's purposes, the auditor needs to either:

- agree with the expert on the nature and extent of further work to be performed by the expert;
- consider employing another expert; or
- perform additional audit procedures.

Reference to the expert in the auditor's report

When the auditor is satisfied with the work of the expert, there is no need for the expert to be referred to in the audit report, unless specifically required by law or regulation. If the auditor needs to refer to the expert because such a reference is relevant to an understanding of a modification in the report, then the auditor must make it clear in the report that the reference does not in any way reduce the auditor's responsibility for the opinion.

Documentation

When an auditor asks an auditor's expert for advice, ISA (UK) 620:15-1 requires that the auditor must document the request made and the advice received.

Audit documentation will also normally include evidence supporting the auditor's assessment of the expert's competence, capabilities and objectivity and the auditor's evaluation of the adequacy of the expert's work. For public interest entities, this will also include the required confirmation regarding the expert's independence (see Objectivity).

Using the work of audit and accounting specialists

ISA (UK) 620 is restricted in scope to exclude audit and accounting knowledge. Therefore, where an engagement team requires specialised skills, the individual will fall under the scope of ISA (UK) 220 as an audit and accounting specialist. Audit and accounting specialists are also called 'a member of the engagement team with expertise in a specialised area of accounting or auditing'

ISA (UK) 240 (Revised May 2021), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires the auditor to determine whether the engagement team requires specialised skills or knowledge to:

- perform the risk assessment procedures;
- identify and assess the risks of material misstatement due to fraud;
- design and perform audit procedures to respond to those risks;
- evaluate the audit evidence obtained; or
- investigate further any misstatements identified during the audit due to fraud or suspected fraud.

Considerations when using an audit and accounting specialist

Factors that may affect the auditor's decision about whether the engagement team requires specialised skills or knowledge, include, for example:

- the complexity of transactions;
- the complexity of data flows;
- the use of complex model;
- the complexity of contractual terms;
- the complexity of related party relationships;
- the use of complex financial instruments or other complex financing arrangements;
- the use of special-purpose entities;
- matters involving a high degree of judgement;
- the complexity and extent of the entity's use of information technology;
- the estimation of non-financial information; and
- possible need for forensic skills as part of the risk assessment process, and to follow up on identified or suspected fraud.

When planning to use an audit and accounting specialist it may be useful to consider:

- when the audit and accounting specialist's work is needed, including how this interacts with the work of other team members;
- the Scope of the work, and whether it is sufficiently broad to provide the sufficient, appropriate audit evidence required;

- how they will work with the existing team, including who they will report to, whether they will need junior staff members to help them and who is able to allocate these staff;
- who will be reviewing the work of the audit and accounting specialist, and whether they have sufficient experience and knowledge to be able to review the work appropriately; and
- whether these specialists will be performing audit work, or whether their work will be limited to consultation role and the responsibility for the planning, execution and conclusion being held by the audit team.

The auditor should also consider whether it would be useful to include any specialists at any discussions amongst the engagement team. This may be of particular use for the parts of the discussion relating to fraud. Further guidance on this discussion can be found in Audit team planning meeting.

Insight: Technical teams within firms

Many firms have teams to provide guidance on technical areas of audit and accounting. In general, these teams do not form part of the engagement team and do not perform the audit testing. Where testing is not performed, these teams are limited to being used for ‘consultation’, with responsibility for the testing, conclusion and approach being held within the engagement team. For this consultation to be effective the auditor should ensure that this team:

- is given all the relevant facts that will enable them to provide informed advice; and
- have appropriate knowledge, seniority and experience.

3. Execution

3.1 Audit evidence

Quick overview

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, but will normally result from a mix of tests of control and substantive procedures, including analytical review.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance ~~found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.~~

Scope and definitions

Scope

ISA (UK) 500 (Updated May 2022) *Audit evidence* was updated in May 2022 to include conforming amendments arising from the revision to ISA (UK) 315 (Revised July 2020) *Identifying and assessing the risk of material misstatement*. The updated ISA is effective for audits of financial statements for periods commencing on or after 15 December 2019.

ISA (UK) 501 (Updated May 2022) *Audit Evidence – Specific Considerations for Selected Items* and ISA (UK) 505 (updated May 202) *External confirmations* were also updated in May 2022 to include conforming amendments arising from the revision to ISA (UK) 315 and are effective for audits of financial statements for periods commencing on or after 15 December 2010.

Insight – Revisions to ISA 500

In September 2022, the IAASB issued an exposure draft of a revision to ISA 500. At the time of writing, summer 2023, the final standard was expected in to be issued in summer 2024. When issued, this will result in revisions to the UK standard. In revising this standard, the IAASB aims to:

- clarify the purpose of ISA 500 and how it relates to the other ISAs;
- modernize how the standard deals with the variety of information available to an auditor, and the various sources of such information;
- recognize the use of technology, both in the context of:
- an entity's use of technology in preparing the financial statements and in generating other underlying information; and
- the auditor's use of technology in performing audit procedures;
- clarify the concept of sufficient appropriate audit evidence; and
- emphasize the auditor's responsibility to exercise professional scepticism.

Key definitions

Term	Definition
Accounting records	The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
Appropriateness (of audit evidence)	The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.
Audit evidence	Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and information obtained from other sources.
External information source	An external individual or organisation that provides information that has been used by the entity in preparing the financial statements, or that has been obtained by the auditor as audit evidence, when such information is suitable for use by a broad range of users. When information has been provided by an individual or organisation acting in the capacity of a management's expert, service organisation or auditor's expert, the individual or organisation is not considered an external information source with respect to that particular information.
Management's expert	An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.
Sufficiency (of audit evidence)	The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Source: ISA (UK) 500 (Updated May 2022) Audit Evidence

Audit objectives and concept of evidence

The programmes of detailed audit procedures drawn up by the auditor are designed to achieve the audit objectives and ultimately enable an opinion to be formed on the truth and fairness of the financial statements. ISA (UK) 500 states that: 'The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion' (ISA (UK) 500:4). The *ICAEW Code of Ethics* also requires the auditor to act with professional skill which demands an expertise in accumulating and assessing the evidence necessary to form an audit opinion.

Audit evidence includes information contained in the accounting records underlying the financial statements and information from other sources. It may include information obtained from previous audits, provided that the auditor has determined whether changes have occurred since the previous audit that would affect its relevance to the current audit, or information obtained from the firm's procedures for client acceptance and continuance.

Information that may be used as audit evidence may have been prepared using the work of a management's expert or be obtained from an external information source. Audit evidence comprises both information that supports and corroborates management's assertions and any information that contradicts such assertions. In addition, in some cases, the absence of information (e.g. management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

The tests should be designed to enable the auditor to confirm that sufficient and appropriate audit evidence hasbeen obtained. ISA (UK) 500:5 states that sufficiency is a measure of the quantity of the audit evidence, whereas appropriateness is a measure of the quality or relevance and reliability of the audit evidence obtained. Audit evidence is often persuasive rather than conclusive. It is therefore frequently appropriate to design more than one test relating to the same audit objective in order to allow the auditor to form a conclusion on the sufficiency and appropriateness of the audit evidence that has been obtained.

It is essential that, when designing tests, the auditor is aware of and understands the difference between compliance testing or tests of control and substantive procedures. These two types of test are described below.

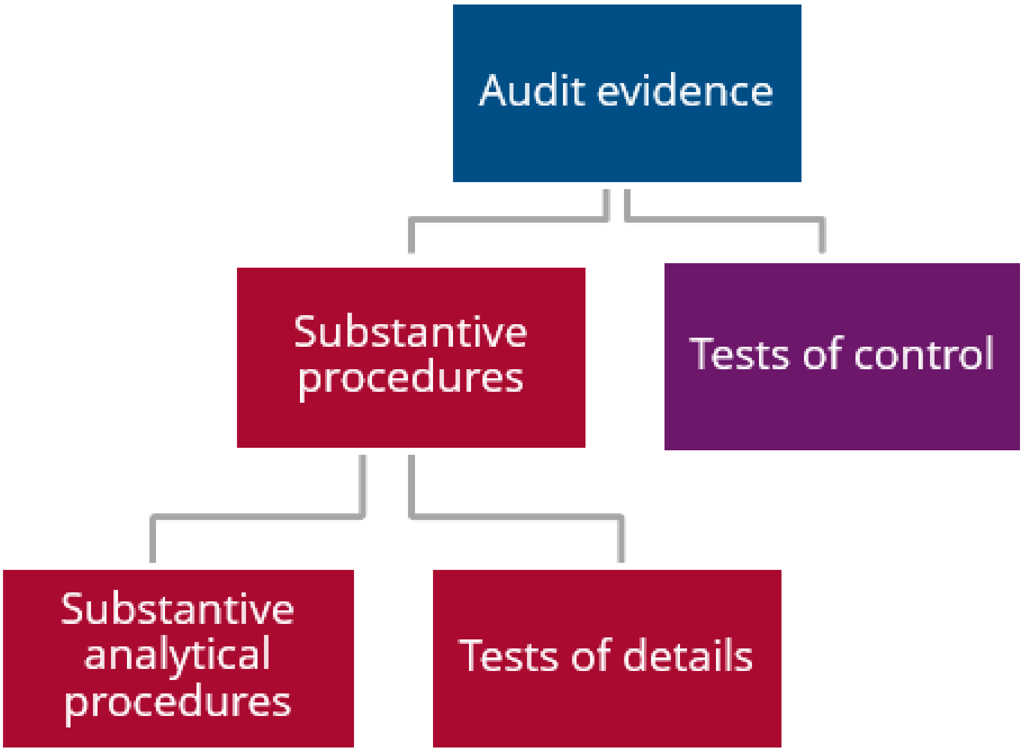
The nature and timing of audit procedures will depend on the information available to the auditor. Where information is held in electronic form, the auditor may carry out Computer Assisted Audit Techniques (CAATs).

Professional scepticism is an essential feature of an audit and is necessary to the critical assessment of audit evidence. Following criticism from regulators and other commentators, the exercise of professional scepticism by auditors and the role of standards in influencing this continue to be matters of debate and an area of focus for standard setters. This is considered in Professional scepticism.

CCH Audit Automation requires audit programmes to be tailored to ensure all risks are covered with the minimumof tests.

Audit testing

Audit evidence can be obtained in a number of different ways, but will normally result from a mix of tests of control (compliance testing) and substantive procedures, including analytical review. In many cases, particularly with small companies, where there are unlikely to be significant controls, audit evidence may be obtained entirely by substantive testing.



Tests of control

Tests of control are audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level, i.e. is the system capable of preventing and detecting material misstatement. When testing the operation of controls, the auditor seeks to establish whether the controls have operated for the whole of the period under review. Where controls are not effective, such testing may indicate the existence of audit risk.

Where tests of control can be undertaken, they may enable the auditor to reduce the number of substantive audit tests that need to be carried out.

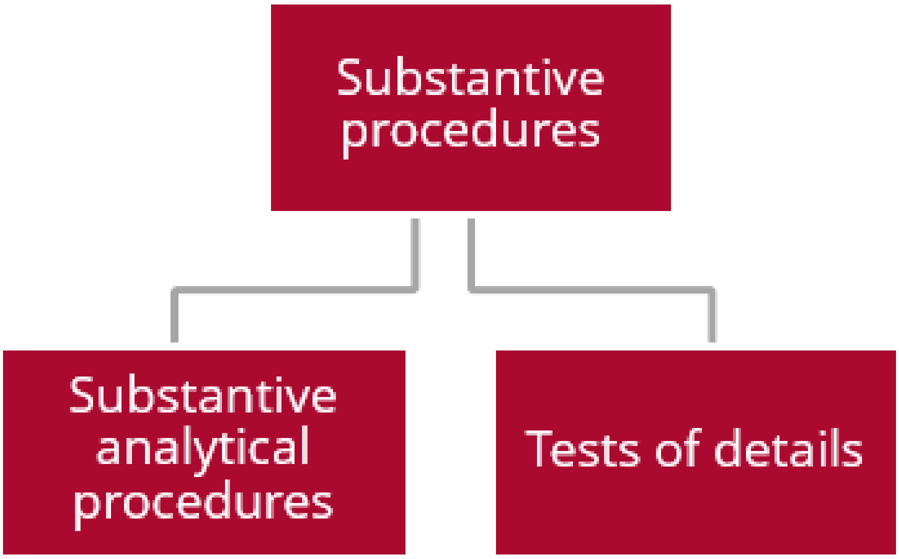
Further details of the types of controls can be found in Accounting systems, processes and controls. In addition, specific controls that can beapplied in individual sections have been separately identified.

Substantive testing

Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. Substantive procedures comprise:

(i) tests of details (of classes of transactions, account balances and disclosures); and

(ii) substantive analytical procedures (or SAPs).



Depending on the circumstances, the auditor may determine that:

- performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls;
- only tests of details are appropriate;
- a combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

Substantive analytical procedures

In general, substantive analytical procedures are more suited to large volumes of transactions that tend to be predictable over time.

Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

Further guidance on these procedures is given in Substantive analytical procedures.

Tests of details

Tests of details is not defined by the standards instead ISA (UK) 330 (Revised July 2017) (updated May 2022) *The Auditor's Responses to Assessed Risks* specifies that tests of details is one of the options for a substantive procedure, with substantive analytical procedures being the other.

Tests of details means performing a procedure on the underlying accounting record or transaction, it is generally more granular than substantive analytical procedures which will look at data patterns. Examples of tests of details include:

- vouching to invoice;
- checking receivable receipts post year end;
- agreeing to debtor confirmations;
- agreeing to bank confirmations;
- checking for unrecorded liabilities;
- vouching reconciliation items.

The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence e.g. this could be selecting items from the fixed asset listing and verifying that they exist. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included e.g. this could involve selecting items from a list of post year end payments, or a list of all suppliers in the period.

The auditor should ensure that they use an appropriate population for the test.

Sufficient appropriate evidence

As noted above, the auditor's objective is to obtain 'sufficient appropriate audit evidence' to be able to draw a conclusion. ISA (UK) 500 contains a discussion on what 'sufficient appropriate evidence' means. Sufficiency is seen as a measure of the quantity of audit evidence and appropriateness is a measure ofits quality, including its relevance and its reliability.

The auditor is rarely able to rely on conclusive evidence, but uses persuasive evidence which is supported by information from different sources. The auditor seeks reasonable, but not absolute, assurance that there are no materialmisstatements and may choose to rely on sample data, extracted either statistically or judgmentally, in order to form their opinion on a particular balance or class of transaction. Reasonable assurance will be obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

The auditor is required to design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. They need to look for evidence that is both corroborative and potentially contradictory.

Audit evidence is cumulative in nature and the decision on whether there is sufficient appropriate evidence is amatter for the auditor's judgment and is influenced by:

- the assessment of the nature and degree of risk of material misstatement at both the financial statement level and at the account balance or transaction level;
- the nature of the accounting and internal control systems and the assessment of the control environment;
- the materiality of the item being examined;

- previous experience of the client and the auditor's knowledge of the business;
- the results of auditing procedures and work on preparing the financial statements; and
- the source and reliability of information available.

The reliability of audit evidence can be judged using the following general criteria:

- external evidence, e.g. confirmation obtained from third parties, and information from an external information source, is generally more reliable than internal evidence;
- evidence from the entity's records and systems is generally more reliable when the related accounting and internal control system is satisfactory;
- evidence obtained directly by the auditor is generally more reliable than that obtained from the entity;
- evidence in the form of documents and written representations is generally more reliable than oral representations; and
- original documents are generally more reliable than photocopies or facsimiles.

Where the auditor performs procedures on information produced by the entity, they should first satisfy themselves as to the accuracy and completeness of the information. For example, if the auditor is verifying provisions against debtors outstanding at the year end, using an aged debts list prepared by the entity, they should first satisfy themselves that the listing is complete and correctly aged by checking invoices raised in the period for inclusion on the listing where appropriate and amounts on the listing back to dated invoices. The auditor also needs to ensure that the information is sufficiently precise and detailed for their purposes, e.g. performance measures used by management may not be precise enough to detect material misstatements where the same information is used by the auditor.

Consistency is obviously important in deciding the sufficiency and appropriateness of the evidence obtained – see Dealing with inconsistent or potentially unreliable evidence. The auditor also needs to consider the relationship between the cost of obtaining evidence and its usefulness bearing in mind that the difficulty and expense of obtaining evidence is not a valid reason for not obtaining it.

Sources of evidence

Some audit evidence is obtained by performing procedures to test the accounting records. For example, analysis and review, reperforming procedures followed in the financial reporting process andreconciling information may help the auditor to determine that the accounting records are internally consistent and agree to the financial statements.

Where the auditor is able to corroborate evidence from different sources or items of a different nature, the auditor will usually obtain more assurance than from those items considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from internally generated information, such as accounting records, minutes of meetings, etc.

External information sources

ISA (UK) 500 includes the concept of 'external information sources', being defined as an external individual or organisation that provides information that has been used by the entity in preparing the financial statements, or that has been obtained by the auditor as audit evidence, when that information is suitable for use by a broad range of users, e.g. mortality tables, credit history data, pricing data, industry specific data such as viewership information or ratings to determine advertising revenue in the entertainment industry.

When the information has come from an individual or organisation acting in the capacity of a management's expert, service organisation or auditor's expert, the individual or organisation is not considered an external information source with respect to that particular information.

An external individual or organisation cannot, in respect of any particular set of information, be both an external information source and a management's expert, service organisation or auditor's expert.

Using assertions to gather audit evidence

ISA (UK) 315 requires that the auditor's consideration of the risk of material misstatement is made at assertion level (see Assessing risk). When seeking to obtain audit evidence from audit procedures, the auditor should consider the extent to which the evidence supports the relevant financial statement assertions.

The term 'assertions' refers to the individual representations made by management and which make up the financial statements. The assertions considered by the auditor ~~using the Croner-i tools~~ are set out in Assessing risk.

Dealing with inconsistent or potentially unreliable evidence

Where evidence is inconsistent, for example, one piece of evidence leads the auditor to believe a company owns an asset whilst another piece of evidence throws doubt on this, or where the auditor has doubts about the reliability of information to be used as evidence, they will need to consider what modifications or additional procedures are necessary to resolve the matter. The auditor will also need to consider the effect of the matter on other areas of the audit and ultimately on the audit opinion.

Selecting items for testing

The auditor needs to determine the means of selecting items for testing that are effective in meeting the purpose of the audit procedure. The means available to the auditor for selecting items for testing are:

- selecting all items (100% examination);
- selecting specific items; and
- audit sampling.

The application of any one or combination of these means may be appropriate depending on the particular circumstances, e.g. the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

Selecting all items

This is when the auditor decides it is most appropriate to examine the entire population of items that make up a class of transactions or account balance. 100% examination may be appropriate when, for example:

- the population constitutes a small number of large value items;
- there is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- the repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Selecting specific items

The decision to select specific items from a population will be based on the auditor’s knowledge of the entity, the assessed risk of material misstatement and the characteristics of the population itself. Items selected may include:

- high value or key items (i.e. those which are themselves material or have some other characteristic);
- all items over a certain value;
- items to obtain information; and
- items to test control activities.

While selective examination of specific items will be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide audit evidence concerning the remainder of the population.

Audit sampling

Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. Further guidance can be found in Sampling and misstatement evaluation.

Methods of obtaining audit evidence

ISA (UK) 500 identifies a number of different procedures that can be used to obtain audit evidence, and these are described below. These procedures may be carried out to:

- obtain an understanding of the entity and its environment and determine audit risk;
- test the operating effectiveness of controls; and
- detect material misstatements at the assertion level.

Inspection

This involves examining records, documents or assets, whether internal or external, paper or electronic.

When examining either records or documents, whether internal or external, in paper form, electronic form or other media, the audit evidence obtained will give a varying degree of comfort – depending on the nature and source of the evidence and on the effectiveness of the controls over their production.

For example, depending on the case, different degrees of reliability will apply to documentary evidence:

- created and provided by third parties;
- created by third parties and held by the entity; and
- created and held by the entity.

Some documentation will give direct evidence about existence but may not provide evidence of ownership or value, e.g. share or bond certificates.

When examining tangible assets, again the inspection provides evidence of their existence but alone is not sufficient to provide evidence of their ownership or value.

Reliability of documents and records

Unless the auditor has reason to believe otherwise, documents and records may be accepted as genuine. Nevertheless, ISA (UK) 240:A10 sets out that the auditor is still required to consider the reliability of information to be used as audit evidence.

If the auditor has reason to believe that a document may not be authentic or that terms in a document have been modified but not disclosed, ISA (UK) 240:14 of ISA (UK) 240 (Revised May 2021) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires the auditor to investigate further. Procedures to investigate further may include:

- confirming directly with the third party; and
- using the work of an expert to assess the document's authenticity.

Observation

This involves watching a process or procedure being performed by the entity – for example, attendanceat a stocktake. Such audit evidence is usually obtained where a procedure leaves no audit trail. Using the stocktake example, except in a minority of cases where continuous stock records are maintained, if the auditor does not attend the stocktake, then it is virtually impossible to be satisfied that stock is fairly stated, as the existence objective will not have been met. It should also be noted that where stockis material, attendance during the stock take is mandatory under the current ISA (UK) 501, unless it can be considered impracticable. This is discussed in more detail in Inventory.

Inquiry

This involves obtaining information from individuals either inside or outside of the audit client. This is an audit procedure that is used extensively throughout the audit and often is complementary to performing other audit procedures. Inquiries may range from formal written inquiries to informal oralinquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

The evidence obtained may provide the auditor with information that they had not previously obtained or it may provide corroborative evidence on a particular objective.

It should be noted that the auditor performs audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Ordinarily, inquiry alone does not provide sufficient audit evidence todetect a material misstatement at the assertion level. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls. For example, in relation to management intentions, in addition to making enquiries, the auditor should consider management’s past history of carrying out its stated intentions and obtain written representation of oral responses.

Care may need to be taken where sensitive information is disclosed to the auditor by an employee of the client.Issues of confidentiality may arise with respect both to the employee and to the information itself, which may pose difficulties in undertaking further audit procedures. The auditor should consider the responses to audit inquiries with due professional scepticism, and bear in mind the reporting and tipping-off requirements of the money laundering regulations.

Where inquiries of management, those charged with governance or others within the entity are inconsistent, or appear implausible, ISA (UK) 240:15 of requires the auditor to investigate the reasons why.

Confirmation

Confirmation, which is a specific type of inquiry, is the process of obtaining a representation of information or of an existing condition directly from a third party – for example, a circularisation of customers of the entity to confirm trade debtor balances. See External confirmations for general comments regarding the use of external confirmations, and the relevant individual sections for practical application in auditing specific areas.

Recalculation

This involves checking the mathematical accuracy of documents or records and may be done through the use of CAATs.

Reperformance

This is the auditor’s independent reperformance of procedures or controls that were originally performed aspart of the entity’s internal control. An example of this is reperforming the ageing of the sales ledger, either manually or through the use of Computer Assisted Audit Techniques or CAATs.

Analytical procedures

These procedures consist of the analysis of relationships between items of either financial or non-financial data and corroborating explanations for any fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted or expected amounts. Further detail on designing these tests is in Substantive analytical procedures.

Directional testing

The objective of directional testing is to ensure that all aspects of the audit are covered as simply and cost-effectively aspossible by eliminating duplication of testing.

Directional testing takes advantage of the double entry principle to reduce the number of tests. For example, thedouble entry to post a sales invoice to the sales ledger is debit sales ledger and credit sales. When testing the sales ledger, the issue of overstatement of the balance – which is the debit balance – is considered within the debtors’ section; the issue of understatement of the balance – that is, testing the credit side of the entry – is dealt with in the testing of sales for understatement. As can be seen from this example, the method of applying directional testing is to test debit balances for overstatement and credit balances for understatement.

This method of testing minimises the amount of duplication and over-auditing and the tests suggested within theremainder of this book follow this principle. One important point to note is that directional testing must go from the cradle to the grave, and back again – that is, from the very start of a transaction cycle to the end. A directional test will not be effective if the sample for testing is selected from the wrong population. For example,when testing sales for completeness of income, it is essential that the starting point is outside of the accounting system. Thus orders, goods despatched notes or a job number could be used. Selecting a sample of sales invoicesfrom those already recorded may be easier but does not help to achieve the objective of ensuring that all sales are fully recorded.

There are two basic rules that should be remembered when applying directional testing; these are:

- when testing for overstatement, the samples should be taken from the nominal ledger (that is, the grave); and
    - when testing for understatement, the sample should be taken from the source document or, alternatively, froma reciprocal population (that is, the cradle). For example, where sales are actually directly related to purchases, then the sample for completeness of income can be taken from cost of sales. That is, the auditor could select a sample of purchases and ensure that a corresponding sale has occurred.

When undertaking the testing for overstatement, it is frequently easier to leave testing until a trial balance isavailable, particularly where the entity does not maintain a nominal ledger.

In addition, it must be remembered that when dealing with an area such as stock, where the balance affects theprofit and loss account as a credit and the balance sheet as a debit, the testing should be designed to cover bothunderstatement and overstatement. Even if stock is not material, some consideration should be given to the riskof understatement.

Finally, and fairly obviously, where the directional testing approach is applied, it is absolutely essential that the auditor ensures both understatement and overstatement are tested. For example, when considering the sales cycle, testing for understatement of sales may be undertaken in the profit and loss account section, but the testson overstatement of sales will be in the debtors section. The auditor must check that both tests have been performed, and not simply reference the objective to another section of the file.

Most proprietary audit systems adopt the convention of testing sales for understatement and debtors for overstatement. However, in principle there is no reason why the reverse convention should not be used, and many larger audit firms take that approach. Most auditors stick to the convention used by their system, but there may be occasions where the opposite convention may be more appropriate. An example would be if therewas a specific identified risk of overstatement of sales due to high levels of bonuses for sales staff based on the level of sales made.

Linked testing

Entities with long term contracts or manufacturing to order may benefit from linked testing. This is where the sales, purchases and related debtors and creditors are all audited together. This can givevery high levels of assurance, but only works if purchases are made for specific projects and the linkbetween purchases and sales can therefore be made. Testing is often performed on a contract or project basis.

External confirmations

As noted in Determining the audit approach, external confirmations are an important source of audit evidence, as they are generally considered to be more reliable, coming froman independent source outside the entity. External confirmations need not be limited to the confirmation of account balances, they may also be used to confirm the terms of agreements or transactions an entity has with third parties. Examples of external confirmations are:

- bank letters to confirm balances and other information;
- trade debtors’ circularisations;
- confirmation of stocks held by third parties, at bonded warehouses for processing or on consignment;
- confirmation of title to property from Land Registry;
- property title deeds held by lawyers or financiers for safe custody or as security;
- investments purchased from stockbrokers but not delivered at the balance sheet date;
- loans from lenders; and
- trade creditors’ circularisations.

The specific practicalities of obtaining these confirmations are discussed later in the relevant sections.

ISA (UK) 505 notes that where management requests the auditor not to seek an external confirmation, the auditor should consider whether there are valid grounds for such a request and obtain auditevidence to support the validity of management’s requests, and consider the impact on the risk assessment. If the auditor agrees to management’s request, alternative audit procedures should be applied to obtain sufficientappropriate audit evidence.

If the auditor does not accept the validity of management’s request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor’s work, and the auditor should considerthe possible impact on the audit report.

Specific considerations for selected items

Segmental information

ISA (UK) 501:13 sets out requirements regarding segmental information. When segmental information is material to the financial statements, the auditor should plan and perform procedures to obtain sufficient appropriate audit evidence about the presentation and disclosure of the segment information. This will usually be done by:

- obtaining an understanding of the methods used by management to determine the segmental information and:
- evaluating whether such methods are likely to result in disclosure in accordance with the financial reporting framework; and
- where appropriate, testing the application of those methods; and
- performing analytical or other audit procedures considered appropriate in the circumstances.

This is likely to involve discussion with those charged with governance about the techniques used to determine the segmental information and analytical techniques.

3.2 Sampling and misstatement evaluation

Quick overview

Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. The objective is to assess whether misstatements in the population might exceed the tolerable misstatement, this means the projected expected population misstatement (plus known misstatements which are not projected) are compared with the tolerable misstatement.

Scope and definitions

Scope

ISA (UK) 500 *Audit Evidence* requires the auditor to design and perform procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base their opinion. It provides guidance on various means for selecting items for testing, of which sampling is one.

Audit sampling is defined in ISA (UK) 530 *Audit Sampling* as the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. However, this need not be an equal chance of selection.

This means sampling is not being used in procedures where individual items which have a particular significance are examined, e.g. all items over £10,000, as here the auditor is testing part of the population in its entirety and cannot use the results to draw conclusions about the rest of the population. Similarly, procedures such as walk-through tests are not sampling.

Key definitions

Term	**Definition**
Audit sampling (sampling)	The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.
Population	The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
Sampling risk	The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions: (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion. (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous

conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Non-sampling risk

The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Anomaly

A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

Sampling unit

The individual items constituting a population.

Statistical sampling

(i) Random selection of the sample items; and

(ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.

Stratification

The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

Tolerable misstatement

A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Tolerable rate of deviation

A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Source: ISA (UK) 530 Audit Sampling

Sampling risk

Where sampling is used, the auditor must accept a risk that the sample is not representative of the population from which it is drawn and that the wrong conclusion may be drawn from the test.

Sampling risk may result in:

- a population, which contains an acceptable total misstatement, may initially be thought to be unacceptable because the sample happens to pick a large proportion of the items containing a misstatement, this then provides a projected misstatement which is above the tolerable misstatement. This normally results in additional audit work but should not affect the validity of the final audit conclusion, because in doing the extra work, the auditor will realise the population contains an acceptable total misstatement; or
- a population, which contains a material misstatement, being accepted as satisfactory because the sample happens not to select any of the items that contain misstatements. This risk is more serious because there is the possibility that an unmodified audit opinion is issued when the financial statements contain material misstatement (although the auditor should organise their other audit procedures so that it is, in fact, unlikely that such a misstatement escapes detection).

Sampling risk does not only affect substantive procedures; tests of controls may result in:

- too high an assessment of control risk, because the misstatement in the sample is greater than that in the population; or
- too low an assessment of control risk, because the misstatement in the sample is less than the misstatement in the population as a whole.

Sampling risk may be reduced by using a rational (possibly a statistical) basis for planning, selecting and testing the sample and for evaluating the results. This will ensure that the auditor has adequate assurance that the sample is representative of the population from which it is drawn.

ISA (UK) 530:7 states:

'The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.'

Non-sampling risk

Non-sampling risk arises from factors that cause an incorrect conclusion to be reached and is not related to the size of the sample. For example, the auditor may plan unsuitable audit procedures or misinterpret audit evidence and fail to recognise a misstatement.

Design of the sample

ISA (UK) 530 requires the auditor, when designing an audit sample for a test of detail, to consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. Further information on designing a sample for operating effectiveness of controls can be found in Testing the operational effectiveness of controls.

Objectives

Sampling is about gathering sufficient appropriate audit evidence in the most efficient way by not testing the entire population but a sample of it. The auditor needs to consider the nature of the audit evidence sought and characteristics of the population, including risk profile. Thought should be given to possible deviation or misstatement conditions relating to that audit evidence as this will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.

For example, in a test of controls operating over purchases, non-compliance with the approval procedures may be assessed as a misstatement. By contrast, the types of misstatements on a substantive test on sales invoices might be arithmetical inaccuracy and/or a failure to reflect them properly in the books of account.

Once the procedures have been decided, the most appropriate form of sampling is designed.

Population

The sample needs to be extracted from the appropriate population to achieve the specific audit objectives; the sample should be representative of the entire population. This is more difficult when the audit objective is testing for understatement, such as the completeness of creditors, as the sample is chosen from a related population. The relevant population for such a test of understatement might be suppliers' statements, post-period payments or a list of all suppliers during the period, rather than unpaid invoices. In these cases, the auditor needs to take steps to ensure that the chosen population is complete, such as choosing suppliers' statements from a list taken from the purchase ledger.

The sampling unit is any of the individual items that make up the population and will vary according to the nature of the audit test. The auditor defines the sampling unit in order to obtain an efficient and effective sample to achieve their audit objective. For example, when testing the validity of debtors, the sampling unit is the individual customer balances or invoices.

Stratification

By dividing a population into discrete sub-populations, sample sizes may be reduced without increasing sampling risk. Populations could be subdivided by monetary value or risk profile, meaning greater audit effort can be directed to larger value or higher risk items. However, the results of audit procedures performed on a stratified population can only be projected to items in the same stratum; other items have to be tested separately.~~ Croner-i's tools stratify the population and strip out high value items or key items and test them separately; this is because these types of items may have a different risk profile.~~

Value-weighted selection

When sampling for tests of detail, the sampling unit can be defined as the monetary unit that makes up the population, e.g. each £1 of the balance. The balance containing the £1 sampling unit is then tested. This means that larger balances have more chance of being selected for testing than smaller ones.

Statistical and non-statistical sampling

Statistical sampling is an approach to sampling that involves random selection of the sample items and the use of probability theory to evaluate the sample results, including the measurement of sampling risk. Any other approach is described as being 'non-statistical'.

Both statistical and non-statistical approaches:

- examine less than the total population to enable the auditor to draw conclusions about the whole population;
- involve consideration of sampling risk;
- provide approximate, not exact, knowledge about the population;
- require performance of similar audit procedures; and
- require audit judgement.

Selection of items for testing on a genuinely random basis is often practically difficult and time consuming and the auditor may conclude that a judgemental approach to sample selection will provide the assurance required.

When using non-statistical methods, the auditor nevertheless needs to be satisfied that the selection is sufficiently representative of the population and of a sufficient size to enable them to draw reasonable conclusions regarding the population as a whole.

In both statistical and non-statistical approaches, sample sizes will depend on factors such as population size, materiality and identified risk.

Obtaining sufficient appropriate audit evidence

When designing audit procedures, the auditor must decide which approach to take. They could use:

- test of controls;

- substantive analytical procedures;
- test of detail; or
- a combination.

Note, when a significant risk is identified, substantive analytical procedures alone are not sufficient.

When performing test of detail, the auditor has a choice of the following:

- select all items in a population (100% examination);
- select specific items;
- use audit sampling; or
- use a combination.

The application of any one or combination of these means may be appropriate depending on the particular circumstances; for example, the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

Selecting all items

This is most appropriate for tests of detail, e.g. where the population constitutes a small number of large value items or where data analytics can be used to test or reperform all the transactions in the period.

Selecting specific items

The decision to select specific items from a population will be based on the auditor's knowledge of the entity, the assessed risk of material misstatement and the characteristics of the population itself. Items selected may include:

- high value or key items (i.e. those which are themselves material or have some other characteristic);
- all items over a certain amount;
- items to obtain information; and
- items to test control activities.

Test of controls

In order to place reliance on controls, the relevant controls of the entity must be tested to ensure that they have operated effectively throughout the period under audit. This is not the same as checking that controls have been designed and implemented (though it may be more efficient to undertake both types of testing at the same time).

Sample sizes for testing the operating effectiveness of controls depend on the frequency of the control. Further information can be found in Testing the operational effectiveness of controls.

Sample size factors

A population will have a risk of material misstatement as assessed by the auditor at the planning stage. The level of risk of material misstatement will have a direct bearing on the sample size used. Where there is a higher risk of material misstatement, the number of items tested from the population will be greater than in situations where the risk of material misstatement has been assessed as at the lower end of the spectrum. A higher sample size will result in lower sampling risk, increasing the auditor's confidence levels that the population does not contain a material misstatement. Other factors will also affect sample sizes.

The basis of determining sample sizes in Croner-i's template uses the following parameters:

- the monetary value of the population;
- the overall level of performance materiality set for the audit (see Materiality for the financial statements as a whole);
- a calculated risk factor (inherent risk);
- the identification of high value and key items; and
- other work performed, i.e. test of controls/analytical procedures.

By selecting the sample size using the combination of the first three items above, the auditor is using the assessments made at the planning stage of the audit to determine the size of the audit sample. The lower the figure of materiality and the lower the sampling risk the auditor is willing to accept (i.e. the higher the risk factor), the larger the sample size will be.

If multiple assertions are being tested through one sample, Croner-i's sampling method expects the auditor to use the highest risk level identified for the assertions being tested. Alternatively, if the population which is assessed as a higher risk can be separated from the total population, it may be more efficient to test the high-risk assertion separately to the lower risk assertions.

Example – Separating the population

If you were testing the valuation (V) and existence (E) assertions of Debtors, where V had a risk rating of 4 but E was 2, it may be more efficient to identify the sub-population driving the risk, e.g. overdue debts. The V assertion could then be tested on the sub population at a 4 rating. The total population could then be tested for E at a level 2.

Example – Multiple assertions

Company A is a supplier of medical test kits. At the 31 March 2023 year end half of the stock is Covid-19 test kits.

The existence of Covid-19 test kits in stock, at the balance sheet date, could be an audit risk, but it would be a mistake to assess the whole of the stock as high risk, as a result.

In this example:

- the stock existence assertion could be low risk, across all stock;
- in terms of stock valuation, the cost element of the valuation (lower of cost and net realisable value (NRV)) could be low risk;
- the NRV element of non-Covid-19 related stock could be low risk; and
- it might only be NRV of Covid-19 related stock that is higher risk.

Obviously, assessing risk too broadly would result in excessive sample sizes in areas where risk was in fact low. It would likely be more efficient to split out the populations and/or assertions when sampling the stock.

Key items

Croner-i's sampling method expects the auditor to identify high value and key items separately for testing. These items are considered sufficiently important to justify selecting all of them. High value items will be identified as transactions that are higher than performance materiality. Key items are other balances or transactions that are identified as significant in the particular circumstance of the test being carried out. The judgement of the auditor is required in assessing whether or not an item is a 'key' item for these purposes. No absolute definition of key items is possible. The residual population is the value of the population after deducting the value of the high value and key items.

The value of the population being tested will relate specifically to the test being carried out.

Example – Value of the population

When undertaking existence testing on fixed assets, the population would be the net book value of the assets.

When undertaking tests on additions to fixed assets, the value of the population will be the value of the additions in the period.

When determining the number of items from a residual population that need to be tested, the auditor should consider the materiality and risk. In addition, consideration needs to be given to the method of obtaining audit evidence. If a test is purely substantive, then a higher sample size will be required than if the testing also includes extensive analytical review and/or tests of control, in which case the number of tests of detail that need to be undertaken will be reduced.

Having identified a method that can be used to determine sample sizes, it must then be applied consistently. The audit working papers must incorporate details of how the sample size was selected. In addition, they must also contain details of how the ultimate sample was selected from the population.

~~The Croner-i sampling tool is also provided in the Croner-i Excel-based audit tools.~~

Other work performed

A smaller sampling factor could be used if additional work is performed such as controls testing and/or tests of details and analytical procedures. Performing controls testing can have the benefit of reducing the assertion risk which would also allow for a smaller sampling factor. More guidance on test of controls can be found in Testing the operational effectiveness of controls.

Example

The below illustrates different sample sizes provided by the sampling methodology in the Croner-i audit tools (such as the Private Company tool) for an assertion with a risk rating of 5.

	£
Performance materiality	45,750
Monetary value of population	1,499,000

Test an assertion with Level 5 risk rating

Work performed	Sample size
Tests of details only performed	98
Tests of details, and analytical procedures OR tests of control performed	66
Tests of details, AND analytical procedures AND tests of control performed	33*

* If controls testing had been performed and deemed effective, the risk rating of the assertion could be reduced. If it went from 5 to 4, then the sample size would be 26.

Professional judgement is required to decide whether sufficient appropriate work has been performed in order to reduce the sample size and this should be fully explained in the audit file.

For example, the auditor may be able to check the completeness of income by carrying out a reconciliation of unit sales multiplied by sales prices.

The degree of assurance that this provides varies from business to business. It is more likely that significant assurance could be gained where there are only a few different product lines, the production process is simple and the production capacity can be verified by observing the production process. In such cases, analytical procedures could come close to providing a proof in total for the sales figure, by adjusting the production capacity for opening and closing stock to arrive at unit sales and then multiplying by sales prices.

Tolerable misstatement/deviation

Tolerable misstatement is the maximum misstatement that is acceptable to the auditor, if they are to conclude that the audit objectives have been achieved. For substantive testing, tolerable misstatement is the application of performance materiality to a particular sampling procedure. Note, the tolerable misstatement may be the same amount or an amount lower than performance materiality. Where tests of controls are being performed, the tolerable rate of deviation will be the maximum rate of failure of an internal control that the auditor is prepared to accept in order to obtain reasonable assurance that the failure rate in the population as a whole is not unacceptably high.

Expected misstatement

Before a test is performed, a misstatement may already be expected. Here, a larger number of items may need to be tested to conclude that the actual misstatement rate in the population is not greater than the planned tolerable misstatement. This may be the case where previous years' audit tests have produced misstatements or the review of the internal controls indicates this. The sample size is likely to be higher the larger the expected misstatement is. If misstatements are so likely that it would result in a material misstatement, it may be inefficient to proceed with the test, given it is highly likely to fail, and alternative procedures performed instead.

Adjustment of sample size

Professional judgement is always needed to decide whether a sample size produced in audit software or tools is appropriate. A suggested sample size may be adjusted when there are appropriate and justifiable reasons that are then clearly explained on the relevant audit working papers.

The FRC however does not consider having a cap on sample sizes to be appropriate. In their Developments in Audit 2020, report they note:

‘Audit teams tend to default to limited sample sizes which can prevent an objective assessment of the actual test results. Limited sample sizes also prevent audit teams from exploring more effective ways of obtaining appropriate audit evidence, such as controls testing, or the use of data analytics.’

By stratifying the population, sample sizes may be reduced without increasing sampling risk. The section on Stratification gives more detail.

Alternatively additional procedures can be performed to reduce the reliance on tests of detail and sampling. ~~This is covered in Other work performed.~~

Summary of factors

Factor	Impact on sample size	Explanation
Inherent risk • Increases • Decreases	• Increases • Decreases	The higher the assessment of inherent risk, the more audit evidence is required to support the auditor’s conclusion.
Control risk • Increases • Decreases	• Increases • Decreases	The higher the assessment of control risk, the greater the reliance on audit evidence obtained from substantive procedures. A high control risk assessment may result in the decision not to perform tests of controls and place reliance entirely on substantive procedures.
Detection risk • Increases • Decreases	• Increases • Decreases	Sampling risk for substantive tests is one form of detection risk. The lower the sampling risk the auditor is willing to accept, the larger the sample size. Other substantive procedures may provide audit evidence regarding the same financial statement assertions and reduce detection risk. This may reduce the extent of the auditor’s reliance on the results of the substantive procedure using audit sampling. The lower the reliance on the results of a substantive procedure using audit sampling, the higher the sampling risk the auditor is willing to accept and, consequently, the smaller the sample size.
Tolerable misstatement rate • Increases • Decreases	• Decreases • Increases	The higher monetary value of the tolerable misstatement rate, the smaller the sample size and vice versa.
Expected misstatement rate • Increases • Decreases	• Increases • Decreases	If misstatements are expected, a larger sample usually needs to be examined to confirm that the actual misstatement rate is less than the tolerable misstatement rate. High expected misstatement rates may result in a decision not to perform sampling.

Population value • Increases • Decreases	• Increases • Decreases	The less material the monetary value of the population to the financial statements, the smaller the sample size that may be required.
Numbers of items in population • Increases • Decreases	• Generally unchanged • Generally unchanged	Virtually no effect on sample size unless population is small.

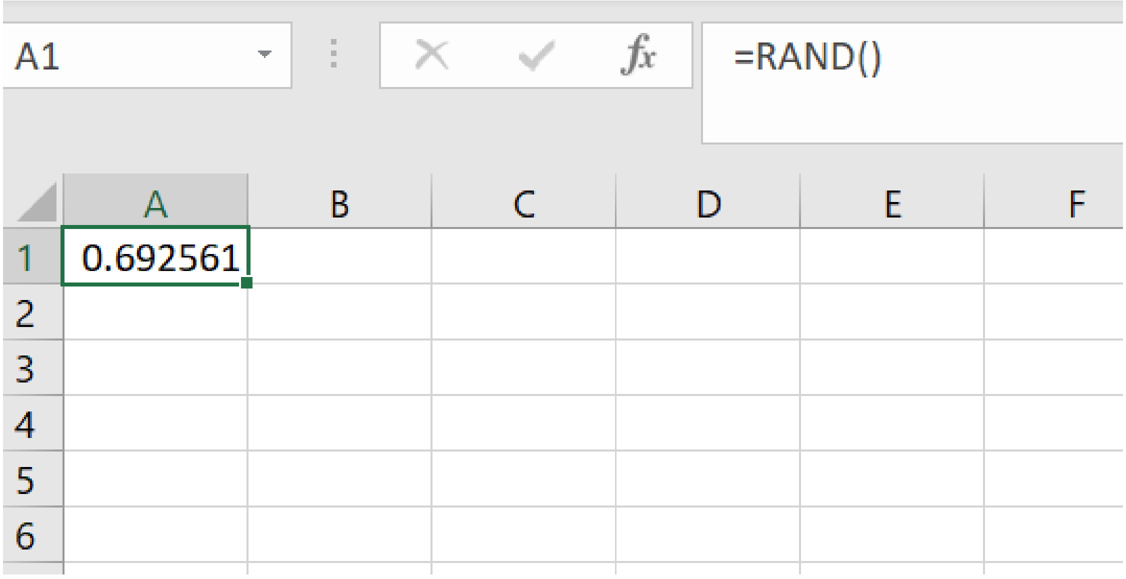
Sample selection

Various means are available for selecting the chosen sample from a population. High value and key items will already have been identified. The sample selected from the residual population should be representative of the whole of the population being tested.

This will involve the use of random, systematic or haphazard means of selection. The auditor should try to avoid the selection of a block of items as this is prone to bias and fails to consider the whole population adequately. The misstatements identified will be projected across the population, therefore it is important to use a robust approach for selection to provide reliable data on which to evaluate misstatements. The working papers should reflect where the sample was selected from and how the items were selected for testing. Sufficient information must be noted about the items sampled to allow them to be identified and to show how the outcome of the test was determined.

For random sampling, a random number table or random number generators can be used.

If using a systematic selection, start with a random number (e.g. use Excel =RAND() or =RANDBETWEEN(X,Y)), selecting every *n*th item thereafter where *n* equals the residual population value divided by the sample size. Again, ignore high value items and key items as these will already have been selected for testing.


A1

=RAND()

0.692561

Haphazard sampling is when no structured technique is followed, care therefore must be taken to avoid bias, e.g., avoid picking items which would be hard to locate. All items within the population should still have a chance of being selected.

Documentation

Although sample sizes should feel right judgementally, it is not sufficient to determine the size of a sample without recording the logic. Furthermore, once the sample size has been selected, it is essential that it is not changed. The only exception is where misstatements have been identified and so the sample size has been increased to reduce these.

Test not applicable to item sampled

If the audit test is not applicable to an item selected in the sample, then a replacement item should be selected (ISA (UK) 530.10). It must be emphasised that an item being not applicable is not the same as a misstatement. So, if the auditor is looking to check that all despatch notes have been invoiced and a particular despatch note number was not used (for whatever reason, which should be verified), then it would be appropriate to select another item. However, if it is not possible to carry out the selected test or any suitable alternative procedures; in this case if the despatch note was not referenced to a sales invoice, this would be a misstatement and should be treated accordingly.

Performing audit procedures

The auditor performs the planned procedures on each item in the sample. If any item selected is not appropriate, a replacement item should be chosen. However, the auditor should consider whether the unsatisfactory item indicates a misstatement. If procedures cannot be completed on a sample item, e.g. the supporting documentation has been lost, alternative audit procedures should be considered for that item. If no alternative procedures are possible, the item should be considered to be a misstatement.

Deviations and misstatements

The investigation and evaluation of misstatements encountered during audit testing is a vital part of the audit. Misstatements should always be followed up. In no circumstances should they simply be ignored.

When a misstatement occurs, there are two specific questions that need to be addressed, namely:

- Could other misstatements exist elsewhere within the population?
- Is it possible that the misstatements could be material to the financial statements?

If the answer to both of these questions is yes, then additional audit work must be carried out. It is important to remember that the second question is asking whether it is possible, not whether it is likely. In normal circumstances, therefore, some additional work must be carried out whenever a misstatement is encountered. The work can be directed specifically to help the auditor answer both of those questions. Alternatively, it may be appropriate to extend the sample size in order to determine whether the level of misstatement encountered is typical of the population as a whole.

Where the increased work identifies a certain level of misstatement within the population, it would usually be appropriate to extrapolate that level of misstatement over the residual population. This, combined with the misstatements found in the high value and key items tested, will give the most likely level of misstatement in the entire population. Consideration must be given to whether this level of misstatement is likely to produce material misstatement within the financial statements.

Misstatements are not always most effectively dealt with by simply increasing the sample size. The nature of the misstatement; and why it may have arisen must be considered. For example, if posting misstatements arise during the period when a particular member of staff was on holiday, it would clearly be sensible to extend tests to concentrate on that period of absence, rather than the year as a whole. Similarly, if misstatements are coming out of one particular branch or depot, additional testing should concentrate on these.

The actual and the extrapolated misstatement should be recorded on the summary of uncorrected misstatements on the audit file (see Preparing the file for review).

Projecting misstatements

For tests of detail, the auditor should project monetary misstatements found in the sample to the population and should consider the effect of the projected misstatement on the particular audit objective and on other areas of the audit.

When projecting misstatements found in the sample for tests of detail to the population from which it was drawn, the method used must be consistent with that used to select the sample. Projection commonly involves extrapolating the misstatements in the sample and estimating any further misstatement not detected due to the imprecision of the methods used. A more robust sample selection will lead to a more reliable calculation of projected misstatement.

There are two main methods of projecting the value of total misstatements in a population – the ratio method and the difference method. The ratio method may be more appropriate where the amount of misstatement in a transaction is related closely to its size – that is, the bigger the transaction, the bigger the misstatement. The difference method may be more appropriate where the size of the transaction would make no difference to the amount of the misstatement – that is, the misstatement is of a constant amount. The basis of each calculation has been set out below.

The ratio method

In this method, the value of the misstatement found in the sample (excluding high value and key items) is multiplied by the population value and divided by the value of the sample to obtain the projected misstatement in a population. The misstatement found in high value and key items is then added to this projection to get a total expected misstatement.

Expected misstatement = Projected misstatement + Known misstatement in high value and key items

Projected misstatement = Misstatement in sampled population × Population value (excluding high value and key items)/Total value of sample

Example

Total value of population			£250,000	
Total value of high value key items			£100,000	(misstatements – £4,000)
Residual population			£150,000	
Sample value			£45,000	(misstatements – £2,000)
Projected misstatement in the residual population	£2,000 × 150,000	=	£6,667	
	45,000			
Overall projected misstatement			£10,667	(£6,667 + £4,000)

Known misstatement	£6,000	(£4,000 + £2,000)

The difference method

This method takes the misstatement found in the sample and multiplies it by the number of items in the population divided by the number of items in the sample to give the projected misstatement in the population. However, as mentioned above, the ratio method is generally the more appropriate one to use.

Projected misstatement in population = Misstatement in population × Number of items in population/Number in sample

Where information about the nature of misstatements is not known, the ratio method is normally the most appropriate method to use.

Because the projected misstatement is unlikely to be the same as the actual misstatement in a population, it will be necessary to consider judgementally whether or not a material misstatement in the financial statements is likely. If it is considered that it might be material, the following options are available to the auditor:

(a) to request management to investigate the misstatements and the potential for further misstatements;

(b) to extend the audit test again and gain a more precise conclusion;

(c) to perform alternative procedures (if possible); or

(d) to qualify or possibly disclaim the audit opinion on the grounds of uncertainty.

If action (a) is chosen, then it should be noted that ISA (UK) 450 (Revised June 2016) (Updated May 2022) *Evaluation of misstatements identified during the audit, ISA (UK) 450:7* requires the auditor to perform additional audit procedures to determine whether misstatements remain.

Action (d) should be the last option, which should only be taken after establishing that it was not possible to form a conclusion from any of the other methods. However, it is essential that the effects of any misstatements found in the audit tests are resolved. It is not acceptable to leave a misstatement position ‘open’; a conclusion about its impact on the individual area being tested and on the financial statements as a whole must be drawn. If misstatements are left unresolved and their effect on the financial statements not properly assessed, it is not possible to assess whether the audit opinion given is in fact reasonable.

ISA (UK) 450:11 states:

‘The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

(a) the size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and

(b) the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.’

Ultimately it is necessary to form a conclusion on the results of the sample tested and whether this provides sufficient appropriate evidence for the purpose intended.

Anomalous misstatements

Anomalous misstatements, i.e. misstatements which arise from an isolated event that has not recurred other than on a specifically identifiable occasion, may be excluded when projecting misstatements to the population. This is because anomalous misstatements will not be representative of the population as a whole. However, their effect still needs to be considered in addition to the projection of non-anomalous misstatements. It should be noted that ISA (UK) 530:13 considers anomalies to be ‘extremely rare’. The same paragraph requires the auditor to obtain ‘a high degree of certainty that such a misstatement or deviation is not representative of the sample … by performing additional audit procedures’. Often little will be gained by treating the misstatement as anomalous because of the additional work needing to be carried out to confirm that it is in fact an isolated occurrence.

Evaluating results

The auditor should assess the results of the sample tested to determine if the objectives of the test have been met.

To assess whether misstatements in the population might exceed the tolerable misstatement, the expected population misstatement (known misstatement + projected misstatement) plus anomalous misstatements (misstatements which are not projected) net of adjustments made by the entity should be compared with the tolerable misstatement, taking into account the results of other audit procedures relevant to that financial statement assertion.

The auditor should use judgement where the projected misstatement in a sample, plus any anomalous misstatement which was not subject to projection, is close to their assessment of tolerable misstatement. The auditor should be aware that sampling risk may mean that selection of a different sample may have provided a misstatement which was greater than tolerable misstatement. The auditor should consider the results of other audit procedures when assessing whether an adjustment to the financial statements is required. Consideration could be given to:

- extending the audit procedures; or
- performing alternative procedures (which may involve reviewing a management’s exercise to investigate misstatements).

This will allow a conclusion to be reached on the test and may result in identifying the need for an adjustment to the financial statements.

Projection of misstatements is not appropriate for tests of controls. On discovering misstatements in a test of controls, the auditor should consider whether the misstatement is indicative of a general weakness in the control system.

For tests of controls, a high incidence of misstatements may lead the auditor to increase their assessment of the risk of material misstatement. For tests of detail, high misstatement rates may indicate that a class of transactions or an account balance is materially misstated.

Test objectives have not been met

If the auditor determines that test objectives have not been met, they may:

- request management to investigate identified misstatements and the potential for further misstatements and to make any necessary adjustments; and/or
- modify the nature, timing and extent of further audit procedures. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures; and/or
- consider the effect on the audit report.

Communication with those charged with governance

The requirement to communicate unadjusted misstatements with those charged with governance is contained in ISA (UK) 450.

ISA (UK) 450:12 states:

‘The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.’

Following on from this point ISA (UK) 450:14 states:

‘The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.’

These requirements are addressed in the conclusion on Misstatements (B5) and also in the pro forma letters of comment and representation included within the ~~*Navigate*~~ *Audit* tools. If the pro forma letters are amended or not used, the auditor still needs to ensure that these matters are addressed where relevant.

Documentation

Sample selection planning forms are available in the audit tools and may be used to determine sample sizes. Sample sizes may be determined without using the form, but, in such circumstances, the basis should be explained.

The form guides the user through the data determined in the planning stage to provide an objective means of determining the sample size.

If it is considered that the sample size determined by means of the form is not, for some reason, appropriate, then judgement may be used and an alternative sample size determined. The reasons for this must, however, be fully documented.

If the sample size is felt to be very large, then the auditor should consider what other testing is being carried out on the financial statement area. Perhaps substantive analytical procedures may provide some audit evidence, thus reducing the evidence required from the test of detail and the sample.

3.3 Nominal ledger, opening balances and comparatives

Quick Overview

This section covers the auditor's responsibilities in relation to opening balances and comparatives, and the client's books and records.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to schedule **C2** and the audit programmes for each financial statement area in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement.

Opening balances and comparatives

Opening balances are the balances brought forward from the end of one accounting period to the beginning of the next accounting period.

Comparatives are amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

ISA (UK) 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements* deals with the auditor's responsibilities relating to comparative information and opening balances in an audit of financial statements.

Where the financial statements of the prior period were audited by a predecessor auditor or were not audited, the requirements and guidance in ISA (UK) 510 (Revised June 2016) *Initial Audit Engagements – Opening Balances* regarding opening balances also apply. These additional requirements are covered separately in the First-year audits section.

Nominal ledger and trial balance

The terms 'nominal ledger' and 'trial balance' are not defined in the ISAs. For the purposes of this section, the following definitions are used:

- the trial balance is a report which lists the balances of all the ledger accounts of an entity at a specified point in time; and
- the nominal ledger comprises all the individual ledger accounts where all accounting transactions are recorded. The terms 'nominal ledger' and 'general ledger' are often used interchangeably.

ISA (UK) 330 (Revised July 2010) (Updated May 2022) *The auditor's responses to assessed risks* requires the auditor to agree or reconcile the financial statements with the underlying accounting records and to examine material journal entries and other adjustments made during the course of preparing the financial statements.

The examination of journal entries is dealt with in further detail in Fraud in the audit.

Key definitions

Term	**Definition**
Comparative information	The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.
Corresponding figures	Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as 'current period figures'). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.
Comparative financial statements	Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.
Opening balances	Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

Source: ISA (UK) 510, ISA (UK) 710

Nominal ledger and trial balance

Audit objectives

ISA (UK) 330:20 requires the auditor to agree or reconcile the financial statements with the underlying accounting records and to examine material journal entries and other adjustments made during the course of preparing the financial statements.

The auditor must ensure that the entity is maintaining adequate books and records and make sure that certain items that must be incorporated within the financial statements are properly identified and audited where necessary.

Controls

The following are controls that are relevant to the client's books and records and could, if working properly, enable the auditor to reduce the substantive work required in this area. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on sample sizes when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	How to test
The ledgers are fully updated on a regular basis.	Review a sample of ledgers and verify that they are updated periodically in accordance with the entity's policy.
All adjustments to the ledgers, including journals, are properly authorised.	Review a sample of adjusting entries and verify that they were properly authorised by a person of an appropriate level.
A review of the records is undertaken regularly by a person of an appropriate level.	Review the processes surrounding the review of the records, select a sample of reviews and verify that they were undertaken by an appropriate person. Verify that any discrepancies identified were followed up.
Only staff with the relevant delegated authority are able to post entries in the ledgers.	Obtain a list of staff with delegated authority to post entries. Select a sample of entries and confirm that they were posted by staff with the delegated authority.

Audit procedures

The auditor should check the accuracy of the information contained within the accounting records by performing appropriate reconciliation and cross-checks of the information to ensure completeness and accuracy. The auditor should complete the following tests:

- check the opening balances to the ledgers;
- check the casts and cross casts of the cashbook, sales day book and purchase day book;
- check the casts of a sample of nominal ledger accounts;
- check postings to the nominal ledger;
- check the extraction of the final trial balance;
- ensure that all adjustments to the financial statements, journals and transfers are recorded in the books of the entity; and
- agree the closing balances to the financial statements.

Professional scepticism should be maintained throughout the testing process.

In the PCAS based audit tools, these tests are covered in schedule **C2** and in the audit programmes for each financial statement area.

Extraction

Where obtaining reports from the client to place reliance on in the audit, for example the trial balance and nominal ledger reports, the auditor should verify and evaluate the reliability, completeness and accuracy of those reports (or extractions), including the reporting parameters used.

Substantive analytical procedures

Analytical procedures can be used to ascertain whether the records, as far as possible, are complete and accurate. Comparison with expectations and the previous year's results will help with this.

Opening balances and comparatives

Audit objectives

The auditor should obtain appropriate evidence about whether the opening balances contain material misstatements that could affect the current period's financial statements.

ISA (UK) 710 also requires the auditor to:

- obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and
- to report in accordance with the auditor's reporting responsibilities.

Audit procedures

For continuing engagements where the auditor also audited the comparatives and opening balances, few procedures are required. For first year engagements, however, and situations where the comparatives are unaudited, additional procedures are required; these are covered in First-year audits.

For continuing engagements, the auditor should ensure:

- that the previous year's closing balances have been correctly brought forward to the current year (or restated where necessary). This would normally mean ensuring that the comparatives in the draft financial statements and the opening balances in the current year's trial balance both agree with last year's signed audited financial statements;
- that accounting policies have been consistently applied, or that any changes have been made properly and disclosed in accordance with FRS 102:10. This would require comparing the accounting policies in the draft financial statements with those in the previous year's signed financial statements; and
- the comparative information agrees with the amounts and other disclosures presented in the prior period financial statements or, where appropriate, has been restated. This would require comparing the amounts and disclosures presented in the

prior year financial statements to the comparative information presented in the current year financial statements.

If, whilst conducting the current year audit, the auditor becomes aware of a possible material misstatement in the comparative information, the auditor must perform additional audit procedures as necessary to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. Where the auditor is unable to obtain such evidence the implications for the audit report must be considered.

ISA (UK) 710:9 requires the auditor to obtain a written representation for all periods referred to in the audit opinion and also a specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affects the comparative information.

Implications for the audit report

Considerations relating to circumstances where the prior period financial statements were audited by a predecessor auditor, or were unaudited, are covered separately in First-year audits.

Modification in auditor's report in prior year

Irrespective of whether the audit is a continuing or an initial engagement, extra consideration is needed if the auditor's report on the prior year's financial statements included a qualified opinion, a disclaimer of opinion or an adverse opinion. In such circumstances, the auditor should consider whether there is any effect on the current year's financial statements. Extra care is needed if the modification was made in respect of inventory as there is a further two-year knock-on effect.

The effect of a modification on a subsequent period depends on whether or not the matter has been resolved:

- when the matter is unresolved, and is material in the context of the current period's opening balances as well as comparatives, the auditor should qualify the current period audit report in respect of opening balances and comparatives;
- where the matter is unresolved and does not affect the opening balances, but is material to the comparatives shown in the current financial statements, the auditor should qualify the audit report in respect of the comparatives; and
- where the matter has been resolved, but is material to the current period, the auditor should include an emphasis of matter paragraph in the audit report on the current period explaining how it has been dealt with.

Example - The matter is unresolved, and is material in the context of the current period's opening balances as well as comparatives

The qualified opinion would describe the matter and its effect on the current and preceding years' figures.

Examples of this would include:

- where in a previous year the company had made a provision for the permanent diminution in value of a fixed asset which the auditor did not believe was necessary. In subsequent years, the auditor would qualify the audit report in respect of the consequential understatement of the depreciation charge and corresponding understatement of the asset and give an ‘except for’ opinion; and

- a disagreement over the necessity for a provision against a debtor.

Where an auditor’s report on the previous year contained a limitation of scope disclaimer covering all aspects of the report, it would be unlikely that the auditor could be satisfied on the profit and loss account or the cash flow statement in the next year, even if sufficient evidence was obtained that the balance sheet for that year showed a true and fair view.

Where this occurs, it normally affects areas such as stock and work in progress or debtors and creditors at the beginning of the period, uncertainty about which directly affects the profit and loss account and the cash flow statements. Where the effect is material, either a qualification or disclaimer on the grounds of limitation of scope is needed, depending on the effect of the limitation on the audit procedures and the significance of the amounts involved to the financial statements.

Example - The matter is unresolved and does not affect the opening balances, but is material to the comparatives shown in the current financial statements

An example of this might be a limitation of scope in respect of the accounting records kept in the first six months of the year which had been destroyed by a fire but which had not led to a qualification in respect of the balance sheet. In the subsequent year, there would be an ‘except for’ opinion in respect of the corresponding profit and loss figures as the auditor would still not have sufficient evidence on them.

Example - The matter has been resolved, but is material to the current period

This situation would result from a fundamental uncertainty which was not properly disclosed in the previous financial statements resulting in a disagreement which has now been resolved.

In contrast, where the auditor issues a modified report because of disagreement over an accounting policy, but this no longer exists following a change in accounting policy, which has been properly disclosed and adjustments made to the prior year, no modification is necessary as the matter has been resolved and dealt with correctly.

Where an issue over which there was a disagreement has been resolved but not satisfactorily, for example, where the disagreement over the accounting policy was resolved by adjusting the current year’s figures when the auditor considered a prior year adjustment was required, then both current period and comparatives would be modified on the basis of disagreement.

For audits under the *Companies Act* 2006, there is no direct requirement to report on comparatives, apart from the fact that they are a ‘disclosure requirement’ under relevant UK law. Any modification should therefore be in terms of this requirement. If corresponding amounts are presented solely as good practice, the audit report reference should be made as an explanatory paragraph.

The guidance to the ISA considers what should be done when the auditor becomes aware of a material misstatement which affects the previous financial statements, which had an unmodified audit opinion. If the previous financial statements have been revised, the auditor needs to ensure that the comparatives agree with the revised financial statements. Where the previous year’s financial statements have not been reissued but the comparatives adjusted, no modification is necessary as long as the matter is properly disclosed. Where no adjustment or disclosure has been made, the auditor needs to consider whether the misstatements in the opening balances will give rise to misstatements in this period’s financial statements or whether the comparatives are materially misstated. Both of which, in the absence of adjustments, will lead to modifications as discussed above.

Further guidance is provided in Drafting the audit report.

Insufficient evidence

If the auditor is unable to obtain sufficient appropriate audit evidence in respect of opening balances and comparatives, the audit opinion should be qualified due to a limitation on scope. Depending on the extent of the problem and materiality of the areas in question, this could either be an ‘except for’ qualification or, in more serious circumstances, a disclaimer of opinion may need to be given. Refer to Drafting the audit report for more discussion of modified audit opinions. ~~Further guidance on audit opinions is also given in Audit reports.~~

3.4 Auditing accounting estimates

Quick overview

This section deals with the audit of accounting estimates and related disclosures.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2018). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance ~~found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.~~

In the *Navigate Audit* tools there are schedules for **Understanding accounting estimates (C8)**, **Review of accounting estimates and related disclosures (*template* C8.1)** and an **Estimates work paper *(template ESTIMATES)*** .

Scope and definitions

Scope

ISA (UK) 540 (Revised December 2018) (Updated May 2022) *Auditing Accounting Estimates and Related Disclosures* was issued in December 2018 and is effective for accounting periods commencing on or after 15 December 2019.

ISA (UK) 540 (Revised December 2018) (Updated May 2022) was developed in response to a changing business environment, increasing use and complexity of estimates in financial reporting and growing concerns from regulators and others that auditors were not always applying an appropriate level of professional scepticism in relation to such estimates. The standard is intended to apply to all estimates and all audits and sets out what the IAASB and FRC consider to be a scalable, risk-based approach. ISA (UK) 540 builds on the broader requirements of ISA (UK) 315 (Revised July 2020) *Identifying and assessing the risks of material misstatements.*

The revised ISA (UK) 540 places greater emphasis on auditor scepticism, risk assessment, responsiveness of procedures to assessed risk, evaluation based on consideration of all available evidence and documentation. Implementation of the standard will have far-reaching effects on the audit of financial statements.

Key definitions

Term	Definition
Accounting estimate	A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.
Auditor's point estimate or auditor's range	An amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate.
Estimation uncertainty	Susceptibility to an inherent lack of precision in measurement.
Management bias	A lack of neutrality by management in the preparation of information.

Management’s point estimate	The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
Outcome of an accounting estimate	The actual monetary amount that results from the resolution of the transaction(s), event(s) or condition(s) addressed by an accounting estimate.

Source: ISA (UK) 540

Accounting estimates

An accounting estimate is defined in ISA (UK) 540 as ‘a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty’ and estimation uncertainty is defined as ‘susceptibility to an inherent lack of precision in measurement’. The term is used for an amount measured at fair value where there is an inherent lack of precision in measurement, as well as for other amounts that require estimation.

Examples of accounting estimates would therefore include items such as:

- valuation of financial instruments;
- stock and trade debtor provisions;
- depreciation, amortisation or impairment of assets;
- valuation of property or infrastructure assets;
- provision for expected credit losses;
- employee retirement benefits liabilities;
- share-based payments;
- fair values of assets and liabilities acquired in a business combination, including the determination of goodwill and intangible assets;
- exchange of assets or liabilities without monetary consideration;
- revenue recognition, e.g. in long-term contracts;
- deferred tax; and
- outcome of pending litigation, claims or warranty provisions.

Accounting estimates are often of a non-routine nature and may be determined only at a period end, a commonapproach with items such as deferred tax. In other instances, they may be a routine procedure performed by theaccounting system, e.g. a formulaic slow-moving stock provision or fixed asset depreciation.

Estimates are often made where there is some level of uncertainty as to the outcome of future events and involve the use of judgment. As a result, there is a higher risk of material misstatement when accounting estimates are involved. Audit evidence may be less conclusive and auditor judgment is likely to be needed,frequently making such areas more difficult to audit.

Examples in this section have been extracted from a number of ICAEW publications.

Risk assessment and accounting estimates

ISA (UK) 540 requires an auditor to gain an understanding of the entities accounting estimates when obtaining an understanding of the entity and its environment, including internal control. The procedures are performed to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

In identifying the risks of material misstatement and assessing inherent risk, the auditor needs to take into account:

(a) the degree to which the accounting estimate is subject to estimation uncertainty; and

(b) the degree to which the following are affected by complexity, subjectivity or other inherent risk factors:

(i) the selection and application of the method, assumptions and data in making the accounting estimate; or

(ii) the selection of management's point estimate and related disclosures for inclusion in the financial statements.

The auditor also needs to determine whether any of the risks of material misstatement identified and assessed are a significant risk. If the auditor has determined that a significant risk exists, they are required to obtain an understanding of the entity's controls, including control activities, relevant to that risk.

ISA (UK) 540 requires the auditor to obtain an understanding of the following specific matters related to the entity's accounting estimates:

The Entity and Its Environment

- the entity's transactions, other events and conditions that may give rise to the need for, or changes in, estimates to be recognised or disclosed;
- the reporting requirements and how they apply in the context of the nature and circumstances of the entity, including how transactions and other events or conditions are subject to, or affected by, inherent risk factors – i.e. estimation uncertainty, complexity and subjectivity;
- any regulatory factors relevant to estimates, such as prudential supervision; and
- the nature of the estimates and related disclosures the auditor expects to be included in financial statements: another subtle shift. Auditors do this anyway, instinctively, but including a requirement heightens expectations regarding the ability to spot something unusual or just 'unexpected'.

The Entity's Internal Control

- the oversight and governance arrangements over financial reporting processes relevant to estimates, how management deals with the need for any specialised skills and how the entity's risk assessment process identifies and addresses relevant risks;
- the entity's information system as it relates to estimates, including:

(d) the classes of transactions, events and conditions that are significant to the financial statements and that give rise to the need for, or changes in, accounting estimates and related disclosures;

(e) how management identifies, selects, considers alternatives for and changes methods, models, assumptions and sources of data;

(f) how management understands and addresses the degree of estimation uncertainty, i.e. how it considers the range of possible measurement outcomes; and

(g) how it goes about selecting a point estimate and related disclosures from that range;

- control activities over management's process for making estimates; and
- how management reviews the outcomes of previous accounting estimates.

The auditor is also required to review the outcome of prior period estimates (or any re-estimation for the purposes of the current period). Such a review is not intended to call into question the judgements made in prior periods but may provide the auditor with information relevant to their assessment of the risks of material misstatement in relation to similar estimates in the current period.

The auditor should also determine whether specialised skills or experience, or use of experts, is required to assist in the risk assessment or design and performance of audit procedures.

Estimation uncertainty

In taking into account the degree to which the accounting estimate is subject to estimation uncertainty, the standard notes that the auditor may consider the following:

- whether the applicable financial reporting framework requires:

- the use of a method to make the accounting estimate that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of unobservable inputs;
- the use of assumptions that inherently have a high level of estimation uncertainty, such as assumptions with a long forecast period, assumptions that are based on data that is unobservable and are therefore difficult for management to develop or the use of various assumptions that are interrelated; or
- disclosures about estimation uncertainty;

- the business environment. An entity may be active in a market that experiences turmoil or possible disruption (e.g. from major currency movements or inactive markets) and the accounting estimate may therefore be dependent on data that is not readily observable;
- whether it is possible (or practicable, insofar as permitted by the applicable financial reporting framework) for management:

- to make a precise and reliable prediction about the future realisation of a past transaction (e.g. the amount that will be paid under a contingent contractual term) or about the incidence and impact of future events or conditions (e.g. the amount of a future credit loss or the amount at which an insurance claim will be settled and the timing of its settlement); or

- to obtain precise and complete information about a present condition (e.g. information about valuation attributes that would reflect the perspective of market participants at the date of the financial statements to develop a fair value estimate).

Thus the more uncertain the estimate, the higher the risk that the estimate is materially misstated.

As a simple example, the estimate of the warranty provision required in respect of televisions sold will be more uncertain if a five-year warranty is given to customers than if a one-year warranty is given.

Some accounting estimates involve a low degree of estimation uncertainty that results in a lower risk of material misstatement. For example, those estimates that are made frequently that relate to routine transactions, that have a history of predictable outcomes and that can be measured through direct observation of the cost of price.

Example

An entity operates items of machinery that are replaced at regular intervals. The technology has evolved over time while their operating life has not substantially changed in recent history. When repairing the machines becomes uneconomic, they are part-exchanged for new ones. In these circumstances, the estimation of the useful life of the machines and of their residual value for the purpose of measuring depreciation may involve a low level of estimation uncertainty. This is because it is based on reliable internal historical data that requires limited judgement to be made by management.

Other accounting estimates may be subject to higher estimation uncertainty that results in a higher risk of material misstatement. Examples include estimates where:

- a number of alternative sources of information from which to determine an amount are available;
- a number of different models exist that are all equally accepted in the industry in which the entity operates;
- the choice of the information source and the model may produce widely different values;
- the outcome of future events or actions is uncertain and dependent on a number of factors, e.g. the outcome of legal action against the entity; and
- constraints on the availability of information or knowledge exist.

Example

An entity has a litigation provision relating to the outcome of a lawsuit. The amount of this provision may rely heavily on the opinion provided by the entity’s legal counsel about the likelihood of a settlement and its expected size. There may also be limited (or no) direct historical precedent to its calculation. The size of an expected settlement may also be significantly sensitive to changes in the key assumptions made by the counsel, thereby increasing estimation uncertainty.

Subjectivity

Subjectivity reflects the inherent limitations in the knowledge or data reasonably available about valuation attributes. Although financial reporting frameworks may reduce the degree of subjectivity by providing a basis for certain judgements, management generally uses judgement when:

- interpreting the requirements of the applicable financial reporting framework;

- identifying the appropriate sources of data to use;
- developing assumptions based on the best available data;
- selecting measurement methods; or
- interpreting data, such as selecting the most appropriate point estimate from a range of possible outcomes.

Certain estimates are highly dependent on judgement and there may be few relevant information sources to rely on. Observable information derived from external sources (such as published interest rates or statistical data) or from internal sources (such as historical information or previous experience) can help to inform such judgements. However, this is not always available.

Wherever management has a choice available, or has to make interpretations, subjectivity will exist.

In taking into account the degree to which the selection and application of method, assumptions or data are affected by subjectivity, the auditor may consider:

- the uncertainty regarding the amount or timing, including the length of the forecast period. The amount and timing are a source of inherent estimation uncertainty and give rise to the need for management judgement in selecting a point estimate, which in turn creates an opportunity for management bias. For example, an accounting estimate that incorporates forward-looking assumptions may have a high degree of subjectivity which may be susceptible to management bias;
- the degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or fraud.

Example

An entity selling products with warranties introduces a radically new product. The estimation of the related warranty obligations is likely to have high uncertainty. In practice, the entity will have no experience of the level of repairs and replacements required by the new product. The historical data relating to its existing conventional products is unlikely to be relevant for the estimate. The assumptions relating to the estimate of the warranty obligations will be more subjective as there will be relatively little internal or external information from which to draw.

Complexity

Sometimes the determination of accounting estimates can be intrinsically complex. Inherent complexity may arise when:

- there are many valuation attributes with many or non-linear relationships between them;
- determining appropriate values for one or more valuation attributes requires multiple data sets;
- more assumptions are required in making the accounting estimate or when there are correlations between the required assumptions; or
- the data used is inherently difficult to identify, capture, access or understand.

Complexity can arise from the method itself, from the computational process or model used to apply it. It may require the use of specific methods or models that require specialised skills or knowledge in relation to their valuation concepts and techniques.

The guidance section of the ISA notes that factors which may affect estimation complexity include:

- the complexity of the process to derive the data, taking into account the relevance and reliability of the data source. Data from certain sources may be more reliable than from others;
- the inherent complexity in maintaining the integrity of the data. When there is a high volume of data and multiple sources of data, there may be inherent complexity in maintaining the integrity of data that is used to make an accounting estimate;
- the need to interpret complex contractual terms. For example, the determination of cash inflows or outflows arising from a commercial supplier or customer rebates may depend on very complex contractual terms that require specific experience or competence to understand or interpret;
- the degree to which the applicable financial reporting framework does not specify the valuation approaches, concepts, techniques and factors to use in the estimation method.

Example

An entity has entered into a derivative financial instrument contract that needs to be measured at fair value. The instrument is not publicly traded and requires the use of a particular specialised model to determine its fair value. The model needs data from a number of internal and external sources and requires specialised knowledge to select the most appropriate data source and to interpret the results.

Example

Consider an entity for which materiality has been determined as £10,000.

The entity has an investment property, revalued each year to open market value. At the year end, the property is under offer for a price of £2m and conveyancing is progressing smoothly. While the value is significant, the degree of uncertainty is low given a firm indication of price from the offer made.

On the other hand, the same entity has a tax liability of £5,000, being tax on profits of £100,000 less group relief of £95,000. The allowability of group relief is disputed and the tax advisors believe it could go either way. With a 50:50 chance of success, the estimation uncertainty is £95,000, which is very high.

The table provides an example of estimates which may have higher/lower subjectivity and complexity.

		Complexity	
		Low	High
Subjectivity	High	Calculating a liability amount contingent on the outcome of a litigation will have high subjectivity but be relatively simple.	Calculating expected credit losses using a complex model incorporating historical data and assumptions in an entity specific scenario may be both complex and involve significant subjectivity in making the judgements used.

Low	Calculating a simple trade receivable provision can have low subjectivity and complexity.	Calculating inventory obsolesce for a wide range of inventory types may require complex systems and processes but have little subjectivity.

Assessment of risk

ISA (UK) 540 requires auditors to ensure that their methodology allows for separate assessments of inherent and control risk and assessment of inherent risk on a spectrum that is not purely binary (high/low or significant/not significant).

They may also need to consider how best to demonstrate that their audit procedures appropriately respond to the risk and incorporate the requirement for reasonableness into their approach.

In order to make sense of this spectrum of risk in an audit tool and working papers, Croner-i tools use a scale of 1 to 5 for the rating of risks; 1 being the lowest level of risk; 5 being the highest.

The susceptibility of an assertion to a misstatement that could be material may be subject to, or affected by, estimation uncertainty, complexity, subjectivity or other inherent risk factors and the interrelationship among them.

Example – Inherent risk assessment

The standard provides three examples for how the auditor's assessment of inherent risk at the assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity or other inherent risk factors.

- Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgements about future events or conditions. Similar considerations apply to insurance contract liabilities.
- An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes, but may involve little subjectivity and the degree of estimation uncertainty may be low, depending on the nature of the inventory.

Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgement, e.g. an accounting estimate that requires a single critical judgement about a liability, the amount of which is contingent on the outcome of the litigation.

ISA (UK) 540 also requires auditors to review the outcomes of previous accounting estimates to help assist with identifying and assessment risks of material misstatement in the current period.

The standard emphasises the need for exercising professional scepticism in relation to accounting estimates and that the importance of scepticism increases as the degree of inherent risk increases. The exercise of professional scepticism is also important when there is greater susceptibility to misstatement due to management bias or fraud.

Further guidance is given in Assessing risk. The auditor's further audit procedures should then be responsive to the assessed risks of material misstatement at the assertion level, considering the reasons for the assessment given to those risks.

In the ~~Navigate~~ *Audit* tools, this work is performed in **Understanding accounting estimates (C8), Review of accounting estimates and related disclosures (*template* C8.1).**

Scalability

ISA (UK) 540 states that when obtaining an understanding of the entity as required by ISA (UK) 315, the procedures to obtain the understanding are performed '… to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement'. It is these words that are intended to be the key to scalability. The related application material states that 'some estimates may not require significant judgements and the processes for making them may not be complex'. It goes on to state that:

'… the entity may have few transactions or other events and conditions that give rise to the need for accounting estimates, the applicable financial reporting requirements may be simple to apply, and there may be no relevant regulatory factors.'

In these circumstances:

'… the accounting estimates may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree and there may be fewer controls relevant to the audit. If so, the auditor's risk assessment procedures are likely to be less extensive and may be obtained primarily through inquiries of management with appropriate responsibilities for the financial statements and simple walk-throughs of management's process for making the accounting estimate.'

Considerations relevant for entities with only simple businesses, which may include many smaller entities, include:

- 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; and
- accounting estimates may be generated outside of the general and subsidiary ledgers, controls over their development may be limited and an owner-manager may have significant influence over their determination. The owner-manager's role in making the accounting estimates may 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.

Example – Risk of misstatement

The assessed risks of misstatement relating to existence or valuation may be lower for a straightforward accrual for bonuses paid to employees shortly after period end and that evidence is likely to involve evaluating events up to the audit report date, rather than other testing approaches.

For audits with a low inherent risk factor and few controls, the auditor could primarily perform the risk assessment procedures through inquiries of management and simple process walkthroughs.

This would be the case for a company which has:

- few transactions with a need to apply estimates;
- limited event or conditions that give rise to the need of accounting estimates; and
- accounting estimates which don't require significant judgements.

Alternatively, for companies which have extensive controls over the accounting estimates and greater inherent risk factors, the audit procedures here will need to be more robust and more audit evidence gathered. The standard details the requirements it will expect the auditor to perform and ISA (UK) 540 reinforces the importance of maintaining professional scepticism.

Further audit procedures

The auditor's further audit procedures in relation to estimates shall include one or more of the following:

(a) obtaining audit evidence from events occurring up to the date of the auditor's report;

(b) testing how management made the accounting estimate; or

(c) developing an auditor's point estimate or range.

These further audit procedures are required to take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be. The auditor shall design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

The *~~Navigate~~ Audit* tools ask the auditor to design and perform appropriate tests for each estimate identified that is material or contains a risk of material misstatement.

If the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively, or substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, then the auditor shall design and perform tests to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls.

Where a significant risk relating to an accounting estimate has been identified, if the auditor plans to rely on controls, then they must test those controls in the current period. When the approach to a significant risk consists only of substantive procedures, those procedures must include tests of details.

The nature, timing and extent of audit procedures required will depend on estimation uncertainty and the assessment of the related risks of material misstatement. For some estimates, estimation uncertainty may be very low and the complexity and subjectivity involved in making them may also be low. For such accounting estimates, the risk assessment procedures and further audit procedures required would not be expected to be extensive. However, when estimation uncertainty, complexity or subjectivity are high, risk or misstatements will be higher and audit procedures would be expected to be much more extensive.

Evidence from events up to the date of the auditor's report

Review of transactions and events after the balance sheet date may provide useful audit evidence when evaluating accounting estimates.

For example, consider a stock provision against stock which is perishable with a sell-by date. Post-year end sales information may conclusively show which items in stock at the year end were not sold after the year end before the expiration of their sell-by date, thus giving the auditor high-quality audit evidence to support the level of the stock provision. A similar argument can also be made in respect of the adequacy of a bad debt provision against trade debtors.

The auditor does however need to evaluate whether such audit evidence is sufficient and appropriate to address the risks of material misstatement relating to the accounting estimate, taking into account that changes in circumstances and other relevant conditions between the event and the measurement date may affect the relevance of such audit evidence.

In some cases, a review of subsequent events may remove the need for the auditor to obtain other evidence to support an accounting estimate. For example, if an estimate is made concerning an insurance claim for loss of profits after a fire and a provisional settlement is agreed during the course of the audit, this will provide evidence supporting the amount of the estimate and means that the auditor may reduce the attention they give to the process by which management originally derived the estimate.

Testing how management made the estimate

When testing how management made the accounting estimate, the auditor needs to obtain sufficient appropriate evidence regarding the risk of material misstatement relating to:

- the selection and application of the methods, significant assumptions and the data used by management in making the accounting estimate; and
- how management selected the point estimate and developed related disclosures about estimation uncertainty.

Testing how management made the accounting estimate may be an appropriate approach when, for example:

- the auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is appropriate;
- the accounting estimate is based on a large population of items of a similar nature that individually are not significant;
- the applicable financial reporting framework specifies how management is expected to make the accounting estimate. For example, this may be the case for an expected credit loss provision; or
- the accounting estimate is derived from the routine processing of data.

It may also be an appropriate approach when neither of the other testing approaches is practical to perform nor may be an appropriate approach in combination with one of the other testing approaches.

Selection and application of methods

When performing procedures related to management's selection and application of methods, those procedures shall address:

(a) whether the method selected is appropriate in the context of the applicable financial reporting framework and, if applicable, changes from the method used in prior periods are appropriate;

(b) whether judgements made in selecting the method give rise to indicators of possible management bias;

(c) whether the calculations are applied in accordance with the method and are mathematically accurate;

(d) when management's application of the method involves complex modelling, whether judgements have been applied consistently and whether, when applicable:

- the design of the model meets the measurement objective of the applicable financial reporting framework, is appropriate in the circumstances and, if applicable, changes from the prior period's model are appropriate in the circumstances; and
- adjustments to the output of the model are consistent with the measurement objective of the applicable

financial reporting framework and are appropriate in the circumstances; and

(e) whether the integrity of the significant assumptions and the data has been maintained in applying the method.

When there are changes from prior periods in a method, significant assumption or data and those changes are not based on new circumstances or new information, or when significant assumptions are inconsistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, the auditor may need to have further discussions with management about the circumstances and, in doing so, challenge management regarding the appropriateness of the assumptions used.

When considering the appropriateness of the method selected by management, the auditor considers:

- whether management's rationale for the method selected is appropriate;
- whether the method is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, other available valuation concepts or techniques, regulatory requirements and the business, industry and environment in which the entity operates;
- when management has determined that different methods result in a range of significantly different estimates, how management has investigated the reasons for these differences; and
- whether the change is based on new circumstances or new information. When this is not the case, the change may not be reasonable or in compliance with the applicable financial reporting framework. Arbitrary changes result in inconsistent financial statements over time and may give rise to financial statement misstatements or may be an indicator of possible management bias.

These matters are important when the applicable financial reporting framework does not prescribe the method of measurement or allows multiple methods.

Particularly in the case of complex models, but also less complex models, the auditor may consider whether:

- the model is validated prior to usage or when there has been a change to the model, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
  - the model's theoretical soundness;
  - the model's mathematical integrity;
  - the accuracy and completeness of the model's data and assumptions; and
  - the model's output as compared to actual transactions;
- appropriate change control policies and procedures exist;
- management uses appropriate skills and knowledge in using the model.

Accounting estimates are often made using spreadsheets, especially at the smaller client. These are notorious for containing mistakes in formulae, such as not including the last line in a list of data when adding up at the bottom. A further risk can arise with clients who are very proficient in the use of spreadsheets and use very complicated formulae, pivot tables, etc. It is not uncommon for such spreadsheets to contain fundamental errors, so that the calculation of the key provision is not done on the desired basis. These types of errors can be difficult to identify, especially if the members of the audit team do not have a high level of expertise in using spreadsheets.

Significant assumptions

In testing how management made their estimate in relation to significant assumptions, the auditor's procedures should address:

- whether the significant assumptions are appropriate in the context of the applicable financial reporting framework and, if applicable, changes from prior periods are appropriate;
- whether judgements made in selecting the significant assumptions give rise to indicators of possible management bias;
- whether the significant assumptions are consistent with each other and with those used in other accounting estimates or with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit; and
- when applicable, whether management has the intent to carry out specific courses of action and has the ability to do so.

Data

With respect to management's data, the auditor's procedures should address:

- whether the data is appropriate in the context of the applicable financial reporting framework and, if applicable, changes from prior periods are appropriate;
- whether judgements made in selecting the data give rise to indicators of possible management bias;
- whether the data is relevant and reliable in the circumstances; and
- whether the data has been appropriately understood or interpreted by management, including with respect to contractual terms.

The auditor needs to ensure that the data is accurate, complete and relevant. For example, if testing a warranty provision, the data of products sold should not include all products that were sold under warranty but only those still under warranty. If any external data or information has been used, including any provided by management's expert(s), the source, relevance and reliability of that data should also be considered.

Management's selection of a point estimate and related disclosures about estimation uncertainty

The auditor's procedures need to address whether management has taken steps to understand estimation uncertainty; and to address estimation uncertainty by selecting an appropriate point estimate and by developing related disclosures about estimation uncertainty.

Where in the auditor's judgement, management has not taken these steps, the auditor shall:

- request management to perform additional procedures to understand estimation uncertainty or to address it by reconsidering the selection of management's point estimate or considering providing additional disclosures relating to the estimation uncertainty and evaluate management's response(s);
- if the auditor determines that management's response to the auditor's request does not sufficiently address estimation uncertainty, to the extent practicable, develop an auditor's point estimate or range; and
- evaluate whether a deficiency in internal control exists and, if so, communicate in accordance with ISA (UK) 265 (Updated May 2022) Communicating deficiencies in internal control to those charged

with governance and management.

Further guidance can be found in Develop a point estimate or range.

Develop a point estimate or range

It may be possible for the auditor to develop a point estimate or range to compare with the estimate prepared by management, indeed there are situations in which the ISA requires this. This may be a suitable approach where the other procedures noted above are not practicable.

This may be an appropriate approach when, for example:

- the auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is not expected to be effective;
- the entity's controls within and over management's 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, when it is appropriate for management to do so, and such events or transactions appear to contradict management's point estimate;
- there are appropriate alternative assumptions or sources of relevant data that can be used in developing an auditor's point estimate or a range; or
- management has not taken appropriate steps to understand or address the estimation uncertainty.

When the auditor develops a point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty, regardless of whether they use management's or their own methods, assumptions or data, they still need to perform procedures to evaluate whether the methods, assumptions and data are appropriate.

If the auditor develops an auditor's range, they shall:

(a) determine that the range includes only amounts that are supported by sufficient appropriate audit evidence and have been evaluated by the auditor to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework; and

(b) design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement relating to the disclosures in the financial statements that describe the estimation uncertainty.

The auditor may develop a point estimate or a range in a number of ways, for example, by:

- using a different model than the one used by management, e.g. one that is commercially available for use in a particular sector or industry or a proprietary or auditor-developed model;
- using management's model but developing alternative assumptions or data sources to those used by management;
- using the auditor's own method but developing alternative assumptions to those used by management;
- employing or engaging a person with specialised expertise to develop or execute a model or to provide relevant assumptions; or
- consideration of other comparable conditions, transactions or events or, where relevant, markets for comparable assets or liabilities.

The auditor also may develop a point estimate or range for only part of the accounting estimate (e.g. for a particular assumption or when only a certain part of the accounting estimate is giving rise to the risk of material misstatement).

Test the operational effectiveness of controls

Testing the operational effectiveness of controls may be appropriate when management's process for making the estimate is well-designed and implemented, particularly where there are strong review procedures and the estimate is derived from routine data processing. An example of such a situation might be a stock provision based on stock ageing, quantities and set provisioning percentages.

However, this may not be a very effective approach for many small clients, where there may be a lack of controls, controls may not be very strong or there may be a lack of segregation of duties. In practice, it is therefore likely that one or more of the other procedures listed above will be used.

It should be noted, however, that the auditor is required to test the operating effectiveness of relevant controls if their assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively or substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

Accounting estimates with significant risks

For a significant risk relating to an accounting estimate, the auditor's further audit procedures shall include tests of controls in the *current period* if the auditor plans to rely on those controls. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

Indicators of possible management bias

The auditor is required to review the decisions and judgements made by management in making their estimates and identify whether there are any indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements; however, where identified, the auditor should consider whether they affect their risk assessment and the implications for the rest of the audit.

When there is also a high level of complexity or a high level of estimation uncertainty, or both, the risk of, and opportunity for, management bias or fraud may also be increased.

Examples of indicators of possible management bias include:

- changes in accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances;
- use of an entity's own assumptions for fair value estimates when they are inconsistent with observable marketplace assumptions;
- selection of significant assumptions that yield a point estimate favourable for management objectives; and
- selection of a point estimate that may indicate a pattern of optimism or pessimism.

If the auditor uses their own assumptions in developing a range to evaluate the reasonableness of management's point estimate, the auditor may also develop a view about whether management's judgements in selecting the significant assumptions used in making the accounting estimate give rise to indicators of possible management bias.

ISA (UK) 200 (Revised June 2016) (Updated May 2022) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)* requires the auditor to maintain professional scepticism throughout the audit. Scepticism is an essential feature of any audit and the subject is discussed further in Professional scepticism.

Stand back requirement

ISA (UK) 540 includes a requirement to 'stand back' and evaluate, based on the audit procedures carried out and the evidence obtained, whether:

- the risk assessments at the assertion level are still appropriate;
- management's decisions relating to recognition, measurement and presentation and disclosure are in accordance with the financial reporting framework; and
- sufficient appropriate audit evidence has been obtained.

There is a particular emphasis here on taking account of all relevant audit evidence, whether corroborative and contradictory. This evaluation includes determining whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated, and whether management has included disclosures beyond those specifically required, that are necessary to give a true and fair view.

Reasonable, in this context, means that the relevant requirements of the applicable financial reporting framework have been applied appropriately, including:

- the making of the accounting estimate (method, assumptions and data);
- selection of management's point estimate; and
- disclosures, including disclosures about the development of the estimate and the nature, extent and sources of estimation uncertainty.

Written representations

The auditor is required to obtain written representations from management, and where appropriate those charged with governance, whether they believe significant assumptions used in making their accounting estimates are reasonable.

An assumption used in making an accounting estimate is considered to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.

Depending on the nature, materiality and extent of estimation uncertainty, other representations about accounting estimates may cover:

- management has taken into account all relevant information when making accounting estimates;
- appropriateness of measurement processes including related assumptions and models, and consistency in application of measurement processes;
- confirmation that assumptions reflect management's intent and ability to carry out specific courses of action, where relevant to the accounting estimates and disclosures;

- appropriate specialised skills or expertise has been applied in making the accounting estimates;
- confirmation that disclosures are complete and appropriate under the relevant accounting framework; and
- that no subsequent events require adjustment to the accounting estimates or disclosures in the financial statements.

Further guidance on written representations is in Letters of representation.

Documentation

ISA (UK) 540 contains some explicit documentation requirements. Specifically, the auditor should document:

- key elements of understanding of the entity and its environment, including internal control related to accounting estimates;
- linkage of further audit procedures with the assessed risks of material misstatement at the assertion level;
- the auditor's response(s) when management has not taken appropriate steps to understand and address estimation uncertainty;
- indicators of possible management bias related to accounting estimates, if any, and implications for the audit; and
- significant judgements in determining whether accounting estimates and related disclosures are reasonable or are misstated.

In the *~~Navigate~~ Audit* tools, this is documented in **Understanding accounting estimates (C8)**, **Review of accounting estimates and related disclosures (*template* C8.1)** and an **Estimates work paper** *template*.

Further general guidance is in Documentation.

Disclosure

The auditor is required to obtain sufficient evidence as to whether disclosure of the accounting estimate in the financial statements is in accordance with the applicable financial reporting framework.

Where accounting estimates give rise to significant risks, the ISA also requires the auditor to evaluate the adequacy of the disclosure of the estimation uncertainty. In some situations, the auditor may consider it appropriate to encourage management to provide additional information regarding estimation uncertainty in the notes to the financial statements. Where the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading, this may have implications for the auditor's opinion.

Communication with those charged with governance

The auditor is required to communicate with those charged with governance or management about certain matters, including significant qualitative aspects of the entity's accounting practices and significant deficiencies in internal control. The auditor should consider whether there are any such matters to be communicated in relation to management's use of accounting estimates. The table below gives examples of matters that may be relevant.

Matters that it may be relevant to communicate

(a) How management identifies transactions, other events and conditions that may give rise to the need for, or changes in, accounting estimates and related disclosures.

(b) Risks of material misstatement.

(c) The relative materiality of the accounting estimates to the financial statements as a whole.

(d) Management's understanding (or lack thereof) regarding the nature and extent of, and the risks associated with, accounting estimates.

(e) Whether management has applied appropriate specialised skills or knowledge or engaged appropriate experts.

(f) The auditor's views about differences between the auditor's point estimate or range and management's point estimate.

(g) The auditor's views about the appropriateness of the selection of accounting policies related to accounting estimates and presentation of accounting estimates in the financial statements.

(h) Indicators of possible management bias.

(i) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates.

(j) When there has been a change from the prior period in the methods for making the accounting estimate, why, as well as the outcome of accounting estimates in prior periods.

(k) Whether management's methods for making the accounting estimates, including when management has used a model, are appropriate in the context of the measurement objectives, the nature, conditions and circumstances and other requirements of the applicable financial reporting framework.

(l) The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions.

(m) Whether significant assumptions are consistent with each other and with those used in other accounting estimates or with assumptions used in other areas of the entity's business activities.

(n) When relevant to the appropriateness of the significant assumptions or the appropriate application of the applicable financial reporting framework, whether management has the intent to carry out specific courses of action and has the ability to do so.

(o) How management has considered alternative assumptions or outcomes and why it has rejected them or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

(p) Whether the data and significant assumptions used by management in making the accounting estimates are appropriate in the context of the applicable financial reporting framework.

(q) The relevance and reliability of information obtained from an external information source.

(r) Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to data obtained from an external information source or valuations performed by management or a management's expert.

(s) Significant differences in judgements between the auditor and management or a management's expert regarding valuations.

(t) The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the estimation uncertainty associated with accounting estimates.

(u) The reasonableness of disclosures about estimation uncertainty in the financial statements.

(v) Whether management's decisions relating to the recognition, measurement, presentation and disclosure of the accounting estimates and related disclosures in the financial statements are in accordance with the applicable financial reporting framework.

Further general guidance on communicating with those charged with governance is in Reports to management.

Current issues and further resources

Current issues

The auditor may need to give additional consideration to certain accounting estimates as a result of the political situation in Russia, Ukraine and surrounding countries. For example, some entities may have assets which are based on accounting estimates, where an underlying model relies on assumptions that include macroeconomic factors. These factors may have changed considerably because of the war and related sanctions, for example the higher interest rate set by the Russian Central Bank. Auditors will need to assess whether the assumptions underlying these models are still appropriate, and then obtain evidence that assets, or liabilities, based on these models are not materially misstated.

3.5 Going Concern

Quick overview

This section sets out the auditor's consideration of the appropriateness of the use of the going concern basis of accounting and of the adequacy of disclosures relating to the future solvency or liquidity of the entity. It is an area that continues to attract much attention, particularly in the light of recent high-profile corporate failures.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas~~ of *Navigate Audit*.~~

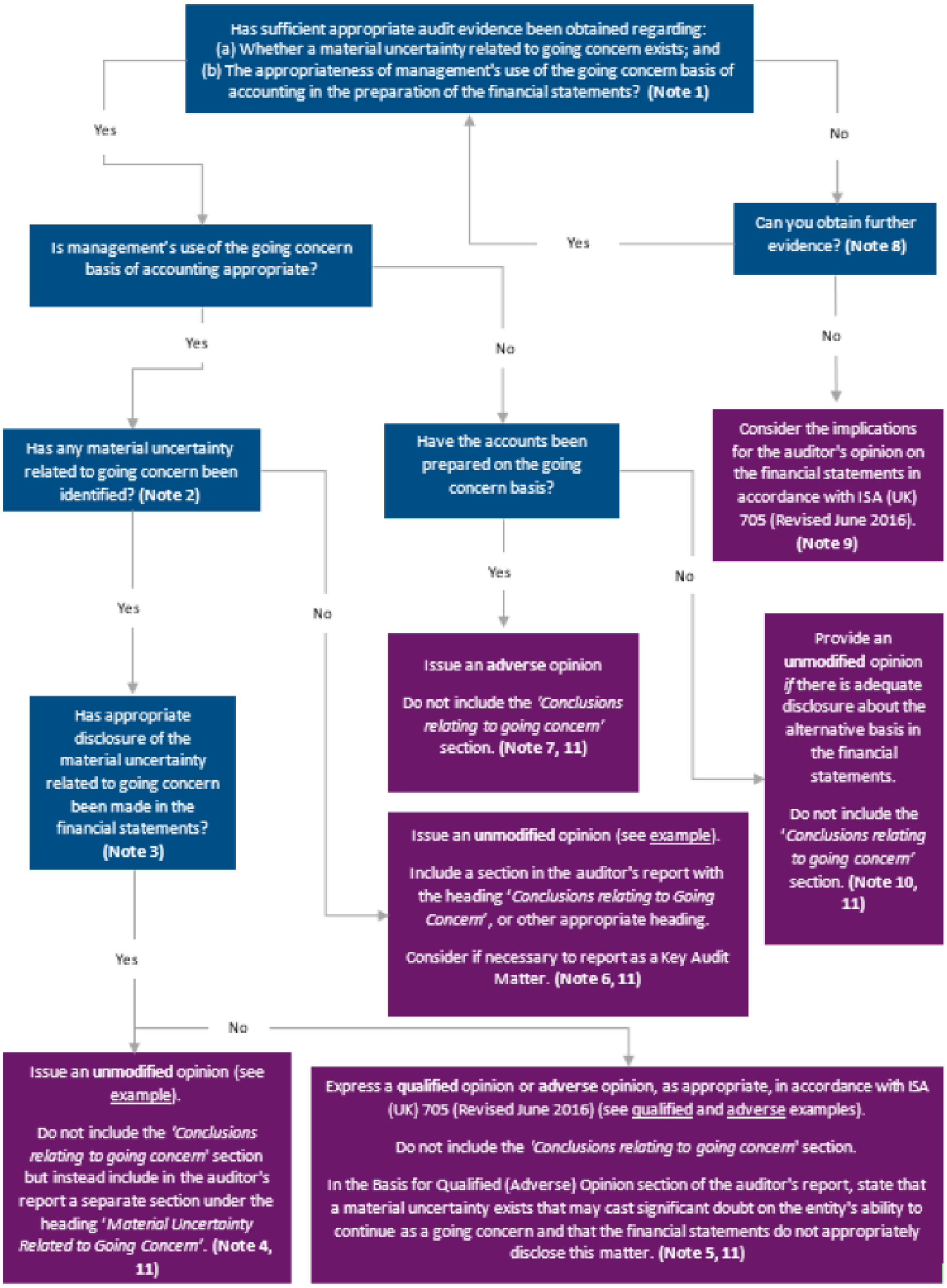
This section relates to section D in the ~~*Navigate*~~ *Audit* tools.

Going concern assessment

When preparing financial statements, management needs to make an assessment of the company's ability to continue as a going concern. FRS 102 states that 'an entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue'.

An interactive decision tree to guide audit reporting considerations relating to going concern, including guidance notes and examples, is below.~~ A PDF version of the decision tree is here.~~

Decision tree



Has sufficient appropriate audit evidence been obtained regarding:
(a) Whether a material uncertainty related to going concern exists; and
(b) The appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements? **(Note 1)**

Is management's use of the going concern basis of accounting appropriate?

Can you obtain further evidence? **(Note 8)**

Has any material uncertainty related to going concern been identified? **(Note 2)**

Have the accounts been prepared on the going concern basis?

Consider the implications for the auditor's opinion on the financial statements in accordance with ISA (UK) 705 (Revised June 2016). **(Note 9)**

Has appropriate disclosure of the material uncertainty related to going concern been made in the financial statements? **(Note 3)**

Issue an **adverse** opinion

Do not include the *'Conclusions relating to going concern'* section. **(Note 7, 11)**

Provide an **unmodified** opinion *if* there is adequate disclosure about the alternative basis in the financial statements.

Do not include the *'Conclusions relating to going concern'* section. **(Note 10, 11)**

Issue an **unmodified** opinion (see example).

Include a section in the auditor's report with the heading '*Conclusions relating to Going Concern*', or other appropriate heading.

Consider if necessary to report as a Key Audit Matter. **(Note 6, 11)**

Issue an **unmodified** opinion (see example).

Do not include the *'Conclusions relating to going concern'* section but instead include in the auditor's report a separate section under the heading '*Material Uncertainty Related to Going Concern*'. **(Note 4, 11)**

Express a **qualified** opinion or **adverse** opinion, as appropriate, in accordance with ISA (UK) 705 (Revised June 2016) (see qualified and adverse examples).

Do not include the *'Conclusions relating to going concern'* section.

In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not appropriately disclose this matter. **(Note 5, 11)**

Scope and definitions

Scope

ISA (UK) 570 (Revised September 2019) (Updated May 2022) *Going Concern* is effective for the audit of financial statements for periods commencing on or after 15 December 2019.

The revised ISA requires a more robust assessment of management's going concern assessment than the previous ISA, drawing on a wider range of available information to support the auditor's work, through enhanced risk assessment procedures and a more rigorous challenge of the method, information and assumptions used by management in making their going concern assessment.

Professional scepticism also features heavily with more robust risk assessment requirements that provide a better basis for identifying events and conditions, including events or conditions not identified by management and assessing whether a material uncertainty exists related to them. Auditors must also consider the possibility of management bias.

Finally, there is a requirement to 'stand back' and consider all audit evidence obtained, whether corroborative or contradictory, when evaluating going concern.

For entities that are required, or choose voluntarily, to report on how they have applied the UK Corporate Governance Code, the ISA contains additional requirements for the auditor. These are covered in Entities applying the UK Corporate Governance Code.

For those entities which do not apply the Code, guidance was issued in April 2016, titled *Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks*. This is covered in FRC guidance.

Key definitions

Term	Definition
Management bias	A lack of neutrality by management in the preparation of information.
Material uncertainty related to going concern	An uncertainty related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern, where the magnitude of its potential impact and likelihood of occurrence is such that appropriate disclosure of the nature and implications of the uncertainty is necessary for: (i) in the case of a fair presentation financial reporting framework, the fair presentation of the financial statements; or (ii) in the case of a compliance framework, the financial statements not to be misleading.

Source: ISA (UK) 570:9-2

Accounting requirements

Under the going concern basis of accounting, an entity will be assumed to continue in business for the foreseeable future without the intention or need to liquidate, cease trading or seek protection from its creditors. Assets and liabilities will, therefore, be recorded assuming that they will be traded or settled in the normal course of business.

In the UK, most financial statements will be prepared under either IFRS or UK accounting standards. The requirements relating to going concern are similar under the two frameworks and entities should use the going concern basis unless the entity has ceased trading or is being liquidated or the directors either intend or have no realistic alternative but to cease trading or liquidate the entity. Most financial statements will therefore be prepared on a going concern basis even where there is uncertainty regarding the entity's ability to remain a going concern.

Under UK accounting standards, in assessing whether the going concern basis of accounting is appropriate, those charged with governance take into account all available information about the future, which is at least, but is not limited to, 12 months from the date when the financial statements are authorised for issue.

When those charged with governance are aware, in making their assessment, of material uncertainties related to events or conditions that cast significant doubt upon the entity's ability to continue as a going concern, the entity must disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

IAS 1 contains almost identical requirements to UK accounting standards but requires that the directors' assessment covers a period of at least 12 months from the balance sheet date. In practice, however, for UK entities, those charged with governance are usually expected to consider a period of 12 months from the date of approval.

Directors' vs auditors' responsibilities

The responsibility for the going concern assessment of a company rests with those charged with governance. The financial reporting frameworks applicable in the UK all require the directors (or equivalent) to make an assessment of the entity's ability to continue as a going concern. However, these frameworks provide little guidance to those charged with governance on how this assessment should be made or the level of detailed analysis that may be required to make this assessment. The FRC has provided guidance on going concern to directors of companies that apply the UK Corporate Governance Code and those entities that do not.

Insight – Directors' responsibilities to going concern

The FRC noted in its Feedback Statement: ISA (UK) 570 (Revised September 2019) Going Concern (2019) that some respondents expressed concern that they thought the proposals in the exposure draft of ISA (UK) 570 meant that auditors would be required to go further than management are required to do in making their assessment of going concern.

However, the FRC explained that this has always been the case: ISA (UK) 570 (Revised June 2016):6 states:

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

The FRC added that irrespective of whether management have made an assessment – detailed or otherwise – the auditor is required to undertake work on the going concern basis of accounting and determine whether a material uncertainty related to going concern exists. The FRC hopes the revisions made to ISA (UK) 570 will help to ensure that this process will be done more consistently and robustly.

ISA (UK) 570 also notes that the auditor's responsibilities in relation to going concern exist even if the specific accounting framework used does not require an explicit assessment by management.

When making their assessment, those charged with governance should be aware that:

- the outcome of an event is less certain the further it is likely to occur from the date the assessment is made;
- judgements can only be made on the basis of information available at the time. Subsequent events can contradict a decision which was reasonable at the time it was made; and
- any judgement will be affected by the size and complexity of the entity, its type of business and how susceptible its activities are to outside influences.

The auditor should also consider these factors when forming an opinion on the assessment made by those charged with governance.

Regardless of the accounting framework used, management's assessment should normally cover a period of at least 12 months from the date of approval of the financial statements. If it does not, the ISA requires that the auditor should request management to extend its assessment. The section in Audit reports: Going concern and the auditor's opinion explains the implications if management is unwilling or unable to do so.

Audit objectives and responsibilities

In preparing financial statements, it is the responsibility of those charged with governance to determine whether it is appropriate to apply the going concern basis of accounting and whether any assumptions and uncertainties are adequately disclosed.

The auditor's audit objectives when considering going concern are to:

(a) obtain sufficient appropriate audit evidence regarding, and conclude on:

(i) whether a material uncertainty related to going concern exists; and

(ii) the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements; and

(b) report in accordance with this ISA (UK).

The ISA defines a 'material uncertainty related to going concern' as:

'An uncertainty related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern, where the magnitude of its potential impact and likelihood of occurrence is such that appropriate disclosure of the nature and implications of the uncertainty is necessary for:

(i) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements; or

(ii) In the case of a compliance framework, the financial statements not to be misleading.'

The revised ISA significantly changes the emphasis such that the auditor is not simply concluding on the existence or otherwise of a material uncertainty on the basis of evidence obtained, but is actively required to obtain sufficient evidence on which to base their opinion. Evidence needs to be obtained about both management's use of the going concern basis and the possibility of a material uncertainty itself.

Audit procedures

The auditor's ultimate objective is to conclude on whether a material uncertainty related to going concern exists and to ensure that the going concern basis of accounting is appropriate and appropriate disclosure is made. In order to do this, the auditor is required to:

- Carry out risk assessment procedures and related activities;
- Consider management's assessment of going concern;
- Evaluate management's assessment of going concern;
- Evaluate the sufficiency and appropriateness of evidence obtained; and
- Consider the implications for the audit report.

To ensure that the going concern basis of accounting is appropriate, there are a number of detailed procedures that should be completed. It is very important that the auditor considers the wider picture when reviewing going concern and does not concentrate solely on financial measures, which in some entities may not be a problem. An entity could still have significant going concern worries due to other indicators.

Risk assessment procedures and related activities

When performing risk assessment procedures, the auditor needs to consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern; and whether or not a material uncertainty related to going concern exists.

This includes obtaining an understanding of:

- the entity's business model, objectives, strategies and related business risks;
- the nature of the entity and its operation, plans for investments and disposals and how the entity is structured and financed;
- the measurement and review of the financial performance of the entity including forecasts, future cash flows and the entity's budgeting process;
- the requirements of the applicable financial reporting framework relating to going concern and the related disclosures that the auditor expects to be included in the entity's financial statements;
- the nature and extent of oversight and governance that the entity has over management's assessment of going concern;
- how the entity's risk assessment process identifies risks relating to going concern and their potential impact and likelihood and how the entity addresses those risks; and
- the entity's information system and related business processes as it relates to going concern.

Management's assessment of going concern

The auditor needs to determine whether the directors have already performed a preliminary assessment of the entity's ability to continue as a going concern.

Going concern assessment performed by management

If management have carried out an assessment, then the auditor should discuss this with the directors and determine whether they have identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, what their plans are to address them.

No going concern assessment performed by management

If management have not yet performed an assessment, then the auditor requests them to make an assessment.

If management are unwilling to make or extend its assessment when asked to do so, then the auditor discusses the matter with management and, if appropriate, with those charged with governance. The auditor should discuss with them the basis for the intended use of the going concern basis of accounting and enquire whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

If sufficient information about the entity's ability to continue as a going concern is still not provided, the auditor needs to think about the implications on:

- the auditor's opinion on the financial statements; and
- whether there is a significant deficiency in internal control with regard to management's assessment of the entity's ability to continue as a going concern.

Evaluating management's assessment of going concern

The auditor should evaluate management's assessment of the entity's ability to continue as a going concern. In doing so, the auditor should perform procedures to obtain audit evidence about whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern; whether or not a material uncertainty related to going concern exists; and the appropriateness of management's use of the going concern basis of accounting.

The auditor should also evaluate whether events or conditions that may cast significant doubt on the entity's ability to continue as a going concern give rise to a risk of management bias in the preparation of the financial statements.

In this evaluation, the auditor should cover the same period used by management. If this covers less than 12 months from the date of approval of the financial statements, then the auditor should ask management to extend their assessment period.

The auditor's evaluation may involve holding discussions with management; examining appropriate supporting documentation; and planning and performing procedures designed to identify any material matters which could impact on the entity's ability to continue as a going concern, including considering the process followed to make the assessment, the assumptions on which the assessment is based and plans for the future.

Procedures to perform

The extent of the procedures carried out will depend on the headroom between financial requirements and the facilities available but should include:

- evaluating management's method to assess the entity's ability to continue as a going concern, including determining if:

- the method selected is appropriate in the context of the applicable financial reporting framework and the auditor's understanding of the entity;
- changes from the method used in prior periods are appropriate; and
- whether the calculations are applied in accordance with the method and are mathematically accurate;

    - evaluating the relevance and reliability of the underlying data used to make the assessment;

    - evaluating the assumptions on which management's assessment is based by determining whether there is adequate support for the assumptions underlying management's assessment. This shall include determining:

- whether the assumptions are appropriate in the context of the applicable financial reporting framework and, if applicable, changes from prior periods are appropriate; and
- whether the assumptions are consistent with each other and with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit;

    - evaluating management's plans for future actions in relation to its going concern assessment, including determining whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances;

    - considering whether any additional facts or information have become available since the date on which management made its assessment; and

    - requesting written representations from management and, where appropriate, those charged with governance, regarding:

- its plans for future action;
- its assessment that the entity is a going concern; and
- any relevant disclosures in the financial statements.

The ISA also requires that the auditor maintains professional scepticism throughout the audit and in particular when reviewing future cash flows relevant to the entity's ability to continue as a going concern.

When performing these procedures, the auditor should cover the same period as that used by management to make its assessment of the entity's ability to continue as a going concern as required by the applicable financial reporting framework or by law or regulation if it specifies a longer period; and consider whether management's assessment includes all relevant information, including all available information about the future, of which the auditor is aware as a result of the audit.

If management, or those charged with governance, do not provide sufficient information about the entity's ability to continue as a going concern, then the auditor needs to consider the implications for the audit and also determine whether there is a significant deficiency in internal control with regard to management's assessment of the entity's ability to continue as a going concern.

In the *~~Navigate~~ Audit* tools, the schedule **Going concern: Forecast work paper (D3)** sets out procedures that can be used to evaluate management's forecasts.

Events after the period

The 12-month period is not intended to be a hard cut-off point and the auditor should also make enquiries regarding management's knowledge of events or conditions beyond the period of their assessment that may cast significant doubt on the entity's ability to continue as a going concern.

Events this far in the future are unlikely to be certain, but the auditor should consider the possible significance of any such event which is made known to them up until the date of the audit report. For example, it may be that the company's cash flow forecasts show a significant dependence on the availability of a loan facility. Where those charged with governance know, or suspect, that the company's situation will make renewal of the facility difficult, they should take this into account in their assessment even where the renewal date is later than 12 months after the date of approval of the financial statements.

However, the auditor has no responsibility to design audit procedures, other than enquiry of management, to discover such events or conditions.

Example audit procedures

Some possible procedures that the auditor may consider in evaluating management's assessment of going concern are given below.

Example audit procedures

Meetings and minutes

Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.

Reading minutes of meetings of management and, where applicable, those charged with governance and correspondence between the entity and providers of finance.

Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.

Forecasts and budgets

Analysing and discussing the entity's latest available interim financial statements and management accounts with management.

Review cash flow forecasts and budgets, where available, from the expected date of approval of the financial statements.

Perform sensitivity analysis on the key components of forecasts and budgets.

Consider the assumptions used in preparing the forecasts, for example:

- anticipated levels of sales;
- projected winning of new customers;
- expected cash collection performance;
- capital expenditure programme;
- timing of anticipated payments to HMRC;
- basis of payment terms to existing suppliers;
- ensure forecasts represent the timing of cash flows, not profits;

- where forecasts assume an increase in sales, ensure that associated costs (advertising, sales/admin staff, distribution, increased stock levels, etc.), are also factored in; and
- ensure the entity has the capacity to deliver at the increased sales level forecast.

Assess reliability of directors' previous forecasting.

Borrowing facilities

Confirm the existence and terms of facilities, for example:

- establish the date for renewal of facilities;
- assess the future intentions of lenders via discussion or correspondence;
- assess possible breaches of any borrowing covenants imposed by lenders;
- check for any arrears of interest on current borrowings;
- review the value of any assets granted as security for borrowings; and
- review correspondence between directors and lenders.

Contingent liabilities

Consider possible exposure to contingent liabilities arising, for example, from:

- legal proceedings;
- guarantees or warranties; and
- retentions.

Assess potential intra-group guarantees (e.g. unlimited multilateral guarantees).

Review possible breaches of grant conditions leading to repayment of grants.

Financial risk

Review directors' assumptions about projected foreign currency exchange rates.

Consider exposure to major fixed-price contracts.

Financial adaptability

Assess the entity's ability to adapt to unexpected events, for example:

- disposal of fixed assets;
- leasing;
- debt restructuring;
- share capital issue;
- financial support from group companies; and
- new sources of finance.

Borrowing facilities

When considering adequacy of borrowing facilities, the auditor may need to make an assessment of the intentions of the company's bankers or other providers of finance, where:

- there is a low margin of financial resources available;
- headroom between the finance required and available to the entity is marginal;
- the company's facilities are shortly due for renewal;
- they are aware of previous difficulties in agreeing facilities and the bankers have imposed further conditions for continued lending;
- the directors have projected a significant deterioration in the cash position;
- the value of assets granted as security for the borrowings is declining; or
- the company has recently breached or is likely to breach its borrowing covenants.

Such an assessment may include:

- reviewing correspondence between directors and their bankers; and
- meeting with the directors and bankers to clarify the latter's intentions.

The auditor may, despite the above, decide it is necessary to obtain confirmation from bankers of the existence and terms of facilities.

If the auditor is neither able to satisfy themselves about the existence and terms of facilities or about the bankers' future intentions, they then need to consider whether this represents a material uncertainty that should be disclosed in the financial statements and may have implications for their report.

Considerations for smaller entities

In many cases, the management of smaller entities may not have a detailed method to assess the entity's ability to continue as a going concern, but instead may rely on in-depth knowledge of the business and anticipated future prospects. Nevertheless, the auditor needs to evaluate management's method to assess the entity's ability to continue as a going concern. For smaller entities, it may be appropriate to discuss the medium and long-term financing of the entity with management, provided that management's intentions can be corroborated by sufficient documentary evidence and are not inconsistent with the auditor's understanding of the entity. Therefore, the requirement in ISA (UK) 570 for the auditor to request management to extend its assessment may, for example, be satisfied by discussion, inquiry and inspection of supporting documentation, e.g. orders received for future supply, evaluated as to their feasibility or otherwise substantiated.

Where available, the auditor should obtain copies of the cash flow forecast and/or budgets and, in the light of the information contained within them, consider:

- whether applicable bases and assumptions and accurate data were used;
- whether they provide adequate evidence of the entity's ability to continue as a going concern (from a financial point of view); and
- where a period of less than 12 months from the anticipated date of approval of the financial statements has been considered, what other evidence is available to demonstrate the entity's ability to continue as a going concern.

Where, as will happen with many small clients, no cash flows or budgets are prepared, the auditor should consider what other evidence is available to demonstrate that the entity is a going concern. Very often, the approach comprises discussion with the directors and the consideration of a number of factors that may affect the entity's ability to continue as a going concern.

The factors that would be expected to be covered are set out in Examples of events or conditions that may cast doubt on the ability to continue as a going concern. Discussions should consider financial, operational and other indicators which could affect the entity's ability to continue as a going concern.

Undertaking such a review and discussion with the directors is actually a way of providing the client with a better quality service. For example, if on completing the review it becomes clear that the entity is relying very heavily on one major customer or supplier, then discussion with the client regarding its contingency plans should it lose the client may prompt the client to plan an alternative course of action.

Identification of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

If the auditor identifies events or conditions that may cast significant doubt on the entity's ability to continue as a going concern that management has not previously identified or disclosed to the auditor, the auditor needs to request management to perform additional procedures to understand the effect of the events or conditions on management's going concern assessment.

The auditor also enquires as to why management's going concern assessment failed to identify or disclose the events or conditions; and they perform additional audit procedures relating to the newly identified events or conditions.

The auditor should remain alert throughout the audit for evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

If such events or risks are identified, the auditor may need to revise their risk assessment and may need to reconsider the nature and timing of their procedures in response to the assessed risks of material misstatement.

Examples of events or conditions that may cast doubt on the ability to continue as a going concern

Some examples of events and conditions that may cast doubt on the entity's ability to continue as a going concern are given below.

Financial indicators

The auditor should consider:

- whether the entity has net liabilities or net current liabilities;
- whether the entity has failed to negotiate finance to cover its borrowing requirements. At the date of writing, this may well be a significant risk for many entities, even those which may previously have been considered to be perfectly creditworthy, due to the general lack of availability of debt funding as a result of the 'credit crunch';
- has fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets;

- has major debt repayment falling due where refinancing is necessary to the entity's continued existence;
- whether the entity has defaulted on a loan agreement or breached any covenants;
- whether the entity has any liquidity or cash flow problems;
- whether the entity has sustained major losses or experienced cash flow problems since the period end which could threaten the entity's continued existence;
- whether there are substantial operating losses or a significant deterioration in the value of assets used to generate cash flows;
- whether the entity has sold a substantial number of fixed assets that will not be replaced;
- whether the entity is seeking a major restructuring of its debts;
- whether the entity has experienced problems in obtaining and/or retaining normal terms of trade credit from suppliers;
- whether there are indications of withdrawal of financial support by debtors and other creditors;
- whether the entity has major debt repayments which are due or are about to fall due where refinancing is necessary to meet the obligation;
- whether the entity is experiencing problems paying debts as they fall due;
- any reduction in normal terms of trade credit by suppliers or suppliers changing from credit to cash-on-delivery transactions;
- whether the entity has any adverse key financial ratios;
- any inability to obtain financing for essential new product development or other essential investments;
- whether the entity has any arrears or discontinuance of dividends; and
- the general financial outlook for the economy in the UK and that of any countries with which the entity has significant trade.

Operational indicators

The auditor should consider for all entities, including those that have prepared cash flows or budgets:

- whether there have been any fundamental changes in the market or technology to which the entity is unable to adapt adequately;
- whether there have been any externally forced reductions in operation;
- whether the entity has lost any key management or staff without replacement;
- whether the entity is experiencing any staffing difficulties;
- whether the entity has suffered a loss of a major market, franchise, licence or principal supplier;

- whether the entity is experiencing any problems with shortage of important supplies;
- whether the entity is relying on a few product lines and/or is operating within depressed markets; and
- whether the entity has lost any key suppliers or customers or there have been technical developments which could render a key product obsolete.

Other indicators

The auditor should also consider the following issues for all clients:

- whether the entity is involved in any major litigation in which an adverse judgement could imperil the entity's continued existence;
- whether there are any issues which involve a range of possible outcomes so wide that an unfavourable result ould affect the appropriateness of the going concern basis;
- changes in legislation or government policy expected to adversely affect the entity;
- non-compliance with capital or other statutory requirements;
- a substantial decrease in share price; and
- whether there are any other factors which could adversely affect the appropriateness of the going concern basis.

Evaluating sufficiency and appropriateness

Based on the audit procedures performed and audit evidence obtained, the auditor evaluates whether sufficient appropriate audit evidence has been obtained and concludes on whether, in their judgement, a material uncertainty related to going concern exists and on the appropriateness of management's use of the going concern basis of accounting.

If the auditor has not obtained sufficient appropriate audit evidence and is unable to obtain further audit evidence, the auditor considers the implications for their opinion on the financial statements (see Auditor's report).

In making the evaluation and conclusions, the auditor evaluates whether judgements and decisions made by management, even if they are individually reasonable, are indicators of possible management bias. The auditor also takes into account all relevant audit evidence obtained, whether corroborative or contradictory.

When the auditor identifies indicators of possible management bias, further discussion with management may be needed and the auditor may need to reconsider whether sufficient appropriate audit evidence has been obtained. An example of an indicator of possible management bias with respect to management's assessment of the entity's ability to continue as a going concern may be where management has made assumptions or selected data that only yield a favourable outcome.

Disclosures and reporting implications

In the ~~Navigate~~ *Audit* tools, the checklist **Going concern – Checklist for disclosures and reporting implications (D4)** contains procedures relating to the disclosure and reporting implications of the going concern assessment in various scenarios.

Disclosures

If the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty related to going concern exists, the auditor shall determine whether the financial statements disclose (normally in a note):

- the nature of the uncertainty; and
- the conditions which have caused it.

Even when no material uncertainty related to going concern exists, ISA (UK) 570:20 requires the auditor to evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide appropriate disclosure about events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Some financial reporting frameworks may require disclosures about:

- principal events or conditions;
- management's evaluation of the significance of those events or conditions in relation to the entity's ability to meet its obligations;
- management's plans that mitigate the effect of these events or conditions; or
- significant judgments made by management as part of its assessment of the entity's ability to continue as a going concern.

Reported disclosures in *Navigate IFRS Accounting* contain example going concern disclosures extracted from published annual reports in order to demonstrate how going concern can be presented in the financial statements.

Auditor's report

The auditor has a responsibility to consider the requirements of the applicable financial reporting framework and the adequacy of disclosures, whether or not they consider a material uncertainty to exist.

A material uncertainty exists when the potential impact of the events or conditions and the likelihood of them occurring is such that appropriate disclosure is necessary to achieve fair presentation. The auditor needs to conclude on whether such a material uncertainty exists regardless of whether or how the applicable financial reporting framework defines a material uncertainty.

Even when no material uncertainty exists, the auditor is required to evaluate whether the financial statements provide adequate disclosure about events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

The auditor may conclude that:

- use of the going concern basis of accounting is not appropriate in the circumstances;

- use of the going concern basis is appropriate and no material uncertainty exists; or
- use of the going concern basis is appropriate but one or more material uncertainties exist.

These conclusions are discussed further in Going concern and the auditor's opinion. Example audit report templates are in the Templates and letters area of *Navigate Audit*. Guidance on the accounting consideration and disclosures can be found in Going concern in *Navigate UK GAAP Accounting*.

Events or conditions have been identified and a material uncertainty related to going concern exists

If the auditor concludes that the use of the going concern basis of accounting is appropriate but that there remains a material uncertainty related to going concern, they should determine whether the financial statements:

- disclose appropriately the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and those charged with governance's plans to deal with these events or conditions; and
- disclose clearly that the material uncertainty exists and that it may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

Events or conditions have been identified but no material uncertainty related to going concern exists

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty related to going concern exists, the auditor evaluates whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide appropriate disclosures about these events or conditions.

Significant delay in the approval of financial statements

If there is a significant delay in the approval of the financial statements by those charged with governance, the auditor inquires as to the reasons. If the auditor believes the delay may be related to events or conditions relating to the going concern assessment, they perform additional audit procedures as necessary as well as considering the effect on their conclusion regarding the existence of a material uncertainty.

Consolidated financial statements

The provisions of ISA (UK) 570 apply to consolidated financial statements as well as individual company ones and in a group situation the consolidated financial statements may well be prepared on a going concern basis even where the going concern basis is not appropriate for certain individual components of the group. Similarly, material uncertainties in relation to the ability of subsidiary entities to continue as going concerns may or may not have a material impact at group level depending on the significance of the subsidiary to the group and the nature of the uncertainties.

Preparation of group financial statements on a going concern basis does, however, depend on the ability of the parent entity to continue as a going concern.

In a group audit, the group auditor should ensure that they have a good understanding of how going concern issues may affect individual subsidiaries in order to be able to assess the impact on the group as a whole and the implications for their audit opinion on the group financial statements. Care should be taken when entities within the group (including the parent) are dependent on being able to realise investments in or assets held by from subsidiaries or otherwise derive cash flows from group entities and in situations where group companies are apparently dependent on financial support provided by other group companies.

Further guidance on groups is in Consolidation and groups.

Entities applying the UK Corporate Governance Code

Companies applying the UK Corporate Governance Code are also required to:

- include a statement in annual and half-yearly financial statements as to whether the directors considered it appropriate to adopt the going concern basis of accounting in preparing them and identify any material uncertainties to the company's ability to continue to do so over a period of at least 12 months from the date of approval of the financial statements; and
- explain in the annual report how the directors have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. The directors should state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary ('viability statement').

Auditors of premium listed UK companies are required under the Listing Rules to comment on these statements in the auditor's report.

Other codes of corporate governance may contain similar requirements.

For those entities required, or who voluntarily choose to report on how they have applied the UK Corporate Governance Code, the ISA requires the auditor to read the following and consider them in the light of the auditor's knowledge obtained in the audit, performing such procedures as are necessary in their professional judgement to identify whether there is a material inconsistency between the auditor's knowledge obtained in the audit, including that obtained in the evaluation of management's assessment of the entity's ability to continue as a going concern, and:

- the Board's confirmation in the annual report that it has carried out a robust assessment of the entity's emerging and principal risks;
- the disclosures in the annual report that describe those principal risks, what procedures are in place to identify emerging risks and an explanation of how these are being managed or mitigated;
- the Board's statement in the financial statements about whether it considered it appropriate to adopt the going concern basis of accounting in preparing them and its identification of any material uncertainties to the entity's ability to continue to do so over a period of at least 12 months from the date of approval of the financial statements;
- the Board's explanation in the annual report as to how it has assessed the prospects of the entity, over what period it has done so and why it considers that period to be appropriate; and

- the Board's statement as to whether it has a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of its assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

The auditor's procedures may include:

- obtaining an understanding of management's method to assess the entity's viability;
- obtaining and considering management's assessment of the entity's viability and the underlying supporting documents;
- considering the appropriateness of the assessment period used by management over which viability is assessed;
- where management has prepared cash flow forecasts:

– checking whether the calculations within the cash flow forecasts are arithmetically accurate;

– considering whether there are inconsistencies between the cash flow forecasts prepared to support the viability assessment and those prepared for other purposes (e.g. for going concern, impairment, deferred taxation). In most cases, the auditor would expect the underlying data generated to prepare the forecasts to be the same, whilst recognising there may be permissible differences between certain items in the individual forecasts (e.g. remedial actions);

- where management have considered a range of alternative outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the significant assumptions or the data used in assessing the entity's viability, considering the appropriateness of the outcomes;
- considering whether the statements and disclosures made in the annual report comply with the relevant provisions of the UK Corporate Governance Code and are consistent with management's assessment of:

– the entity's viability and the underlying supporting documents;

– the entity's ability to continue as a going concern, including all relevant information of which the auditor is aware as a result of the audit.

Management may use the same period of assessment for the viability of the entity as they use for the assessment of the entity's ability to continue as a going concern or they may use different periods of assessment. Where the period applied by management is different, the auditor may consider whether this is appropriate given the nature and circumstances of the entity, including its size and complexity. The length of the period is also likely to depend upon such factors as the entity's reporting and budgeting systems and investment and planning time horizons.

The auditor determines whether they have anything material to add or to draw attention to in their audit report in relation to the matters referred to above.

Guidance for directors of companies applying the UK Corporate Governance Code is available in *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* issued by the FRC in September 2014.

Documentation

It is important that the auditor's documentation includes:

- key elements of the auditor’s understanding of the entity and its environment, including the entity’s internal control related to going concern;
- indicators of possible management bias related to going concern, if any, and the auditor’s evaluation of the implications for the audit;
- significant judgements relating to the auditor’s determination of:

– whether or not a material uncertainty related to going concern exists;

– the appropriateness of management’s use of the going concern basis of accounting in the preparation of the financial statements; and

– the appropriateness of management’s disclosures in the financial statements. The major controls that can be introduced in respect of subsequent events and going concern are via the use of budgets, cash flows and management accounting information.

Discussions with management and those charged with governance should also be documented, including the nature of any significant matters discussed and when and with whom the discussions took place. By ensuring such matters are properly documented, this will help the auditor demonstrate how significant judgements and key audit issues were addressed and how the auditor has evaluated whether sufficient and appropriate audit evidence has been obtained.

Ensure an attitude of professional scepticism is maintained throughout the audit and budgets and forecasts are reviewed critically. Assumptions can be manipulated to show a favourable picture, in which case the budget or forecast will not provide reliable audit evidence. The entity’s management should be robustly challenged on the validity of assumptions and optimistic predictions.

Remember the auditor should prepare sufficient audit documentation to enable an experienced auditor, having no previous connection with the audit, to understand among other things:

- the significant decisions made regarding significant matters arising during the audit;
- conclusions reached thereon; and
- significant judgements made in reaching those conclusions.

Communication with those charged with governance

Unless all those charged with governance are involved in managing the entity, the auditor communicates with those charged with governance, those events or conditions identified that may cast significant doubt on the entity’s ability to continue as a going concern. This includes whether the events or conditions constitute a material uncertainty, whether the use of the going concern basis of accounting for the preparation of the financial statements is appropriate, the appropriateness of related disclosures in the financial statements and, where applicable, the implications for the audit report.

Reports to management gives further guidance on communications.

Regulator findings

FRC thematic review

The UK Corporate Governance Code requires the directors to include an explanation in the annual report as to how they have assessed the prospects of the entity, over what period they have done so and why they consider that period to be appropriate. The directors are also required to make a statement as to whether they have a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions. This is often referred to as a viability assessment and statement.

Auditors are required to consider any such explanation and statement as part of their consideration of 'other information' in accordance with ISA (UK) 720 (Revised November 2019) (Updated May 2022) *The Auditor's Responsibilities Relating to Other Information* and are required to report whether they have anything material to add to the directors' explanation of the viability assessment, the appropriateness of the assessment period or the viability statement.

As part of its Audit quality thematic review: *Other information in the annual report* in December 2018, the FRC considered the work of auditors in this area. Based on a sample of 30 audits, its findings were that:

- in only a few instances were specific targeted procedures aimed at consideration of viability, as opposed to going concern;
- in most cases, the assessment period chosen by the company was three years, and in the majority of cases, there was no evidence of challenge of the appropriateness of this period by the auditor;
- in five cases, there was no evidence of an explicit assessment made by the directors to support the viability statement;
- in some cases, the FRC found discrepancies between the assessment performed by the directors and the disclosures in the annual report; and
- the same forecasts were frequently used for impairment testing, going concern and viability assessment with no consideration by the auditor as to whether this was appropriate or whether adjustments should be made.

The FRC concluded that there was scope for improvement in this area.

FRC guidance

In 2016, the FRC published *Guidance on the going concern basis of accounting and reporting on solvency and liquidity risks* . The guidance aims to assist directors of companies that do not apply the UK Corporate Governance Code in assessing the going concern basis of accounting, material uncertainties, solvency and liquidity risk; the periods of assessment; and the relevant disclosure requirements. This guidance notes that even where the going concern basis of accounting is appropriate, there may be material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue to adopt the going concern basis of accounting in the future and these uncertainties should be disclosed.

Current issues and further resources

Current issues

Covid-19 considerations

It is expected that, given the worldwide uncertainty and volatility caused by the Covid-19 pandemic, more companies and auditors may need to consider reporting on material uncertainties. Where they do so, auditors should draw on the available facts and circumstances, not generically report on material uncertainties.

Companies and their auditors will need to take into account the terms of their financing facilities, the terms of any liquidity or other support accessed and whether any such support taken on gives rise to future obligations. Deferral of payments now, or the receipt of grants to offset costs, may alleviate liquidity challenges but may affect the entity's solvency if the liquidity support does not continue long enough for the entity to recoup those losses from future profits.

It is expected that, in these circumstances, the auditor's going concern work will be more extensive, require more evidence and will continue to be performed through to the point of signing the auditor's report. In view of this, more evidence may be required from the entity and the auditor should set a clear expectation with the audited entity of any additional time that will be needed to complete the audit in this area.

In addition, auditors should exercise professional scepticism where management and those charged with governance have determined that the current circumstances are not reasonably expected to have any material financial impact on the audited entity and that no material uncertainties related to going concern exist for the entity.

The FRC has issued a number of documents to assist auditors including the letters issued to audit firms in June 2020 and November 2020.

War in Ukraine

Companies need to consider going concern issues if they are adversely affected by the war in Ukraine and sanctions on Russia and Belarus.

Management will need to evaluate the impact of the crisis on the going concern assessment. The auditor, correspondingly, will need to demonstrate professional scepticism and judgement to consider whether management has taken all relevant factors into account. For example, management's assessment of going concern may need to include:

- updating forecasts and sensitiveness as considered appropriate, considering risk factors identified and different possible outcomes;
- reliance on financing, donations or other funding from individuals who have been sanctioned or had their assets frozen or seized;
- reviewing of projected covenant compliance in different scenarios;
- changing management's plans for future actions;
- business disruption, including both ceasing trade with the Russian consumer base and supply chain issues;
- insurance cover of assets;
- currency valuation; and
- investments in Russian entities.

In some circumstances it may be necessary to consider whether it is appropriate to prepare the financial statements on a going concern basis. For this, the company should consider all available information about the impact on future trading.

The going concern assessment should be continuously updated to the date the financial statements are approved.

3.6 Substantive analytical procedures

Quick overview

This section considers the use of substantive analytical procedures within audits. ‘Substantive analytical procedures’ (SAP) refers to those procedures that are applied during the course of the audit on specific areas of the financial statements, or on the financial statements as a whole, as a means of providing formal audit assurance. These procedures, when effective and the results are satisfactory, can enable the auditor to significantly reduce the amount of detailed substantive audit testing. Substantive analytical procedures are distinct from detailed substantive testing at the assertion level and from detailed tests of controls.

These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.

This section relates to the SAP work paper *available within the pool tests or as a template* in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

An auditor’s objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review. This guidance explains how to apply substantive analytical procedures.

Substantive analytical procedures

ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* requires the auditor to use analytical procedures as part of their risk assessment procedures and ISA (UK) 330 (Revised July 2017) (Updated May 2022) *The Auditor’s Responses to Assessed Risks* contains standards and guidance relating to the use of substantive analytical procedures when responding to assessed risks.

ISA (UK) 520 (Updated May 2022) *Analytical Procedures* sets out additional requirements and guidance when performing substantive analytical procedures to obtain relevant and reliable audit evidence and also requires the use of analytical procedures near the end of the audit when the auditor is forming an overall conclusion on the financial statements.

‘Analytical procedures’ are the examination and comparison of the financial and non-financial information of a business with internal and external information, for both the current and different periods. This is usually achieved by calculating ratios and trends and investigating fluctuations and inconsistencies. It may be described as the process of reviewing the figures to see if they make sense.

Crucially, analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Methods used range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components, such as subsidiaries or divisions, and individual elements of financial information.

As well as comparing the current year information with that of prior periods, analytical review also includes comparisons with:

- budgets;
- estimates prepared by the auditor, such as depreciation; and
- similar industry information.

It also includes the consideration of various relationships among elements of financial information that are expected to conform to a predictable pattern based on the entity's experience, such as gross profit margin percentages, and between financial information and relevant non-financial information, such as payroll costs to number of employees.

Comparisons should also be made with other branches or divisions in the same line of business, which are part of the same company or group or with other companies within the same industry. It is often helpful to make comparisons on a monthly or quarterly basis where such figures are available. This can eliminate any distorting effects of seasonal trade and may enable the auditor to distinguish genuine seasonal fluctuations from window dressing around the year end.

Analytical procedures at the planning stage are considered in Preliminary analytical procedures and those at the end of the audit are in Final analytical procedures.

Key definitions

Term	**Definition**
Analytical procedures	Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Source: ISA (UK) 520

Further key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 520:5 states that when designing and performing substantive analytical procedures on individual audit sections, the auditor must:

- determine the suitability of using substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of detail, if any, for these assertions (see Suitability of procedure to satisfy objective);
- evaluate the reliability of the data, whether internal or external, from which expectations are developed (see Reliability of source data);
- develop an expectation of recorded amounts or ratios and evaluate whether that expectation is sufficiently precise to be able to identify a material misstatement that, either individually or in aggregate, may cause the financial statements to be materially misstated (see Expectation of result including precision); and

- determine the amount of any difference between expectation and the actual amount recorded which is acceptable without further investigation (see Acceptable level of difference).

The auditor must then substantiate and corroborate the outcome of substantive analytical procedures and investigate significant inconsistencies in outcomes (see Outcome of substantive analytical procedures).

Finally the auditor evaluates if the results of analytical review justify reducing the nature or extent of detailed testing, in each of the business cycles and tailors the audit programmes accordingly, cross-referring to relevant sample selection planning schedules (see Conclusion).

The SAP work paper *available in the pool tests or as a template* in the Private Company (PCAS) based audit tools takes the auditor through these stages.

Analytical procedures may be performed as a substantive test wherever the auditor considers that they are necessary or will be effective. Carrying out substantive analytical procedures can lead to excellent audit assurance in certain areas and should reduce the extent of the detailed transaction or balance testing.

ISA (UK) 520 :A4 suggests that auditors should use their judgement to assess 'the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level'. Therefore, when determining the most efficient audit approach and tailoring the audit programmes at the planning stage, the auditor should consider whether or not analytical procedures will be used as a substantive test on particular audit sections.

Note that these are not the same as preliminary analytical procedures , which are mandatory and performed as part of the risk assessment at the planning stage.

The auditor should be aware of the types of information available from the client on which substantive analytical procedures can be based. This can include financial information prepared by the entity but, where this occurs, it is important that the auditor satisfies themselves as to the accuracy and completeness of that information, as discussed in Sufficient appropriate evidence.

In addition, substantive analytical procedures may bridge a gap in the audit trail where, for example, detailed inventory records are not maintained. This could arise in the retail trade, where detailed inventory movements tend not to be recorded. If audit tests are based on copy sales invoices, it can never be certain that these contain details of all sales, as some may not be recorded on a sales invoice. Transaction testing will never identify such an error, as no such transaction test can.

Extensive analytical review procedures may highlight fluctuations in ratios. These may be normal fluctuations (business trends, seasonal changes, trade cycles, cost/selling price relationships) or abnormal fluctuations (exceptional transactions, bad debts, loss of assets by fire or theft, bases of valuation of inventory and cut-off errors).

In analysing the cause of the fluctuations, the auditor should take care to check that the facts given by management are valid and complete and that their effect is sufficient to explain the fluctuation. The recording of such explanations and corroborating their validity in the working papers will be as important as the identification of the fluctuation itself. Only corroborated commentary provides valid audit evidence.

Substantive analytical procedures may provide alternative audit procedures enabling appropriate reliable audit evidence to be derived from a combination of transaction testing and analytical review, and from which it can be concluded that amounts have not been materially misstated.

An analytical approach will not necessarily reduce the amount of time spent on the audit, although it will increase understanding of the entity and may lead to useful insights. For example, a detailed analytical review may take the same amount of time as ticking 30 invoices, but it is doubtful ticking 30 invoices will provide an auditor with as much insight into a business.

Designing SAPs

Suitability of procedure to satisfy objective

It is necessary to assess the suitability of substantive analytical procedures in light of the assessed risks of material misstatement as well as other tests of detail (if any) for given assertions. Firms have been criticised for failing to determine the suitability of substantive analytical procedures and this is evidenced by the procedures applied failing to provide sufficient evidence to satisfy the audit assertion.

Designing substantive analytical procedures involves a lot of thought – there is no 'one-size-fits-all' solution to substantive analytical procedures. Care needs to be taken not to use substantive analytical procedures inappropriately (i.e. as a time-saving mechanism) because in so doing, the auditor runs the risk of failing to gather sufficient appropriate audit evidence to satisfy the key audit assertions. It is important to appreciate that if substantive analytical procedures are not suitable in certain areas of the financial statements, then further tests of detail will be necessary to ensure the audit evidence is sufficient and appropriate.

Key considerations

In determining the suitability of substantive analytical procedures, given the assertions, the auditor should consider the following key points:

- the assessment of the risk of material misstatement;
- the auditor considers the understanding of the entity and its internal control, the materiality and likelihood of misstatement of the items involved and the nature of the assertion in determining whether substantive analytical procedures are suitable. For example, if the controls over sales order processing are weak, the auditor may place more reliance on tests of detail rather than on substantive analytical procedures for assertions related to trade debtors;
- any tests of detail directed toward the same assertion;
- substantive analytical procedures may also be considered appropriate when tests of details are performed on the same assertion. For example, when auditing the collectability of trade debtors, the auditor may apply substantive analytical procedures to an ageing of customers' accounts in addition to after-date cash testing; and
- an area with a historical problem of high error levels may be best tested using tests of detail as analytical procedures may show little or no trends for comparison purposes.

Particular care must be taken to ensure the following points are considered.

Analytical procedures are computed on a consistent basis for each period or location under review.	Where there is a change in the basis of the calculation of a ratio or in the relationships which make up the ratio, comparability may be lost. The ratio for the prior year may be restated to obtain a meaningful comparison.

	For example, if inventory turnover is calculated using average inventory for the previous period, there is little point trying to make a comparison with a ratio for this year using year end inventory. Major changes in pricing policy and product lines may also render past relationships inconsistent with current results.
There ought to be a meaningful relationship between the items being compared.	For example, there is little point in comparing head office overheads with sales since there is unlikely to be any connection between them. Similarly, there is little point in examining the relationship between sales and gross profit if inventories are valued by reference to a fixed gross profit ratio.
Results and balance sheet values are not distorted by the effects of changing price levels.	For example, under historical cost accounting, assets acquired at different times are stated at different price levels. This means that any ratio involving fixed assets is affected by when the assets were purchased. Hence, ratios such as return on capital employed and fixed asset turnover can be distorted and comparisons between different companies made meaningless unless they are carried out on a current cost basis.
Analytical procedures are not distorted by unusual items.	Such items are often first detected by means of analytical review procedures and once detected, they should be investigated separately and their effects removed from any ratios and trends.
Analytical procedures are not distorted by changes in accounting policy or accounting estimates.	It is necessary to adjust the figures for the prior year in order that comparisons can be made. It may also be useful to calculate the figures or ratios using the old accounting policy or estimate; this is not always possible but, if it is, it may give some indication of the effect, if any, of the change.

ISA (UK) 330:21 requires that where the approach to a significant risk consists only of substantive procedures, those procedures must include tests of detail, i.e. substantive analytical procedures alone will not provide sufficient evidence in relation to that particular assertion.

Designing suitable procedures

The entire premise of substantive analytical procedures is based on the expectation that there are relationships among data which continue in the absence of known conditions to the contrary. However, reliance on the results will depend on the auditor's assessment of the risk that even when the analytical procedures may identify relationships as expected, in fact a material misstatement exists.

In undertaking suitable procedures, the following can be noted:

- substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Where a financial statements amount is a result of few transactions, year-on-year comparisons are less likely to be a useful source of evidence, as the components of the balance are likely to be different year on year;
- the profit and loss account lends itself better to an analytical approach than the balance sheet because the figures can be analysed by product or period, etc. and compared with the prior period or with budgets or with other similar businesses;

- where an analytical approach is used for profit and loss account figures, the balance sheet audit work provides additional comfort. This is because the difference between the opening and closing balance sheets represents the profit or loss for the period. Audit work on related areas may provide additional comfort, e.g. audit work showing the records to be reliable for debtors provides background comfort in relation to the sales population;
- specific analytical procedures must be designed to meet the relevant financial statement assertions. For example, these could be comparisons either against budgets or against the prior period. The audit file should include detailed commentary on variations. However, high level, general commentary would usually be more suited to preliminary analytical review and would not provide any basis for reducing the sampling risk factor;
- an analytical approach is more likely to be fruitful if the client makes use of regularly prepared management information;
- analytical procedures are more likely to be effective if the auditor has gained a thorough understanding of the client's business; and
- analytical procedures require significant skill on the part of the auditor, so should not be delegated to an inexperienced member of the audit team.

A typical example of how substantive analytical procedures could be used is confirming the reasonableness of staff costs – starting with staff costs last year and adjusting for changes in employee numbers, pay rises, etc. This work could then be used to justify cutting down on detailed checks on the wages calculations. An example is provided below.

Example: Variable relationships

A company had 50 employees last year with total wages of £420,000 and 50 employees this year with a wage bill of £525,000, an increase of 25%. It is known that the annual pay rise was 12% and the level of business has remained approximately constant.

At first sight, the figures do not appear to make sense because the increase is substantially greater than expected. There may, however, be satisfactory explanations. For example, there may have been a change in sales mix with previously bought-in goods being replaced by goods manufactured in-house, resulting in substantial authorised overtime. This could be verified by looking at the sales figures for different products as well as the payroll. Alternatively, there could have been a switch to more skilled, and hence more expensive, labour; this could be verified from payroll and production records.

If no such explanation is available, it is possible that the payroll has been inflated by, for example:

(a) miss-posting in the general ledger;

(b) 'dummy' employees on the payroll;

(c) unauthorised overtime being paid; or

(d) employees being paid at higher rates of pay than authorised.

The auditor may direct their substantive testing towards finding any errors of this nature.

Reliability of source data

Assurance is needed that the information used in analytical procedures is reliable. Gaining and documenting an understanding of the client's systems is therefore important. If the systems are not considered sufficiently reliable, significant assurance cannot be gained from analytical procedures. For example, this could apply if it is known from past experience that the records are likely to contain a number of errors requiring correction. Equally, manual records are less likely to provide an adequate basis for reliance than records held on a reliable proprietary computerised system. If the risk of fraud is considered high, an analytical approach should not be used.

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained, i.e. direct from a third party or via the client. In determining whether data is reliable for purposes of designing substantive analytical procedures, the auditor should consider the following points:

- The source of the information. Information is ordinarily more reliable, e.g. when it is obtained from independent sources outside the entity.
- The comparability of the information. For example, broad industry data may not be comparable to that of an entity that produces and sells specialised products.
- The nature and relevance of the information available. Budgets, for example, can be drawn up in many ways – some as an expectation of actual results, whereas others are more like a target or goal to be achieved.
- Controls over the preparation of the information – for example, controls over the preparation, review and maintenance of budgets. Where budgets are amended during the period to bring them closer in line to actual results, this will lessen their use for comparative purposes.
- Prior knowledge and understanding – for example, the knowledge gained during previous audits, together with the auditor's understanding of the effectiveness of the accounting and internal control systems and the types of problems that in the past have given rise to accounting adjustments.
- Whether or not the information is produced internally. The reliability of internal information is enhanced if it is produced independently of the accounting system or where there are adequate controls over its preparation.
- ISA (UK) 520 also notes that the auditor should consider testing the controls, if any, over the entity's preparation of information that will be used in substantive analytical procedures. When such controls are effective, the auditor has greater confidence in the reliability of the information and, therefore, in the results of substantive analytical procedures. See Accounting systems, processes and controls.

Expectation of result including precision

The requirement to develop an expectation also links in to evaluating the reliability of the data itself. There is little point in developing an expectation from data which is either unreliable or where the auditor is not satisfied over the adequacy of the controls relating to that data.

When developing an expectation, it is important to adequately document it. Essentially the point of developing an expectation at the outset is to then have a 'benchmark' as to what to expect. If there is no benchmark (i.e. the expected value), then there is nothing to compare actual values to, so if, for example, the financial statements show a depreciation charge for the year of £10,000 and the auditor applies proof in total as a substantive analytical procedure which shows the depreciation charge to be £30,000, then they know that actual values deviate from expected values and therefore they should perform additional procedures to understand the difference.

In assessing whether the expectation can be developed sufficiently precisely to identify a material misstatement at the desired level of assurance, the auditor should consider:

- the accuracy with which the expected results can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses such as advertising;
- the degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on a divisional basis than when applied to the financial statements of the entity as a whole;
- the availability of the information, both financial and non-financial;
- the frequency with which a relationship is observed, e.g. a pattern repeated monthly as opposed to annually.

Setting expectations is usually not a problem if the analytical procedure is a proof in total, e.g. for payroll, interest, depreciation, rent etc. The difficulty tends to arise when performing analytical procedures of the comparison type, particularly when auditing expenses. Traditionally, many auditors have taken the simplistic approach of comparing the current year's expenses to last year's, calculating the year-on-year movement and then seeking explanations from the client for movements which exceed a particular level. However, ISA (UK) 520:5(c) makes clear that the auditor must develop an expectation of recorded amounts or ratios first.

When auditing a stable business, the auditor's expectations of the expenses for the year may not differ substantially from last year's figures. However, this should at least be explained and justified on the file before examining the numbers. As a minimum, inflation should be factored in, remembering that inflation for volatile items such as fuel and utilities is often very different to the level of general inflation.

For other clients, the auditor needs to factor in their knowledge of the client to set their expectations. For example:

- For clients who lease their premises, a review of the lease agreement on the permanent file should reveal whether the rent will be the same as last year or whether there has been a rent review during the period.
- If the auditor knows that the client has purchased a number of new additional vehicles, it should be possible to predict the corresponding increase in fuel and motor expenses.

The auditor can also make use of the fact that many expenses will be linked. For example, if a retail client expands and opens a new shop, as well as the rent increase the auditor should also be able to predict the increase in business rates and utility bills.

When setting expectations, it is important to be as specific and as accurate as possible, and that the magnitude of any expected movement is quantified. Many auditors limit their expectations to whether something will increase or decrease, without considering how much is reasonable. This approach will not yield sufficient audit evidence and support the audit opinion.

Setting expectations that are sufficiently accurate requires experience, skill, professional judgement and an in-depth knowledge of the client, yet substantive analytical procedures are often allocated to junior audit staff. It can also be very time consuming. Auditors should not underestimate the time needed to perform analytical procedures properly when planning their audit approach and preparing the budget.

Acceptable level of difference

In designing and performing substantive analytical procedures, the auditor must consider the degree of variance from expectation that can be accepted without the need for further investigation. This consideration is influenced primarily by materiality and the consistency with the desired level of assurance, taking into account the assessed risk of misstatement.

ISA (UK) 330 reminds the auditor that more persuasive audit evidence is needed as risk increases. The auditor will need to determine an appropriate tolerable level of difference, which is likely to be below performance materiality to allow a margin of safety. The level of tolerable difference considered acceptable is a judgemental decision, taking into account the individual entity and the risk levels.

Outcome of substantive analytical procedures

ISA (UK) 520 says that the auditor must obtain appropriate audit evidence to corroborate the client's responses. Simply taking the client's word for any fluctuations is not appropriate, as a key part to analytical procedures is corroboration.

Management's explanations can be corroborated by:

- considering them in the light of the auditor's understanding of the entity and its environment and other evidence obtained during the audit; or
- performing other audit procedures to confirm the explanations received.

For example, if the client argues that an increase in turnover was due to a large, one-off order in the month of February, the auditor should obtain evidence to back-up that explanation and ensure that the procedures adopted and the evidence obtained is adequately documented.

Where management are unable to offer any explanation, the auditor should carry out additional work to identify the cause of the inconsistency.

Not all explanations are capable of verification; nevertheless, the auditor may be able to decide on the reasonableness of those offered. For example, if a decrease in sales is attributed to a fall in demand, it may not be possible to verify this explanation directly nor quantify its effect (unless there are total market figures published and available in time for the audit). If the decrease is in line with the auditor's knowledge of the industry and prevailing market conditions, they may accept it as being reasonable. If the explanation cannot be verified, they must rely on other sources of evidence to satisfy themselves in this area.

Investigation

The investigation stage is where the primary evidence is obtained. Auditors must undertake an investigation where fluctuations or inconsistencies are evident in light of other relevant information or where results differ from expected values by a significant amount. It is important that this investigation is clearly documented and that adequate explanations and appropriate corroborative audit evidence are obtained.

Unexpected results may arise as a result of:

- actions of the client of which the auditor is unaware when they perform the review;
- external factors not controllable by the client of which the auditor is unaware when they carry out their review;

- other errors or omissions in the auditor's understanding resulting in inappropriate expectations being set; or
- errors or omissions in the recorded amounts subject to review.

The first stage of the investigation is usually inquiry and discussion with the client. Statements along the lines of 'cost of sales have increased because the company has bought more goods' would not be considered sufficient and appropriate audit evidence by audit regulators and professional bodies.

Conclusion

If sufficient assurance can be gained from analytical procedures, then it may be possible to eliminate detailed transactions testing. Even where this is possible, some tests of detail should be performed, unless the analytical procedures amount to a proof in total.

To achieve reliance on substantive analytical procedures, the analytical review procedures must provide audit evidence that amounts to or comes close to a proof in total of a particular figure or figures. In such cases, providing the balance doesn't contain a significant risk, analytical procedures comprise the only necessary audit evidence.

On occasions where substantive analytical procedures are applied and the auditor concludes more work is needed in certain areas, it might be that additional tests of detail are needed rather than redesigning the substantive analytical procedures. Provided all the relevant audit objectives are addressed, the tests of detail need not necessarily be transactions tests. For example, they could be cut-off tests or reviews of records for large or unusual transactions.

Substantive analytical procedures alone are not sufficient if the assessed risk of material misstatement at the assertion level is significant. In such cases, either substantive tests of detail or tests of controls also need to be performed.

Generally, if the steps for substantive analytical procedures in ISA (UK) 520 are followed properly, the auditor should be able to draw a conclusion and at the same time the analytical procedures can go to serve as sufficient and appropriate audit evidence for the current audit file.

Obtaining sufficient audit evidence

If there is an unacceptable level of difference between the auditor's expectation of the results of analytical procedures and what the figures actually show, then the auditor should perform further analysis and make inquiries of the client to obtain explanations for the differences. Such explanations often relate to unusual transactions or accounting or business changes.

The explanations obtained from the client must be substantiated. This can usually be achieved in one of two ways. The auditor would either apply their understanding of the business (including knowledge gained when performing audit work both in the present and in the past) and/or carry out further checking of other evidence supporting the explanations given. One of the main reasons that analytical procedures are performed poorly is that many auditors do not then go on to corroborate the explanations received from management, as required by ISA (UK) 520:7(a) of the ISA. Examples of ways to corroborate management explanations include:

- inspecting invoices and other supporting documentation;
- obtaining an explanation of the same matter from a relevant third party; and
- vouching to industry or sector data, often available on the internet.

If management is unable to provide an explanation, or if the explanation plus any corroborative audit work is not considered sufficient, then ISA (UK) 520 requires the auditor to perform other audit procedures in order to obtain sufficient audit evidence. Examples include:

Analytical procedure	Suggested testing if analytical procedures are unsatisfactory
Depreciation proof in total	Substantively test the depreciation charge for a sample of assets, ensuring that: • the correct rate has been used and reperform the calculations; • fully written down assets and assets disposed of in the current period have not been over-depreciated; • additions have been depreciated from the date of acquisition.
Comparison of the current period's expenses with the auditor's expectations	Substantively test a sample of expenses to purchase invoices, ensuring that: • only genuine business expenses are included; • capital items have not been expensed; • expenses have been allocated to the correct nominal ledger account; • the amount has been input correctly and VAT has been treated appropriately.

When conducting substantive analytical review procedures, it is important to ensure that the amounts tested, the results (including any explanations and corroborative evidence for any unexplained fluctuations) and a conclusion are all properly documented.

Impact on other audit procedures

Many sampling systems enable the auditor to cut sample sizes as a result of substantive analytical review. It is important, however, to note that sample sizes should only be reduced where this is justified by the extent and results of the work undertaken. Where this is the case, the analytical review is usually described as extensive.

For example, calculating debtor days on trade debtors would not constitute extensive analytical review and, therefore, merely calculating this figure and obtaining explanations for a significant change would not enable the auditor to reduce sample sizes. ~~*Navigate Audit*~~ guidance sections from each financial statement area within execution include a number of suggested substantive analytical procedures that can be applied in order to reduce the extent of substantive testing and perhaps, depending on the materiality of the amounts involved, the assessed risk and strength of the procedures undertaken, eliminate the need for detailed substantive testing.

Care must be taken when analysing the results of substantive analytical procedures; they do not result in automatic reduction in the extent of detailed testing. Only if the results of the procedures are satisfactory can the extent of substantive testing be reduced.

Where substantive analytical procedures indicate unexpected variations that cannot be explained, further investigation will be required. In such circumstances, it may be inappropriate to reduce the level of substantive testing.

In some circumstances, substantive analytical procedures could enable the auditor to eliminate detailed substantive testing altogether on certain sections of the audit. There are several scenarios where substantive analytical procedures could, if successful, result in no detailed testing being performed; and three examples are given below. However, such situations are a matter of judgement and will vary from one audit to another.

In addition, there are circumstances where tests of details are specifically required by the ISAs. For example, ISA (UK) 330 requires that if the auditor has assessed there to be a significant risk at the assertion level, then substantive procedures must be performed that are specifically responsive to that risk. Where only substantive procedures are performed, then those procedures must include tests of detail, i.e. substantive analytical procedures alone will not suffice.

- If inventory is around the materiality level set at the planning stage, then, depending on the level of risk, extensive analytical review could be wholly relied upon to assess whether or not inventory is fairly stated. The types of analytical review procedures that could be used are described in Inventory within audit execution. Generally, the auditor would look at changes in value on individual inventory lines or types.
- This principle could be extended further to situations where the auditor has restricted the detailed substantive testing to items above the tolerable error level and other key items. The residual population may then be such that the random sample size is around or below one. In this situation, it may be more effective to apply substantive analytical procedures to the residual population.
- Substantive analytical procedures can also be used to eliminate detailed testing in specific circumstances, e.g. where a significant level of accounts preparation work is undertaken. A good example is testing wages and salaries.

3.7 Intangible assets and goodwill

Quick overview

This section explains how to audit intangible assets and goodwill and provides example audit objectives for the section. In addition, it covers the type of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to Section E in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Intangible assets

FRS 102 defines an intangible asset as an identifiable non-monetary asset without physical substance. Common examples of intangible assets include brands, patents, trademarks and customer lists.

Intangible assets are typically measured at cost less amortisation. FRS 102 includes an option to carry intangible assets at fair value through other comprehensive income, but this is rarely available in practice because there needs to be an active market for that specific type of intangible asset.

FRS 102 requires all intangible assets (including goodwill) to be amortised. If a useful economic life cannot be reliably estimated, the useful life attributed must not exceed ten years.

Goodwill

FRS 102 defines goodwill as future economic benefits arising from assets that are not capable of being individually identified and separately recognised.

Neither the Companies Act nor FRS 102 allows the recognition of internally generated goodwill and so the audit procedures for goodwill will only consider purchased goodwill. In a business combination, purchased goodwill is measured as the excess of the cost of the business combination over the acquirer's interest in the net amount of the identifiable assets, liabilities and contingent liabilities recognised in the business combination.

Research and development costs

FRS 102 does not allow the recognition of an intangible asset for research expenditure; it must be treated as an expense. However, development expenditure may be capitalised if certain criteria are met. This is an accounting policy choice which must be applied consistently.

Further guidance on the accounting requirements for intangible assets under the applicable standards can be found in *Navigate UK GAAP Accounting*:

- Private Company (FRS 102) – Intangible assets (Section 18);

- Small Company (FRS 102 1A) – Intangible assets (Section 18);
- Micro Entity (FRS 105) – Intangible assets other than goodwill (Section 13).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives in respect of the audit of intangible assets are as follows.

Financial statement area	Objective	Assertion	Audit procedures
Intangible assets, Goodwill	To ensure the assets exist and are owned by the entity at the balance sheet date.	E	Additions, Internally generated intangible assets
Intangible assets, Goodwill	To verify that all intangible assets are completely and accurately recorded in accordance with the applicable accounting framework.	C, A, V	Additions
Intangible assets	To ensure that all revalued assets are supported by proper valuations and the basis is acceptable.	V	Revaluation
Amortisation	To establish that amortisation is correctly calculated and is adequate.	C, E, A, V	Amortisation
Intangible assets, Goodwill	To ensure that all intangible assets are recorded.	C	Additions, Goodwill, Internally generated intangible assets
Gain/loss on disposal	To confirm that all disposals are correctly accounted for.	C, E, A	Disposals

Intangible assets, Goodwill	To ensure that all accounting estimates recognised or disclosed in the accounts are reasonable in the context of the applicable accounting framework.	V	Estimates
Impairment	To confirm that adequate provision is made for impairment and any permanent diminution in value.	V	Impairment
Intangible assets, Goodwill, Amortisation, Gain/loss on disposal	To confirm that all necessary disclosures concerning intangible assets have been made and that information is appropriately presented and described.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity. The existence assertion used in the *Navigate Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (*template* C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Intangible assets		X	X	X		Classification, Cut-off, Presentation
Goodwill	Y	X	X	X		Presentation
Amortisation	Y	X	X	X	X	Presentation
Impairment	Y				X	Presentation
Gain/loss on disposal		X	X	X		Presentation

Controls

The following are controls that are relevant to intangible assets and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on sample sizes when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	**How to test**
A budget detailing the capital commitment is drawn up each year and agreed by the relevant owners of the business or the directors.	Select a sample of additions and ensure that they have been approved or authorised in the relevant board minutes.
Additions during the year are only made after the relevant authorisation form has been completed. If the addition has already been agreed as part of the capital budget at the start of the year, the department manager's signature should be required.	Select a sample of intangible asset additions and inspect relevant authorisation for the purchase.

An intangible asset register is maintained and reconciled monthly to the nominal ledger account.	Select a sample of the monthly reconciliations to verify that they have been performed and any reconciling items have been followed up appropriately.
Intangible assets need approval from directors before they are sold or disposed. Hierarchical levels of authority can be set for this purpose. For example, allowing disposals of up to a set amount to be dealt with by a manager.	Select a sample of disposals and ensure that they have been approved or authorised as per company policy.
The costs capitalised in internally generated intangible assets are reviewed as part of the monthly management reporting process to ensure the criteria for capitalisation has been met.	Select a sample of costs capitalised in relation to internally generated intangible assets and verify that management have reviewed them against the criteria for capitalisation.
All calculations of profits or losses on disposal are checked for accuracy by management.	Select a sample of disposals and recalculate the profit/loss on disposal. Verify that the calculation was performed and reviewed by an appropriate individual.
A regular review of amortisation rates should be undertaken to ensure that the rates are appropriate.	Select a sample of amortisation reviews performed by management and ensure that it has been appropriately reviewed with action taken where required.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

In practice, it can be difficult to apply substantive analytical procedures to intangible assets, given there is often no correlation in capital purchases. The exception to this is with amortisation. However, in each section are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not intangible assets are fairly stated.

Additions

Usually, costs brought forward from earlier years will have been tested in the year of purchase. Therefore, the audit work for intangibles should concentrate on testing additions in the current period. However, the auditor should ensure that tests are only performed where additions are material.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit tools*.

Audit procedure	**Assertion being tested**
Vouch additions to documents of title, e.g. patent, licence, etc. Ensure that:	
• the cost is correctly determined and recorded;	A
• the assets are correctly classified;	Classification
• ownership has been granted; and	E
• assets acquired were controlled by the entity prior to the balance sheet date.	Cut-off

Substantive analytical procedures

Although there is usually only a weak correlation, the auditor may compare this year's level of intangible asset additions with levels in previous years. The larger the business, the more relevant this particular procedure will be.

Very often, even small companies will have budgets for capital expenditure. The auditor may be able to compare the actual intangible asset additions to the budgeted levels. It is likely in such scenarios that the client may document any departure from capital expenditure budgets and, therefore, this can be used to corroborate any explanations for differences given to the auditor by the client. The auditor may also be able to compare actual additions made with forecasts obtained from the client in previous years.

Tests of detail

In regard to patents and trademarks, the auditor may:

- ask the UK Intellectual Property Office to send a certified copy of the register entry. This will include details of the owner of the patent, along with specific details of any licences or mortgages that have been notified to the office. If the entity has a large number of material patents or licences, a sample should be selected; or
- inspect the assignment or other agreement transferring the ownership from the previous registered owner, if the ownership is not recorded at the UK Intellectual Property Office. Where this is the case, ascertain why the registration has not been made.

For other intangible assets, the auditor will need to review the relevant documentation available and, in some cases, also review the relevant receipt of related income, such as royalties to verify existence of the asset.

Note that not all patent costs should be capitalised. Some amounts payable on patents relate to annual fees and should be taken to the profit and loss account immediately.

Tests to be performed over capitalised development expenditure are set out in Internally generated intangible assets.

Internally generated intangible assets

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Verify that the relevant criteria have been met for the capitalisation of costs in line with the applicable accounting standards.	C, E, Classification
Select a sample of costs and agree to supporting documentation, e.g. time sheets, purchase invoices, schedules of overheads, etc.	A, V
Verify that the costs have been accurately recorded.	A

Substantive analytical procedures

Substantive analytical procedures will not always be relevant to internally generated assets. However, the auditor can compare the level of capitalised expenditure during the year with other relevant information including budgets to identify potential misstatements.

Tests of detail

The auditor should review the evidence of expenditure capitalised by the client (e.g. development expenditure) and determine whether it is reasonable and in line with the applicable accounting standards. Enquiry of management will be necessary to understand the rationale for capitalisation and assess against the relevant criteria. Inspection of documents such as timesheets, invoices, schedules of overhead will help to verify the accuracy and classification of the costs. The auditor may also review a breakdown of the research expenditure balance to determine if there are any development costs that should have been capitalised in accordance with the client's accounting policy.

There is no requirement to capitalise development expenditure under UK GAAP. It is therefore important to ensure that any accounting policy in respect of development expenditure is consistently and properly applied.

Disposals

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Vouch disposals to available evidence. Ensure that:	
• sales proceeds have been correctly accounted for;	A
• profit/loss on disposal has been correctly calculated;	A
• they have been removed from the intangible asset register/listing.	E

Substantive analytical procedures

By their very nature, disposals of intangibles are one of the more erratic figures in a set of accounts financial statements. However, the auditor may still be able to correlate disposals with other information. If the entity has a formal, or informal, renewal policy, then this may be compared to the actual level of disposals in a year.

Tests of detail

It may be more efficient to test *all* disposals, as there are not likely to be many in a period. However, where there are numerous disposals, sampling should be applied.

For the items selected for sampling, the auditor should ensure that:

- items have been deleted from the intangible asset register;
- any profit or loss on disposal is correctly calculated and accounted for;
- the disposal is properly authorised (which can be ascertained by reviewing supporting documentation, if any, or board minutes); and
- proper consideration was given to the reasons for the disposal (e.g. why patents have been allowed to lapse).

If there is a risk of unrecorded disposals, the following tests can be applied:

(a) consider whether additions result in, or are associated with, disposals;

(b) review minutes, correspondence, etc. for evidence of unrecorded transactions; and

(c) obtain management representations that all disposals are recorded.

Goodwill

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
For goodwill recognised during the year as a result of a business combination, complete audit programme **W9**.	C, E, A, V
If reporting under FRS 102, ensure that the policy for the amortisation of goodwill is in accordance with the accounting standards applied.	A, V
If reporting under IFRS, obtain and review management's impairment reviews. Perform the procedures under ' Impairment'.	A, V

Substantive analytical procedures

It is unlikely that substantive analytical procedures will be relevant to testing goodwill except in regard to the amortisation of goodwill.

Tests of detail

The auditor should:

- ensure that any goodwill is correctly measured as the excess of the cost of the business combination of the purchaser's interest in the net amount of the identifiable assets, liabilities and contingent liabilities recognised in the business combination;
- where any 'negative goodwill' arises, ensure that this has been correctly measured and that the credit balance is included in the balance sheet immediately below any existing goodwill balance, followed by a sub-total of net goodwill;
- ensure that the policy for the amortisation of goodwill is in accordance with the accounting standards applied;
- consider whether there are any indications of impairment.

W9 of the Private Company Audit Tool in ~~*Navigate*~~ *Audit* provides further audit procedures relating to business combinations.

Revaluation

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Where there is a policy of revaluation for a class of assets, is that policy applied consistently to all assets in that class and can the fair value be clearly determined with reference to an active market?	V
Obtain independent third-party evidence to support the fair value.	V
Ensure that where assets have been revalued during the year, the increase in revaluation is accounted for correctly through the Statement of Comprehensive Income as appropriate.	V

Substantive analytical procedures

An expectation of market values of intangible assets could be made using available market data.

Tests of detail

Where there is a policy of revaluation for a class of assets, the auditor should ensure that policy is applied consistently to all assets in that class. The auditor should also ensure that revaluations are carried out sufficiently frequently to keep valuations materially correct as required by FRS 102.

Intangible assets can only be revalued if there is an active market. It is usually therefore straightforward for the auditor to agree the revalued assets to publicly available prices.

Where a revaluation has occurred, the auditor should ensure that any revaluation surplus or deficit is correctly treated. In most instances, the increase or decrease in value should be reflected in the revaluation reserve in the Statement of Comprehensive Income. However, if this pushes the reserve into deficit, the balance is charged to the profit and loss account in accordance with FRS 102:17.

Impairment

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Consider whether there are any indicators of impairment, which might adversely affect the value of the assets, and ensure that these have been dealt with in accordance with applicable accounting standards.	V
Perform the following procedures on any impairment workings:	
• review the assumptions and cash flow projections and assess for reasonableness;	V
• consider the reasonableness of the discount rate;	V
• assess how sensitive the impairment model is to changes in inputs; and	V
• recalculate the impairment model to verify accuracy.	A, V
Where an impairment loss has been recognised, ensure it has been recognised appropriately.	A

Substantive analytical procedures

Impairment of intangible assets is usually specific to events and circumstances. There isn’t often a substantive analytical procedure which can be performed.

Tests of detail

An impairment review is carried out if there are any indicators of impairment, that is the asset’s recoverable amount is lower than its carrying amount.

The auditor will need to consider via discussion and the auditor’s knowledge of the entity whether any intangible asset or goodwill balance has suffered a permanent fall in value that should be provided for in the accounts.

In relation to development costs, the auditor should consider whether a permanent fall in value has occurred by:

- reviewing the commercial viability of the project, comparing estimated future expenditure with the estimated revenue to be generated;
- ensuring that the client has sufficient funds to complete the project;

- considering how reliable the client's predictions have been in the past for other projects; and
- considering whether it is technically feasible to complete the project. (The auditor should consider using an appropriately qualified expert in this situation.)

For other intangible assets, the auditor will consider if:

- the term of a patent, royalty or franchise has expired or the item has been terminated;
- the sale or closure of a business, where purchased goodwill existed, experienced continued losses or lack of profits;
- the entity has ceased to use a patent or patented products; or
- there are disputes over the use of a patent or trademark.

Where an impairment trigger has been identified, the auditor should review management's impairment model and verify the validity of the assumptions used to support the assessment, e.g. discount rate, industry data on growth rates and forecasted cash flows.

Where any of the above has been identified, the auditor should ensure that all appropriate action has been taken and any necessary adjustments have been made.

The auditor may also consider obtaining directors' representations on the matter.

Amortisation

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Confirm that all assets are being amortised in accordance with the company's accounting policy and in accordance with the relevant accounting standards.	A, Presentation
Review the methods applied and consider whether they are appropriate to the pattern of consumption of the assets.	A
Check calculations, this may involve a recalculation or a substantive analytical review, use the **SAP work paper** *available in the templates* for this.	C, E, A
Ensure that no assets have been amortised by more than cost.	V

Substantive analytical procedures

Substantive analytical procedures are likely to be the main way to test the amortisation balance – usually through a proof in total. The auditor calculates an expected value for amortisation per asset category based on the current year's intangible asset cost and the client's amortisation policy. Some assumptions may need to be used in relation to the timing of intangible asset additions and disposals during the year. Further guidance on this can be found in Fixed assets.

Tests of detail

The auditor can recalculate the amortisation charge across the categories of intangible assets or reperform a sample of the client's calculations. The auditor should also:

- determine the rates and methods of amortisation used by the client for the different types of intangible asset and goodwill. These rates should match with the accounting policies note in the accounts. Note that FRS 102 and company law limit the life of an intangible asset to ten years where a reliable estimate of the useful life cannot be made;
- review the amortisation rates used to confirm that they give a reasonable approximation of the useful economic lives of the assets concerned. Where necessary, the auditor should ensure that amortisation is applied from an appropriate date (e.g. development expenditure from the date of commercial sales or production);
- include tests to ensure the following:

(a) that the correct rate of amortisation has been used for the type of asset concerned;

(b) that the calculations have been properly performed; and

(c) that no amortisation has been charged on fully amortised assets.

The auditor should also review the success of a project where development costs have been capitalised.

Ownership

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Confirm that assets are still owned by the entity.	E

Substantive analytical procedures

It is unlikely that substantive analytical procedures will be relevant to testing for ownership.

Tests of detail

The auditor should ensure that patents or trademarks held by the entity have not elapsed by referring to the original documentation (a copy of which can be maintained on the permanent file). Where appropriate, ensure that the trademark or patent has been renewed by tracing payment of a renewal fee in the year.

Estimates

Design and perform appropriate tests for estimates, e.g. amortisation, using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In the ~~*Navigate*~~ *Audit* tools, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosure

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

Many of the disclosure requirements for intangible fixed assets are complex and it is essential that the auditor has sufficient knowledge of the relevant accounting standards and legislative requirements to ensure that full and adequate disclosure is made within the financial statements.

~~Croner-i *Interactive Disclosure Checklist*, an automated financial statement disclosure tool, addresses the requirements of FRS 102, UK company law, and any other relevant requirements to ensure completeness of disclosure.~~

3.8 Fixed assets

Quick overview

This section explains how to audit property, plant and equipment (PPE) (or fixed assets) and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of Navigate Audit.

This section relates to section F in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Property, plant and equipment

An item of property, plant and equipment (PPE) is an asset having physical substance that is intendedfor continuing use within the business – for example, a car, plant and machinery or a building. Under FRS 102, PPE is addressed in Section 17.

Generally items of PPE are initially recognised at cost and are subsequently measured either under the cost model or the revaluation model. The selection of measurement model is an accounting policy choice by class of asset. Under therevaluation model, fair value gains and losses pass through other comprehensive income and accumulate in a revaluation reserve within equity, except that where a valuation decrease exceeds the accumulated gains in equity, any excess is recognised in profit or loss.

Further guidance on the accounting requirements for PPE under the applicable standards can be found in Navigate UK GAAP Accounting:

- Private Company (FRS 102) – Property, plant & equipment (Section 17);
- Small Company (FRS 102 1A) – Property, plant & equipment (Section 17);
- Micro Entity (FRS 105) – Property, plant and equipment and investment property (Section 12).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing fixed assets are:

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
PPE	To establish that PPE exist and are beneficially owned by the entity at the balance sheet date.	E	Additions, Physical verification, Ownership
PPE	To verify that all PPE are completely and accurately recorded and disclosed at cost or valuation and that the basis is acceptable.	C, A, V	Additions
PPE	To ensure that all revalued assets are supported by proper valuations and that the basis is acceptable.	V	Revaluation
Gains and losses	To ensure that disposals are accounted for correctly.	C, E, A	Disposals
Depreciation	To confirm that depreciation is adequately provided over the estimated useful lives of the assets.	C, E, A, V	Deprecation
Impairment	To ensure that there is adequate consideration of the need for any permanent write-downs.	V	Impairment
PPE, Impairment, Depreciation, Gains and losses	To ensure that all accounting estimates recognised or disclosed in the accounts are reasonable in the context of the applicable accounting framework.	V	Estimates
PPE, Impairment, Depreciation, Gains and losses	To confirm that all necessary disclosures concerning fixed assets have been made and that the information is appropriately presented and described.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows:

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.

E – Existence

Assets, liabilities and equity interests exist.

The entity holds or controls the rights to assets; and liabilities are the obligations of the entity.

For the income statement, all transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.

The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy

Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation

Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions

Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table:

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Property, plant and equipment		X	X	X		Presentation
Depreciation	Y	X	X	X	X	Presentation
Impairment	Y				X	Presentation
Gain/loss on disposal		X	X	X		Presentation

Note, the majority of the testing for PPE is on debit balances and will be focused on overstatement, ensuring the PPE exist. Testing the understatement of PPE could be performed by physical verification to the fixed register and also testing the reciprocal population when testing the creditors and profit and loss sections.

Controls

The following are controls that are relevant to fixed assets and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	**How to test**
A budget detailing the capital commitment is drawn up at the beginning of the year and agreed by the relevant owners of the business or the directors.	Select a sample of additions and ensure that they have been approved or authorised in the relevant board minutes.
Any addition during the year is only be made after the relevant authorisation form has been completed. If the addition has already been agreed as part of the capital budget at the start of the year, the department manager's signature should be required.	Select a sample of fixed asset additions and ensure that there is an authorised order form for them.
The entity uses pre-numbered fixed asset purchase order requisitions.	Select a sample of additions and ensure the purchase order requisitions are sequential.
Invoices received are grid stamped to evidence that they have been checked for accuracy and that the posting code is correct before the items are posted to the nominal ledger.	Select a sample of additions, review the invoices for evidence they have been checked according to policy.
The client undertakes and records regular inspections on the condition and use of assets, which is reconciled to the fixed asset register. In some organisations, this must be undertaken in order for them to comply with health and safety regulations.	Select a sample of the inspection reports and ensure any reconciling items have been followed up appropriately.
A fixed asset register is maintained and reconciled monthly to the nominal ledger account.	Select a sample of the monthly reconciliations to verify they have been performed and any reconciling items have been followed up appropriately.
Fixed asset items need approval from directors before they are disposed/sold. Hierarchical levels of authority can be set for this purpose. For example, allowing disposals of up to a set amount to be dealt with by a manager.	Select a sample of disposals and ensure that they have been approved or authorised as per company policy.
All calculations of profits or losses on disposal are checked for accuracy by the client.	Select a sample of disposals and check a calculation of profit/loss on disposal has been correctly performed and reviewed by an appropriate person.

A regular review of depreciation rates should be undertaken to ensure that the rates are appropriate and not excessive.	Select a sample of the reviews of depreciation rates and ensure they have been appropriately reviewed with action taken if required on the depreciation rates.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances ofthe particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

In practice, it can be difficult to apply substantive analytical procedures to PPE, given there is often no correlation in capital purchases. The exception to this is with depreciation. However, in each section are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not fixed assets are fairly stated.

Additions

Usually, costs brought forward from earlier years will have been tested in the year of purchase. Therefore, the audit work for PPE should concentrate on testing additions in the current period. However, the auditor should ensure that tests are only performed where additions are material.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Vouch additions to purchase invoices. Ensure that:	
• the cost is correctly determined and recorded;	A
• they are correctly classified;	Classification
• ownership has been granted;	E
• they are of a capital, not revenue, nature;	Classification
• assets acquired were delivered prior to the balance sheet date; and	Cut-off

• assets acquired under finance leases are treated correctly (see Finance lease audit programme).	Classification, Presentation
Carry out physical inspection of fixed assets additions.	E
Confirm title to all freehold properties by means of a land registry search.	E

Substantive analytical procedures

The auditor can compare the level of additions to fixed assets during the year with other relevant information.

Although there is usually only a weak correlation, the auditor may compare this year's level of fixed asset additions with levels in previous years. The larger the business, the more relevant this particular procedure willbe.

Very often, even small companies will have budgets for capital expenditure. The auditor may be able to comparethe actual fixed asset additions to the budgeted levels. It is likely in such scenarios that the client may document any departure from capital expenditure budgets and, therefore, this can be used to corroborate any explanations for differences given to the auditor by the client. The auditor may also be able to compare actual additions made with forecasts obtained from the client in previous years.

The auditor should also consider expected increases in capital expenditure, e.g. expansion of the business into new premises or outlets. Obviously, when such expansion occurs, it would be usual for a certain level of additions to fixed assets to be made. The auditor's understanding of the client's business should enable arough estimate to be made of the types of fixed assets that would be required in the new premises. The actual level of fixed asset additions shown in the accounts can then be compared with this estimate and any variances explained.

Depending on the replacement policy of the client, the auditor may also be able to deduce that if certain assetsare disposed of, then additions should be made to replace them. For example, if a director's car is disposed of, another one would usually take its place.

Finally, there will be a correlation between the level of capital expenditure and the repair policy of the client. If the client decides to repair more of the fixed assets rather than replace them, the auditor may well expect to seea downturn in the level of capital expenditure.

Tests of detail

Invoice addition testing

Select a sample of invoices or supporting documentation and test the following matters:

- the cost is correctly determined and recorded on the fixed asset register;
- they are correctly classified;
- ownership has been granted;
- they are of a capital, not revenue, nature;
- assets acquired were delivered prior to the balance sheet date – review the good received note;
- assets acquired under finance leases are treated correctly;
- (if applicable) ensure that the asset has been capitalised in accordance with the entity's policy;

- consider whether any items should be reclassified as repairs or maintenance and so be eligible for full tax relief; and
- consider whether VAT on cars has been incorrectly capitalised;
- review board minutes to confirm that the purchase was authorised (this may be performed as part of the controls testing).

Additional considerations

The auditor should ensure that leased assets are properly accounted for in accordance with Section 20 of FRS 102. The auditor should review the terms of any material leases to ensure that they are properly classified as finance or operating leases and accounted for accordingly. Further details of testing in this area can be found in Creditors and accruals.

Where an entity has assets in the course of construction, the auditor should review the following to ensure that costs are correctly allocated to the right asset:

- for labour – timesheets, clock cards or any other summaries of time spent;
- for borrowing costs – loan agreements or bank statements;
- for materials – invoices, internal requisition notes or any other record of the materials used; and
- for overheads – management accounts, standard costs.

The auditor should ensure that the client has recognised all government grants related to PPE where there is reasonable assurance that the entity will comply with the conditions attaching to them; and the grants will be received.

Physical verification

Carry out a physical inspection of fixed assets additions.

Ownership

For those properties which have been purchased in the period, confirm title to all freehold properties by means of a land registry search.

Search the Land Registry website for proof of title, ensuring that:

- the client’s name is shown on the title;
- the description agrees with that shown in the accounts (a title map can also be requested from Land Registry at a small additional cost); and
- there are no restrictions on dealing or use of the land which have been broken.

Some older properties may not yet appear on the Land Registry electronic database, especially if they have not changed hands in recent years. This is because the Land Registry is still in the process of adding such properties to the database. Should a search of the Land Registry database draw a blank, then some negative assurance that the client has not sold the property can still be gained, as a recent sale would be included on the database.

However, care must be taken to ensure that the correct search details have been used and that the reason for an unsuccessful search is not the use of incorrect information.

For mortgaged property, third-party confirmation of any legal charges over the property should be sought from the lender (usually the bank) and Companies House, where the register of mortgages and charges may be searched for a nominal fee.

For leasehold property, the auditor should review the lease and consider whether any property has been mortgaged. The auditor should then ensure that the property in the lease and the mortgage are the same and that any necessary permission has been obtained from the landlord. The auditor should also ensure that the lease is in the name of the entity.

Disposals

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Vouch disposals to available evidence. Ensure that:	
(a) sales proceeds have been correctly accounted for;	A
(a) profit/loss on disposal has been correctly calculated; and	A
(a) they have been removed from the fixed asset register/listing.	E

Substantive analytical procedures

By their very nature, disposals of fixed assets are one of the more erratic figures in a set of financial statements.

However, the auditor may still be able to correlate disposals with other information. If the entity has a formal, orinformal, replacement policy, then this may be compared to the actual level of disposals in a year. Also, for the reasons described above, the auditor may be able to relate disposals to particular additions. For example, when a motor vehicle is purchased, there is often a corresponding disposal.

Also, in direct contrast to one of the points above, if the entity undertakes any form of downsizing in its operations, the auditor would expect some disposal of fixed assets.

Tests of detail

The auditor should consider carrying out some of the following tests on the items which have been disposed of in the period to ensure:

- that sale proceeds appear reasonable, considering the type and condition of assets sold;
- that the disposal was properly authorised and that proper consideration was received;
- that the profit or loss on disposal is correct and accounted for properly, and that any finance lease terms are complied with;
- that the items have been removed from the fixed assets register; and

- where assets were sold or transferred to a related party, that prices were reasonable and that suitable disclosure is given.

If there is a risk that material disposals may not be recorded, the auditor should perform the following procedures:

- review minutes and correspondence for evidence of unrecorded disposals;
- obtain management representations regarding the completeness of recorded disposals;
- discuss the disposal of assets with factory managers and other client staff. This should be done when the actual work on physical existence is being carried out; and
- consider if there are any changes in the business which would lead to disposals, e.g. rationalisation, discontinued product lines, closure of a particular site or production line;

The addition of certain assets may lead the auditor to think that some assets have been disposed of.

The auditor should consider whether a disposal may require a provision in other areas (e.g. obsolete machinery parts or grant repayment) or may affect VAT or tax liabilities.

Revaluation

Example tests

The following tests are used in PCAS.

Audit procedure	**Assertion being tested**
Where there is a policy of revaluation for a class of assets, is that policy applied consistently to all assets in that class?	V
Obtain valuation or calculations to support revaluation amount. [Use Auditor’s expert work programme if calculation performed by an expert.]	V
Ensure that where assets have been revalued during the year the revaluation is accounted for correctly through the Statement of Comprehensive Income as appropriate.	P
Ensure that where assets have been revalued during the year the necessary historical cost information is available for disclosure purposes.	P

Substantive analytical procedures

An expectation of market values of assets could be made using market data, e.g. a property valuation could be estimated using market value website data.

Tests of detail

Where there is a policy of revaluation for a class of assets, ensure that policy is applied consistently to all assets in that class. The auditor should ensure that revaluations are carried out sufficiently frequently to keep valuations materially correct as required by FRS 102.

Valuation report

Obtain a copy of the valuation report. The auditor should consider whether any events have occurred since the date of the last valuation that are likely to affect the value of revalued assets and hence whether any adjustment is required.

Perform a sense check on the valuation report and agree, where possible, the inputs used. The **expert work programme** will need to be used to ensure sufficient appropriate audit work has been performed over the valuation. ~~Guidance on this can be found in Other common planning issues.~~

Where the valuation has been performed by a third party, consider:

- the qualifications of the valuer in terms of their ability to value the property and also whether the qualifications are disclosed correctly;
- whether the valuer is independent of the client;
- the scope of the valuation – in particular, whether any assets were excluded;
- whether the basis of the valuation will comply with the requirements of the Companies Act to show fixed assets at market value at the date of the last valuation or at their current cost;
- whether the useful economic life of the asset should be revised;
- which items have been included in the scope of the valuation (e.g. fixed plant and machinery should not be included both in the valuation of property and under the heading ‘plant and machinery’);
- whether the valuation of property separates land and buildings to identify the amount to be depreciated;
- whether the valuer was given all relevant facts;
- whether the disclosures are adequate;
- whether the valuer has given permission for the valuation to be included within the financial statements of the entity;
- whether the valuation is reasonable, compared to the auditor’s knowledge of the client, the premises and the locality (for property); and
- whether all assets of the same class have been revalued as required by FRS 102.

If the valuation has been carried out internally by management’s expert, the following procedures should be applied as per ISA (UK) 500:8 (Updated May 2022) *Audit Evidence*:

- evaluate the valuer’s competence, capabilities and objectivity. This would include considering the possibility that the client would want to manipulate asset values by artificially inflating (more likely) or reducing the valuation;
- obtain an understanding of the work of that expert – this might include considering:

(a) whether that expert’s field has areas of specialty within it that are relevant to the audit;

(b) whether any professional or other standards, and regulatory or legal requirements apply;

(c) what assumptions and methods are used by the expert, and whether they are generally accepted within that expert’s field and appropriate for financial reporting purposes; and

(d) the nature of internal and external data or information the expert uses;

- evaluate the appropriateness of the expert's work as audit evidence – this might include:

(a) the relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence and whether they have been appropriately reflected in the financial statements;

(b) if that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

(c) if that expert's work involves significant use of source data, the relevance, completeness and accuracy of that source data.

The auditor may also need to compare the client's valuation with other evidence (e.g. in the case of property, prices of similar properties in the local area), if available.

Presentation

Where a revaluation has occurred, ensure that any revaluation surplus or deficit is correctly treated. In most instances, the increase or decrease in value should be reflected in the revaluation reserve in the Statement of Comprehensive Income. However, if this pushes the reserve into deficit, the balance is charged to the profit and loss account in accordance with Section 17 of FRS 102.

Ensure that where assets have been revalued during the year, the necessary historical cost information is available for disclosure purposes.

Deferred taxation

The auditor should also ensure that appropriate provision is made for deferred tax in relation to revaluation gains and losses.

Impairment

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Consider whether there are any indicators of impairment, which might adversely affect the value of the assets, and ensure that these have been dealt with in accordance with applicable accounting standards.	V
Carry out physical inspection of fixed assets from both the fixed asset register to asset and from physical assets to the fixed asset register. Check the asset is in the condition as listed on the fixed asset register.	C, V, E

Substantive analytical procedures

Impairment of assets is usually specific to events and circumstances, there isn't often a substantive analytical procedure which can be performed.

It is possible to look at PPE utilisation, there is a standard ratio of fixed asset utilisation that can be calculated. This is:

actual sales:fixed assets

This can be compared to previous accounting periods for the same entity or it can be compared to industrystandards. However, in small companies, this ratio may not necessarily be particularly useful.

As the fixed asset utilisation increases, so the entity becomes more efficient in using its fixed assets. If the ratio decreases, there is an increased chance of under-depreciation of the fixed assets or of assets that do not exist being reported in the balance sheet. There may be other, more relevant reasons for the changes, such as poor asset utilisation or obsolescence of the fixed asset in use. Another reason for an apparent worsening in this ratiocould be a decision to source assets on operating leases rather than hire purchase agreements or other sources of financing for the purchase of fixed assets.

Tests of detail

Indicators of impairment

Under SI 2008/409 or SI 2008/410 , as well as FRS 102, provision is required for a permanent diminution in value or impairment of a fixed asset. The auditor could identify such assets by:

- considering whether there has been any significant change in the level of production or the range of products, which may indicate that certain assets are no longer being used;
- reviewing levels of repairs and renewals, as a high level of expenditure might indicate that fixed assets are approaching the end of their useful economic life and so ought to be written down; and
- considering underuse of assets during physical inspection.

Consider whether any assets written down in earlier years have recovered in value to such a degree that the provision for diminution in value should be decreased.

Where assets have been, or are being, built by the client, consider whether the carrying value is in excess of likely open market value.

Consider the valuation of assets in the light of other available information, such as valuers' reports, trade publications, subsequent sale proceeds or the auditor's knowledge of the client.

If there are any concerns, consider obtaining directors' representations on the matter.

Physical verification

The auditor should select the appropriate sample size from the fixed asset register and ask to see those specific assets. Working papers should be clear that this is how the issue has been addressed. The sample should give an appropriate spread across all fixed asset categories, opening balances and additions, and should concentrate on higher value assets. When inspecting the asset, check the condition is as listed on the fixed asset register, otherwise an impairment may be required.

The auditor should select a sample from the fixed asset register, including additions during the year (though they could be tested separately), and seek to identify those assets at the client's premises. Physical verification can often be performed when the auditor is attending the stocktake.

Insight – Directional testing

If the auditor selects the sample by touring the client's premises and ticking on the fixed asset register, then the items tested have been selected from the physical assets themselves and not the asset register. The test has therefore been performed in the wrong direction, thus testing completeness and not existence.

Where physical verification is not possible because, for example, an asset is not available or is inaccessible, the auditor should consider whether the objective can be satisfied through one or more of the following procedures:

- reviewing valuations by a third party (usually only applicable on buildings);
- reviewing vehicle registration documents, although this provides proof of ownership and not proof of existence as such (if the auditor has verified existence, there is usually no need to perform this test as well);
- identifying appropriate expenditure, e.g. insurance, repairs, maintenance;
- identifying income generated by the asset (it may be possible to reconcile a sample of fixed assets to income in respect of those fixed assets around the year end); and
- reviewing insurance policies (if an asset is insured, it probably exists).

When physical verification of the assets has to be undertaken by alternative means, ensure the audit programme explains these alternative means. However, it is necessary to consider the possibility in these circumstances that the auditor may be able to undertake sufficient work to be satisfied that the assets exist, yet not obtain adequate assurance on the condition of those assets.

Obsolete assets and assets no longer in use

Obsolete assets and assets no longer in use may be included in the fixed assets register. While undertaking physical verification testing, it is essential that the auditor checks that the assets are actually *in use*, not only whether they still exist. It is also essential that the auditor looks at their condition and, even as a non-expert, considers the probability of their being worth the amount at which they are included in the accounts.

The auditor should also consider the reverse situation. Some clients are in the habit of accounting for fully written down assets as disposals, even when the assets are still held and are in use. In such circumstances, the correct treatment is to leave the assets in the fixed asset register.

Depreciation

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Confirm that all assets are being depreciated in accordance with the company’s accounting policy.	A, P
Review the methods applied and consider whether they are appropriate to the pattern of consumption of the assets.	A
Check calculations, this may involve a recalculation or a substantive analytical review.	C, E, A
Ensure that no assets have been depreciated by more than cost.	V

Substantive analytical procedures

Unlike for the other areas when auditing PPE, substantive analytical procedures are likely to be the main way to test the depreciation balance – usually through a depreciation proof in total. The auditor calculates an expected value for depreciation per asset category based on the current year's fixed asset cost and the client's depreciation policy. Some assumptions may need to be used in relation to the timing of fixed asset additions and disposals during the year.

Potentially, the auditor can look at depreciation as a percentage of gross cost of the fixed assets ((depreciation/gross cost) x 100%). This can then be analysed through fixed asset categories.

Possible explanations for changes in this percentage from year to year, other than errors in calculation, could include the age of the assets, the different depreciation methods used, the level of fully depreciated assets included in the figures and any change in the depreciation rates used. Any of these explanations could easily be corroborated with reference to the auditor's knowledge of the client.

Another ratio that can be used to assess the reasonableness of the depreciation charge, and also the reasonableness of any additions or disposals, is the ratio of fixed assets at net book value (NBV) to fixed assets at original cost (fixed asset at NBV:cost). This effectively gives the unexpired life of the fixed assets. Again, this canbe split into different fixed asset categories. Possible explanations for any changes to this ratio could include:

- a change in the repair and maintenance policy of the entity;
- a change in the depreciation rates and/or depreciation methods used; and
- expansion or downsizing of the business.

Again, any of these explanations could easily be corroborated with reference to the auditor's knowledge of the client.

Tests of detail

Calculate the depreciation charge across the categories of fixed assets or check a sample of the client's calculations.

Review the client's accounting policies and consider whether:

- the policies have been consistently applied from one year to the next and between different types of assets;
- the rates of depreciation are reasonable given the types of asset (see below);
- any special circumstances exist which could shorten the period over which depreciation is charged (e.g. franchise, licence, lease term – leasehold improvements should not be written off over a term longer than the lease); and
- rates are consistent across similar clients or across a group.

When reviewing depreciation rates for reasonableness, the auditor should consider the following:

(a) the useful economic life and net realisable value of the assets (the useful economic life is the period over which the client expects to use the asset, rather than the actual life of the asset);

(b) whether the client consistently makes gains or losses on disposals. This could indicate the use of inappropriate rates of depreciation;

(c) whether any changes in rates can be justified in terms of a revised useful economic life;

(d) whether there are fully depreciated assets still in use (which suggests that assets have been written off too quickly);

(e) whether the client tends to replace assets after a certain period (the replacement period should then be used as the useful economic life);

(f) whether the residual values (where used) are reasonable (see Depreciation on freehold property); and

(g) whether any of the assets could be obsolete due to technological changes.

Depreciation on freehold property

It is not unusual to find the situation where freehold property has not been depreciated, but often the reason given for non-depreciation is not valid. FRS 102.17.18 requires an entity to allocate the depreciable amount of an asset on a systematic basis over its useful life. The only exception to this is therefore where any depreciation charge and the accumulated depreciation would not be material. Forthis to occur, there must be a high residual value, a long economic life or both. FRS 102 (Glossary) defines residual value as:

'The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of itsuseful life.'

If this treatment is to be adopted, it is essential that the auditor undertakes testing to consider the followingquestions.

- Is the property being maintained to a high standard? If there has been no expenditure at all on repairs andrenewals for the past five to ten years, then it may be more difficult to justify a high residual value and long economic life.
- The comments above about determining residual value notwithstanding, is the assertion that the estimatedresidual value materially equates to cost reasonable? Whilst this may be more likely it must still be demonstrated and if this is not the case, then the difference should be depreciated.
- Would the accumulated depreciation be material? It might be easy to successfully claim that the annual depreciation charge would be immaterial, but the accumulated depreciation is often ignored, and it can becomematerial in time.

Inadequate depreciation policies

It is essential to ensure that the adequacy of depreciation rates is considered and documented during each audit. In doing this, the auditor should also consider the useful economic life of assets in terms of their use within the entity.

Over-depreciation of assets

Over-depreciation of assets can also be a problem. Regular material profits made on the disposal of assets, or assets written down to nil or £1 that are still in use, are both indicators of an overly prudent depreciation policy. The auditor should review the rates used in these circumstances and recommend a more appropriate policy to the client.

Ownership

Example tests

The following tests are used in the ~~Navigate~~ *Audit* tools.

Audit procedure	Assertion being tested

Confirm that assets are still owned by the entity.	E

Substantive analytical procedures

There isn't often a substantive analytical procedure which can be performed for ownership of assets.

Tests of detail

The key issue of property ownership is often not addressed in sufficient depth. Specific confirmation should be sought that the property is held in the name of the entity. The fact that the bank may hold a charge over a property against the entity's borrowings does not prove conclusively that the property is in the name of the entity rather than, say, in the name of one of the directors.

If it becomes clear that certain assets (typically cars and property) are in the name of one or more of the directors, then the auditor should obtain specific confirmation from the directors involved to the effect that they are holding the asset(s) in trust on behalf of the entity, ideally via a formal nominee agreement.

Property

Since the tests on property are relatively quick and easy to do, and since property usually forms a very material part of the balance sheet, testing **ownership** by searching on the Land Registry database, should be performed annually.

For companies (such as property investment companies) with large numbers of properties, consideration should be given to using sampling or testing properties on a rotational basis. A management representation should also be obtained if all properties are not checked each year.

Other assets

Beneficial ownership of assets is tested during the work on additions. However, this does not give concrete evidence that the assets owned at the beginning of the accounting period are still owned by the client at the balance sheet date. The fact that an asset exists and is being used by the client is usually sufficient evidence of continuing ownership.

The auditor should review loan agreements or contracts to determine if any assets have been pledged as security.

Estimates

Design and perform appropriate tests for estimates, e.g. depreciation, using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

3.9 Finance leases

Quick overview

This section explains how to audit finance leases and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to schedule F4 in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice usually a mix of tests of control and substantive procedures, including analytical review.

Finance leases

All leases are classified as either an operating lease or a finance lease.

FRS 102 defines finance leases as a lease which transfers substantially all the risks and rewards of ownership from the lessor to the lessee. These are dealt with under Section 20 of FRS 102 and are accounted for at amortised cost using the effective interest method.

Further guidance on the accounting requirements for finance leases under the applicable standards can be found in *Navigate UK GAAP Accounting*:

- Private Company (FRS 102) – Leases (Section 20);
- Small Company (FRS 102 1A) – Leases (Section 20);
- Micro Entity (FRS 105) – Leases (Section 15).

For the audit of operating lease receivables or liabilities, please refer to ~~*Navigate Audit*~~ guidance sections on Creditors and accruals and Debtors and prepayments.

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives in respect of the audit of finance leases are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Finance leases	To ensure that finance leases have been identified and correctly classified.	C, Classification	Identification of finance leases
Finance lease additions	To ensure that finance lease additions exist and they have been appropriately recognised.	E, A, V, Cut off, E	Additions – lessee, Additions – lessor
Finance lease terminations	To ensure that finance lease terminations have been appropriately accounted for.	A, Cut off	Termination of lease – lessee, Termination of lease – lessor
Existing finance leases	To ensure that existing finance leases have been appropriately accounted for, classified and presented.	A, V, Classification, Cut off, Presentation	Existing finance leases
Impairment	To ensure that there is adequate consideration of the need for any permanent write-downs.	V	Impairment
Depreciation	To confirm that depreciation is adequately provided over the estimated useful lives of the assets.	A, E	Depreciation
Presentation and disclosures	To ensure that finance leases are adequately presented and disclosed.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity.

For the income statement, all transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.

The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy

Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation

Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions

Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Finance leases		X	X	X	X	Cut-off, Classification, Presentation

Controls

The controls listed in Fixed assets around the process of fixed assets are also applicable to finance leases and, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on sample sizes when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls .

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

In each section are some substantive analytical procedures that can be used to give additional audit comfort regarding whether finance leases are fairly stated.

Identification of finance leases

Not all contracts that contain leases clearly specify the fact that there is a lease. A lease may exist despite not containing words such as ‘lease, right to use, rent, right to right’. Determining whether a lease exists within a contract might require judgement to be applied.

To obtain assurance over the completeness and classification of finance leases, auditors should undertake procedures to determine whether an arrangement is or contains a lease. In particular, under FRS 102, it is necessary to consider whether:

(1) fulfilment of the arrangement is dependent on provision of a specific asset or assets; and

(2) the arrangement conveys a right to use the asset.

IFRS 16 states that a contract is or contains a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. In principle, this is similar to FRS 102, but it does state that the contract needs to convey the right to ‘control the use’ of the asset rather than to just ‘use’ the asset.

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Examine any minutes for evidence of additions or disposals of finance leases.	C
Review any arrangements or contracts that may include an asset(s). Determine whether the arrangement is or contains a lease, in accordance with the relevant accounting framework.	Classification, C
Determine whether the arrangement is or contains a finance lease, in accordance with the relevant accounting framework.	Classification

Substantive analytical procedures

The identification and classification of finance leases is an area where substantive analytical procedures are unlikely to provide assurance, given the judgement and criteria to be applied.

For completeness testing, there may be a weak correlation with the level of finance leases identified in prior years. Auditors should consider expected levels of leases based on capital expenditure, budgets and their understanding of the entity, however this will not address the classification assertion in relation to finance leases.

Tests of detail

Tests of detail will be required including examination of contracts or relevant client information to determine lease arrangements:

- examining any minutes for evidence of additions or disposals of finance leases;
- review any arrangements or contracts that may include an asset(s). Determine whether the arrangement is or contains a lease, in accordance with the relevant accounting framework;
- determine whether the arrangement is or contains a finance lease, in accordance with the relevant accounting framework.

Additions – lessee

Usually, costs brought forward from earlier years will have been tested in the year of purchase. Therefore, the audit work for finance leases should concentrate on testing additions in the current period. However, the auditor should ensure that tests are only performed where additions are material.

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Vouch finance lease additions to supporting documentation. Ensure that:	
• the leased asset is held by the entity under a valid lease agreement;	E
• the value of the leased asset is correctly determined and recorded, in accordance with the relevant accounting framework;	A, V
• the value of the corresponding lease liability (see L Creditors) is correctly determined and recorded, in accordance with the relevant accounting framework;	A, V
• the leased asset was acquired prior to the balance sheet date.	Cut off
Carry out physical inspection of finance lease additions to confirm existence.	E

Substantive analytical procedures

The auditor can compare the level of additions to finance leases during the year with other relevant information. Detailed guidance can be found in substantive analytical procedures in the additions section of Fixed assets.

Tests of detail

Addition testing

Select a sample of invoices or supporting documentation and test that the leased asset is:

- held by the entity under a valid lease agreement and therefore ownership has been granted;
- confirm that the value of the leased asset is correctly determined and recorded, in accordance with the relevant accounting framework;
- the value of the corresponding lease liability is correctly determined and recorded, in accordance with the relevant accounting framework;
- the leased asset was acquired prior to the balance sheet date (review goods received note to confirm delivery took place prior to the balance sheet date).

The above depends on whether the entity is applying FRS 102 or IFRS.

Under FRS 102, auditors need to confirm the asset has been appropriately recorded at the lower of the leased item's fair value or the present value of the minimum lease payments, using the interest rate implicit in the lease (or incremental borrowing rate of the lessee where the implicit interest rate is not available). The corresponding liability will also be recorded initially at the same value.

Under IFRS, the 'right of use' asset and corresponding lease liability will be recorded differently. The right of use asset will be measured at cost which is:

(1) the amount of the initial measurement of the lease liability;

(2) any lease payments made at or before commencement date less any lease incentives received;

(3) any initial direct costs incurred by the lessee; and

(4) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset and restoring the site or the asset.

The lease liability is initially measured at the present value of the lease payments that are not paid at commencement date of the lease. The discount rate is the rate implicit in the lease.

Physical verification

Carry out physical inspection of finance lease additions for lessees to confirm existence.

Termination of lease – lessee

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Vouch lease terminations to available evidence. Ensure that:	
• sales proceeds have been correctly accounted for;	A
• profit/loss on disposal has been correctly calculated;	A

• termination penalties have been included in the gain or loss on termination; and	A
• they have been removed from the asset register/listing.	Cut off

Substantive analytical procedures

By their very nature, lease terminations (disposals) are one of the more unpredictable areas that can be challenging to develop a reliable expectation for, and therefore substantive analytical procedures will be less useful for assurance purposes.

However, the auditor may still be able to correlate lease terminations with other information. If the entity has a formal, or informal, replacement policy, then this may be compared to the actual level of disposals in a year. Also, for the reasons described above, the auditor may be able to relate disposals to particular additions. For example, when a motor vehicle is leased, there is often a corresponding disposal.

If the entity undertakes any form of downsizing in its operations, the auditor may expect some disposals of assets including finance lease terminations.

Tests of detail

Vouch lease terminations to available evidence. Ensure that:

- sales proceeds have been correctly accounted for;
- profit/loss on disposal has been correctly calculated;
- termination penalties have been included in the gain or loss on termination; and
- they have been removed from the asset register/listing.

Additions – lessor

Under FRS 102, a lessor recognises a receivable measured at the value of the net investment in the lease (i.e. the gross investment, discounted at the interest rate implicit in the lease) plus direct costs.

The gross investment in the lease is the sum of the total minimum lease payments receivable plus any unguaranteed residual value.

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Vouch finance lease additions to supporting documentation. Ensure that:	
• the leased asset is held by the entity under a valid lease agreement;	E

• the value of the leased investment is correctly determined and recorded, in accordance with the relevant accounting framework;	A, V
• the leased asset was acquired prior to the balance sheet date.	Cut off
Carry out physical inspection of finance lease additions to confirm existence.	E

Substantive analytical procedures

Substantive analytical procedures will be similar to those found in Additions – lessee.

Tests of detail

Check the finance lease additions to supporting documentation. Ensure that:

- the leased asset is held by the entity under a valid lease agreement;
- the value of the leased investment is correctly determined and recorded, in accordance with the relevant accounting framework;
- the leased asset was acquired prior to the balance sheet date.

For material finance lease additions, the auditor may carry out a physical inspection of the additions to confirm existence.

Termination of lease – lessor

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Vouch lease terminations to available evidence. Ensure that:	
• sales proceeds have been correctly accounted for;	A
• profit/loss on disposal has been correctly calculated;	A
• they have been removed from the asset register/listing.	Cut off

Substantive analytical procedures

Substantive analytical procedures will be similar to those found in Termination of lease – lessee.

Tests of detail

Vouch lease terminations to available evidence. Ensure that:

- sales proceeds have been correctly accounted for;

- profit/loss on disposal has been correctly calculated. Ensure any termination penalties have been included in the gain or loss on termination;
- they have been removed from the asset register/listing.

Existing finance leases

Although existing finance leases may have been tested in previous periods, auditors should ensure that the amounts rolled forward, conditions and terms of the lease are appropriately determined under the accounting framework.

Example tests

The following tests are used in the ~~Navigate~~ *Audit* tools.

Audit procedure	**Assertion being tested**
For existing finance leases, ensure that the correct amount has been charged to the profit and loss account and that the correct asset balance is carried forward.	A
Review the terms of the finance lease and confirm if any terms, conditions or circumstances have changed/modified. Evaluate if the impact has been appropriately addressed in accordance with the relevant accounting framework.	A, V, Classification, Cut off
Ensure that the amounts carried forward are correctly classified as due within or after one year.	Presentation

Substantive analytical procedures

Substantive analytical procedures may be less useful in providing assurance. Auditors should nonetheless draw on prior years to identify any significant issues with brought forward values and obtain additional audit comfort over the balance.

Tests of detail

For existing finance leases, ensure that the correct amount has been charged to the profit and loss account and that the correct asset balance is carried forward.

Review the terms of the finance lease and confirm if any terms, conditions or circumstances have changed/modified. Ensure the lease is still in the entities name. Evaluate if the impact has been appropriately addressed in accordance with the relevant accounting framework.

Make sure that the amounts carried forward are correctly classified as due within or after one year.

Impairment

Example tests

The following tests are used in the ~~Navigate~~ *Audit* tools.

Audit procedure	Assertion being tested
Consider whether there are any indicators of impairment, which might adversely affect the value of the lease assets and ensure that these have been dealt with in accordance with applicable accounting standards.	V

Substantive analytical procedures

Guidance can be found in substantive analytical procedures in the impairment section of Fixed assets.

Tests of detail

Under SI 2008/409 or SI 2008/410, as well as FRS 102, provision is required for a permanent diminution in value or impairment of a leased asset. The auditor could identify such assets by:

- considering whether there has been any significant change in the level of production or the range of products, which may indicate that certain assets are no longer being used;
- reviewing levels of repairs and renewals, as a high level of expenditure might indicate that fixed assets are approaching the end of their useful economic life and so ought to be written down; and
- considering underuse of assets during physical inspection.

Consider whether any assets written down in earlier years have recovered in value to such a degree that the provision for diminution in value should be decreased.

Where assets have been, or are being, built by the client, consider whether the carrying value is in excess of likely open market value.

Consider the valuation of assets in the light of other available information, such as valuers' reports, trade publications, subsequent sale proceeds or the auditor's knowledge of the client.

If there are any concerns, consider obtaining directors' representations on the matter.

Depreciation

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Confirm that all leased assets are being depreciated in accordance with the company's accounting policy.	A
Review the methods applied and consider whether they are appropriate to the pattern of consumption of the assets.	A
Check calculations, this may involve a recalculation or a substantive analytical review.	A

Consider if there are any special circumstances exist which could shorten the period over which depreciation is charged (e.g. franchise, licence, lease term – leasehold improvements should not be written off over a term longer than the lease).	A
Ensure that no properties have been depreciated by more than cost.	E

Substantive analytical procedures

Substantive analytical procedures are likely to be the main way to test the depreciation balance – usually through a depreciation proof in total. The auditor calculates an expected value for depreciation per asset category based on the current year's finance lease asset cost and the client's depreciation policy. Some assumptions may need to be used in relation to the timing of finance lease asset additions and disposals during the year.

Tests of detail

Calculate the depreciation charge across the categories of leased assets or check a sample of the client's calculations.

Review the client's accounting policies and consider whether:

- the policies have been consistently applied from one year to the next and between different types of assets;
- the rates of depreciation are reasonable given the types of assets (see below);
- any special circumstances exist which could shorten the period over which depreciation is charged (e.g. franchise, licence, lease term – leasehold improvements should not be written off over a term longer than the lease); and
- rates are consistent across similar clients or across a group.

When reviewing depreciation rates for reasonableness, the auditor should consider the following:

- the useful economic life and net realisable value of the assets (the useful economic life is the period over which the client expects to use the asset, rather than the actual life of the asset);
- whether the client consistently makes gains or losses on disposals. This could indicate the use of inappropriate rates of depreciation;
- whether any changes in rates can be justified in terms of a revised useful economic life;
- whether there are fully depreciated assets still in use (which suggests that assets have been written off too quickly);
- whether the client tends to replace assets after a certain period (the replacement period should then be used as the useful economic life);
- whether the residual values (where used) are reasonable (see Depreciation on freehold property); and
- whether any of the assets could be obsolete due to technological changes.

Inadequate depreciation policies

It is essential to ensure that the adequacy of depreciation rates is considered and documented during each audit. In doing this, the auditor should also consider the useful economic life of assets in terms of their use within the entity.

Over-depreciation of assets

Over-depreciation of assets can also be a problem. Regular material profits made on the disposal of assets, or assets written down to nil or £1 that are still in use, are both indicators of an overly prudent depreciation policy. The auditor should review the rates used in these circumstances and recommend a more appropriate policy to the client.

Estimates

Design and perform appropriate tests for estimates, e.g. finance lease provisions, using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

3.10 Investment property

Quick overview

This section explains how to audit investment property and provides example audit objectives for the section. In addition, it covers the type of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas~~ of Navigate Audit.~~

This section relates to section F in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Investment property

Investment property is addressed in Section 16 of FRS 102. It is defined by FRS 102:16.2 as:

'Property (land or a building, or part of a building, or both) held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes; or
- sale in the ordinary course of business.'

Under FRS 102, investment properties are measured at fair value through profit or loss and are not subject to depreciation. Obtaining a valuation for most residential property is relatively straightforward. There is also a lot of data on commercial property yields available. However, an expert may be required.

FRS 102 requires investment property to be fair valued at each reporting date. There is no requirement for an external valuation, although the accounts must disclose to what extent an external valuer was involved. The valuation regime is therefore less onerous for the company. However, it does provide additional complications for the auditor as they will need to consider the client's assessment of reasonableness of the valuation and whether it remains sufficiently up to date.

Where property has mixed use, the balance sheet value will need to be separated for accounting purposes between investment property and property, plant and equipment (PPE). This would most likely be done on a square footage basis with the assistance of a professional valuer.

There is an exemption for holding a property at fair value when a property is let out to another group member.

Further guidance on the accounting requirements for PPE can be found in the relevant area depending on the accounting framework:

- Private Company (FRS 102) – Investment property (Section 16);
- Small Company (FRS 102 1A) – Investment property (Section 16).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing investment property are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Investment property	To establish that investment property is owned or held under a finance lease to earn rentals or for capital appreciation or both.	E	Additions
Investment property	To verify that all investment property is appropriately recorded in accordance with the applicable accounting framework.	C, A, V	Investment property held at fair value, Investment property held at cost
Investment property	To ensure that all transfers to or from investment property are recorded in line with the applicable accounting framework.	C, E, A	Transfers to and from investment property
Gains and losses	To ensure that disposals are accounted for correctly.	C, E, A	Disposals
Investment property	To ensure that all accounting estimates recognised or disclosed in the accounts are reasonable in the context of the applicable accounting framework.	V	Estimates
Investment property, Gains and losses	To confirm that all necessary disclosures concerning investment property have been made and that the information is appropriately presented and described.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity. The existence assertion used in the *~~Navigate~~ Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the *~~Navigate~~ Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Investment property		X	X	X	X	Presentation
Depreciation	Y	X	X	X	X	Presentation
Impairment	Y				X	Presentation
Gain/loss on disposal/revaluation		X	X	X		Presentation

Note, the majority of the testing for investment property is on debit balances and will be focused on overstatement, ensuring it has been correctly classified and is recognised at an appropriate value.

Controls

The controls set out in Fixed assets may be relevant to investment property and could, if working properly, enable the auditor to reduce the substantive work required in these areas. It is unlikely that controls exist that cover the valuation of investment property and this is an area that is likely to need significant audit attention.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

Disposals

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Vouch disposals to available evidence. Ensure that:	
(a) sales proceeds have been correctly accounted for;	A
(a) profit/loss on disposal has been correctly calculated;	A
(a) they have been removed from the fixed asset register/listing.	E

Substantive analytical procedures

It is unlikely that substantive analytical procedures will be relevant to disposals testing.

Tests of detail

The auditor should consider carrying out some of the following tests on property that has been disposed of in the period to ensure that:

- sale proceeds appear reasonable, considering the type and condition of the property sold;
- the disposal was properly authorised and proper consideration was received;

- the profit or loss on disposal is correct and accounted for properly, and any finance lease terms are complied with;
- the items have been removed from asset register; and
- where assets were sold or transferred to a related party, prices were reasonable and suitable disclosure is given.

Additions

Usually, balances brought forward from earlier years will have been tested in the prior year. The audit work for investment property should therefore concentrate on testing new property additions and other movements in the balance in the current period. (See also Investment property held at fair value.)

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Vouch additions to supporting documentation. Ensure that:	
• the cost is correctly determined and recorded;	A
• the costs are correctly classified;	Classification
• ownership has been granted or the property is held under a lease;	E
• purpose of ownership is to earn rentals or for capital appreciation or both;	Classification
• property was acquired prior to the balance sheet date;	Cut-off
• property interest held under a lease is treated correctly.	Classification, Presentation
Confirm title to all freehold properties by means of a land registry search.	E
If only a portion of the building is used to generate income, determine whether classification is appropriate.	Classification

Substantive analytical procedures

Analytical procedures do not play a significant role in auditing additions to investment property.

Tests of detail

Addition testing

Obtain supporting documentation and test the following matters in relation to property additions:

- the cost is correctly determined and recorded on the asset register;
- ownership has been granted;
- the property is held to earn rentals and/or for capital appreciation;
- property was acquired prior to the balance sheet date;
- property acquired under finance leases is treated correctly on initial recognition;
- (if applicable) ensure that the property has been capitalised in accordance with the entity's policy;
- review board minutes to confirm that the purchase was authorised (this may be performed as part of the controls testing).

Additional considerations

The auditor should ensure that property held under a lease is accounted for as if the lease were a finance lease, regardless of what its classification would be under FRS 102:20 *Leases*. ~~Further guidance is available in Private Company (FRS 102) – Investment property (Section 16).~~

Ownership

For those properties which have been purchased in the period, confirm title to all freehold properties by means of a land registry search. Guidance can be found in Ownership.

Classification

The auditor should obtain evidence to support the purpose of ownership, i.e. to earn rentals and/or for capital appreciation. Inspection of rental agreements will confirm the purpose of holding the property. Board minutes should also be inspected to determine management's intentions when purchasing the property.

The auditor should also verify that only costs of a purchased investment property are recognised on initial recognition. Costs that relate to the property's subsequent use, but are not considered to be directly attributable costs, such as marketing costs to attract new tenants, should not be included.

Carry out a physical inspection of the property by the auditor to confirm its general condition and use. Inspection may also help determine the use of the property and to confirm it is not owner-occupied.

Transfers to and from investment property

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Ensure the transfers to and from investment property have been properly classified and accounted for under applicable accounting standards.	C E, Classification

Substantive analytical procedures

It is unlikely that substantive analytical procedures will be relevant to testing transfers to and from investment property.

Tests of detail

Generally, an entity can only transfer a property to, or from, investment property when the property first meets, or ceases to meet, the definition of investment property. FRS 102:16 provides for three types of transfer:

- from investment property to owner-occupied property or inventory;
- from owner-occupied property to investment property;
- from inventory to investment property.

The auditor should review the journal entries made in relation to the transfer, tie amounts to supporting documentation and confirm that the accounting treatment is in line with relevant applicable accounting standards. ~~Further guidance on the accounting treatment is available in Private Company (FRS 102) – Investment property (Section 16).~~

Investment property held at fair value

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Confirm that the entity carries all its investment property at fair value.	V
Obtain valuations or calculations to support revaluation amount. [Use **Auditor's expert** work paper if the calculation is performed by an expert.]	V
Any gain or loss arising from a change in fair value of investment property is recognised in profit & loss in the period in which it arises.	V

Substantive analytical procedures

An expectation of market values of assets could be made using market data, e.g. the property valuation could be estimated using publicly available market value data.

Tests of details

The auditor should ensure that investment property is measured at fair value at each reporting date with changes in fair value recognised in profit or loss, in accordance with FRS 102:16.

Valuation report

Obtain a copy of the valuation report. The auditor should consider whether any events have occurred since the date of the last valuation that are likely to affect the value of revalued assets and hence whether any adjustment is required.

Perform a sense check on the valuation report and agree, where possible, the inputs used. The **expert work programme** will need to be used to ensure sufficient appropriate audit work has been performed over the valuation. ~~Guidance on this can be found in Other common planning issues.~~

Where the valuation has been performed by a third party, consider:

- the qualifications of the valuer in terms of their ability to value the property and also whether the qualifications are disclosed correctly;
- whether the valuer is independent of the client;
- the scope of the valuation – in particular, whether any assets were excluded;
- which items have been included in the scope of the valuation;
- whether the valuer was given all relevant facts;
- whether the disclosures are adequate;
- whether the valuer has given permission for the valuation to be included within the financial statements of the entity; and
- whether the valuation is reasonable, compared to the auditor's knowledge of the client, the premises and the locality (for property).

If the valuation has been carried out internally by management's expert, the following procedures should be applied as per ISA (UK) 500:8 (Updated May 2022) *Audit Evidence*:

- evaluate the valuer's competence, capabilities and objectivity. This would include considering the possibility that the client would want to manipulate asset values by artificially inflating (more likely) or reducing the valuation;
- obtain an understanding of the work of that expert – this might include considering:

(a) whether that expert's field has areas of specialty within it that are relevant to the audit;

(b) whether any professional or other standards, and regulatory or legal requirements apply;

(c) what assumptions and methods are used by the expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes; and

(d) the nature of internal and external data or information the expert uses.

- evaluate the appropriateness of the expert's work as audit evidence – this might include:

(a) the relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence and whether they have been appropriately reflected in the financial statements;

(b) if that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

(c) if that expert's work involves significant use of source data, the relevance, completeness and accuracy of that source data.

The auditor may also need to compare the client's valuation with other evidence (e.g. in the case of property, prices of similar properties in the local area), if available.

Investment property rented to another group entity

The auditor should ensure the relevant audit procedures relating to fixed assets have been performed where investment property is rented to another group entity and the cost model in accordance with Section 17 has been applied.

Deferred taxation

The auditor should also ensure that appropriate provision is made for deferred tax in relation to fair value gains and losses.

Investment property held at cost less accumulated depreciation and impairment

Guidance on investment property held at cost less accumulated depreciation and impairment is in the Fixed asset section.

Ownership

Example tests

The following tests are used in the ~~Navigate~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Confirm that assets are still owned by the entity.	E

Substantive analytical procedures

It is unlikely that substantive analytical procedures will be relevant to testing for ownership.

Tests of detail

Specific confirmation should be sought that the property is held in the name of the entity. The fact that the bank may hold a charge over a property against the entity's borrowings does not prove conclusively that the property is in the name of the entity rather than, say, in the name of one of the directors.

Since the tests on property are relatively quick and easy to do, and since property usually forms a very material part of the balance sheet, testing ownership by searching on the Land Registry database should be performed annually. For companies (such as property investment companies) with large numbers of properties, consideration should be given to using sampling or testing properties on a rotational basis. A management representation should also be obtained if all properties are not checked each year.

Search the Land Registry website for proof of title, ensuring that:

- the client's name is shown on the title;
- the description agrees with that shown in the accounts (a title map can also be requested from Land Registry at a small additional cost); and
- there are no restrictions on dealing or use of the land which have been broken.

Some older properties may not yet appear on the Land Registry electronic database, especially if they have not changed hands in recent years. This is because the Land Registry is still in the process of adding such properties to the database. Should a search of the Land Registry database draw a blank, then some negative assurance that the client has not sold the property can still be gained, as a recent sale would be included on the database.

However, care must be taken to ensure that the correct search details have been used and that the reason for an unsuccessful search is not the use of incorrect information.

For mortgaged property, third-party confirmation of any legal charges over the property should be sought from the lender (usually the bank) and Companies House, where the register of mortgages and charges may be searched for a nominal fee.

For leasehold property, the auditor should review the lease and consider whether any property has been mortgaged. The auditor should then ensure that the property in the lease and the mortgage are the same and that any necessary permission has been obtained from the landlord. The auditor should also ensure that the lease is in the name of the entity.

Estimates

Design and perform appropriate tests for estimates using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an audit work paper for auditing estimates *available in the templates.*

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements. This includes the Companies Act requirement to provide the comparable historical cost value (or difference between the fair value and the historic cost).

3.11 Investments in group and associated undertakings andother investments

Quick Overview

This section explains how to audit investment in group and associated undertakings, as well as other investments, and provides example audit objectives for the section. In addition, it covers the type of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.

This section relates to Section G in the *~~Navigate~~ Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Investments

The materiality of investments in the balance sheet will depend on the nature of the company and its activities, e.g. whether it is a parent company or fixed asset investment company. Listed investments are often managed by third party stockbrokers or investment managers. These managers can produce evidence as to the existence, valuation and ownership of the investments, although it is important to consider whether the third party is a service organisation and if so whether ISA (UK) 402:9 (Updated May 2022) *Audit considerations relating to an entity using a service organisation* applies – see Service organisations for further guidance.

Fixed asset investments

Non-current or fixed asset investments are those investments that are held for the medium or long term. This may well include investments in group or associated companies.

Section 9 of FRS 102 permits investments in subsidiaries, associates and joint ventures to be held at cost, fair value through other comprehensive income, or fair value through profit or loss. This is an accounting policy choice by class of investment (e.g. investments in subsidiaries may be held at cost but investments in associates at fair value through profit or loss (FVTPL)).

Any other type of investment in shares falls into the scope of Sections 11 and 12 of FRS 102. The default for subsequent measurement of investments in non-derivative financial instruments that are equity of the issuer (e.g. most ordinary shares and certain preference shares) in the scope of Section 11 is at FVTPL. If fair value is not available (because the shares in question are not publicly traded and there is no other reliable means of determining their value), then they are measured at cost less impairment. Other types of share investment fall into Section 12 of FRS 102 and must be held at FVTPL with no option to fall back to cost.

Fixed asset investments may rarely include other types of instrument, such as long-term loans, usually to other group companies. These may be classed as fixed asset investments if, for instance, the loan has a long contractual term and annual payment is interest only (in other words, the loan essentially forms part of the company's investment in the other group company). Such loans fall within the scope of Sections 11 and 12 and are likely to be accounted for at amortised cost under Section 11, unless they fail the 'basic' criteria set out therein.

Current asset investments

Current asset investments are relatively uncommon and tend to include those investments that are a temporary investment of surplus funds, but which do not meet the definition of 'cash equivalents'. Examples could include loans receivable which do not meet the definition of trade receivables (debtors) or marketable shares or securities. The accounting treatment will be determined by the typeof instrument; short term loans receivable will typically be measured at amortised cost unless they fail to meet the 'basic' definition in Section 11 of FRS 102, in which case they would be measured at FVTPL.Short-term investments will generally need to be measured at fair value through profit or loss.

Current asset investments may contain items that were previously included as fixed asset investments and whichthe company is proposing to sell within the next accounting period.

Auditing fair values is considered in Financial instruments section.

Further guidance on the accounting requirements for investments in group undertakings under the applicable standards can be found in *Navigate UK GAAP Accounting*.

• Private Company (FRS 102) – Investments in associates (Section 14), Investments in joint ventures (Section 15);

• Private Company (FRS 102) – Financial instruments (Sections 11, 12 and 22); and

• Micro Entity (FRS 105) – Subsidiaries, associates, jointly controlled entities, intermediate payment arrangements and investments in joint ventures (Section 7 & 11).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives in respect of the audit of investments in group undertakings and other investments are as follows.

Financial statement area	Objective	Assertion	Audit procedures
Investments in associates/joint ventures, Other investments	To ensure that investments exist, the value is accurate	E, A, Classification	Additions

	and are appropriately classified.		
Investments in associates/joint ventures, Other investments, Loans to group undertakings	For investments held at cost less impairment, ensure the amount recognised is accurate.	V	Investment held at cost less impairment
Investments in associates/joint ventures, Other investments, Loans to group undertakings	For investments listed a fair value, ensure the value is accurate.	V	Investments carried at fair value
Investments in associates/joint ventures, Other investments, Loans to group undertakings	To ensure that intercompany balances exists and are recognised at the correct value.	E, A, V	Intercompany balance
Investments in associates/joint ventures, Other investments, Profit/loss on disposal	To ensure that any profits or losses on disposal are correctly accounted for.	C, E, A	Disposals
Investment income, Dividends/distributions from investee	To ensure that investment income exists and is accounted for appropriately.	C, E, A	Investment income
Investments in associates/joint ventures, Other investments, Loans to group undertakings, Dividends/distributions from investee, Profit/loss on disposal	To ensure that all accounting estimates recognised or disclosed in the accounts are reasonable in the context of the applicable accounting framework.	V	Estimates
Investments in associates/joint ventures, Other investments, Loans to group undertakings, Dividends/distributions from investee, Profit/loss on disposal	To ensure the investments are appropriately presented and disclosed.	Presentation	Presentation and disclosure

In the *~~Navigate~~ Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity.

For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity.

The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy

Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation

Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions

Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Loans to group undertakings		X	X	X	X	Presentation
Investments in associates/joint ventures		X	X	X	X	Classification, Presentation
Other investments		X	X	X	X	Presentation
Dividends/distributions from investee		X	X	X		Presentation
Profit/loss on disposal		X	X	X		Presentation

Controls

The following are controls that are relevant to investments and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on sample sizes when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls .

Control in place	How to test
The maintenance of a register of investments is regularly updated, reviewed and reconciled to the nominal ledger.	Inspect the register of investments for evidence of maintenance and review. Reperform the reconciliation to the nominal ledger.
Management receive confirmation of investments held by third parties on a regular basis and reconcile the confirmation to a register of investments.	Inspect a sample of confirmations received from third parties and reperform the reconciliation to the register of investments.
Separate investment custodians and investment managers are used and there is regular reconciliation of the reports received from each.	Enquire with management as to whether there are separate investment custodians and investment managers. Inspect a sample of reconciliation of reports.
Acquisition or disposal of an investment is authorised by a senior officer.	Select a sample of acquisitions/disposals and review evidence of authorisation.
There is review by a senior officer of investment certificates on delivery.	Enquire with management as to the review procedures and inspect investment certificates for evidence of review.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

In each section are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not investments in group and associates are fairly stated.

Additions

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Examine board minutes for evidence of additions or disposals of investments during the period.	C, E
Vouch all additions to supporting documentation (i.e. share certificates or third-party confirmation) and:	

• agree the details of investment to the client’s records;	A
• confirm it has been correctly recorded and classified.	Classification
Verify that the client is clearly shown as the beneficial owner.	E

Substantive analytical procedures

Analytical procedures do not play a significant role in auditing additions to investments.

Tests of detail

Examine board minutes for evidence of additions during the period.

The auditor should test additions by:

(a) reviewing contract notes or purchase agreements; and

(b) ensuring that the transaction was authorised, where appropriate.

The auditor should inspect documents of title where these are held by the client, or obtain confirmation from third parties that they are holding such documents on the client’s behalf. Inparticular, the auditor should ensure that:

- details of the investment agree with the client’s records and that the client is clearly shown as the beneficial owner;
- the client has both a signed blank transfer form and a declaration of trust in its favour where the shares areheld by a nominee;
- any scrip issues, rights issues or conversions have been correctly accounted for and are reflected in the sharecertificates. Details about listed investments may be obtained from *Bloomberg* or other similar publications; and
- details have been obtained of any investments that have been pledged as security via discussions with themanagement, review of the bank letter or similar correspondence.

An alternative method of obtaining comfort on ownership is to examine dividend vouchers received. The auditorshould ensure that the correct number of dividends has been received, as well as matching the details on the dividend vouchers to the share certificates and the client’s records. Companies such as *Bloomberg* give details of all dividends that should have been received.

The auditor should ensure that any holdings are correctly accounted for as joint ventures, associates or subsidiaries, where appropriate.

If long-term loans to other parties are included as investments, the following procedures should be undertaken:

(a) obtain direct confirmation from the borrower;

(b) ensure that any differences between the client’s balance and that confirmed by the borrower are valid reconciling items;

(c) review any loan agreement to confirm rates of interest and repayment terms;

(d) obtain confirmation of the loan terms from the directors, if there is no formal agreement in place; and

(e) check details of any security given.

Investment held at cost less impairment

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Agree the opening figures of cost with last year’s financial statements.	V
For assets valued at cost, consider whether there are any indicators of impairment which might adversely affect the value of the assets and ensure that these have been dealt with in accordance with applicable accounting standards.	V

Substantive analytical procedures

It is unlikely that substantive analytical procedures will be relevant to this area.

Tests of detail

The auditor should consider the recoverability of items not held at fair value and assess if adequate provision for impairment and/or collectability has been made.

Where the client has a subsidiary, the auditor should review the valuation by considering whether any of the following conditions exist:

- post-acquisition losses – such future losses could indicate that the value of the investment is decreasing;
- apparently insolvent subsidiaries where provisions may be required, including against loans due to the holding company;
- the holding company’s share of net assets is less than the book value of the investment; and/or
- discuss recoverability with the directors and management. The auditor may wish to obtain specific representations on this issue.

The auditor should ensure that copies of the latest financial statements are obtained and, where these were prepared in the past, that information on the current situation is also obtained so that the carrying value of the investments can be assessed. It is vital that any potential impairment is adequately considered and documented. If a subsidiary has net liabilities, it would be very difficult to justify no impairment. Where net assets are between nil and the carrying value of the investment, then the future growth and profitability of the subsidiary should be considered. The same issues are also relevant when considering intercompany balances.

Investment carried at fair value

Example tests

The following tests are the standard test in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
For listed investments, agree details to independent exchange lists.	V
Verify that gains or losses have been recognised in accordance with applicable accounting standards.	V
For non-listed investments, ensure the latest financial statements are obtained and consider the value of the investment in their light.	V
Where a valuation model is used, evaluate whether the assumptions used by management are reasonable. Verify the accuracy of any data used, perform a recalculation of the model and review relevant information for internal consistency.	V

Substantive analytical procedures

The auditor can compare values of investments with previous periods, taking into consideration general changes in the market conditions during the period, to help provide audit comfort in respect of valuation of the investments.

Tests of detail

Where investments are carried at valuation, the following tests will be appropriate:

- **for listed investments** – agree details to the Stock Exchange Daily Official List or Financial Times (this should also be extended so that the auditor also considers the post-balance sheet valuations);
- **for unlisted investments** – review the methods adopted by the directors to value the investment and considerwhether they are reasonable. The auditor should also review the available accounts (net assets, profitability andlikely going concern problems) and any reports used by the directors in reaching their valuation.

Intercompany balances

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Ensure that all intercompany balances agree to the respective accounts of those companies at the year end.	A

Obtain confirmation where there are any group companies or associated undertakings audited by component auditors outside the firm.	E
Consider the recoverability of amounts owed by group companies and associated undertakings at the reporting date and assess if adequate provision for impairment and/or collectability has been made.	V
Where intercompany loans are at below market rates and are not repayable on demand, have they been discounted to the net present value of future cash flows receivable?	V

Substantive analytical procedures

It is unlikely that substantive analytical procedures will be relevant to this area.

Tests of detail

For loans treated as investments, the following procedures may be applied:

- ensure that repayments of principal and/or interest are being made on time and in accordance with any terms in the loan agreement;
- consider whether the loan is at a market rate of interest and, if not, whether an appropriate market rate has been imputed;
- recalculate the current carrying value of the loan based on the terms of the loan agreement and using the appropriate effective rate of interest;
- ensure that interest is being paid promptly, and in accordance with the terms of the loan;
- consider whether there are any other factors that might cast doubt on the recoverability of the loan; and
- check that the security for the loan is effective (e.g. charges are properly registered with CompaniesHouse) and is adequate to cover the loan.

It is quite common for intra-group loans to be interest free and also repayable after more than one year so that they are not part of current liabilities in the creditor company. A below market rate loan that is not repayable on demand must initially be accounted for at present value discounted at a market rate of interest for a similar debt instrument. If the loan is repayable on demand, it will be accounted at the value of the net proceeds and is treated as current. ~~Further guidance on financing transactions and off-market loans is available in the Private Company section of *Navigate UK GAAP Accounting*.~~

Disposals

Example tests

The following tests are standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**

Examine board minutes for evidence of additions or disposals of investments during the period.	C, E
Vouch disposals to available evidence. Ensure that:	
• sales proceeds have been correctly accounted for;	A
• profit/loss on disposal has been correctly calculated; and	A
• all disposals have been removed from the client’s accounting records.	E

Substantive analytical procedures

It is unlikely that substantive analytical procedures will be relevant to this area.

Tests of detail

The auditor should:

(a) agree details of any disposal to the contract note, correspondence or other documentary evidence;

(b) ensure that the disposal has been properly authorised by reviewing board minutes or other supportingdocumentation;

(c) ensure that disposals to related parties are properly identified and disclosed;

(d) check the calculation of the profit or loss on disposal. If only part of the investment has been sold, the calculation of the unsold balance should also be checked;

(e) ensure that the item sold has been deleted from any register of investments and from the nominal ledger inthe correct period;

(f) consider – where there are doubts regarding the independence of the broker, or where the investment is notlisted – if the selling price is reasonable (e.g. by reviewing the audited accounts or price/earnings ratiosof similar businesses);

(g) consider – where sales are being made within the group – whether realised profits have been generated,particularly if a company is also paying a dividend; and

(h) for loans classified as investments, ensure that substantially all of the risks and rewards of the loan have beentransferred such that derecognition is appropriate.

Investment income

Example tests

The following tests are used in the ~~Navigate~~ *Audit* tools.

Audit procedure	**Assertion being tested**

Confirm that any income received from investees has been accounted for in full.	C, E, A
Compare total income received to expected income calculated using known and verifiable inputs, e.g. interest rates for fixed rate investments.	A

Substantive analytical procedures

The auditor should compare expected income on fixed-rate investments (e.g. loans, debentures, government securities and fixed-rate preference shares) by computing total income expected using the principaloutstanding and the known interest rate.

In somecircumstances ratios can be used to ascertain whether or not the return received on investment is reasonable. The following ratios can be used:

- return on investment: cost;
- return on investment: market value.

Both ratios should be reasonably consistent. The ratios can also be used on fixed asset investment properties togive comfort on completeness of income. However, there are legitimate reasons for these ratios moving. The values of investments on the stock exchange and non-quoted companies can be fairly volatile.

Tests of detail

The auditor should ensure that all related income has been included for a sample of investments. This can be achieved by referring to *Bloomberg* or a similar publication (for listed companies) or the latest financial statements (for unlisted companies).

Estimates

Design and perform appropriate tests for estimates using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In the ~~*Navigate*~~ *Audit* tools, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

The auditor should consider the nature of the assets held and discuss their treatment with management to ensure that investments are properly classified, e.g. as fixed or current assets, and that the treatment is consistent.

It is important to be aware that fixed assets (under the wording of CA 2006) arenot the same as 'non-current' assets under the wording of, for example, IFRS. Non-current assets arethose which are not recoverable within 12 months of the year end. Fixed assets are defined in the Glossary to FRS 102 as those intended for use in the entity's activities on a continuing basis. Current assets are those not intended for use on a continuing basis in the entity's activities. It is not sufficientfor the business to intend to hold the asset for longer than one year to meet the definition of a fixed asset; the key point is to understand the purpose for which it is held. Conversely, it is not always the case that a current asset is due within one year. Justification for the treatment of investments as current or fixed should be documented on the audit file.

If the entity subject to audit has adapted the balance sheet format as permitted by the Accounting Regulations (SI 2008/409 and SI 2008/410 as amended by SI 2015/980), this distinction will no longer be relevant as they willnow split the balance sheet between non-current (due after 12 months) and current (due within 12 months) assets, consistent with IFRS.

3.12 Financial instruments

Quick overview

This section explains how to audit financial instruments, including those measured at amortised cost and fair value. In addition, it covers the types of controls that could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such, this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

Basic financial instruments such as cash, loans and borrowings, debtors, and creditors are dealt with in the relevant sections of *Navigate Audit*.

This section relates to Section Hi in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Financial instruments

This section provides an overview of the audit of financial instruments.

Further guidance on the accounting requirements for financial instruments under the applicable standards can be found in *Navigate UK GAAP Accounting* and *Navigate IFRS Accounting*:

- Private Company (FRS 102) – Financial instruments (Sections 11, 12 & 22);
- Small Company (FRS 102 1A) – Financial instruments (Sections 11, 12 & 22);
- Micro Entity (FRS 105) – Financial instruments (Section 9);
- Financial instruments – overview (IAS 32, IFRS 7, IFRS 9, IAS 39).

A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another.

A financial asset is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity’s own equity instruments and:

(i) under which the entity is or may be obliged to receive a variable number of the entity’s own equity instruments; and

(ii) that will or may be settled other than by exchanging a fixed amount of cash or another financial asset for a fixed number of the entity’s equity instruments.

For this purpose, the entity’s own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity’s own equity instruments.A financial liability is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity’s own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity’s own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for afixed number of the entity’s own equity instruments. For this purpose, the entity’s own equity instruments donot include instruments that are themselves contracts for the future receipt or delivery of the entity’s own equity instruments.

Equity is the residual interest in the entity’s assets after deducting all liabilities.

Typical examples of financial assets and liabilities in a relatively uncomplicated set of financial statements might include:

- cash (part (a) in the asset definition);
- trade debtors (receivables) (part (c)(i) in the asset definition);
- trade creditors (payables) (part (a)(i) in the liability definition);
- bank loans payable (part (a)(i) in the liability definition);
- investments in shares or debt of other companies (part (b) in the asset definition); and
- forward currency contracts (part (c)(ii) in the asset definition, or (a)(ii) in the liability definition).

Where an entity has any financial instruments similar in nature to the characteristics below, the financial instruments work programme in the *Navigate Audit* tools should be completed:

- interest rate swaps;
- currency forwards/swaps;
- purchased/written options;
- commodity contracts;
- collars/caps;

- credit derivatives;
- cash or net share settleable derivatives on own shares;
- derivatives on subsidiaries, associates, and joint ventures;
- embedded derivatives;
- loan commitments held for trading;
- financial guarantees; and
- other investments.

Common assets and liabilities that are not financial instruments include prepayments (which give a right to receive a future service, not to receive cash), tax balances (which are statutory, rather than contractual, obligations), and deferred income (which usually represents an obligation to provide goods or services, ratherthan to repay cash).

Hedge accounting

Section 12 of FRS 102 also addresses the application of hedge accounting. Hedge accounting is optional and many entities may choose not to use it. However, where it is used, it is essential to understand the details of the contracts involved and the effect on the financial statements.

Further guidance in relation to the accounting requirements for hedge accounting under the applicable standards can be found in *Navigate UK GAAP Accounting* and *Navigate IFRS Accounting*:

- Private company (FRS 102) – Hedge accounting (Section 12); and
- IFRS 9 – Hedge accounting.

Alternatives under FRS 102

Under FRS 102:11.2, an entity can choose to apply the recognition and measurement principles of Section 11 and 12 of FRS 102 or IAS 39 or IFRS 9. Although, entities can choose to apply IAS 39 or IFRS 9 recognition and measurement principals, the disclosure requirements are still driven by IFRS 9.

~~Further guidance in relation to differences between FRS 102, IAS 39, and IFRS 9 can be found at *Navigate UK GAAP Accounting* .~~

Practice Note 23 Special Considerations in Auditing Financial Instruments

Further guidance on auditing financial instruments is contained in Practice Note 23 *Special Considerations in Auditing Financial Instruments* (PN 23). The Financial Reporting Council (FRC) issued the current version in July 2013 based on the International Auditing Practice Note (IAPN) 1000 *Special Considerations in Auditing Financial Instruments* supplemented with further UK guidance.

- PN 23 is intended to assist auditors in understanding the nature of, and risks associated with, financial instruments, the different valuation techniques and types of controls that may be used by entities in relation to them and identify the important audit considerations.
- PN 23 was issued prior to the revision of ISA (UK) 540 (Revised December 2018) (Updated May 2022) *Auditing Accounting Estimates and Disclosures*, and references in the Practice Note to that standard should be interpreted accordingly.
- Practice Note 19 (Revised July 2019) contains specific guidance on the application of ISA (UK) 540 to the audit of financial instruments in the audit of banks and building societies.

Relevant sections from PN 23 are included throughout this guide.

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances, and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing financial instruments are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Financial instruments	To ensure the financial instrument exists at the balance sheet date	E	Existence, Rights, and Obligations
Financial instruments	To ensure that the company has rights and obligations of all financial instruments at the balance sheet date.	E	Existence, Rights, and Obligations
Financial instruments	To ensure that financial instruments are appropriately identified, recognised, classified, and measured within the financial statements.	C, A, V, Classification	Recognition and classification, Embedded derivatives, Financial instruments measured at amortised cost, Financial instruments measured at fair value
Impairment	To ensure that any impairment of financial instruments is identified and provided.	A, V	Impairment
Interest income / interest expense	To ensure the effective interest rate adjustments are calculated and accounted for correctly.	A	Financial instruments measured at amortised cost
Hedge accounting	To ensure that hedge accounting has been appropriately applied in accordance with the applicable accounting framework.	E, A, V, Classification, Cut-off	Hedge accounting

Financial instruments	To ensure that all the accounting judgements and key sources of estimates recognised or disclosed in the accounts are reasonable in the context of the applicable accounting framework.	Presentation	Presentation and disclosures, Estimates
Financial instruments	To confirm that all necessary disclosures concerning financial instruments have been made and that the information is appropriately presented and described.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities, and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities, and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity. The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
V – Valuation, accuracy, and allocation	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities, and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

The ~~*Navigate*~~ *Audit* tools illustrate the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (*template* C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Financial instruments	Y	X	X	X	X	Presentation, Classification, Cut-off
Impairment	Y			X	X	Presentation
Interest income/ expenses	Y			X	X	Presentation
Hedge accounting	Y	X	X	X	X	Presentation, Classification, Cut-off

When dealing with simpler entities that apply FRS 102, existence is often the easiest to address. This is because existence testing starts from the accounting records of the entity and by obtaining third-party direct confirmations. Completeness can also be addressed by obtaining third-party confirmation. However, obtaining such direct third-party confirmations can be challenging, and alternative audit procedures may need to be designed in such instances. While performing audits of group companies, there can be intercompany loans payable / receivables from / to group companies; in such instances, getting confirmation from group companies may not be sufficient audit evidence to address the risk of completeness and existence.

For entities with few complex instruments in place, the auditor would be expected to check all or a high proportion of such instruments to underlying contracts but, by definition, this cannot be very time consuming. Obtaining such documentation will also make addressing the assertion of rights and obligations straightforward.

The greatest challenges are likely to be those associated with valuation and allocation.

As noted above, many simpler entities are likely to deal with few counterparties, making it simpler to ensure that balances are complete, e.g., by direct confirmation. However, it is also worth pointing out that completeness, valuation and allocation may be connected under FRS 102. Because FRS 102 divides financial instruments into basic and other instruments, non-basic instruments are usually recognised at fair value through profit or loss; the population of non-basic instruments must be complete. As noted above, this may mean that the auditor is required to review the terms of financial instruments not to determine whether they fall to be recorded at all but to determine the basis on which they fall to be recorded. If, for example, a financial instrument is misclassified between basic and other and therefore valued on an inappropriate basis, this will give rise to an error in the financial statements.

Entities applying the option given under Section 11:2 (b) of FRS 102 to apply the classification and measurement as per IAS 39 will have to classify the financial assets under one of the following categories as per IAS 39:45:

- financial assets at fair value through profit or loss;
- available-for-sale financial assets;
- loans and receivables; and

- held-to-maturity investments.

Under IAS 39:47, the financial liabilities will be classified into the following categories.

- Financial liabilities at fair value through profit or loss
- Other financial liabilities measured at amortised cost using the effective interest method.

Audit planning

PN 23 provides the following list of items on which audit planning for financial instruments should focus:

- understanding the accounting and disclosure requirements;
- understanding the financial instruments to which the entity is exposed and their purpose and risks;
- determining whether specialised skills and knowledge are needed in the audit;
- understanding and evaluating the system of internal control in light of the entity's financial instrument transactions and the information systems that fall within the scope of the audit;
- understanding the nature, role, and activities of the internal audit function;
- understanding management's process for valuing financial instruments, including whether management has used an expert or a service organisation; and
- assessing and responding to the risk of material misstatement. [PN 23, para. 23]

While these considerations always apply, they may need to be considered slightly differently in the first year the entity reports in accordance with FRS 102. In particular, the approach to any instruments that may need to be recorded, which may previously only have been disclosed, will need to change. Similarly, the approach will need to change for instruments carried on a different basis than before, which will usually mean stating at fair value items previously stated at cost or amortised cost.

This may have an impact on other aspects of the audit. For example, it might mean that the approach to materiality will need to change from that which might previously have been applied on the basis that there may be balances that may not previously have appeared in the financial statements.

The issue of understanding the accounting and disclosure requirements becomes an issue of understanding FRS 102. Auditors must be familiar with the relevant requirements.

Understanding the financial instruments to which the entity is exposed, and their purpose and risks, is all about identifying which instruments the entity has and in some cases the uses to which they are put. It will also be important to understand the contractual terms of each instrument. PN 23 notes that the auditor is required to understand the entity's objectives and strategies, which will include understanding those business risks that may result in a risk of material misstatement and the entity's risk assessment process. Nonetheless, it also stresses that it is not the auditor's role to determine what risks an entity should take on or how to monitor and manage risk.

Understanding the business, industry and environment

Financial instruments can be held for various purposes including trading, managing exposure to risk (hedging), and investment. It is important to understand why the client is holding financial instruments and to review contracts and other paperwork relating to financial instruments, as this could affect their accounting treatment, presentation, and disclosure.

The use of experts or specialists also needs to be considered. An expert or specialist may be employed to come up with valuations or required to audit the financial instruments where the instruments used are complex, where various instruments are combined to achieve an overall effect or where the entity is engaged in trading financial instruments. One of the problems is that using the term ‘complex’ in relation to financial instruments can cause problems; what is considered complex tends to depend on who is considering the issue, with a complex instrument for one person being considered straightforward by another.

Also, there are additional disclosure requirements under FRS 102 for entities that fall within the definition of financial institution as per paragraphs 34:19 to 34:33 of FRS 102. ~~The guidance on which entities meet the definition of financial institution can be found at *Navigate UK GAAP accounting*.~~

It is also important to understand management’s basis for valuing financial instruments (where this is required and where an expert has not been used to carry out the valuation). For some of the smaller entities within the scope of FRS 102, management may have little, if any, process for doing this and may rely upon other parties including the counterparty. If this is the case, then it is crucial that the auditor identifies this at an early stage.

As noted in alternatives under FRS 102 above, the entity has a choice for determining the accounting policy for the recognition and measurement of the financial instruments. Hence, it is key to understand the accounting policy choices applied by management before commencing the audit planning as this will impact the risks identified and the audit procedures to be performed, as the classification and measurement principles differ depending upon the accounting policy choice.

An important part of the planning process is assessing the risk of material misstatement, which needs to be undertaken at the assertion level. The auditor needs to consider the entity’s instruments and the whole management process surrounding this and then determine the risk levels that will be used to determine the extent of work undertaken. Such consideration will need to consider any fraud risk factors and the risks of non-fraudulent misstatement.

Risk assessment

PN 23 also stresses (as does ISA (UK) 315) that the risk of material misstatement needs to be reconsidered as the audit progresses and that the assessment at the assertion level may change as additional information is obtained. While this is always relevant, it may be of special importance in the first year in which an entity is complying with FRS 102 since it is more likely on first-time adoption of FRS 102 that an auditor may identify matters that will cause a reassessment of the risks. For example, an auditor may identify that there are financial instruments that had been considered to be basic (hence accounted for under Section 11) but where a review of the terms indicates that they contain a clause that makes them non-basic (hence they should be accounted for under Section 12). This would then be likely to increase the risk associated with financial instruments.

Materiality itself can pose some problems when dealing with financial instruments. Some instruments, and in particular some derivatives, may have quite small values (often nil values) when they are initially entered into and give rise to few early cash flows, but they have the potential to give rise to substantial assets or liabilities. Auditors therefore need to ensure that they do not approach their work simply by reference to the size of the carrying values of the instruments in place. The risk of understatement can apply in many areas of an audit, but the audit of financial instruments is one area where this risk may be greatest. Therefore, qualitative considerations also need to be applied while making the risk assessment.

Valuation gives rise to its own risks. PN 23 provides the following guidance in relation to assessing the risk of material misstatement in relation to valuation:

‘When evaluating whether the valuation techniques used by an entity are appropriate in the circumstances and whether controls over valuation techniques are in place, the factors considered by the auditor may include:

- who developed the valuation techniques and whether design and implementation could have been unduly influenced by traders or others who may not be objective. Where the entity obtains input from traders without independent oversight, the auditor considers whether that input is appropriate in the circumstances;
- whether the valuation techniques are commonly used by other market participants and have been previously demonstrated to provide a reliable estimate of prices obtained from market transactions;
- whether the valuation techniques operate as intended, whether there are no flaws in their design, particularly under extreme conditions, and whether they have been objectively validated. Indicators of flaws include inconsistent movements relative to benchmarks;
- whether the valuation techniques take account of the risks inherent in the financial instrument being valued, including counterparty creditworthiness and own credit risk in the case of valuation techniques used to measure financial liabilities;
- how the valuation techniques are calibrated to the market, including the sensitivity of the valuation techniques to changes in variables;
- whether market variables and assumptions are used consistently and whether new conditions justify a change in the valuation techniques, market variables, or assumptions used;
- whether sensitivity analysis indicates that valuations would change significantly with only small or moderate changes in assumptions;
- the organizational structure, such as the existence of an internal department responsible for developing models to value certain instruments, particularly where level 3 inputs are [1]involved. For example, a model development function that is involved in assisting in pricing deals is less objective than one that is functionally and organizationally segregated from the front office; and
- the competence and objectivity of those responsible for developing and applying the valuation techniques, including management’s relative experience with particular models that may be newly developed. [2]

[1] Level 3 inputs are used in some financial reporting frameworks, such as IFRS, to deal with those valuations where one or more inputs are not based on observable data and therefore, require an assessment by the valuer.

[2] Para. 109, PN 23.’

Note that Level 3 inputs are used in some financial reporting frameworks, such as IFRS, to deal with those valuations where one or more inputs are not based on observable data and, therefore, require an assessment by the valuer. In FRS 102, the equivalent would be unobservable inputs into a valuation model such as an option pricing model (e.g., the Black-Scholes model).

The above PN 23 guidance regarding valuation risk is primarily aimed at larger and more complex entities. For an entity with less complex instruments, the assessment will likely be based more on the auditor’s assessment of management’s understanding of the instruments they use and the competence of the party undertaking the valuation.

As part of risk assessment, auditors should consider performing the sensitivity analysis used in management estimates to pinpoint the significant risks and benchmarking the impairment provisioning, assumptions used in fair valuation, etc., with industry peers. Additionally, by performing preliminary analytical procedures by comparing the current year to the previous year and making inquiries with management, the auditor will understand if there have been changes in any accounting policies, methodologies, assumptions, etc., which need to be factored into the risk assessment.

Financial instrument risks

PN 23 provides a long, although explicitly not exhaustive, list of the risks associated with financial instruments. These can be summarised as:

- **credit (or counterparty) risk** – the risk that one party to a financial instrument will fail to discharge an obligation, often associated with default. It includes settlement risk, which is the risk being the risk that one side of a transaction will be settled without consideration being received from the customer or counterparty;
- **market risk** – the risk that a financial instrument's fair value or future cash flows will fluctuate because of changes in market prices. Examples include currency risk, interest rate risk, commodity and equity price risk;
- **liquidity risk** – this includes the risk of not being able to buy or sell a financial instrument at an appropriate price in a timely manner due to a lack of marketability;
- **operational risk** – relates to the specific processing required for financial instruments. It may increase as the complexity of a financial instrument increases and affects other types of risk. It includes:

(a) the risk that confirmation and reconciliation controls are inadequate, resulting in incomplete or inaccurate recording of financial instruments;

(b) the risk of inappropriate documentation of transactions and insufficient monitoring of these transactions;

(c) the risk that transactions are incorrectly recorded, processed, or risk managed and, therefore, do not reflect the economics of the overall trade;

(d) the risk that undue reliance is placed by staff on the accuracy of valuation techniques without adequate review, and transactions are therefore incorrectly valued, or risk is improperly measured;

(e) the risk that the use of financial instruments is not adequately incorporated into the entity's risk management policies and procedures;

(f) the risk of loss resulting from inadequate or failed internal processes and systems or from external events, including the risk of fraud from both internal and external sources;

(g) the risk that there is inadequate or non-timely maintenance of valuation techniques used to measure financial instruments and

(h) legal risk relates to losses resulting from a legal or regulatory action that invalidates or otherwise precludes performance by the end-user or its counterparty under the contract terms or related netting arrangements. For example, this could arise from insufficient or incorrect documentation for the contract or an inability to enforce a netting arrangement in bankruptcy;

- **model risk** – the risk that imperfections and subjectivity of valuation models used to determine the value of certain financial instruments are not properly understood and accounted for or adjusted for. This includes the risk that undue reliance is placed by staff on information derived from valuation models, which may result in loss of control over market, counterparty, and operational risk.

Professional scepticism

Unsurprisingly, PN 23 also stresses the importance of the application of professional scepticism in the audit of financial instruments to reduce the risks of:

- overlooking unusual circumstances;
- over-generalising when concluding audit observations;
- using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof; and
- not identifying management bias or over-optimism.

In some cases, considerable judgement may be required when valuing financial instruments. Some valuations require assumptions about future events, where there might be considerable scope for different assumptions to be used even by competent and objective persons. Another example might be where there is a balance between one company in a group and another (or with another related party), which contains a financing element but where the terms of the balance are not at arm’s length. In this case, the financial reporting must be based on unobserved assumptions about, for example, the rates at which third-party financing could or would have been obtained. The auditor will need to critically assess of the assumptions that have been applied and whether these are reasonable.

Controls

The following controls are relevant to financial instruments and could enable the auditor to reduce the substantive work required in these areas if working properly. The auditor should identify the existing controls and design tests to ensure that they operate effectively before reducing the level of substantive testing.

It is recommended that the auditor encourages management to prepare a paper on the critical judgement or estimation in relation to the financial instruments. This paper should set out clearly the nature and purpose of the instrument, classification and measurement principles applied, assumptions / methodologies used with how management have developed such assumptions, sensitivities, reconciliation of numbers from underlying workings to the financial statements, disclosures, etc. The preparation and review of such a paper by management can be considered a control that the auditor can test.

Control in place	**How to test**
Calculations and estimates are made by a competent and experienced member of the accounting staff.	Evaluate the level of experience of the relevant client staff and confirm relevant supporting evidence.

	Check the numbers in the spreadsheet tied to the general ledger / journal entry. Understand the threshold used for follow-up on the errors / issues noted. Understand the information used in performing the control and how the accuracy and completeness of such information can be relied upon.
Review of methodology / assumptions used in the valuation of the financial instruments by the director or member of senior management.	Understand the competency authority of the person performing the review. Understand and assess the appropriateness of the challenges the member places on the valuation methodology and assumptions based on the current environment and stand-back assessment. Select a sample of estimates and obtain evidence that they have been subject to appropriate review or authorisation by senior management.
The client undertakes checks on the accuracy of spreadsheet formulae and calculations.	Understand the competency authority of the person performing the checks. Frequency of the control (number of times during the year control is performed). Check the numbers in the spreadsheet tied to the general ledger / journal entry. Understand the threshold used for follow-up on the errors / issues noted. Understand the controls in relation to the spreadsheet - locking of the formulae, users who have access to the spreadsheet, etc. Reperform the checks for the samples. Review the spreadsheet for the accuracy and functionality of formulae and calculations. Obtain evidence that appropriate review and checks have taken place.
The entity has applied appropriate risk management procedures, including determining risk appetite, investment policies, control frameworks and sufficient monitoring procedures.	Evaluate the risk management procedures and processes surrounding financial instruments. Select a sample of estimates to confirm that they have been appropriately applied.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Insights: operational effectiveness of controls

An entity’s controls over financial instruments are more likely to be effective where management and those charged with governance have:

- established an appropriate control environment with active participation by those charged with governance in controlling the use of financial instruments, clear rules, organisational structure, and assignment of roles and responsibilities;
- established a risk management process;
- established information systems to provide those charged with governance with an understanding of the nature of activities involving financial instruments and the associated risks;
- designed and documented a system of internal control to ensure that the use of financial instruments is within the entity’s risk management policies and in accordance with its ‘risk appetite’, ensure compliance with laws and regulations, and monitor risk.

Practice Note 23

PN 23 provides a useful discussion of internal control considerations and how these may differ between entities:

‘An entity may have a control culture generally focused on maintaining high internal control. Because of the complexity of some treasury activities, this culture may not pervade the group of personnel responsible for financial instrument activities. Alternatively, because of the risks associated with some financial instrument activities, management may enforce a stricter control environment than elsewhere within the entity. In entities without a treasury function, dealing in financial instruments may be rare, and management’s knowledge and experience may be limited. Accordingly, the auditor may need to consider in its risk assessment the control environment applicable to those responsible for functions dealing with financial instruments, particularly if the instruments are complex. [PN 23, para. 89-1]’

It then provides further comment in relation to entities with few relevant transactions:

‘In those entities with relatively few financial instrument transactions:

- management and those charged with governance may have only a limited understanding of financial instruments and how they affect the business;
- the entity may only have a few different types of instruments with little or no interaction between them;
- there is unlikely to be a complex control environment (for example, the controls described in the Appendix may not be in place at the entity);
- management may use pricing information from third-party pricing sources to value their instruments and
- controls over pricing information from third-party pricing sources may be less sophisticated. [PN 23, para. 93]’

Larger entities would be expected to introduce segregation of duties, although this may not be practical for many of the smaller entities within the scope of FRS 102.

An appendix to PN 23 provides examples of controls that may exist within an entity with a high volume of financial instrument transactions. While the appropriate specific procedures will differ substantially between entities, the basics of risk management apply in all cases. Even for the smallest of entities, it would be expected that they should:

- determine the amount of financial exposure they are willing to accept, often referred to as the risk appetite;
- set policies for investing in financial instruments and a control framework to deal with them;
- establish policies for documenting and authorising entering into instruments;
- establish policies for processing such transactions;
- establish policies for obtaining valuations; and
- monitor the controls once they have been put in place.

PN 23 notes that the business risk and the risk of material misstatement increase if management and those charged with governance:

(a) do not fully understand the risks of using financial instruments and have insufficient skills and experience to manage those risks;

(b) do not have the expertise to value them appropriately in accordance with the applicable financial reporting framework;

(c) do not have sufficient controls in place over financial instrument activities or

(d) inappropriately hedge risks or speculate. [PN 23, para. 16]

Thus, if management does not fully understand the risks inherent in financial instruments, this can directly affect management's ability to manage the risks appropriately and could even threaten the entity's viability and, therefore, its going concern status.

While this is undoubtedly correct, it is useful to distinguish between the business risks and other risks of material misstatement in financial statements. In some cases, management may understand the financial implications of an instrument without having the expertise to value it.

For example, the company may take out a floating rate loan and simultaneously enter into a simple floating to fixed interest rate swap (with an amortisation schedule based on the expected profile of the loan) to obtain certainty about future cash flows. Management may fully appreciate the financial implications of what they have done irrespective of whether they can place an accounting value on the swap. This does, of course, assume that the instruments progress as originally expected (for example, the loan is not prepaid leaving the swap outstanding), but this is often a reasonable basis for management to assume.

Audit procedures

Detailed below are some individual tests that can be applied to help satisfy the objectives noted in the Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

Auditors need to consider whether they have identified any significant risks in their assessment of the risk of material misstatement. This might apply where, for example:

- there is very high measurement uncertainty in relation to the valuation of instruments, e.g., where there are significant unobservable inputs;
- there is little evidence to support management's valuation, which again may be particularly associated with these instruments where the value reflects one or more unobservable inputs and
- there are indications of a lack of management understanding of the instruments held or a lack of understanding of valuation bases or applicable financial reporting requirements.

If any significant risks are identified, the auditor will need to evaluate:

- how management has considered alternative assumptions or bases or how it has otherwise addressed measurement uncertainty;
- the methodology that has been applied for the valuation of the financial instruments (e.g., impairment model, effective interest rate model, or fair valuation model);
- the assumptions that have been used by management; and
- management's intent to carry out specific courses of action where this is relevant to valuation.

Insights - Practice Note 23

PN 23 sets out some example factors that may make auditing financial instruments particularly challenging:

- it may be difficult for both management and the auditor to understand the nature of financial instruments, what they are used for, and the risks to which the entity is exposed;
- market sentiment and liquidity can change quickly, placing pressure on management to manage their exposures effectively;
- evidence supporting valuations may be difficult to obtain;
- individual payments associated with certain financial instruments may be significant, which may increase the risk of misappropriation of assets;
- the amounts recorded in the financial statements relating to financial instruments may not be significant, but there may be significant risks and exposures associated with these financial instruments and
- a few employees may exert significant influence on the entity's financial instrument transactions, particularly where their compensation arrangements are tied to revenue from financial instruments, and there may be possible undue reliance on these individuals by others within the entity.

These factors may cause risks and relevant facts to be obscured, which may affect the auditor's assessment of the risks of material misstatement, and latent risks can emerge rapidly, especially in adverse market conditions.

Existence, rights and obligations

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Inspect documents of title such as signed contracts or share certificates. Ensure that:	
• details are correctly recorded, including type and amounts;	E
• the instrument is in the company name;	E
• where a third party holds title documents, obtain written confirmation of rights and ownership; and	E
• verify the subsequent to the year-end receipts for the financial assets and subsequent payments for the financial liabilities on a sample basis.	E

Substantive analytical procedures

There isn't often a substantive analytical procedure that can be performed for recognising financial instruments.

Tests of detail

A financial asset or financial liability is recognised only when the entity becomes a party to the instrument's contractual provisions.

Where applicable, the auditor should perform the following test of detail to establish whether the entity is party to the financial instrument:

- Inspect documents of title, such as signed contracts or share certificates. Ensure that:
  (a) details are correctly recorded, including type and amounts;
  (b) the instrument is in the company name; and
  (c) where documents of title are held by a third party, obtain written confirmation of rights and ownership.

Recognition and classification

FRS 102 classifies financial instruments into – 'basic' (dealt with under Section 11) and 'other'(dealt with under Section 12). The 'other' category will include instruments such as foreign exchange forward contracts (an example of a derivative contract) and loans with complicated terms. This classification determines the accounting treatment for the instrument, so the auditor should review thedetails of any financial instruments carefully to ensure that the instrument has been classified appropriately.

Basic financial instruments are defined in the standard as:

- cash;

- debt instruments meeting certain conditions set out in Section 11;
- commitments to receive a loan which cannot be settled net in cash and which, when executed, meet the debt instrument criteria; and
- Investments in non-derivative financial instruments that are equity of the issuer (e.g., most ordinary shares and certain preference shares).

The conditions for debt instruments to qualify as basic are set out in FRS 102:11.9; they are complex and detailed, and failure of any one condition means that the instrument fails to qualify as basic andmust be dealt with under Section 12. However, an override in FRS 102:11.9A allows for a principle-based definition that allows a financial instrument to be classified as basic even if it breaches one or more of the rules in FRS 102:11.9.

‘A debt instrument not meeting the conditions in paragraph 11.9 shall, nevertheless, be considered a basic financial instrument if it gives rise to cash flows on specified dates that constitute repayment of the principal advanced, together with reasonable compensation for the time value of money, credit risk and other basic lending risks and costs (e.g., liquidity risk, administrative costs associated with holding the instrument and lender’s profit margin). Contractual terms that introduce exposure to unrelated risks or volatility (e.g., changes in equity prices or commodity prices) are inconsistent with this.’

Basic financial instruments within the scope of Section 11 are generally measured at cost or amortised cost, less provision for impairment. The exception is for investments in non-derivative financial instruments that are equity of the issuer (e.g., most ordinary shares and certain preference shares), which are measured at fair value through profit or loss (FVTPL) unless a reliable measure of fair value is not available, in which case they are measured at cost less impairment (as discussed in Fixed asset investments).

‘Other’ (non-basic) financial instruments within the scope of Section 12 are measured at FVTPL.

Insight – Entity applying alternatives under FRS 102

Under FRS 102:11.2, entity can choose to apply the recognition and measurement principles of section 11 and 12 of FRS 102 or IAS 39 or IFRS 9. Although, entities can choose to apply IAS 39 or IFRS 9 recognition and measurement principals, the disclosure requirements are still driven by IFRS 9.

Following guidance is relevant for entities applying either IAS 39 or IFRS 9 recognition and measurement principals to the financial instruments.

Under IAS 39, the financial assets are classified into four categories, i.e., financial assets at fair value through profit or loss, Available-for-sale financial assets, Loans and receivables, and Held-to-maturity investments) and the financial liabilities are classified into two categories, i.e., financial liabilities at fair value through profit or loss and other financial liabilities measured at amortised cost using the effective interest method.

Under IFRS 9, the financial assets are classified into three categories, i.e., amortised cost, fair value through other comprehensive income, and fair value through profit or loss. Financial liabilities are classified into three categories, i.e., measured at amortised cost, measured at fair value through profit or loss, and designated at fair value through profit or loss. Additionally, a debt instrument can be measured at amortised cost only if it passes the business model and cash flow characteristics test. ~~Additional guidance can be found at *Navigate IFRS Accounting* .~~

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Review the accounting treatment of all financial instruments and note whether they are classified and recognised in accordance with applicable accounting standards.	Classification
Have financial assets been derecognised in the following circumstances:	
• where the contractual rights to the future cash flows in relation to the instruments expire;	Classification
• where the financial asset has been transferred, and the transfer meets the criteria for derecognition in accordance with applicable accounting standards;	Classification
• the instrument has otherwise been sold or disposed of; and	Classification
• where financial instruments have been transferred or reclassified, consider whether the accounting treatment is appropriate.	Classification

Substantive analytical procedures

There isn’t often a substantive analytical procedure which can be performed for recognising and classifying financial instruments.

Tests of detail

The auditor should perform the following tests of detail:

- review the accounting treatment of all financial instruments and note whether they are classified and recognised in accordance with applicable accounting standards.
- have financial assets been derecognised in the following circumstances:
  (a) where the contractual rights to the future cash flows in relation to the instruments expire;
  (b) where the financial asset has been transferred, and the transfer meets the criteria for derecognition in accordance with applicable accounting standards;
  (c) the instrument has otherwise been sold or disposed of; and
- where financial instruments have been transferred or reclassified, consider whether the accounting treatment is appropriate.

Embedded derivatives

The significance of embedded derivatives in FRS 102 differs from that in IFRS 9. For reference, in IFRS 9, where a contract contains an embedded derivative that is not closely related to the underlying contract, this element must be separated and accounted for as a distinct arrangement, using the same treatment as for stand-alone derivatives. The ‘host contract’ (the arrangement in which the derivative is embedded) is then accounted for as if it, too, existed as a stand-alone arrangement.

An example would be a bank loan at a fixed rate, but where the borrower has the right to extend the term at the same fixed rate for an additional period beyond the loan's maturity date. This is an embedded derivative because – crudely – the value to the borrower of the extension feature varies depending on the interest rates prevailing at the time. So, the extension feature would be pulled out and accounted for separately, while the original loan would be accounted for as if it had identical terms but without the option to extend.

Under FRS 102, there is no requirement to separate a contract that is commercially and legally only one arrangement. Indeed, there is no requirement to identify embedded derivatives, and the term is not even defined in the standard, as it has no direct relevance. Indeed, the example above of a loan with an embedded extension option is cited in FRS 102:11 as an instrument that would normally be classified as basic despite this feature.

However, FRS 102:12.4 notes that the section applies to all contracts that impose risks on the buyer or seller that are not typical of contracts to buy or sell non-financial items. Such contracts may well be determined to contain embedded derivatives if assessed under IFRS 9.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Review relevant contracts entered into by the company to ensure that all contracts with embedded financial instruments are identified.	C, Classification
Where appropriate, confirm that the embedded derivative has been separated from the underlying host contract and accounted for separately.	Classification
Where the value of an embedded derivative that meets the criteria to be separated from the host contract cannot be separately measured, confirm this has been treated correctly in accordance with applicable accounting standards.	Classification

Substantive analytical procedures

There isn't often a substantive analytical procedure that can be performed for embedded derivatives.

Tests of detail

Where applicable, the auditor should perform the following tests of detail:

- review relevant contracts entered into by the company to ensure that all contracts with financial instruments embedded in them are identified;
- where appropriate, confirm that the embedded derivative has been separated from the underlying host contract and accounted for separately; and
- where the value of an embedded derivative that meets the criteria to be separated from the host contract cannot be separately measured, confirm this has been treated correctly in accordance with applicable accounting standards.

Financial instruments measured at amortised cost

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Where a financial instrument is measured at amortised cost, ensure:	
• the criteria for measurement at amortised cost has been met;	Classification
• the amount at which the instrument was initially recognised agrees with supporting evidence;	A, V
• the value of principal repayments agrees to supporting evidence;	A, V
• cumulative amortisation has been appropriately calculated using the effective interest method;	A, V
• interest revenue/expense has been allocated correctly over the relevant contractual period;	Cut-off
• any modifications of contractual cash flows have been recalculated and recognised appropriately;	A, V, Cut-off
• to understand and assess the appropriateness of the effective interest rate model developed by management;	V
• to assess the treatment of fees and charges on the financial instruments and the appropriateness of their inclusion or exclusion in the effective interest rate models;	V
• to challenge the appropriateness of the behavioural life's adoption based on historical information; and	V
• to recalculate the EIR adjustments on a sample basis.	V

Substantive analytical procedures

There isn't often a substantive analytical procedure that can be performed for financial instruments at amortised cost.

Tests of detail

Where relevant, the auditor should perform the following tests of detail:

- Where a financial instrument is measured at amortised cost, ensure:
  - the criteria for measurement at amortised cost has been met;

- the amount at which the instrument was initially recognised agrees with supporting evidence;
- the value of principal repayments agrees to supporting evidence;
- cumulative amortisation has been appropriately calculated using the effective interest method;
- interest revenue/expense has been allocated correctly over the relevant contractual period; and
- any modifications of contractual cash flows have been recalculated and recognised appropriately.

The principle of measuring amortised cost is that an instrument is initially recorded at a prescribed amount, and over its life, the costs associated with that instrument are recognised evenly in profit. This concept of evenness does not mean that a straight-line basis is used; instead, a calculation is performed so that the annual charge or credit gives a constant rate of return on the carrying amount of the debt. Auditors should ensure that the method, calculation, and relevant inputs have been appropriately applied.

When the new financial instrument is issued during the year, recognised at amortised cost, it is necessary to test whether the fees and costs included / excluded within the effective interest calculations are appropriate.

Amortised cost

The amortised cost method is set out in FRS 102:11.15 as follows:

The amortised cost of a financial asset or financial liability at each reporting date is the net of the following amounts:

(a) the amount at which the financial asset or financial liability is measured at initial recognition;

(b) minus any repayments of the principal;

(c) plus, or minus the cumulative amortisation using the effective interest method of any difference between the amount at initial recognition and the maturity amount; and

(d) minus, in the case of a financial asset, any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

The effective interest rate is defined as:

'...the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period, to the carrying amount of the financial asset or financial liability.'

Loans at non-market rates under FRS 102

As per FRS 102:11.14(a)(iii) the debt instrument is a financing transaction, other than the basic financial liability of a small entity that is a loan from a person who is within a director's group of close family members and a public benefit entity concessionary loan, the effective interest rate is the market rate of interest for a similar debt instrument used to determine initial measurement adjusted to amortise directly attributable transaction costs. The intercompany loans which aren't at market rate or zero interest rate and not repayable on demand will have to recognise the difference between the market interest rate and the contractual rate within the financial statements. Therefore, careful consideration needs to be given to the new financing transactions with the related party company, and the auditor should perform the procedures to ensure the interest rate is at the market rate except when the loan is repayable on demand.

Financial instruments measured at fair value

Example tests

The following tests are the standard tests in the ~~Navigate~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Evaluate whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework.	Presentation, Classification
In respect of the fair value measurement of financial instruments, consider whether:	
• Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.	V, Classification
• The valuation method is appropriate given the nature of the asset or liability being valued and the entity's applicable financial reporting framework.	V, Classification
• The valuation method is appropriate for the business, industry, and environment in which the entity operates.	V, Classification
Evaluate whether the entity's method for its fair value measurements is applied consistently.	V, Classification
Determine whether there is a need to use the work of an expert. Use the Auditor's expert work paper.	V
Test on a sample basis for the accuracy and completeness of the inputs to the fair valuation model to underlying source data.	C, A
Perform a stand-back assessment of the appropriateness of the assumptions, model, and input data to evaluate any contradictory evidence.	V

Substantive analytical procedures

It should be noted that analytical review techniques may be of limited use in the transitional year to a new accounting framework. They will also be of limited value where a company makes use of financial instruments only on an occasional basis or for the financial instruments held at fair value through profit or loss as in such instances the balance cannot be predicted based on the prior year information. The fair valuation as of the balance sheet date should be based on the present factors affecting the market value of the financial instrument.

Tests of detail

The auditor should perform the following tests of detail:

- evaluate whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework;
- with respect to the fair value measurement of financial instruments, consider whether:
  - management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method;
  - the valuation method is appropriate in the circumstances given the nature of the asset or liability being valued and the entity's applicable financial reporting framework;
  - the valuation method is appropriate for the business, industry and environment in which the entity operates;
- evaluate whether the entity's method for its fair value measurements is applied consistently; and
- determine whether there is a need to use the work of an expert.

Valuation

The extent of the auditor's work on valuation will be most affected by the level of complexity of the instruments held. Again, PN 23 provides some guidance on the auditor's considerations:

'... the auditor considers the entity's valuation policies and methodology for data and assumptions used in the valuation methodology. In many cases, the applicable financial reporting framework does not prescribe the valuation methodology. When this is the case, matters that may be relevant to the auditor's understanding of how management values financial instruments include, for example:

- whether management has a formal valuation policy and, if so, whether the valuation technique used for a financial instrument is appropriately documented in accordance with that policy;
- which models may give rise to the most significant risk of material misstatement;
- how management considered the complexity of the valuation of the financial instrument when selecting a particular valuation technique;
- whether there is a greater risk of material misstatement because management has internally developed a model to be used to value financial instruments or is departing from a valuation technique commonly used to value the particular financial instrument;
- whether a model used to prepare actuarial information follows the principles in Technical Actuarial Standard M: Modelling;
- whether management made use of a third-party pricing source;
- whether those involved in developing and applying the valuation technique have the appropriate skills and expertise to do so, including whether a management expert has been used; and
- whether there are indicators of management bias in selecting the valuation technique to be used. [PN 23, para. 108]'

The relevance of such considerations will depend upon the size and complexity of the entity. Some entities will need a framework and rely upon a third party for valuations, sometimes the counterparty, and will have few formal procedures for dealing with valuations.

As PN 23 notes, there are three ways in which auditors can test valuation:

- verification of external prices. This can be done directly for quoted instruments and indirectly for market assumptions that are built into models;
- confirming the validity of valuation models; and
- evaluating the overall result for residual uncertainties.

This then gives rise to four main techniques:

- testing management's method for making the estimate, including testing the data used;
- testing the operating effectiveness of controls over the making of the estimate, which will be possible only for larger and more complex entities;
- develop a point estimate or a range to compare with management's estimate; and
- determining whether subsequent events provide audit evidence.

Subsequent events are often of limited use, since some of the more complex instruments can change value quickly and the requirement is that they are stated at their fair value at the reporting date rather than at some date after this.

For entities with few complex instruments, developing point or range estimates as the primary audit technique will often be appropriate.

Fair valuation hierarchy

FRS 102 requires financial instruments to be carried at fair value where that value can be estimated reliably. Paragraph 2A.1 sets out the fair valuation hierarchy.

The existence of published price quotations in an active market is the best audit evidence of fair value as set out in the hierarchy, e.g., share prices quoted on a recognised stock exchange. It will normally be relatively straightforward to determine the fair value of a financial instrument quoted in an active market.

Where this is not the case, the auditor will need to consider in more detail how management will go about valuing the financial instruments and the implications this has in terms of risk assessment and the audit procedures required in response.

IFRS 13 sets out an equivalent fair value hierarchy~~, and further guidance on the differences to UK GAAP can be found in *Navigate IFRS Accounting*~~.

Note that the procedures described in Auditing accounting estimates in relation to accounting estimates also apply to auditing fair values.

Auditing fair values

While ISA (UK) 540 guides auditing fair value measurements and disclosures, audit evidence obtained from other audit procedures may also provide audit evidence relevant to the measurement and disclosure of fair values. For example, inspection procedures to verify the existence of an asset measured at fair value may also provide relevant audit evidence about its valuation, e.g., the physical condition of the underlying collateral.

Because of the wide range of possible fair value measurements, from relatively simple to complex, the auditor's procedures can vary significantly in nature, timing, and extent. However, the following procedures should be applied when auditing fair values and related disclosures.

For items other than those that have a specific market price, management may:

- develop their own models for valuation, including making their own assumptions;
- use a third-party pricing source;
- use commonly accepted models but obtain data from pricing sources;
- use an expert to develop estimates; or
- rely upon the counterparty for valuations, common for smaller entities.

Where management develops its own estimates, this auditor's work will involve consideration of the validity of the models used and the assumptions that have been included. The auditor can either:

- test management's model by considering its appropriateness and making individual assessments of the assumptions and data used, as well as the method's mathematical accuracy; or
- develop a separate estimate and then compare this with that of the entity.

Where the model and assumptions are to be tested, then the auditor needs to consider at least the following:

- whether and how management has incorporated market inputs into its assumptions;
- whether the assumptions are consistent with observable market conditions and the characteristics of the financial asset or financial liability;
- whether the sources for assumptions are relevant and reliable and how management has decided between assumptions where more than one basis could be used; and
- whether sensitivity analyses indicate that valuations would change significantly with only small or moderate changes in assumptions.

In cases where there is little option but for management to make assumptions and where market data will not be directly easily available, the relevant judgements and assumptions will need to be assessed. For example, an intra-group balance clearly contains a financing arrangement but where the terms are not market. In this case, the recording will need to reflect market terms, but some of these are specific to the entities involved. So, for example, management may need to determine an appropriate discount rate that needs to be applied. This might start from market data, such as a proper base rate, but would then need to be adjusted for the risks specific to the entities, usually in the form of a premium above the base rate. In many cases, the intra-group balance may be in place of third-party financing, so there may be no direct evidence of the appropriate premium. Management will need to make a judgement, and the auditor will need to assess that judgement in light of the knowledge of the borrowing entity.

In some cases, for example, where methodologies and assumptions are not made available, the auditor may need to develop a separate estimate as it will not be possible to assess the process.

Where a counterparty is used, the auditor's main issue may be the lack of independence of that party. The auditor will often then need to undertake a separate estimate.

Where third-party sources are used, either for valuation or data, the auditor must consider the quality of data from that source. This will include:

- assessment of the transparency of the third-party process, e.g., whether they make their methodology and assumptions available;
- whether that source is using observable or unobservable data;
- the reputation and experience of the source;
- the objectivity of the source; and
- the relevant controls, covering both those at the entity under audit and the source.

Valuation model

If a valuation model (i.e., level ‘c’ in the Appendix to Section 2 – Fair value measurement) is used, the auditor should evaluate:

(a) whether the assumptions used by management are reasonable, focusing on those that have the most material impact on the outcome of the valuation, including those sensitive to variation or uncertainty in amount or nature and those susceptible to misapplication or bias. The application and evidencing of professional scepticism are important here;

(b) whether an appropriate model was used; and

(c) whether management used relevant, accurate and complete information reasonably available at the time. Specific audit procedures include verifying the source of any data used, mathematical recalculation, and reviewing information for internal consistency.

Management’s intentions

Where management’s intentions with respect to an asset or liability are criteria for determining fair value, the auditor should obtain audit evidence about management’s intent to carry out specific courses of action and consider its ability to do so. These might include:

- considering management’s history of carrying out its stated intentions;
- reviewing written plans, budgets, minutes, etc.;
- considering management’s stated reasons for choosing a particular course of action; and
- considering management’s ability to carry out a particular course of action, given the entity’s economic circumstances and any contractual commitments.

Consideration should also be given to the effect of subsequent events on fair values. For example, a sale of an equity investment shortly after the year end may provide audit evidence relating to the fair value measurement. However, fair value information after the year-end may also reflect events occurring after the year-end rather than the circumstances existing at the balance sheet date, so care needs to be taken here.

The letter of representation should confirm that, in the directors’ opinion, significant assumptions pertaining to fair values are reasonable and that those assumptions reflect their intent and ability to carry out specific courses of action on behalf of the entity. Letters of representation are considered further in Letters of representation.

Valuation techniques in the absence of an active market

FRS 102 *Appendix to Section 2 – Fair value measurement* requires an entity to determine value by way of an estimation technique in the absenceof an active market and where recent transactions of an identical asset are not a reasonable estimate of fair value. A valuation technique's objective is to estimate the transaction price at the date of measurement in an arm's length transaction between knowledgeable and willing persons.

The transaction price that the valuation technique will arrive at must be a reasonable estimate of the instrument's fair value at the measurement date, and it follows, therefore, that the valuation process must reflect how the market could be expected to price the instrument. To achieve this objective, the valuation process should use, as far as is practicable, observable market inputs and rely less on entity-specific inputs. In thebroadest terms, the valuation process should consider all factors market participants would consider in arriving at a price and be consistent with accepted methodologies for pricing financial instruments.

The valuation process is complex, and the starting point for any valuation process is to consider the data the entity has available which may help the process. This data can be adjusted if it indicates that other market participants might use different data. In this respect, the entity does not have to go into huge depth to gather information regarding market participants' assumptions. Still, conversely, the entity cannot ignoretheir assumptions when it is reasonably available.

Examples of valuation techniques include:

- price/earnings models;
- discounted cash flows; and
- option pricing models.

In cases where there is a common valuation technique used by market participants to price the asset, and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions,the audit position is more straightforward where the entity adopts the use of that technique.

Valuations by the issuer

When a company has an interest rate product such as a swap, a valuation by the issuing bank isnot an independent valuation for audit purposes. As the issuer, the bank is not independent of the transaction; it is the counterparty. This could pose difficulties for the auditor if the instrument is complex and it is not possible to confirm the reasonableness of the bank's calculation by reference to relevant interest rates and the capital sum involved. In such circumstances, the auditor may need to consider the appointment of their own expert.

Management appointed valuation experts

Where management appoints an expert to value a financial instrument, the same approach should be taken here as with any other appointed expert. That is, the auditor cannot simply accept the valuation. The auditor needs to consider the matters specified in ISA (UK) 500 such as the qualifications of the expert, the scope of their instructions, and the adequacy of the information provided to them as they would for any other management appointed expert, such as a surveyor or an actuary. For further guidance see Using the work of management's expert.

Auditor's expert

It may be necessary to involve one or more experts or specialists when understanding an entity's use of financial instruments, including understanding the entity's control environment and carrying out the auditor's risk assessment. This may be particularly appropriate where:

- financial instruments are complex;

- relatively simple financial instruments are combined to produce a more complex product; or
- the entity is engaged in the trading of complex financial instruments.

Where an expert is used, then ISA (UK) 500 and ISA (UK) 620 (Revised November 2019) (Updated May 2022) *Using the Work of an Auditor's Expert* deals with the requirements that apply; some are the same as those that apply with the use of a third-party pricing source. The auditor would need to evaluate the expert's competence, capabilities, and objectivity and obtain an understanding of the work undertaken. The auditor would also need to consider the appropriateness of the work as evidence. This might be conducted by the auditor developing estimates independently of the expert with respect to a sample of valuations and making comparisons. Guidance on using the work of an auditor's expert is given in Using the work of an auditor's expert.

Evaluating results

Once valuations have been undertaken or obtained, the auditor must consider the results obtained and determine whether they provide sufficient appropriate audit evidence. Many of the considerations are the same as those that apply in evaluating all other sources of audit evidence. Still, a few issues are of particular relevance to the valuation of financial instruments. There is a need to distinguish between errors and estimation uncertainty – for many instruments, even quite simple ones, there is a range of values that could be determined. The auditor needs to assess whether a valuation difference is simply normal estimation uncertainty, providing audit support, or an error. Even where market data is used, there may be differences, such as the methods used by different parties to construct curves or where an instrument has a small built-in spread when the auditor uses data based on mid-market prices. Auditors also need to be careful in the methods they use to determine the extent of errors.

Materiality is clearly relevant, but it is often useful to concentrate more on the variability measured in a different way, e.g., by looking at any valuation differences on, say, an interest rate swap in terms of basis points rather than absolute amount. In some cases, percentage differences may be very misleading. This is particularly the case with derivative instruments where the underlying amount may be substantial, but the derivative's value is currently very small. In this case, an acceptable valuation difference may be a very high percentage of the instrument's carrying value or there may even be cases where the auditor determines a recorded asset to give rise to a liability or vice versa. This is one reason why the results of valuation work on derivative instruments will rarely be capable of being extrapolated to the whole population from which the sample was taken.

Impairment

Example tests

The following tests are the standard tests in the ~~Navigate~~ *Audit* tools.

Audit procedure	Assertion being tested
Consider whether there is evidence that a financial instrument or group of financial instruments may be impaired.	E, V
Confirm that the tests in the accounting estimates section of this programme have been performed over the estimate of impairment.	E, A, V
Perform the accuracy and completeness check on the data used in impairment calculations by agreeing on relevant information to the underlying documents and	C, A

performing tests from the reciprocal population to verify the completeness. E.g., testing customers' ageing analysis ensures all the customers within the ageing report are included in the impairment assessment.	
Perform the recalculation of impairment provisions.	V
Consider verifying customer correspondence on a sample basis to test the completeness of the impairment provisions, where applicable. This test can help to ensure that the forbearance indicators identified by management are complete and accurate, too.	V
Assess the impairment methodology of the company by Section 11 of FRS 102 or IAS 39 or IFRS 9	V
Perform stand-back assessment of provisioning by comparing the actual losses / write-offs during the year compared to the provisions held at the previous year-end.	V
Challenge the appropriateness of the assumptions used within the impairment model, such as impairment triggers, expected cash flows, expected costs to sell, etc.	V

Substantive analytical procedures

There isn’t often a substantive analytical procedure that can be performed for financial instrument impairments.

Tests of detail

The auditor should perform the following tests of detail:

- consider whether there is any evidence that a financial instrument or group of financial instruments may be impaired; and
- confirm that the tests in the accounting estimates section of this programme have been performed over the estimate of impairment.

Impairments are an important consideration when auditing financial instruments. With many financial assets being carried at cost or amortised cost, financial statements always carry an inherent risk that their values could be overstated, in the sense of being perfectly calculated in accordance with the rules but still over-representing the assets’ true worth.

Some assurance is needed against a situation where carrying values in the financial statements are unrealistically high, and this comes with the concept of impairment, where, in certain situations, an asset’s value will be written down to a lower amount, with a charge in profit or loss.

Auditors should note that the measurement requirements for an impairment loss (once a loss event has been identified) depend on whether the impaired asset is measured at amortised cost or cost.

Where an asset is already measured at fair value, there is no need for separate impairment rules because any fall in value is already accounted for in profit or loss.

Amortised cost

For assets at amortised cost, such as trade receivables and loans receivable, FRS 102:11.25(a) states that:

‘... the impairment loss is the difference between the asset’s carrying amount and the present value of estimated cash flows discounted at the asset's original effective interest rate. If such a financial instrument has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.'

Cost

For assets held at cost, such as investments in ordinary shares that are not publicly traded and whose fair value cannot be reliably measured, FRS 102:11.25(b) applies, requiring that:

'the impairment loss is the difference between the asset's carrying amount and the best estimate (which will necessarily be an approximation) of the amount (which might be zero) the entity would receive for the asset if it were sold at the reporting date.'

Insights: Impairments

When reviewing evidence that a financial instrument or group of financial instruments may be impaired, the auditor should consider:

(a) significant financial difficulty of the issuer or obligor;

(b) a breach of contract, such as a default or delinquency in interest or principal payments;

(c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;

(d) it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

(e) the disappearance of an active market for that financial asset because of financial difficulties; or and

(f) observable data indicates a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets. However, the decrease has yet to be identified with the individual financial assets in the group.

Hedge accounting

Auditors should be mindful that hedge accounting varies depending on the nature of:

- the hedged item (that is, the item giving rise to the risk in the first place);
- the hedging instrument (the instrument being used to manage the risk, usually through cash flows or fair value movements in opposite directions to the original instrument); and
- the risk that is being hedged.

The audit approach and testing undertaken should be based on the circumstances and purposes of the hedge and the risk it addresses.

Example tests

The **Hedge Accounting (H3)** work programme in the ~~*Navigate*~~ *Audit* tools can be completed where hedge accounting has been applied. The following are the standard testing areas in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Recognition	Classification, A, V
Fair value hedge	Classification, E, A, V, Cut-off
Cash flow hedge	Classification, E, A, V, Cut-off
Hedge of a net investment in a foreign operation	Classification, E, A, V, Cut-off
Derecognition	Classification

Substantive analytical procedures

There isn't often a substantive analytical procedure that can be performed for hedge accounting.

Tests of detail

Where applicable, the auditor should perform the following tests of detail.

Recognition

- Review the accounting treatment of all financial instruments designated as hedging instruments and confirm they are correctly treated in accordance with applicable accounting standards.
- Confirm that each hedging relationship satisfies the hedge accounting criteria in accordance with applicable accounting standards. In particular:
  - the hedging relationship consists only of a hedging instrument and a hedged item;
  - the hedging relationship is consistent with the entity's risk management objectives for undertaking hedges;
  - there is an economic relationship between the hedged item and the hedging instrument;
  - the entity has documented the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified; and
  - the entity has determined and documented causes of hedge ineffectiveness.

Fair value hedge

- Where a fair value hedge has been applied:
  - ensure it is appropriate under the financial reporting framework;
  - ensure that cumulative changes in the fair value of the hedged item are appropriately recognised as an asset or liability in the statement of financial position and adjusted against the carrying amount of the hedged item;
  - ensure that the corresponding gain or loss in the hedged item is recognised through profit or loss; and
  - ensure that there is no change to the accounting treatment of the hedging instrument itself.

Cash flow hedge

- Where a cash flow hedge has been applied:

  - ensure it is appropriate under the financial reporting framework;
  - ensure that the portion of the gain or loss on the hedging in an instrument that is determined to be an effective hedge is appropriately recognised in other comprehensive income (OCI) in the correct period;
  - ensure that any ineffectiveness in the hedging instrument is appropriately recognised in profit or loss in the correct period; and
  - ensure there is no change to the accounting treatment of the hedged item.

Hedge of a net investment in a foreign operation

- Where a hedge of a net investment in a foreign operation has been applied:
  - ensure it is appropriate under the financial reporting framework;
  - ensure that the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is appropriately recognised in other comprehensive income (OCI) in the correct period;
  - ensure that any ineffectiveness in the hedging instrument is appropriately recognised in profit or loss in the correct period; and
  - ensure there is no change to the accounting treatment of the hedged item.

Derecognition

- Was hedge accounting discontinued prospectively where any of the following occurred?
  - an election to discontinue hedge accounting is documented;
  - the hedging instrument has expired, is sold, terminated, or exercised; or
  - the conditions for hedge accounting in the relevant standards are no longer met.

Estimates

Design and perform appropriate tests for estimates, e.g., impairment, effective interest rate accounting, and fair value estimates. Use the **estimates work paper** *available in the templates* for each estimate identified as material or contains a risk of material misstatement.

The ~~*Navigate*~~ *Audit* tools have an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

The disclosures required around financial instruments are comprehensive and detailed. As with all account balances, the auditor needs to ensure sufficient evidence on the file to support the disclosures made in the financial statements.

Most financial reporting frameworks require disclosures in the financial statements to enable users to make meaningful assessments of the entity's activities involving the use of financial instruments. These will generally include:

(a) quantitative disclosures regarding amounts recognised in the financial statements as assets, liabilities, or transactions;

(b) quantitative disclosures about significant judgements made, e.g., sensitivity analysis;

(c) qualitative disclosures about policies, procedures, and controls; and

(d) disclosures regarding exposure to risk and any changes to this, and policies and processes for managing risk.

Fair value disclosures are often significant to users of financial statements due to the complexity of determining many fair value measurements and their materiality to the accounts. Some entities disclose additional voluntary fair value information in the notes to the financial statements. Accordingly, extra care must be taken when checking fair value disclosures to ensure they are complete and accurate. Particular attention should be paid to the level of disclosure where there is a high degree of measurement uncertainty.

~~Croner-i *Interactive Disclosure Checklist* , an automated financial statement~~ *The* disclosure *checklists* ~~tool,~~ address~~es~~ the requirements of FRS 102, UK company law and any other relevant requirements to ensure completeness of disclosure.

Current issues

Businesses continue to recover from the impact of the Covid-19 pandemic. Still, they have been affected by various economic issues such as high costs (particularly energy), high inflation, high-interest rates, and supply chain interruptions.

Unlike IFRS 9, which is an expected credit loss model, under FRS 102 and IAS 39, impairment is recognised on an incurred-based model using historical data. While the impairment model under FRS 102 and IAS 39 does not need to factor the macro-economic events within the impairment model, the auditor needs to be sceptical about the reversal of provisioning in the current economic environment and challenge management's assumptions and judgements in relation to incurred but not reported provisioning as well as the fair value, where applicable.

Related guidance for entities applying IFRS

The following IFRICs relate to financial instrument issues:

- IFRIC 2 Member's shares in Co-operative Entities and Similar Instruments;
- IFRIC 16 Hedges of a Net Investment in a Foreign Operation; and
- IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments.

3.13 Inventory

Quick overview

This section explains how to audit inventory and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas~~ of *Navigate Audit*.~~

This section relates to section I in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Inventory

FRS 102 refers to inventories, whereas 'stock' is the term required by the Companies Act formats and Regulations. The two terms should be regarded as being interchangeable.

FRS 102 defines inventories as assets:

- held for sale in the ordinary course of business;
- in the process of production for such sale; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventory can take a number of different forms, including:

- raw materials and consumables;
- goods for resale in the course of production, i.e. work-in-progress;
- finished goods and goods for resale; and
- consignment inventory and inventory held by third parties.

Under FRS 102, inventory is held at the lower of cost and estimated selling price less costs to complete and sell (morecommonly referred to as net realisable value or NRV). FRS 102 permits the use of the first-in, first-out (FIFO) method and the weighted average cost formula for measuring the cost of inventories. Last in, first out (LIFO) is prohibited.

The audit of inventory can be one of the most difficult areas of the audit. It is certainly one of the easiest figures formanagement to manipulate. By altering their judgment on the valuation of inventory, management can:

- decrease the value of inventory, depressing profit and possibly reducing tax bills; or

- increase the value of inventory, inflating profit and net assets, perhaps in anticipation of a potential sale.

As such, where inventory is material, significant time should be invested in reducing the risk of material misstatement within the financial statements as a result of manipulation of, or an error in, the inventory figures.

Work in progress arising under construction contracts is addressed separately in Construction contracts.

~~Further guidance on the accounting requirements for inventory under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Inventories (Section 13);
- Small Company (FRS 102 1A) – Inventories (Section 13);
- Micro Entity (FRS 105) – Inventories (Section 10).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Auditing standards and guidance

ISA (UK) 501 (Updated May 2022) *Audit Evidence – Specific Considerations for Selected Items* sets outs requirements and provides guidance for the auditor regarding audit evidence in relation to inventory where this is material to the financial statements.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives in respect of the audit of inventory are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Raw materials, Work in progress, Finished goods	To ensure that the entity has good title to inventory and work in progress and that they exist.	E	Attendance at stocktake
Raw materials, Work in progress, Finished goods	To ensure that cut off has been correctly applied.	C, E, A, Cut off	Cut off

Raw materials, Work in progress, Finished goods	To ensure that inventory and work in progress have been valued correctly, consistently and in accordance with applicable legislation and accounting standards.	A, V	Valuation of raw materials, work in progress and finished goods
Inventory impairment	To ensure that adequate provision has been made for all damaged, obsolete or slow moving inventory and work in progress.	V	Impairment
Raw materials, Work in progress, Finished goods	To ensure that inventory held by third parties is appropriately accounted for in accordance with applicable legislation and accounting standards.	C, E, A, V	Inventory held by third parties
Raw materials, Work in progress, Finished goods	To ensure that consignment stock is appropriately accounted for.	C, A, V	Consignment stock
Raw materials, Work in progress, Finished goods, Inventory impairment	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates
Raw materials, Work in progress, Finished goods, Inventory impairment	To confirm that all necessary disclosures concerning inventory and work in progress have been made and that the information is appropriately presented and described.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity. The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy
Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation
Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions
Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Raw materials		X	X	X	X	Cut off, Presentation
Work in progress		X	X	X	X	Cut off, Presentation
Finished goods		X	X	X	X	Cut off, Presentation
Inventory impairment	Y	X	X	X	X	Presentation

Note that inventory is a debit balance in the balance sheet, but a credit balance in the profit and loss account. The testing undertaken on inventory must therefore be for both understatement and overstatement.

Controls

The following are controls that that are relevant to inventory and work in progress and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on sample sizes when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls .

Control in place	How to test
Physical security	
Access to inventory locations is restricted and there is physical security over inventory.	Observe that access to inventory locations is restricted (e.g. entry with key card).
The entity uses surveillance equipment to monitor the physical security of inventory.	Physically verify that there is surveillance equipment in place, that it is in working order and is appropriately located to provide security.
Organisation of inventory	
Inventory is labelled and easily identifiable.	Observe that inventory is clearly labelled and identifiable.
The entity maintains a record of inventory held by or for a third party.	Review the entity's records of inventory held by or held for a third party. For inventory held by a third party, obtain confirmation of the inventory held by the third party to check that the company's records are accurate and complete. Where inventory is held for a third party, ensure that such inventory is readily identifiable.
Accounting records	
Regular inventory counts are performed and inventory records are subsequently updated to reflect the results of the count.	Select a sample of the inventory records to verify they have been counted and any variances have been followed up and appropriately addressed.
Inventory statistics and key ratios are regularly reviewed.	Select a sample of reviews and ensure that inventory has been accurately and appropriately reviewed, with findings communicated to management and action taken if required.
Segregation of duties	
There is a segregation of duties between the warehouse, despatch, production and finance.	Enquire of the relevant staff what their duties are to check that duties are segregated.
There is a segregation of duties between staff carrying out stocktakes and those responsible for subsequent adjustments to inventory records.	Enquire of the relevant staff what their duties are to check that duties are segregated.
Purchases/goods received	
There is a single point of receipt for goods in.	Observe that there is a single point of entry for goods received.

The entity uses pre-numbered goods received notes (GRNs) and stock requisition notes (SRNs). Regular checks for missing numbers are performed.	Select a sample of goods received and stock requisitions and ensure the GRNs and SRNs are sequential.
SRNs are authorised by the department manager.	Select a sample of stock requisitions and ensure there is an authorised SRN for them.
Goods in are matched with sales documentation.	Select a sample of GRNs and ensure they have been matched with purchase invoices and purchase orders.
Sales/goods despatched	
An independent check on whether actual despatches match the despatch notes is made by persons other than those responsible for the inventory. This may be on all despatches or on a sample basis.	Observe independent checks being carried out on a sample of despatches. Ensure that items to be despatched agree to despatch notes.
Goods out are matched with sales documentation.	Select a sample of goods despatched notes (GDNs) and ensure they have been matched sales invoices and sales orders.
Quality control	
Quality control checks are performed on both purchases and finished goods.	Observe quality control checks being carried out on both purchases and finished goods.
Staff costs	
Clock cards or timesheets are authorised by the department manager.	Select a sample of clock cards or timesheets and check for evidence if they were authorised as per company policy.
Damaged and obsolete inventory	
Slow-moving, obsolete or damaged inventory is reported to relevant levels of management and the value of inventory is adjusted accordingly where appropriate.	Select a sample of slow-moving, obsolete or damaged inventory from the inventory listings and check that it has been reported appropriately to management and where appropriate the value of inventory has been adjusted.
The entity maintains an authorised record of scrapped and damaged goods.	Select a sample of expenses relating to scrapped, damaged and obsolete inventory and check that the scrappage or write-down was appropriately authorised.
Stock taking	

Written stocktake instructions are issued to staff involved in counting inventory.	Verify that written instructions were emailed to all relevant staff.
The entity regularly calibrates weighing machines used to measure or weigh inventory.	Review entries in the calibration log to verify that regular calibrations have been performed and any issues followed up appropriately.

Having controls in place which operate effectively prevents the following from occurring:

- incorrect quantity recorded on receipt of goods;
- goods received not recorded;
- items wrongly described;
- items rejected on receipt recorded as received;
- unordered goods accepted;
- goods despatched but not invoiced;
- obsolete inventory not identified;
- inventory is omitted or double counted at the stocktake; and
- theft of inventory.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

In each section are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not inventory and work in progress is fairly stated.

Planning substantive analytical procedures

The following procedures can be applied in respect of analytical review on inventory.

Inventory turnover ratio

The inventory turnover ratio is usually calculated as part of the final review of the financial statements. However, in accordance with ISA (UK) 315, it should also be calculated at the planning stage if the figures are available. Certainly, the ratio should be examined as soon as practicable.

The ratio may be expressed in two ways:

(a) cost of sales/inventory;

(b) (inventory/cost of sales) × 365.

Ratio (a) measures the number of times during the year that inventory flows through the business.

Ratio (b) gives the average number of days taken for the inventory to flow through the business.

On the assumption that a client would like as little money as possible tied up in inventory, any increase in the figure for inventory turnover days is described as ‘worsening’. Similarly, if the inventory turnover ratio decreases, this is also a worsening.

A worsening inventory turnover ratio may indicate that inventory is overstated. However, there are many legitimate reasons why the ratio would ‘worsen’ and it is important for the auditor to ascertain which of these reasons apply. For example, there may be a change in the inventory holding policy. This could be for reasons such as potential future expansion, bulk buying to take advantage of discounts or seasonal factors (especially if the entity has changed year ends).

Conversely, an improving inventory turnover ratio may indicate a potential understatement of inventory. Similarly, there may be legitimate reasons for the improvement, e.g. a concerted effort by the entity to reduce inventory levels to reduce financing costs. Seasonal factors or a change in the year end could also affect the ratio. It is important that the auditor fully corroborates any explanations received.

It may also be useful, if applicable, to split the ratio between the various different types of inventory, such as raw materials, work-in-progress and finished goods.

If allowed by the accounting records, it may be possible to further split the inventory turn ratios into inventory categories. This will allow a very detailed analytical review to be performed – the more disaggregation that can be achieved when conducting analytical review, the more reliable the evidence is.

Inventory analysis

The main form of substantive analytical procedure that will enable a reduction in detailed inventory testing is to examine any significant changes in the value of individual inventory lines or inventory groups. The auditor should ensure that explanations are obtained and corroborated for all significant variances.

The auditor should also follow up any changes in the level of inventory that were expected from discussions with the client at the planning stage.

Where applicable, the auditor should also consider obtaining the inventory turnover ratio for each individual inventory line or group and comparing with previous years.

Seasonal fluctuations

The auditor should also consider the level of inventory held by the client in relation to the cycle of activity within the business.

Example – Seasonal fluctuations

If considering a toy shop, then the year end of the client would be critical when determining what a reasonable level of inventory should be. Inventory levels at the end of November would be expected to be significantly higher than inventory levels at the end of December due to seasonality in Christmas sales.

There are numerous examples of situations where the level of inventory held by the client will vary significantly due to seasonal fluctuations. It is important that the auditor considers whether or not the level of inventory held is reasonable in relation to the cycle of activity.

Expansion and contraction

The auditor should consider the possibility of changes to the client’s business that would result in a change in inventory levels. Expansion of the client’s business usually means an increase in inventory levels, while a contraction of the client’s business usually results in inventory reduction. Obviously, the timing of the planned expansion or downsizing will affect the expected change. The increase or reduction in inventory may not be immediate and may take, for example, 18 months to two years to work through.

Attendance at the stocktake

ISA (UK) 501 (Updated May 2022) *Audit evidence – specific considerations for selected items* notes that, ordinarily, inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the perpetual inventory system.

Where inventory is material, ISA (UK) 501:4 requires the auditor to obtain appropriate evidence by:

- attending a stocktake, unless it is 'impracticable' to do so; and
- performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results (see Year end procedures on the stocktake).

As part of their stocktake attendance procedures, the auditor should:

- evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting (see Review of stocktake instructions);
- observe the performance of management's count procedures; and
- inspect the inventory (see At the stocktake: observing the count) and perform test counts (see At the stocktake: test counting and inspection).

In the ~~*Navigate*~~ *Audit* tools there is a **stocktake work paper** to help ensure the specific requirements are all documented.

Before the stocktake

Risk assessment procedures

The auditor should start by considering their knowledge of the client, inventory and related systems, as this should direct the planned level of work on inventory. Factors to consider when planning stocktake attendance include:

- risks of material misstatement related to inventory;
- reliability of accounting and recording systems and related controls for inventories including, in relation to work in progress, the systems that track location, quantities and stages of completion;
- whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting;
- timing of stocktakes relative to the year-end date and the reliability of records used in any 'roll-forward' of balances;
- whether the entity maintains a perpetual inventory system;
- location of inventories, including inventories on 'consignment', inventories in transit and inventories held at third-party warehouses;
- whether ISA (UK) 600 (Revised November 2019) (Updated May 2022) Special Considerations – Audits of Group Financial Statements (Including the Work of

Component Auditors) may be relevant if other auditors are involved with regard to stocktakes at a remote location;

- physical controls over the inventories and their susceptibility to theft or deterioration;
- objectivity, experience and reliability of the inventory counters and of those monitoring their work;
- degree of fluctuation in levels of inventories;
- nature of the inventories, for example, whether specialist knowledge (e.g. an auditor's expert) is needed to identify the quantity, quality, identity and/or stage of completion of items of inventories; and
- difficulty in carrying out the assessment of quantity and/or stage of completion of items of inventory, for example, whether a significant degree of estimation is involved.

Decide which locations to visit

It may not be practical to attend all the stocktakes if the client has several locations. When deciding which locations to visit, the auditor should consider:

- the relative materiality of inventories held at each location;
- unusual inventory levels, gross margins or operating results at a particular location;
- results of the client's counts in previous years and the current period;
- any internal audit reports; and
- management expectations.

The auditor should aim to cover all locations on a cyclical basis.

Where there are logistical problems in attending a stocktake, the auditor may use the services of the client's internal auditors or a local firm of auditors. In these circumstances, the auditor would have to be satisfied as to the independence and competence of the staff to be used and the scope of work to be performed in accordance with ISA (UK) 610 (Revised June 2013) (Updated May 2022) or ISA (UK) 600 respectively.

Review of stocktake instructions

The auditor needs to review and evaluate the client's stocktaking instructions to ensure that they are likely to lead to an accurate count, including:

(a) use, whenever possible, of independent counters not involved with day-to-day inventory control;

(b) checks to ensure that all items are counted and are correct;

(c) cut-off procedures before and during the counts (and in relation to the year end, if different);

(d) separation of inventories held for customers or third parties, so that these are excluded;

(e) investigation of differences highlighted by the stock counts where the client has a continuous stock-recording system;

(f)identification of obsolete, slow-moving and damaged inventories;

(g) procedures to ensure that the stock records are up to date;

(h) procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;

(i) controls over movements between areas and locations during the count;

(j) a logical layout of the stock to make the count easier;

(k) controls to ensure no double counting of stock held at a single location, such as the marking of items once theyhave been counted on the floor;

(l) controls to ensure no double counting of stock held at different locations (there is a potential problem if counts are held at different locations at different times – stock can be moved from one location to another, andbe counted more than once); and

(m) controls over the issue and completion of stock sheets.

At the stocktake: observing the count

Many of the procedures and controls set out in the stocktake instructions are designed to prevent fraud, a key risk consideration under ISA (UK) 240 (Revised May 2021) (Updated May 2022) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*. The auditor should therefore ensure that the stocktaking procedures as set out by the management are actually followed in practice by attending the count while it is still in progress.

The auditor should also perform following actions:

(a) ensure that non-client inventory is identified and excluded from the count;

(b) consider whether the count is orderly, well controlled and methodical from the outset;

(c) check that inventory sheets issued to counters are adequately controlled;

(d) check that slow-moving, obsolete or damaged inventory is clearly identified;

(e) review cut-off controls to segregate inventory received during the count;

(f) ensure that non-client stock is identified and excluded from the count;

(g) consider checking that any measuring or weighing machine to be used in the count gives accurate results;

(h) obtain details of a sample of selling prices of the stock lines; and

(i) note details and serial numbers of the last goods in and out, together with goods despatched note (GDN) and goods received note (GRN) references. The information is required for cut-off testing, though precisely what theauditor requires will vary from system to system.

The auditor should also consider whether other audit tests for different areas need to be performed at this time (e.g. fixed asset verification and trade debtor and creditor circularisations).

At the stocktake: test counting and inspection

Where the client counts most or all of the stock at one time, the auditor must attend the stocktake in order to obtain adequate evidence of existence (assuming the stock figure is material).

Inspecting the stock when attending the physical stocktake assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership) and in identifying, for example, obsolete, damaged or ageing inventory.

As well as observing management's count procedures, the auditor must carry out test counts in both directions as follows:

(a) from the stock sheets to the physical stock, verifying the existence and quantity (that is, test for overstatement); and

(b) from the physical stock to the count records to ensure that all items are correctly included (that is, test forunderstatement).

The auditor should review any errors found and determine the potential for further errors and quantify theeffect of any such errors.

The auditor should obtain the stock sheets at the end of the count to ensure that records have not been manipulated, suppressed, added to or substituted after the count. If it is not practical to keep a full copy of the stock sheets, the auditor should extract details for a sample of items that can be checked later.

Sample sizes at the stocktake

The auditor should estimate risk, materiality and the stock value to arrive at a sample size in accordance with the firm's usual procedures.

Note that the full sample size should then be used for testing from sheet to floor, and vice versa, as these are two separate tests. The sample size should not be split in two, with one half tested from floor to sheet and the other half from sheet to floor.

Work in progress

The auditor should ensure that the nature and stage of completion of work in progress is consistent with the records. Where work in progress consists of a small number of high value items or projects, it may be worth the auditor taking photographs of the actual state of completion when attending the stocktake. The auditor should ensure that any important or contentious issues are included in the letterof representation.

A third-party expert stocktaker should be used where the auditor does not have the necessary expertise inrelation to the stock to be counted. In such cases, the auditor would have to consider the competence andreliability of the expert's work in accordance with ISA (UK) 620 (Revised November 2019) (Updated May 2022) *Using the work of an auditor's expert*, which is considered in more detail in Using the work of an auditor's expert.

Confirmation of title

Stock held at a client's premises is often the property of that client, but this is not always the case. Ensure confirmation is obtained as to ownership. Possible risk areas include:

(a) stock purchased by the client may be subject to a Romalpa (reservation of title) clause that may need to be disclosed (but this does not affect the treatment of the stock as being effectively owned (FRS 102:23.13));

(b) the client may hold stock on behalf of third parties;

(c) the stock may represent items returned by customers for repair or upgrade; and

(d) the client may be holding consignment stock – in which case the auditor must ensure that proper consideration has been given to who has the risks and rewards of ownership in accordance with FRS 102:23A.6.

Year end procedures on the stocktake

In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results. The auditor should:

(a) agree the balance on the nominal ledger to the final inventory sheets;

(b) trace all items selected at the stocktake to the final stock sheets, and where appropriate, internal inventory records, ensuring that all items have been included in the final valuation;

(c) select a sample of items from the final inventory sheets and trace to the copies of the counters' inventory sheets taken during the stocktake;

(d) check the arithmetic accuracy of a sample of the final inventory sheets;

(e) review stock sheets and ensure that any amendments are properly authorised and valid. It may be necessary to review any movements by reference to the goods despatched and received records; and

(f) carry out a general examination of the inventory sheets to ensure there are no obvious omissions or unusual items.

Stocktake not at the year end

In some cases, it may be necessary to count inventory before the year end in order to meet a short reporting deadline. If this is the case, the auditor needs to ensure that:

(a) the system will produce a reliable inventory figure at the year end; and

(b) stock movements are tested for the period between the count and the year end. The movements may be audited by analytical procedures or detailed testing of a sample of individual transactions, to ensure that they are valid stock movements.

In other cases, it may be necessary to count stock at a time very close to the year end, but not actually at the year end (e.g. on a day of the week when the premises are closed), or the count may continue over a couple of days. The procedures will be the same in (b) above. Remember, though, that a company's actual year-end day can fluctuate by seven days either side of the accounting reference date specified to the Registrar of Companies. This is common for retail businesses and those who supply retailers.

Perpetual stocktaking

Although the client will not count all the stock at any one time, the auditor should still attend one of the counts, preferably as near as possible to the balance sheet date. The stocktaking instructions should still be reviewed to ensure they are effective as noted above.

Alternatively, the auditor can conduct test counts at the fieldwork stage of the audit, or at the year end, checking a sample of counts from the stock floor to perpetual stock records, and vice versa.

Professional valuation

The auditor should consider whether attending the stocktake is the most effective method of valuing stock, as it can be cheaper and more effective to use an external valuer. If the client does not wish to pay for this service, there is no reason why the auditor should not pay and include the costs within disbursements. This is common practice when conducting audits for clubs, pubs, chemists and newsagents.

However, where a professional valuation has been used it is important that the requirements of ISA (UK) 500 (Updated May 2022) *Audit evidence* are followed (using management's expert). The general requirements are considered in Using the work of management's expert. In applying these principles to the valuation of inventory, the following procedures are followed:

- the auditor should ensure that the valuer is both independent of the entity and competent to undertake the assignment;
- the work of the expert should be understood by the auditor; and
- when the valuation has been undertaken, the auditor should obtain a detailed report from the valuer providing details of:
- how the count was undertaken;
- the method of valuation used;
- cut-off procedures; and
- how obsolete inventory was identified.

The report should incorporate a full list of all individual inventory items. If this is unavailable for any reason, the auditor should consider the impact that this will have on the audit report due to the requirements of either SI 2008/409 or SI 2008/410 to keep full details of all inventories held at the year end and of the *Companies Act* 2006 to maintain adequate accounting records.

The auditor should perform a limited amount of work to confirm that the third party inventory report is adequate for the purposes of the audit, as it will have been prepared principally for management's use. In addition to reviewing the scope, competence and objectivity of the stocktaker, the auditor should also consider attending the stocktake, even if only irregularly. Also, some verification work should be performed on the valuations made by the stocktaker on a sample of inventory lines. At the very least, some analytical procedures should be conducted on the third-party stocktaker's results.

It is important to fully understand the scope of the work of the external 'valuer'. It is sometimes the case that external valuers only count inventory and do not independently value it, relying instead on the purchase cost per the client's systems. In such circumstances, it is vital that the auditor tests the valuation of inventory and does not rely on the external report for this purpose.

Non-attendance at stocktake

Attendance at the stocktake is mandatory under ISA (UK) 501, unless it is impracticable, and then alternative procedures must be performed.

The auditor is required to document on file how the existence of inventory has been confirmed. This objective applies whether or not the auditor attended the stocktake. Where the auditor did not attend the stocktake and inventory is material, it is essential that any alternative procedures to confirm existence are fully documented. For example, it may be that comfort can be gained through performing counts at the time of the audit and reconciling back via post-year end accounting records. Alternatively, analytical procedures may confirm that the inventory figure is not materially misstated. In some cases where attendance is impracticable, alternative audit procedures, e.g. inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical stocktake, may provide sufficient appropriate audit evidence about the existence and condition of the inventory.

If alternative procedures do not provide sufficient appropriate audit evidence, then the auditor must consider whether there has been a limitation on scope requiring modification to the audit report (see Non-attendance at stocktake and Drafting the audit report).

Cut-off

There can be a higher risk of error with cut-off testing, as year-end procedures happen infrequently and could be manipulated. Errors can arise when systems are inconsistent in recording transaction dates. At the period end, this can cause a cut-off issue if a transaction is recognised in the incorrect period. Cut-off tests on inventory should be coordinated with cut-off tests for sales, purchases, debtors and creditors. Tests should ensure that despatches and receipts of goods are recorded in the correct accounting period and that corresponding sales or purchases are also recorded in the same period.

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Select a sample of goods dispatched notes pre and post-year end and ensure they have been recognised for in the correct period.	C, E, Cut off
Select a sample of goods received notes pre and post-year end and ensure they have been recognised for in the correct period.	C, E, Cut off
Where there are goods in transit at the reporting date, verify that these items were genuinely in transit by reviewing goods received notes after the balance sheet date.	C, Cut off

Substantive analytical procedures

Where applicable, the auditor should carry out an analytical review on inventory held at different locations and the inventory levels should be compared – in as much detail as possible – with those of previous years and also reviewed in relation to any management information available for the location.

Insight – Transfers between locations

If a client has a number of different locations and inventory is checked at different times, it may be possible for the client to transfer the inventory from one location to another between the two stocktakes and effectively double-count it. Realistically, this would be very difficult to detect from a substantive inventory counting test. Therefore, the best way of actually identifying this problem is through detailed analytical review.

Tests of detail

The auditor should test cut-off at the year end and at the stocktaking date. The following procedures should be applied:

(a) using the details collected at the stocktake, select items from the goods inwards and goods outwards records either side of the year end, and agree these to the relevant inventory records, and hence to the sales and purchase records; and

(b) where inventory moves between internal departments or locations, ensure that cut-off also operates correctly so that items are neither omitted nor double counted.

Valuation of raw materials, work in progress and finished goods

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Raw materials	
Understand the method used for valuing raw materials and consider whether:	
• it has been correctly applied;	A, V
• it is an acceptable basis of valuation under applicable legislation and accounting standards; and	V
• it is consistent with previous years and with the company’s accounting policy.	V
Check that the unit costs recorded on the inventory sheets are accurate and appropriate.	V
Test check items of raw materials from the year-end inventory sheets to sales invoices after the balance sheet date to ensure those items are being sold in excess of cost, taking into account costs to complete and sell.	V
Work in progress	
Understand the method used for valuing work in progress and consider whether:	
• it has been correctly applied;	A, V
• it is an acceptable basis of valuation under applicable legislation and accounting standards; and	V
• it is consistent with previous years and with the company’s accounting policy.	V
Review work in progress and ensure that:	
• the material costs have been correctly recorded;	A, V
• the allocation of labour costs has been applied correctly, consistently and is reasonable; and	A, V
• the allocation of overheads has been applied correctly, consistently and is reasonable.	A, V

Test check items of work in progress from the year-end inventory sheets to sales invoices after the balance sheet date to ensure those items are being sold in excess of cost, taking into account costs to complete and sell. V

Finished goods

Understand the method used for valuing finished goods and consider whether:

- it has been correctly applied; A, V
- it is an acceptable basis of valuation under applicable legislation and accounting standards; and V
- it is consistent with previous years and with the company's accounting policy. V

Review finished goods and ensure that:

- the material costs have been correctly recorded; A, V
- the allocation of labour costs has been applied correctly, consistently and is reasonable; and A, V
- the allocation of overheads has been applied correctly, consistently and is reasonable. A, V

Test check items of finished goods from the year-end inventory sheets to sales invoices after the balance sheet date to ensure those items are being sold in excess of cost. V

Substantive analytical procedures

The audit of production work in progress is a very difficult and judgemental area. Analytical procedures can provide an effective tool for assessing the reasonableness of specific judgements and also of the overall work in progress figure. The components of work in progress should be examined in as much detail as possible.

Tests of detail

Method of valuation

The auditor should review the methods of valuing raw materials, work in progress and finished goods and ensure that they have been consistently applied and are in accordance with the applicable accounting standard and the entity's accounting policies. The following matters should be considered:

- inclusion of import duties, transport and handling costs in the inventory valuation;

- inclusion of direct labour, direct expenses and an appropriate proportion of production and other overheads in a manufacturing company in the inventory valuation; and
- exclusion of selling and distribution overheads and inter-branch profits from the inventory valuation.

Guidance on valuing inventory is available in *Navigate UK GAAP Accounting*.

Costs

The auditor should check, on a sample basis, that the unit costs of raw materials and costs recorded for work in progress and finished goods on the inventory sheets are accurate and appropriate by reviewing such supporting evidence as:

- suppliers' invoices (if inventory is valued on the 'first in first out' basis): the auditor should ensure that sufficient invoices have been examined to cover the amounts in inventory;
- labour costs (timesheets, clock cards, etc.);
- overhead allocation calculations; and
- standard costing calculations (review for reasonableness by reviewing variance analysis).

The auditor should check the arithmetic accuracy of the final costing calculations.

When performing this testing, an alternative approach to selecting a sample of inventory lines from the final inventory listings is to extract a sample of purchase invoices from the period it takes inventory to turn over (say, the two months before the year end) and to check that the appropriate cost is recorded on the inventory sheet. Performing this test from the purchase invoice still satisfies the objective of ensuring that inventory is valued correctly.

Example – Manufacturing companies: finished goods and work in progress

The precise work involved for finished goods and work in progress will depend on the client's system for recording costs. However, the stage of completion of the inventory should be considered at the stocktake.

If a standard costing approach is used, the auditor should select a sample of standard costs and verify its make-up. This could be done with reference to changes from the previous year on items such as labour rates. The auditor should be aware of any technological advances which should lead to labour-time efficiencies.

The issue of net realisable value should be considered. The auditor should ensure that costs to completion are taken into account when arriving at net realisable value. These could be taken from the standard costing cards.

Where the production time is short, the amount of work in progress may not be material and it may be sufficient to undertake some limited analytical procedures.

Impairment

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain details of the basis for making provisions and determine if it is both adequate and consistent. Compare last year's provision against actual results.	V
Where the client determines the provision on the basis of a formula or other estimation basis, design and perform appropriate tests for those estimates using the **estimates work paper** *available in the templates*.	V
Review the inventory count sheets and ensure that adequate provision has been made for any items identified as damaged, slow moving or obsolete.	V
Select a sample of inventory and compare costs to the selling price less expenditure necessary for realisation.	V
Review the inventory ageing report and select a sample of aged inventory to determine whether any provision is necessary. Verify the accuracy of the ageing report.	V
Where a provision is made on a finished product, consider whether any provision should be made against work in progress and raw materials used in the process.	V

Substantive analytical procedures

Reasonableness of provisions

Analytical procedures are useful in assessing the reasonableness of inventory provisions. If there have been increases in the level of inventory held without an adequate explanation and there has been a worsening of the inventory turnover ratios, then this could, potentially, lead the auditor to conclude that an increase in the level of inventory provision is required. When considering this issue, the auditor may be able to review the inventory records (including details such as inventory ageing) to determine the last time that a particular inventory line was sold and bought.

Unless the stockholdings have changed significantly, or there have been other changes to inventory, the level of the inventory provisions should be relatively consistent over time. While the main risk is usually understatement of inventory provisions, in the case of profitable clients, the main risk is that inventory provisions are overstated to reduce the tax burden. In some cases, therefore, it is important to critically evaluate whether any inventory provision is necessary. This may best be done through analytical procedures, assessing the provision for reasonableness compared with previous years and the auditor's knowledge of the client (including any changes to the business).

Provision calculations

The auditor may also be able to conduct analytical procedures on the client's inventory provision calculations. A key point with inventory provisions is consistency; any changes to the level of inventory provisions need to be properly justified. The auditor also needs to consider whether the method of arriving at the level of provision is appropriate, particularly where a fixed percentage is applied. Developing a point estimate may also be useful if a 'proof in total' style analytical review test can be used.

Tests of detail

Confirming that inventories are valued at the lower of cost and estimated selling price less costs to sell can usually be achieved by further testing of the sample used to check unit costs in raw materials, work in progress and finished goods.

FRS 102 requires the auditor to consider the net realisable value of inventory on an item-by-item basis and so it is not sufficient to look at it globally. The auditor should review individual lines to determine whether any provision is in fact necessary.

When testing for impairment, any related selling costs should also be taken into account along with the selling price at which a unit was sold after the year end. Also consider how many units have been sold at the price. The auditor should consider the following questions when assessing the risk of estimated selling price less costs to sell being less than cost.

(a) If production levels are high and inventory turnover is low, does this indicate that inventory levels are excessive?

(b) Are production levels falling?

(c) Will the introduction of new products make existing products obsolete?

(d) Have any inventory lines been discontinued?

(e) What is the shelf life of goods, particularly perishables and those with expiry dates?

(f) Has all inter-branch or departmental profit been eliminated?

(g) Have the costs of completing items and any selling and distribution costs been considered?

(h) Were any items identified as old, obsolete or slow moving at the stocktake?

(i) Have the contract price, after-date orders and sales and other relevant information been reviewed in relation to work in progress?

(j) Are there any likely changes in technology or market demands?

(k) Are actual inventory levels high compared to expected inventory levels from budgets and previous years?

(l) Are actual inventory levels high in comparison to orders received and anticipated demand?

(m) Do costs or selling prices fluctuate?

Agree sales prices to invoices ensuring any discount given is taken into consideration.

At the time the auditor is undertaking much of the audit work, it is usual for some items that were in inventory at the year end to still be unsold. The auditor should consider not just the sales price, but also how many items have been sold after the year end as a proportion of the quantity in inventory at the year end in order to assess whether there is an issue of slow-moving inventory.

This approach principally makes use of reviewing subsequent events (i.e. post year-end inventory sales and write offs) to test valuation.

Assessing the adequacy of provisions is an area that requires judgement and discussion with the client. The auditor must ensure that sufficient evidence has been noted on file to satisfy the objective that the level of any inventory provision is fairly stated. Auditors need to take care that they have performed the mandatory procedures required by ISA (UK) 540 (Revised December 2018) (Updated May 2022) *Auditing Accounting Estimates and Related Disclosures* as described in Auditing accounting estimates. It is essential that the auditor maintains a high level of professional scepticism when auditing the inventory provision and robustly challenges management's assertions.

Inventory held by third parties

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Establish the reasons why inventory is held by a third party and determine whether this is reasonable in the circumstances.	E
For material inventory held by third parties on behalf of the company, do either one or both of the following:	
• request confirmation from the third party as to the quantities and condition of inventory held and that the client retains title to the goods; or	C, E, A, V
• inspect the inventory and carry out other appropriate procedures such as test counts as per ISA (UK) 501:A16.	C, E, A, V

Substantive analytical procedures

There isn’t often a substantive analytical procedure which can be performed for identifying inventory held by third parties.

Tests of detail

Where a third party holds inventory on behalf of a client, the auditor should:

- establish the reasons why the client’s inventory is held by a third party and determine whether this is reasonable in the circumstances;
- be particularly wary of cases where this is not in the normal course of business or is unusual in the particular industry sector;
- ensure that the client exerts control over such inventory and keeps adequate records; and per ISA (UK) 501:8, must either:

(a) confirm in writing with the third party the quantities and condition of the inventory and that the client retains title to the goods (this should be done even if the records suggest that the third party is holding immaterial amounts of inventory or none at all at the year end); or

(b) perform physical inspection or other alternative audit procedures. (This should obviously be agreed with the client and the third party. Depending on the materiality of the amounts involved, such counts could be performed on a cyclical basis. Other alternative procedures might include obtaining evidence that the client bought the goods and that they were delivered to the third party on condition that title remained with the client (there should be some form of confirmation to this effect, e.g. the delivery address is usually specified on an invoice, which may indicate where such inventory is held).)

Consignment stock

The auditor should consider whether any inventory held on consignment should be included in the client's balance sheet. Consignment inventory is inventory held by one party (the 'dealer') but legally owned by another (usually the 'manufacturer'), on terms that give the dealer the right to sell the inventory in the normal course of its business or, at its option, to return it unsold to the legal owner. Such inventory is commonly seen in new car main dealerships.

Guidance on accounting for consignment stock can be found in *Navigate UK GAAP Accounting*.

Estimates

Design and perform appropriate tests for estimates, e.g. inventory provisions, using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

3.14 Construction contracts

Quick overview

This section explains how to audit construction contracts and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy ~~areas of *Navigate Audit*.~~

This section relates to section I in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Construction contracts

FRS 102 defines a construction contract as a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. FRS 102:23.17 then requires that when the outcome of a construction contract can be estimated reliably, an entity should recognise contract revenue and costs associated with the construction contract as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period. FRS 102 calls this the percentage completion method.

~~Further guidance on the accounting requirements for construction contracts under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Revenue (Section 23);
- Micro Entity (FRS 105) – Revenue (Section 18).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives in respect of the audit of construction contracts are as follows.

Financial statement area	Objective	Assertion	Audit procedures
Construction contract assets, Construction contract revenue, Construction contract expenditure	To ensure that all construction contracts have been identified.	C	Construction contracts
Construction contract assets, Construction contract revenue, Construction contract expenditure	To ensure that construction contracts exist.	E	Construction contracts
Construction contract assets, Construction contract revenue, Construction contract expenditure	To ensure that construction contracts have been valued correctly, consistently and in accordance with applicable legislation and accounting standards.	A, V	Construction contract assets, Construction income, Construction expenditure
Construction contract assets, Construction contract revenue, Construction contract expenditure	To ensure that cut-off has been correctly applied.	C, E, Cut-off	Cut-off
Construction contract assets	To ensure that adequate provision has been made for onerous construction contracts.	C, E, A, V	Provisions and onerous contracts
Construction contract assets, Construction contract revenue, Construction contract expenditure	To ensure that all accounting estimates recognised or disclosed in the accounts are reasonable in the context of the applicable accounting framework.	V	Estimates
Construction contract assets, Construction contract revenue, Construction contract expenditure	To confirm that all necessary disclosures concerning construction contracts have been made and that the information is appropriately presented and described.	Presentation	Presentation and disclosure

In the *~~Navigate~~ Audit* tools, the assertions are defined as follows.

Assertion	Definition
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.

E – Existence

Assets, liabilities and equity interests exist.

The entity holds or controls the rights to assets; and liabilities are the obligations of the entity.

For the income statement, all transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.

The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy

Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation

Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions

Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Construction contract assets	Y	X	X	X	X	Cut off, Presentation
Construction contract revenue	Y	X	X	X	X	Cut off, Presentation
Construction contract expenditure	Y	X	X	X	X	Cut off, Presentation

Controls

The following are controls that are relevant to construction contracts and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on sample sizes when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	How to test
Contract pricing and tenders are independently checked and reviewed and invoices are within the set limit.	Review the process of tender pricing ensuring it has been appropriate reviewed. For a sample of invoices, check that they agree to the tender.
Stocktakes are planned to include construction contracts in progress.	Attend stocktakes to ensure construction contracts are included.
Valuation of the contracts being undertaken by an experienced staff member or independent valuer during the course of the contract term.	Review a sample of valuations and access the qualifications and suitability of the valuer.
Invoices are raised based on an appropriate valuation of work performed.	Review a sample of invoices and ensure they agree to an appropriate valuation and amount billed agrees to the valuation.
Adequate supervision and segregation of duties exists.	Select a sample of invoices and ensure the invoice was raised by a different person to the one who valued the contract.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

In each section are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not construction contracts are fairly stated.

Construction contract assets, income and expenditure

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Construction contracts	
Obtain a list of construction contracts from the client.	

- Test the arithmetic accuracy of the final contracts listings and agree the total to the nominal ledger. A

- Ensure existence by selecting a sample from the list and agreeing to support. E

Select a sample of construction contracts from a file containing details of quotes given and contracts offered.

- Confirm that contracts in progress at the year end are included on the contract listing above. C

- Where a quote that was unsuccessful, obtain the reason. C

Review contracts at the start of the year and ensure that all such contracts are either in progress at the end of the year or have been completed during the year. C

Review minutes, correspondence, contract files and contract records to ensure that all contracts are included. C

Review a sample of purchase invoices relating to raw materials and ensure that the delivery addresses are accounted for as contracts. C

Confirm the basis on which the client has estimated the stage of completion and recognised revenue and costs. Consider whether:

- it has been correctly applied; A

- it is an acceptable basis of valuation under applicable accounting standards; and V

- it is consistent with previous years and with the company's accounting policy. A

Construction contract assets

Select a sample of contract calculations. For each contract, perform the following procedures:

- check arithmetical accuracy; A

- agree the terms to the underlying contracts; A

- agree contract amounts to valuations (or calculations); V

• ensure that costs, including overheads and labour, have been recorded accurately, consistently and in accordance with applicable accounting standards and terms of the contract;	C, E, A, V
• ensure changes in the estimate of contract revenue or costs have been accounted for in accordance with applicable accounting standards;	V
• consider the reasonableness of assumptions made (e.g. total estimated costs, gross profit/losses). Take into account the accuracy of forecasts and estimates made in previous years. Complete the estimates work paper where appropriate; and	E, A, V
• ensure that adequate provision has been made for any anticipated losses.	V
Discuss with client the impact, if any, on the financial statements for any disputes or delays on construction contracts.	V

Construction income

For a sample of construction contracts, confirm that revenue has been recognised by reference to the stage of completion of contract activity.	V
Review contract revenue and ensure that the following items are recorded correctly in accordance with applicable accounting standards: • variations in contract work; • claims on reimbursement for costs; • incentive payments.	A, V
If revenue has been recognised on a mark up basis, ensure the margin used is appropriate.	A, V
Consider whether all costs to completion have been considered in the expected margin of the contract.	C, E

Construction expenditure

For a sample of construction contracts, confirm that expenditure is recognised by reference to the stage of completion of contract activity.	A, V

Substantive analytical procedures

A substantive analytical review can be performed to compare actual costs against forecasts. Any variances from the expected costs would need to be investigated. In performing a detailed substantive analytical review, this can reduce the amount of tests of detail which need to be performed.

Analytical procedures are useful to ensure that the relationships between the figures make sense. This means looking at typical ratios of, for example, material costs and labour costs to the total contract value, etc. In addition, comparisons between the actual figures and any original budgets, prepared when quoting for the project, also provide good analytical review evidence that the client's costings can be relied upon. The auditor should ensure that any variances are followed up with the client. As with all audit areas, the auditor needs to ensure that the data they use to carry out analytical procedures is reliable.

Tests of detail

Construction contracts interlink a number of balance sheet and profit or loss account figures – debtors (amounts recoverable on contracts), creditors (progress payments in advance), profit and loss (attributable turnover and profit), as well as inventory. Better quality evidence may be obtained if the whole cycle in respect of long-term contracts is considered at the same time.

The sample can be selected from the contracts or quotes records and then used to cover all aspects of the cycle.

Construction contracts

Existence

The auditor must perform sufficient work to verify that the contracts actually exist. The auditor should obtain a list of construction contracts from the client and perform the following procedures:

- test the arithmetic accuracy of the final contracts listings and agree the total back to the nominal ledger; and
- confirm the existence of a sample of listings by agreeing to supporting evidence.

Existence of physical work in progress under construction contracts is best verified by attending the stocktake. If the auditor is unable to attend a stocktake, or lacks the necessary expertise, then looking at the movement of plant, material and subcontractor invoices, staff job sheet, etc. for a specific contract can help to obtain comfort as to the existence, if not the valuation of the work in progress.

Testing cash after date can verify both valuation and existence.

Completeness

A sample of construction contracts should be selected from a file containing details of quotes given and contracts offered to ensure completeness. Where the auditor has selected a quote that was unsuccessful, the reason should be noted. The following procedures should also be applied:

- review contracts at the start of the year and ensure that all such contracts are either in progress at the end of the year or have been completed during the year;
- review minutes, correspondence, contract files and contract records to ensure that all contracts are included; and
- review a sample of purchase invoices relating to raw materials and ensure that the delivery addresses are accounted for as contracts.

Estimated stage of completion

The auditor should confirm the basis on which the client has estimated the stage of completion of construction contracts and consider whether:

- it has been correctly applied;
- it is an acceptable basis of valuation under the applicable accounting standards; and
- it is consistent with previous years' basis of estimation and with the company's accounting policy.

The auditor should consider undertaking a physical verification visit, particularly with reference to the stage of completion and the value of work to date (that is, income).

Construction contract assets

Calculation of the contract asset

For a sample of construction contract calculations/workings, the auditor should perform the following procedures:

- check the arithmetic accuracy of the of the workings;
- agree the terms to those in the underlying contracts;
- agree the contract amounts to valuations (or internal calculations);
- ensure that all contract costs, including overheads and labour, have been recorded accurately, consistently and in accordance with applicable accounting standards and terms of the contract;
- ensure that any changes in the estimate of contract revenue or costs have been accounted for in accordance with applicable accounting standards;
- consider the reasonableness of any assumptions made, such as gross profit/losses and expected costs to complete, taking into account the accuracy of forecasts and estimates made in previous years; and
- ensure that adequate provision has been made for any anticipated losses.

Valuation

Where an external valuer has been used, the auditor should consider the following:

- the independence and competence of the valuer (e.g. professional qualifications and experience with this type of contract);
- whether the valuer received accurate information;
- whether the bases and assumptions used are reasonable and consistent with previous years; and
- where applicable, the accuracy of valuations carried out by the valuer in previous years.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an audit programme for **Using the work of management's expert (Sup2)** *available in the templates*.

Recoverability of contract assets

The auditor should check the receipt of cash after date for an appropriate sample of amounts recoverable on long-term contracts. It is not uncommon to find that the customer pays only a percentage of the request for payment – especially if it is the contractor's valuation that makes up the request for payment. This is in addition to funds withheld as a retention.

Retentions

The auditor should consider whether retentions are valid and recoverable – by inspecting correspondence with the customer or by reviewing cash received after the balance sheet date. The auditor should also check that the customer has accepted liability for any additional work performed.

Other considerations

Front loading of contracts

The auditor should be aware of the distortion that can arise where, for example, low costs are incurred at the beginning of the contract, which could result in a disproportionate amount being charged to the client.

Construction contract income

The allocation of attributable profit will almost certainly be high risk as it is very dependent on the use of judgement and the calculations are often quite complex. Therefore, a higher risk level should be used and the sample biased towards the high risk and material contracts, for example:

- contracts with unusual profits or losses;
- contracts with material profits, losses or cash flow requirements;
- contracts in politically sensitive or volatile areas overseas;
- contracts where costs to date, with costs to completion, are likely to exceed the original contract price; and
- contracts that are late where there are significant penalties for late delivery.

The auditor should confirm that income has been recognised with reference to the stage of completion of contract activity (where the outcome can be reliably measured), in accordance with FRS 102:23.

It should be confirmed that the following have been recognised correctly in the contract income calculations:

- variations in contract work;
- claims on reimbursement for costs; and
- incentive payments.

Where income has been recognised on a mark up basis, the auditor should ensure that the margin used in calculating income is appropriate. It is important to consider whether all expected costs to completion have been considered in deriving the expected margin of the contract.

In many cases, income is based on an external valuation that normally gives the value of the work done to date – that is, the total income to date on that contract. In such cases, tests on income should link with tests on valuation.

Contract expenditure

The auditor should confirm that construction contract expenditure has been recognised by reference to the stage of completion (where the outcome can be reliably measured), in accordance with FRS 102:23.

Standard purchase and expense tests should be used for raw materials, direct expenses, labour and direct overheads (see Profit and loss account: expenditure and Wages, salaries and other remuneration). Where there are a number of different contracts, the auditor should ensure that the amounts are charged to the correct contract.

The auditor should be alert to any questionable payments or 'commissions' by clients to secure contracts.

Insight – Lack of detailed costing records

If the client does not keep full detailed costing records, the customer's valuations are likely to be used as a basis for their requests for payment. In such circumstances, turnover will usually be the amount that has been requested for payment. Any such amounts unpaid will be the amounts recoverable on contracts. Any costs incurred in the year will be cost of sales. However, care will need to be taken to ensure that cut-off has been correctly observed for turnover, cost of sales and work in progress.

Cut-off

There is usually a higher risk of error with cut-off testing as year-end procedures happen infrequently and such procedures can usually be easily manipulated. Cut-off tests on construction contracts should be coordinated with cut-off tests for sales, purchases, debtors and creditors.

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
For a sample of construction contracts, review amounts invoiced pre- and post-year end and ensure that revenue and costs have been accrued or deferred in the correct period.	C, E, Cut-off
Review the schedule of works for a sample of construction contracts and confirm that all expected revenue and costs to the year end have been accounted for.	C, E, Cut-off

Substantive analytical procedures

The stage of completion of each construction contract at the reporting date will depend on the specific circumstances of each contract, therefore there may not be a substantive analytical procedure which can be performed for cut-off of construction contracts.

However, an expectation of construction contract revenue could be made using the estimated stage of completion and total contract value, which could provide additional comfort over cut-off.

Tests of detail

For a sample of construction contracts, review amounts invoiced pre- and post-year end (these may be called progress payments) and ensure that revenue and costs have been accrued or deferred in the correct period. This may be covered by reviewing cash after date.

Review the schedule of works for a sample of construction contracts and confirm that all expected revenue and costs to the year end have been accounted for.

Provisions and onerous contracts

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain details of the basis for making provisions and determine if it is both adequate and consistent.	V
Discuss the status of contracts selected for testing with contract managers, establish whether any provisions are required and if profit margin is still achievable.	C, E, A, V
Ensure expected losses on onerous contracts have been recognised accurately and in accordance with applicable accounting standards.	C, A, V

Substantive analytical procedures

Understanding the majority of provisions for a construction contract at the reporting date is likely to depend on the specific circumstances of each contract, therefore there may not be a substantive analytical procedure which can be performed.

However, substantive analytical procedures could be performed over the retention balances, the recoverability of these and whether any provision is required against the retentions. Comparisons of retentions with previous years – both as an absolute amount and as a percentage of turnover – may be useful in determining the client’s ongoing ability to recover such amounts. Previous rates of retention recoverability can also be used to ensure an adequate provision is made against the current retentions.

The financial statements should disclose that the retention is recoverable after more than one year.

Tests of detail

The auditor should obtain details of the basis for making provisions and determine if it is both adequate and consistent.

The status of individual construction contacts should be discussed with contract managers, surveyors, engineers and site supervisors, as well as management to establish whether any provisions are required and if profit margin is still achievable. The following issues should be considered when discussing the contracts:

- whether there are any technical or building problems;
- potential extra costs, e.g. labour disputes, fines due to delays in completion; and
- estimated completion dates.

The auditor should also review any correspondence with the customer.

The auditor should ensure that events on specific contracts are considered in the post-balance sheet events review.

Circumstances which may indicate a provision is required include:

- delays to the contract;
- outstanding payments which are overdue; and
- supply chain issues.

If required, ensure expected losses on onerous contracts have been recognised accurately and in accordance with applicable accounting standards.

Guarantees and warranties

The auditor should consider whether any contingent liability may arise where the client issues a guarantee or warranty in respect of a construction contract.

Estimates

Design and perform appropriate tests for estimates, e.g. stage of completion, using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

Other considerations

Assets associated with specific contracts

If fixed assets have been purchased for a specific contract which is due to end, or has ended, the auditor should consider whether these assets need to be reviewed for impairment.

3.15 Debtors and prepayments

Quick overview

This section explains how to audit debtors (or receivables) and prepayments and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas~~ of *Navigate Audit*.~~

This section relates to schedule J in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Debtors and prepayments

Debtors are those amounts that are receivable by the client, e.g. amounts due from customers. FRS 102 refers to receivables rather than debtors. However, as debtors is required by the Companies Act formats and regulations and continues to be commonly used by privatecompanies, this term will be used instead. Debtors are financial instruments and will typically fall within the scope of Section 11. They are measured at the undiscounted amount of cash receivable, unless extended credit terms are offered, in which case they are measured at the present value of the cash receivable, discounted at the prevailing market rate of interest for a similar receivable.

Prepayments are those amounts that have been paid in advance, e.g. a subscription. Unlike debtors, prepayments are not financial instruments because they do not convey a contractual right to cash. They represent a good or service which has been paid for but not yet received by the company.

Accrued income represents income which has been earned because the good or service has been provided, butwhich has not yet been invoiced. Accrued income commonly arises in relation to contracts to provide services over a specified period of time.

This section is primarily concerned with trade debtors although other debtors and prepayments are also considered. In all cases, it is assumed that the debtors will be classified as basic financial instruments and measured at the undiscounted amount of cash receivable. The audit of other financial instruments which aregenerally carried at fair value is addressed in Financial instruments.

- Private Company (FRS 102) – Financial instruments (Sections, 11, 12 and 22);
- Small Company (FRS 102 1A) – Financial instruments (Sections, 11, 12 and 22);
- Micro Entity (FRS 105) – Financial instruments (Section 9).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing debtors and prepayments are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Trade debtors	To ensure that debtors exist at the balance sheet date and that the client has valid title to them.	E	Debtors circularisation
Trade debtors, Prepayments	To ensure that debtors and prepayments are due at the value recorded in the balance sheet.	E, A, Cut off	Trade debtors – cut off, Trade debtors – credit notes, Trade debtors – aged listing, Prepayments and other debtors
Trade debtors, Prepayments	To ensure that all debtors and prepayments are recorded in the balance sheet.	C, E, A	Trade debtors – after date cash received, Debtors circularisation
Bad debt provision	To ensure that adequate provision is made for all bad or doubtful debts at the balance sheet date.	C, E, V	Bad debt provision
Trade debtors, Bad debt provision, Prepayments	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates
Trade debtors, Bad debt provision, Prepayments	To ensure that debtors and prepayments are appropriately presented and disclosed in the financial statements.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**

C – Completeness
All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.

E – Existence
Assets, liabilities and equity interests exist.

The entity holds or controls the rights to assets; and liabilities are the obligations of the entity.

For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity.

The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy
Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation
Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions
Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Trade debtors		X	X	X	X	Cut-off, Presentation
Bad debt provision	Y	X	X		X	Presentation
Prepayments		X	X	X		Presentation

Controls

The following are controls that are relevant to debtors and prepayments and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	**How to test**
New customers are asked for suitable credit references and a search is completed.	Select a sample of new customers and confirm that appropriate credit references and searches were completed.
Credit limits are set, regularly reviewed and adhered to.	Select a sample of customers and confirm that credit limit processes were adhered to.
Access to the despatch area is restricted to those staff working within the department.	Review physical/IT access controls to confirm that access is restricted to the relevant staff.
Goods are only allowed to leave the premises with a valid despatch note.	Select a sample of goods and confirm that a valid despatch note was issued prior to despatch.
Regular stocktakes occur to ensure that the records are reconciled to the goods despatched and goods received.	Attend a stocktake and confirm that reconciliations have been adequately performed.
Invoices are only raised once a valid order and/or despatch note has been provided.	Select a sample of invoices and confirm a valid purchase order/despatch note was issued prior to raising.
Any unmatched despatch notes and invoices are followed up independently.	Select a sample of unmatched despatch notes and invoices to confirm that adequate follow up was undertaken by an individual independent to the relevant team.
Invoice pricing is independently checked and reviewed and invoices are within the limits.	Select a sample of invoices and agree to the client's price listing to confirm invoicing is within the limits.
Invoices are sequentially numbered.	Review a listing of invoices issued in the period and confirm that sequential numbering has been applied.
Segregation of duties exists with invoices being raised in a department separate from the sales department.	Review the processes surrounding the raising of invoices and confirm that segregation of duties from the sales department applies.
A copy of the despatch note is signed by the customer to confirm delivery.	Select a sample of despatch notes and confirm that customer signatures have been obtained on delivery.
Any non-routine transactions are authorised.	Select a sample of high value or unusual customer transactions and confirm that appropriate authorisation was obtained.
Outstanding statements are sent to customers on a monthly basis. Queries or complaints are appropriately followed up.	Select a sample of customers and confirm that outstanding statements and items where queries or

	complaints were made to confirm there was appropriate follow up.
Overdue debtors are regularly reviewed by an authorised person and agreed action taken to recover the money.	Select a sample of overdue debtors and confirm they have been appropriately reviewed and followed up.
Overdue debtors are put on stop until money is received.	Select a sample of overdue debtors and confirm that appropriate blocks have been introduced until receipt of funds.
The detailed debtors' ledger is regularly reconciled to the sales ledger control account, any differences identified are reviewed and written off as appropriate.	Obtain copies of the debtors reconciliation to the sales ledger and reperform to confirm accuracy. Select a sample of differences and confirm that appropriate review/write off was undertaken.
Credit notes are appropriately authorised before issuing.	Select a sample of credit notes and confirm there was appropriate authorisation prior to issue.

Audit procedures

When planning the audit, all the available tests should be reviewed to determine those that will most effectively satisfy each of the individual objectives for the client in question. Not all the tests relating to an individual objective need be carried out on each audit. Where the balance includes accounting estimates, refer also to the guidance in Auditing accounting estimates.

Trade debtors – aged listing

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain or prepare an aged list of balances and test the mathematical accuracy and that it agrees to the nominal ledger.	
Obtain a sample of invoices from the aged debtor listing and check the invoices are listed in the correct aged period.	
Agree the aged list of balances to the control account. Obtain explanations for all material adjustments to the control account.	A, Cut-off

Substantive analytical procedures

Debtor days

The main ratio to calculate when looking at debtors is debtor days. The formula is:

(trade debtors/turnover) × 365

The ratio shows how many days, on average, customers take to pay their debts. Two points to bear in mind when calculating the ratio are as follows:

- •an adjustment should be made for VAT. Otherwise, in most businesses, the auditor will not be comparing like with like. The auditor should either add VAT onto the turnover figure or deduct it from the trade debtors figure;
- the turnover figure used in the calculation should relate solely to credit sales – that is, any cash sales should be eliminated.

An increase in the level of debtor days may simply indicate that the customers are not paying up as promptly as previously, perhaps because credit control procedures are not being followed due to staff illness. However, a significant increase in the debtor days figure from one year to the next could also indicate insufficient provision for bad debt.

There may be other justifiable reasons for the figure has increasing, so it is important that any explanations given to the auditor are corroborated. If the client has increased the level of activity towards the end of the year, the auditor would expect an increase in the debtor days figure, as sales made in the last month or two may not be due for payment until after the year end and this would distort the figure.

In such circumstances, it may be worth calculating debtor days using the ‘count back’ method. This method calculates the length of time it takes for a debt to be settled, thus taking account of any changes in activity levels close to the year end which may otherwise distort the calculation when done on an annual basis. Two examples follow.

Example – Ratio vs count back method

Alpha Limited has a year end 31 December.

	Current	**1–30 days overdue**	**31–60 days overdue**	**61–90 days overdue**	**>90 days overdue**	**Total**
Trade debtors (excluding VAT)	£803,000	£642,000	£56,000	£33,000	£19,000	£1,553,000
	December	**November**	**October**	**September**	**August**	**Total annual**
Turnover	£810,000	£805,000	£788,000	£802,000	£767,000	£9,600,000

Under the ratio method, debtor days are calculated as:

(1,553/9,600) × 365 = 59 days

Under the count back method, debtor days would be calculated as follows (assuming invoices are raised evenly throughout each month):

((803/810) × 15) + ((642/805) × 45) + ((56/788) × 75) + ((33/802) × 105) + ((19/767) × 135) = 65 days

Beta Limited is identical to Alpha Limited, except that Beta had a very large additional order that was despatched and invoiced in December.

	Current	**1–30 days overdue**	**31–60 days overdue**	**61–90 days overdue**	**>90 days overdue**	**Total**
Trade debtors (excluding VAT)	£1,500,000	£642,000	£56,000	£33,000	£19,000	£2,250,000

	December	November	October	September	August	Total annual
Turnover	£1,510,000	£805,000	£788,000	£802,000	£767,000	£10,300,000

Under the ratio method, debtor days are calculated as:

(2,250/10,300) × 365 = 80 days

Under the count back method, debtor days would be calculated as follows (assuming invoices are raised evenly throughout each month):

((1,500/1,510) × 15) + ((642/805) × 45) + ((56/788) × 75) + ((33/802) × 105) + ((19/767) × 135) = 64 days

While the count back method can therefore give a ‘fairer’ picture of the actual ageing of debt, it does have its weaknesses. In these examples, it does not highlight the sudden leap in turnover and debtors in December which may indicate a cut-off error.

Alternatively, the auditor could extend use of the debtor days ratio calculation to look at debtor days at the end of each month. This could help the auditor to substantiate any explanations given by the client for the increases in the year-end ratio. It should also assist in identifying other fluctuations in sales during the year.

Tests of detail

Generally, the audit work on trade debtor is performed on the aged debtor analysis as at the year end. When compared to the latest aged debtor analysis is used, it is possibly to identify which debtors have been paid/removed. However, if adopting this approach, it is essential that adequate work is undertaken on the ageing to make sure that it is accurate and that no manipulation of the balances is possible. This can be done by selecting a sample of invoices from the aged debtor listing and checking the invoices are listed in the correct aged period.

Agree the aged list of balances to the control account. Obtain explanations for all material adjustments to the control account.

If the aged debtors report is used as the basis for auditing the adequacy of the bad debt provision, ensure some testing has been performed over the accuracy and completeness of the ageing and the report in general. Alternatively, test the operating effectiveness of the system.

Trade debtors – after date cash received

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Select a sample of cash receipts received post-year end and agree them to amounts on the debtors listing.	C, E, A
For a sample of debtor balances where no cash has been received post-year end, perform the following:	

- obtain a circularisation confirming the balance (see Debtors circularisation);

- inspect proof of delivery or despatch. If no such documentation is available, inspect the sales invoice supporting them; and E, A

- review correspondence files to determine whether any disputes exist. E, A

Substantive analytical procedures

Undertaking a critical review of individual debtor balances for inconsistencies before detailed testing commences may enable the auditor to reduce sample sizes on the debtors' circularisation or after-date cash tests. Individual sales ledger balances should be compared to previous periods and explanations sought for significant changes.

Some sales ledger systems may enable the auditor to compare debtor balances to levels of activity for particular customers. This is normally possible on computerised systems. Indeed, just as with inventory, the auditor may actually be able to calculate debtor days ratios for individual customers. Comparing this information to previous periods may provide some comfort as to the existence of debts and will also give a starting point for consideration of the level of the bad debt provision.

Tests of detail

Although the primary risk in relation to debtors is that of overstatement, auditors may wish to conduct testing on after date cash receipts, in conjunction with income cut-off. This will provide assurance over the completeness, existence and accuracy of debtors.

Sales invoices immediately before and after the year end should be examined for correct cut-off carefully and not purely by reference to the date shown on the invoice. If cut-off has not been correctly observed, it will usually be because the actual delivery of the service or goods will not have been invoiced in the correct period. Therefore, the cut-off test should start at the point in the system before the invoice, such as the despatch note.

Insight - Evaluating cut-off testing

It is not uncommon for auditors to conclude on their after-date cash testing that, as a significant proportion of the debtors examined (e.g. 70%) have paid since the year-end, debtors are not materially misstated. However, the remaining proportion could well be material and should be subject to additional procedures, unless the residual balance is immaterial.

There are two options. The auditor should either examine a further sample to test the existence of the unpaid debts and go on to assess if they are recoverable; or they should justify the conclusion to the test by showing that the collection rate since the year-end (e.g. 70%) is expected, given the level of debtor days.

Debtors circularisation

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Select a sample of accounts for confirmation from a complete list of balances (include nil and credit balances where applicable).	
Confirm with the client the debtors you wish to circularise. Obtain explanations where the client does not want you to circularise particular balances and consider alternative procedures that can be applied.	E, A
If applicable, consider whether the refusal to allow circularisation of particular balances is indicative of fraud or imposes a limitation of scope on the audit.	E, A
Send the confirmation requests, ensuring replies are sent directly to the auditor. In respect of each reply:	
• agree or reconcile the balance to that shown in the debtors listing;	C, E, A
• investigate any exceptions;	C, E, A
• consider whether any of the exceptions are indicative of fraud or other misstatement; and	C, E, A
• consider additional procedures when a letter is not received.	C, E, A

Substantive analytical procedures

Substantive analytical procedures are unlikely to be relevant when performing a debtors circularisation.

Tests of detail

Auditors can obtain assurance regarding the completeness, existence and accuracy of debtors direct confirmation of balances with the debtors concerned or by alternative procedures, such as review of post-year end cash receipts. If thereis a risk that the debtors might be recorded but not owned by the client, the auditor should consider the following:

- reviewing the client's terms of sale and major agreements or contracts;
- reviewing correspondence with any debt collectors; and
- contacting significant customers and confirming the client's sales terms with them (use with caution and only with client agreement).

Direct confirmation

Direct confirmation of balances with debtors is a more reliable source of audit evidence because information is being generated by the auditor and provided by a third party not connected with theclient. In addition, the auditor will obtain better evidence that the debt existed at the balance sheetdate, particularly where a client does not keep remittance advices. For example, it would be more difficult to identify a teeming and lading fraud using after-date cash receipts, which is the most common alternative technique used by auditors.

General considerations when requesting external confirmations are discussed in External confirmations, where itwas noted that the auditor must consider whether external confirmations should be used to obtain substantive audit evidence. However, it will only be worth the time involved in a circularisation where the auditor is likely to receive a high level of replies. The auditor may be able to identify the types of client that are likely to give a reasonable response; this will frequently be clients with major customers that have formal accounting departments, although it is common for many companies to not respond. Where a circularisation has been undertaken in the past and the results have been disappointing, the auditor should consider if any action can be taken to improve the quality and/or quantity of the responses received in future years. The basic approach is to send letters to individual customers, asking them to confirm the balance outstanding at the balance sheet date or to provide further details if they do not agree. If the balances agree, or the reconciling items are valid, no further work on existence is generally required.

In some cases, it may be easier to ask for a more specific confirmation, either of individual invoices or to split the balance into its component invoices. This makes it easier for a customer to identify which invoices are includedand so provide more accurate confirmation. This approach should be adopted where customers operate an 'open' sales ledger and therefore cannot confirm balances for a given point in the past.

Standard sampling techniques should be used. A non-representative sample may be appropriate where the population consists of a small number of high value items, together with many low value items. In these circumstances, the auditor would normally concentrate on the high value balances. The auditor should adopt thefollowing practical procedures.

(1) The circularisation requests should be sent as soon as possible after the confirmation date – usually the balance sheet date, although if the auditor is working to a tight deadline it may be appropriate to carry out the circularisation the month before the year end and then reconcile the figures to the year-end balance. Where theauditor is requesting information at the year end, it may be sensible to extract the information during the courseof the stocktake attendance and send the letters out before starting the field work. This should improve the chances of accurate replies and hence the effectiveness of the test.

(2) The auditor should clear the sample of debtors to be circularised with a senior member of the client's staff. If the client does not wish a particular debtor to be contacted, the auditor should gain an understanding of management's reasons for refusing and must seek audit evidence to confirm the validity and reasonableness of those reasons which can be very difficult to do. Even so, in this circumstance, the auditor must perform alternative tests on any such balances and also ensure that the matter is included in the letter of representation.Refusal to allow the auditor to contact a particular client, and failure to retain remittance advices, may indicate ateeming and lading fraud. Any unreasonable refusal by management must be communicated to those charged with governance and may have implications for the audit report.

(3) The response to confirmation requests is usually better if they are sent from the client's email address, or if via letter, on the client's headed notepaper andsigned by a client official. The auditor should either obtain copies of the client letterhead for producing the letters or liase with and provide the client with the relevant details to prepare the emails/letters.

(4) Where letters are being sent via post, the auditor should personally place the letters in the envelopes and post the confirmation requests.

(5) All replies, including email replies, must be returned directly to the auditor and not to the client. Where sent via email, the reply address should be clearly specified, appropriately marked as confidential and not to be circulated widely. Where a letter has been used, it should include a reply-paid envelope addressed to the audit firm. The postmark on returned letters should be checked to ensure it hascome from the correct place.

(6) The auditor should send follow-up letters to those debtors who do not reply, before performing alternative procedures. Such a follow-up can be more effective if performed via email or telephone, particularly where theauditor has a tight reporting deadline.

(7) If the replies do not agree to the balances on the entity's ledger, the auditor should investigate the differences. To keep audit costs down, the auditor should ask the client to reconcile statements if received andto explain any differences. Generally, differences will arise as a result of one or more of the following:

- invoices in the client's records which are not in the customer's balance. These are likely to be those items despatched just before the year end or those where there is some dispute. The auditor should ensure that items were sent to the customer before the balance sheet date. Where the item in question was despatched a long time before the year end, the auditor should endeavour to establish whether the customer is disputing receipt of the product or is anticipating a credit against the balance;
- cash in transit at the balance sheet date. This is also likely to relate to items around the year end and the auditor should review post-year end receipts to ensure that the cash was received. The auditor should investigate any unusual delays in receiving and banking the cash, as this could indicate some form of teemingand lading fraud; and
- goods returned by the customer. Again, this should be a timing problem around the year end. The auditor should ensure that the goods were received just after the year end and that adequate provision has been madefor sales returns.

Even where the auditor has received good responses to the circularisation, some cash after date testing shouldbe undertaken. Agreement of the balance outstanding satisfies the existence objective but does not address recoverability.

It may be necessary to use other audit tests to provide evidence of the validity of the debtor where no reply is received in a positive circularisation, as every item selected must be concluded upon.

The responses may indicate inaccuracies in the part of the population that is not tested and further work may be necessary.

A template for a debtors' circularization is available in Templates *(DEBTORSW)* ~~and Letters within Navigate Audit~~.

Alternative procedures

The auditor should perform these tests only where it has been decided not to ask for direct confirmation from the customers or where the auditor has not obtained a reply to a confirmation request. In the latter case, there is no need to select a further sample. Instead, the auditor need onlyperform the following tests for the balances that have not been separately confirmed or reconciled. The auditor may need to ask the client to retain certain records that it does not normally keep, e.g. remittance advices and GDNs signed by customers as evidence of receipt of goods.

The auditor should trace subsequent payments by the customer. The sample should be taken from the list of debtors at the year end and the subsequent receipt traced for that sample. There is a tendency to start with the post-year end bank records and work in reverse. Ideally, the auditor should see some evidence that the debt wassettled by the customer in question after the balance sheet date and that the balance existed at the year end. Therefore, the auditor should trace the receipt to remittance advices from the customer and to paying-in records and ensure that the receipt has been correctly allocated in the sales ledger in accordance with theinformation contained on the remittance advice.

It is important that remittance advices are checked where these are available as this enables the auditor to:

- ensure cash is properly allocated in the sales ledger;
- check the ageing of balances; and
- check for teeming and lading.

If remittance advices are not available, the auditor may be able to take comfort from the fact that the remittancecorresponds to one or more invoices. The nearer the date of receipt is to the confirmation date, the more persuasive is the evidence that the debt existed at that date.

If the auditor is not able to trace payment of a particular balance or invoice, he or she should seek evidence thatthe sales were made to the customer in question. The auditor should review the following where appropriate:

(1) goods despatched records;

(2) customer service records or contracts;

(3) purchase orders or customer contracts; and

(4) any relevant evidence that the customer received the goods in question.

The auditor should consider the recoverability of individual invoices if that customer has paid other, more recentinvoices. The existence of these outstanding invoices could be the result of a dispute with the customer.

An alternative method of auditing for cash after date can be used where the client has an aged sales ledger. Provided that the auditor has verified the ageing of a sample of the sales ledger balances, and can verify that theclient has not processed any credit notes or journal entries to manipulate the sales ledger aged listing, then a more global approach can be taken. If the audit is being performed four months after the year end, the auditor could review the aged sales ledger three months after the year end and would be able to tell from the ‘three months and over’ column in the sales ledger which of the debtors that were unpaid at the year end remain unpaid. These debts can then be examined more closely for potential recoverability problems. Such a procedure also identifies potential bad debts that were recent invoices as at the balance sheet date – an area frequently overlooked.

Trade debtors – cut off

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
If the company has despatch records, examine sales and despatch records before and after the year end and ensure that:	
• all goods despatched before the year end are excluded from stock and included in sales and debtors where appropriate; and	A, Cut-off
• all goods despatched after the year end are included in stock and excluded from sales and debtors where appropriate.	A, Cut-off

If the company does not have despatch records, specify below the audit work to ensure that cut-off has been correctly applied.	A, Cut-off

Substantive analytical procedures

Analysis of sales by week either side of the year end may highlight sales that have been accounted for in the wrong period.

Tests of detail

Cut-off should be linked with testing performed on stock and sales. Auditors should review sales either side of the year end to ensure that items are included in the correct accounting period. This test should be checked and cross-referenced to the details obtained at the stocktake. Ideally, the auditor should ensure that the customer acknowledges the date of delivery. The auditor’s source for this test must be the event that triggers the invoice, such as the despatch note, as this is the day the actual sale is made.

The auditor should review customer receipts either side of the year end to ensure that they have been included in the correct period. In general, all goods despatched before the year end should be excluded from stock and included in sales and debtors where appropriate and all goods despatched after the year end should be included in stock and excluded from sales and debtors where appropriate.

Trade debtors – credit notes

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
List all credit balances over performance materiality and obtain explanations.	C, E, A
Review credit notes after the year end and consider whether these have been accounted for in the correct period.	Cut-off

Substantive analytical procedures

Auditors may wish to review credit notes issued after the year end to ensure that sales have not been cancelled in the new period and to recalculate accrued income for a sample of contracts to ensure that it has been recognised in accordance with the contract and the related work has been performed.

By reviewing the past history of credit notes and recent sales levels, it may be possible to establish the level of provision of credit notes that the auditor would expect to see.

Tests of detail

If it is likely that debtors could be materially overstated by the omission of credit notes, the auditor should compare credit notes after the year end with the supporting evidence and ensuring that items relating to before the year end were provided for. The auditor should check the credit note was issued for an appropriate reason.

The auditor could also select details of items from the ‘goods returned’ records either side of the year end and ensuring that credit notes were issued in the correct period or that equivalent provision for sales returns was included.

Bad debt provision

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Review ledger accounts and obtain a list of any debts with balances, confirm if a provision has been made, if not obtain evidence as to why one isn't required:	
• not paid within … months of the period end;	C, E, V
• in excess of their credit limit;	C, E, V
• in the hands of liquidators or receivers;	C, E, V
• in the hands of solicitors for collection.	C, E, V
Compare the client's provision with the list completed above and consider its adequacy. Obtain explanations for and justify any material accounts omitted from the client's list. Use the **estimates work paper** *available in the templates*.	C, V

Substantive analytical procedures

A substantive analytical procedure which can be used to assess the adequacy of the bad debt provision is to review the ageing of the debtors in total. When compared to previous years, the auditor may be able to draw some preliminary conclusions on whether or not the level of the bad debt provision needs to be increased. If there is an increase in the number of debtors in the '90 days plus' category, perhaps the question of the bad debt provision may need to be examined further.

This assumes that the auditor has already checked that the aged analysis prepared by the client is complete and accurate. It would not be appropriate for an auditor to adopt a wholly substantive approach to the audit, if relying on the accuracy of reports produced by a system that has not been tested.

Tests of detail

Auditors should perform the following tests of detail.

- Review ledger accounts and obtain a list of any debts with balances, confirm if a provision has been made, if not obtain evidence as to why one isn't required:

– not paid within … months of the period end;

– in excess of their credit limit;

– in the hands of liquidators or receivers;

– in the hands of solicitors for collection.

- Compare the client's provision with the list completed above and consider its adequacy. Obtain explanations for and justify any material accounts omitted from the client's list. Use the estimates work paper.

The basic approach to auditing bad debt provisions is:

- to review individual old or large debts to assess whether specific provisions are adequate, but not excessive; and
- to estimate the likely provision appropriate for other balances.

The risk of error is likely to be higher with the bad debt provision as it will almost invariably be an estimate (see Auditing accounting estimates). Ensure the auditor reviewing this section has appropriate skill and experience to appropriately challenge management on the level of provision.

The best source of data to use for this work is the client's aged debtor analysis, as tested in Trade debtors – aged listing. The auditor therefore needs to perform the testing over the aged debtor analysis to ensure it has been prepared properly and they have obtained assurance over its accuracy and cut-off.

If the client does not produce an aged analysis, the auditor should ask the client for a list of all debts over a certain age (specify by reference to the client's normal credit collection period).

The auditor should select a sample of items that are either old or significant and:

- trace subsequent payment, thus effectively selecting subsequent events review as the audit procedure of choice from the options in Auditing accounting estimates. In these circumstances, it would be better to use an aged debtor listing that is current at the time of the audit field work as this would help to identify those balances that had been paid since the year end and those that had not. If using the year-end list and select all items over a certain age (often 90 days), it will not show the debts that were younger than 90 days at the year end but have since gone bad; and
- where balances have not been paid, discuss recoverability with client staff.

In addition to the above, the auditor should also consider carrying out the following procedures if the balances have not been paid:

(1) reviewing checks on creditworthiness;

(2) reviewing customer's most recent financial statements (this could be important for a client with only a few material debtors);

(3) comparing balances outstanding with credit limits; and

(4) reviewing past payment history, particularly whether the number of days' credit taken appears to be increasing or the customer is making round-sum payments.

Insight - Significant outstanding debtors

Where appropriate and where there are significant amounts outstanding, the auditor should also consider:

- whether any guarantor is able to pay and the value and enforceability of any security held;
- whether debts written off in year were appropriate and properly authorised;
- whether VAT is recoverable on such debts;

- reviewing the sales ledger for evidence of debts previously written off and check whether these are written back, where necessary.

The auditors can consider whether the level of provision is adequate by:

(1) reviewing the adequacy of any previous provisions (a mandatory procedure at the planning stage – see Significant accounting estimates);

(2) considering the reasons for any changes to the policy for determining the level of provision;

(3) enquiring whether any customer has gone into liquidation or bankruptcy since the balance sheet date (this can also be done by reviewing correspondence); and

(4) reviewing movements in exchange rates for companies with foreign currency debtors.

If there are significant amounts outstanding, and/or material debtors have not paid by the date of the audit, the auditor should consider whether any revision is needed to the risk assessment in this area, particularly if the valuation of debtors was not initially assessed as being a significant risk.

Objective evidence of impairment

FRS 102:11.21 requires that there be objective evidence of impairment. This will not usually be a problem in relation to trade debtors, but the auditor should nevertheless ensure that this point is properly documented.

To ensure that amounts due from group and associated undertakings are properly recorded and receivable, the standard approach to debtors should be applied, but the auditor should bear in mind the following:

(1) it is usual to agree intercompany balances with the client and ensure that reconciling items have been dealt with in both companies;

(2) the auditor should consider obtaining direct confirmation of balances from the auditors of other group companies (if their audits are not done by the firm);

(3) where group companies have different year ends, there is a greater risk that errors may go undetected unless rigorous cut-off is applied to both companies at the same time; and

(4) recoverability of debts, particularly for companies with going concern problems or dormant subsidiaries, must be fully considered and documented.

It is common to find that the reconciliation and agreement of intercompany debts is well-documented; auditors should also ensure the issue of recoverability is adequately considered.

Insight - Management representations

Frequently, particularly when dealing with smaller businesses, the auditor may be reliant on management representations to determine whether adequate provision has been made for bad or doubtful debts. This can be a challenge as FRS 102:11.21 requires that there be objective evidence of impairment.

For example, the auditor may judge that some debts need to be written off, but the managing director or finance director insists that the amount will be paid. It is important to ensure that issues such as this are looked at objectively and that the auditor does not place too much reliance upon the assurances of the directors. For example, if a debt has been outstanding for the last two years with no movement on it and the client is not openly chasing for payment, the auditor may consider that a provision should be made.

Even if this issue has been incorporated within the letter of representation, it is still appropriate to incorporate the amount on the schedule of uncorrected misstatements.

If the item is material, the auditor should consider the impact that it might have on the audit opinion.

It is likely that if the bad debt provision is material, the inherent high degree of estimation uncertainty involved will lead to this being assessed as containing significant audit risks and therefore certain procedures will be required under ISAs (UK).

See Auditing accounting estimates and Accounting estimates with significant risks.

Invoice discounting and debt factoring

Another consideration for bad debt provisions is where the client makes use of invoice discounting or debt factoring. The auditor should review the terms of the financing agreement and consider whether the debts should continue to be recognised onthe client's balance sheet or not. The following table gives the details of the appropriate treatments in various situations. Under FRS 102, the key question is whether the client has the risks and rewards of ownership of the debt.

Indicators that the debts are not a client asset	Indicators that the debts remain a client asset
Transfer of debts for a single non-returnable sum.	Cost varies with speed of collection, for example: • adjustment to original amount paid for transfer; and • subsequent transfer amounts adjusted.
No recourse to client for losses.	Full recourse to client for non-payment by debtors.
Factor is paid all amounts from factored debts. Client has no right to further amounts.	Seller required to repay amounts received from factor on or before a set date, regardless of timing or amounts collected from debtors.

The auditor should consider whether factoring expenses are valid by reviewing the financing agreement. Consideration of the presentation of the financing agreement should be fully documented.

The auditor needs to be satisfied that the debts are all valid and that cut-off has been correctly applied. Where a client is suffering cash flow problems, it is not unheard of for invoices to be raised early or even for false invoices to be raised. The auditor should be aware of this problem and consider testing the invoices for validity. If the client is found to be raising invoices early, or raising false invoices, the auditor should consider the impact that this will have on any contingent liabilities and also on the client's ability to continue to trade on a going concern basis.

The balance due to the factor should be confirmed directly as the auditor would normally do with traditional bank borrowings.

Existence and recoverability of factored debts

It is imperative that the auditor gives due consideration to the existence and recoverability of the debts, particularly where the entity may become liable for any bad debts via recourse clauses.

Despite the fact that the client may have already received some – if not all – of the funds relating to the debt (ascan be seen above), if the factor cannot collect the debt, the client may become ultimately responsible for that debt. So the issue of recoverability of factored debts is still relevant. It will often be necessary, therefore, for theauditor to consider cash after date on factored debts to ensure that all potential amounts payable have been accounted for. The validity and existence of the amounts sold to the factors should also be considered since the factor will try to reclaim any sums transferred to the client in respect of non-existent sales, even though there may appear to be no recourse to the client from the agreement.

The following tests should be performed where the factor has recourse to the client for unpaid amounts:

- obtain a confirmation direct from the factor of the amount drawn down (that is, the borrowings);
- reconcile the client's sales ledger to the balance of invoices outstanding shown on statements received fromthe factor; and
- review statements received from the factor after the year end to identify any unpaid debts returned to the client for collection. These are usually separately identified on the 'borrowings' statement as a reduction in themaximum amount available for draw down.

Prepayments and other debtors

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain or prepare a list of items included as prepayments or other debtors and reconcile to the nominal ledger.	A
Select a sample of prepayments and other debtors. Agree to underlying records and confirm that they have been recognised in the correct period.	A, Cut-off
Vouch material items to bank statements and invoices.	E, A, Cut-off

Substantive analytical procedures

The auditor should obtain a list of items included as prepayments and other debtors and ascertain whether the figures are comparable through analytical review.

Insight - Prepayments and other debtors

Where the amounts are immaterial with a low risk rating, the auditor should compare the current and previous year's figures to ensure that no potentially material balances have been omitted and undertake no further work. The audit work on the expenditure cycle, coupled with analytical review, should overlap as it enables the auditor to identify any instances of omission of material prepayments that did not exist in the previous year.

Tests of detail

The auditor should obtain a list of other debtors and other debtors included within the financial statements and reconcile this to the nominal ledger.

Where other prepayments and other debtors are material, a sample of them should be selected and vouched to supporting documentation as to ensure they are accurately recognised in the correct period.

Where balances include amounts outstanding from staff, the auditor should ensure that repayments are being made on the loan in accordance with any agreement.

Within the work on debtors, the auditor should consider the position of the directors. Any loans, or other advances, made to directors within the meaning of CA 2006, s. 413 should be highlighted, as they may need to be disclosed separately in the financial statements.

Estimates

Design and perform appropriate tests for estimates, e.g. the bad debt provision, using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made.

Other debtors may not only be significant but may also contain items that should be disclosed separately within the financial statements, such as amounts outstanding from directors. The auditor should always obtain direct confirmation of amounts due to or from the company by the individual directors, even where there is a zero balance at the year end.

Auditors should also ensure that any factored debts have been accounted for in accordance with the substance of the agreement, as outlined in the testing for the bad debt provision.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Ensure that there is evidence on the file to support the disclosures made in the financial statements.	Presentation
Ensure that any factored debts have been accounted for in accordance with the substance of the agreement.	Presentation

3.16 Cash at bank and in hand

Overview and definitions

This section considers the audit of all bank and cash balances, overdrafts and loans in the balancesheet. It provides example audit objectives for the section, covering the types of control which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail. The statement of cash flows is dealt with in Statement of cash flows. Long-term loans and borrowings are dealt with in Loans and borrowings.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas~~ of *Navigate Audit*.~~

This section relates to section K in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Bank and cash

The cash flow statement reports changes in 'cash and cash equivalents'. Cash equivalents are 'short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value' and would usually include short-term deposits with maturities of less than three months from the date of acquisition.

Bank overdrafts are usually treated as borrowings but may also be included within cash and cash equivalents if they are repayable on demand and form an integral part of the entity's cash management.

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing cash are as follows.

Financial statement area	Objective	Assertion	Audit procedures
Cash	To ensure that all bank balances and overdrafts are owned by the entity and exist.	E, C, A, V, Presentation	Bank confirmations
Cash	To ensure that cash balances have been included at the correct amount at the balance sheet date.	E, A, Cut off	Bank reconciliations
Cash	To ensure that cash balances have been presented appropriately.	A, Presentation	Presentation and disclosure

In the *~~Navigate~~ Audit* tools, the assertions are defined as follows.

Assertion	Definition
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity. The existence assertion used in the *~~Navigate~~ Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the *~~Navigate~~ Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	Is there an estimate in this balance? (C8.1)	Assertions to be tested				
	Y or N	C	E	A	V	Other
Cash at bank and in hand	N	X	X	X	X	Presentation, Cut-off

Controls

The following are controls that are relevant to cash and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls .

Many of the controls relevant to this section are key to ensuring that cash balances are protected. The controls outlined below are some of the more common controls that may be operated by an entity. The existence of such controls may enable the auditor to reduce the amount of substantive audit procedures undertaken – provided that they are working properly and the auditor has been able to design tests to ensure that they are effective. Even if it is not appropriate to reduce sample sizes, the auditor may obtain additional comfort where the controls do exist.

Control in place	How to test
As far as possible, the duties of the person writing up the cashbook should be separated from the person responsible for the nominal ledger, making payments or handling receipts and checking the bank reconciliations. In addition, wherever possible, the person who opens the post and logs cheque or cash receipts should not be the person who maintains the cashbook.	Select a sample of items and walk-through controls to identify that there is adequate separation of duties.
The opening of a new bank account should only be possible with the authorisation of the board of directors.	Review and walk-through controls around the opening of new bank accounts to ensure it is only possible with the authorisation of the board of directors.
Cashbook balances should regularly be reconciled to the nominal ledger control account.	Select a sample of reconciliations to verify they have been performed and any reconciling items have been followed up appropriately.
Controls are in place to ensure payee detail amendments and new payees are genuine, valid and appropriately authorised.	Evaluate payee detail controls to ensure that new payees and requests to amend payee bank account details (e.g. by suppliers or employees) are genuine, valid and appropriately authorised. Select a sample of payees, confirm

	and review evidence that controls were adhered.
Controls are in place to restrict inappropriate or unauthorised access to payment and online banking facilities.	Evaluate the physical and IT controls in place to limit inappropriate or unauthorised access to payments and online banking facilities (e.g. bank cards, cheques, online banking, BACs facilities).
Electronic payments and BACs runs should be subject to sufficient review and approval prior to payment by authorised staff.	Evaluate the controls over the electronic payment and BACs run process and for a sample of payments, confirm adequate review and approval by an authorised person.
Electronic payments and BACs runs are subject to adequate IT security controls and separation of duties between those preparing/ uploading payment templates and those authorising them.	Evaluate the controls over the electronic payment and BACs run process and for a sample of payments, test and confirm that adequate IT security controls and separation of duties apply.
Only staff with the relevant delegated authority are able to authorise payments.	Obtain a list of staff with delegated authority to authorise payments and approve bank transactions (e.g. bank cards, cheques, online banking, BACs facilities). Evaluate the payment processes and systems against the delegated authorities and payment thresholds to confirm that those with the ability to authorise payments have the delegated authority to do so. Select a sample of payments and confirm that they have been authorised in line with delegated authorities and policies.
There should be adequate security over blank cheques and under no circumstances should pre-signed cheques be maintained.	Review and walk-through controls around the issuing of cheques to ensure there is adequate security and pre-signed cheques are not maintained.
Cheques should be despatched immediately after signature and not returned to the person who prepared them.	Review and walkthrough controls around the despatch of cheques to confirm the appropriate process is followed.
A senior member of the client's staff should independently check bank reconciliations.	Select a sample of reconciliations to verify an appropriate individual has reviewed the reconciliation.
Cash counts should be undertaken on a regular basis and without the person in charge of petty cash being aware when they will take place.	Review the controls surrounding regular cash counts to confirm who is aware of them. Attend and observe a cash count.

Petty cash vouchers should be authorised.	Select a sample of petty cash vouchers to confirm they have been appropriately authorised.

Audit procedures

All the tests set out below should be considered when planning the audit to determine those that will most effectively satisfy each of the individual objectives for the client in question. Not all the tests relating to an individual objective need be carried out on each audit. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

Bank confirmations

Example tests

The following tests are the standard tests in the *~~Navigate~~ Audit* tools.

Audit procedure	**Assertion being tested**
Obtain directly from the bank confirmations for all bank accounts open at any time during the year in the entity’s name.	C, E, A, V
Ensure account details and the entity name matches the list of bank accounts provided by the client and the account balance agrees to the nominal ledger.	E
Ensure that the company has not exceeded any restrictions on borrowing powers imposed in the Articles of Association, bank covenants or any loan agreement.	Presentation

Substantive analytical procedures

Analytical procedures are not usually appropriate for bank and cash balances because the balances are not necessarily predictable. However, a comparison of the balances with the previous period, and also with expectations, may give rise to information in respect of either going concern problems or window dressing.

Tests of detail

The bank confirmation tests of detail are as follows:

- obtain directly from the bank confirmations for all bank accounts open at any time during the year in the entity’s name;
- ensure that account details and the entity name match the list of bank accounts provided by the client and the account balance agrees to the nominal ledger;
- ensure that the company has not exceeded any restrictions on borrowing powers imposed in the Articles of Association, bank covenants or any loan agreement.

When performing bank confirmations, the auditor should also consider the following:

- A bank letter should always be obtained from each of the banks at which accounts were open at any time during the year. It is important to follow this procedure, even if the client has changed its bank during the year and closed the old accounts. The old bank should still be circularised at the year end in which the accounts were closed.

- Bank letters should be checked against other audit evidence to ensure that they are consistent. Where there is an inconsistency – either in respect of a balance or other information such as security – the bank should be approached again to confirm the information in the bank letter is correct. If there is an inconsistency, it is frequently the bank letter that needs correction.

- Bank letters should be sent in accordance with and in the form agreed with UK Finance, either using the forms first prepared under Practice Note 16 or using the online Confirmations service.

- It should be noted that some banks provide letters electronically and some only respond to electronic requests, either via email or via Confirmation.com – for guidance see https://www.ukfinance.org.uk/policy-and-guidance/guidance/bank-audit-requests.

- *~~Navigate~~ Audit Automation* includes template bank letters to download and use. The main account number and sort code should be provided for each legal entity to assist the bank in locating the correct customer's details. Similarly, a facility account number for trade finance or derivative and commodity trading information, if required. Note that Practice Note 16 has been withdrawn but the original forms remain in use. A list of banks and their preferred and/or accepted methods of communication is available at UK Finance.

- The fast-track facility should only be used in exceptional circumstances where the normal time frame for receiving a response by the bank (one month after the year end) is likely to be inadequate, e.g. a company reporting to the USA within one month of the year end. The incomplete information form should also only be used in exceptional circumstances and the auditor is expected to acknowledge that the bank may take longer than usual to respond.

- Bank letter requests should be sent out at least one month in advance of the confirmation date.

- Auditors should confirm with the bank that the company has not exceeded any restrictions on borrowing powers imposed in the Articles of Association, bank covenants or any loan agreement.

Insight – Bank letters

Customers must give explicit authority to their banks before any information can be released to their auditor. Where possible, this should take the form of an ongoing standing authority rather than a separate authority each time information is requested.

Although auditors do not need to provide a new Authority to Disclose (ATD) for a client each time they submit an audit request, auditors should ensure that the ATD for each client is reviewed with that client and make sure all legal entities are covered and the authorisation signatures are appropriate.

Auditors should also note that a new authority will be needed in the case of a new audit entity and an updated authority will be needed in the case of entity changes (e.g. new group entities/auditor changes).

Audit staff should read bank letters carefully and note the details of security, contingent liabilities or directors' personal guarantees that are specified. This will ensure that they are appropriately disclosed.

In some instances, a bank letter is not received. This can be due to several reasons.

- The auditor may not issue the request to the bank on a timely basis. It is important that bank letter requests are sent promptly, ideally one month before the end of the accounting period under audit.
- There is a very tight reporting deadline and the bank is unable to respond in time. It may be possible for the auditor to request the fast-track service, but the circumstances in which this may be used are very limited.
- The bank does not hold or cannot locate the client authority to release the information to the auditor. This is very common and emphasises the value of sending the request early. If the bank is unable to locate the client's authority, the auditor should still have time to obtain a replacement from the client.
- The bank is an overseas bank, which results in additional postal delays as well as difficulties for the bank in understanding the nature of the information requested. In this situation, the auditor should consider the need to send a translated version of the request letter.

If a bank letter is not received by the time the audit report is due to be signed, the auditor should document on the file why there is sufficient audit evidence to support the audit opinion in its absence.

Bank reconciliations

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain or prepare bank reconciliations for all accounts, check and verify:	
• Bank balances to bank statement and bank letter.	A
• Cash book balance to nominal ledger.	A
• Casting of the reconciliations.	A
For a sample of reconciling items, obtain an explanation and documentation for the reconciling item and confirm whether its cleared post year end. If not, understand whether it is appropriate to be included in the reconciliation.	E, A, Cut off
Select a sample of receipts pre- and post-year end from the bank reconciliation to the cash book and bank statements ensure the receipts/payments are recognised in the correct period.	Cut-off

Substantive analytical procedures

Analytical procedures are not usually appropriate for bank and cash balances because the balances are not necessarily predictable. However, a comparison of the balances with the previous period, and also with expectations, may give rise to information in respect of either going concern problems or window dressing.

Insight – Window dressing

While conducting the testing of cash against the key audit objectives, auditors also need to remain sceptical around the possibility that window dressing has taken place. The most common methods of window dressing bank balances are:

(1) including monies received after the balance sheet date;

(2) using bank borrowing facilities immediately before the year end to place monies on deposit, thereby improving liquidity ratios (this may be combined with the transfer of money to other group companies, making it more difficult to detect);

(3) sending cheques to creditors before the balance sheet date but not entering them in the cash book until the following period; and/or

(4) entering cheques in the cash book before the balance sheet date, but not sending them to creditors until the following period.

To ensure that no window dressing has occurred, the auditor should:

- review material receipts and payments in the final month of the year and for a reasonable period after the year end to assess whether any appear unusual;
- investigate delays in banking receipts. This forms part of the bank reconciliation tests; and
- investigate delays in the presentation of cheques. Again, this forms part of the bank reconciliation work and might indicate that cheques are being held back.

Tests of detail

The auditor should obtain or prepare bank reconciliations for all accounts and complete the following audit tests:

- checking the bank balances against the bank statement and bank letter;
- checking the cash book balance against the nominal ledger;
- check the casting of the reconciliation;
- for a sample of reconciling items, obtain an explanation and documentation for the reconciling item and confirm whether it has cleared post year end. If not, understand whether it is appropriate to be included in the reconciliation.

Auditors should consider checking uncleared items against after-date bank statements, noting the dates items cleared. Any item that took longer than expected to clear should be followed up. This is particularly important in respect of outstandinglodgements, where any significant delay in the amounts clearing the bank may be an indication of a teeming andlading fraud.

If it is not undertaken within the profit and loss account audit work, the auditor should check a sample of transactions from the bank statements against the cash book, ensuring that all items have been recognised in the correct period. This procedure will identify transactions that have passed through the bank but not been recorded in the entity's accounting records. Checking from the cash book to the bank statement for this objective will not provide assurance as this will be testing in the wrong direction.

Where the client prepares its own bank reconciliation, the auditors should select a sample of reconciling items and obtain an explanation and documentation for the reconciling item and confirm whether its cleared post year end. If not, understand whether it is appropriate to be included in the reconciliation.

The auditor may also wish to check unpresented cheques into the new period on a sample basis to obtain explanations for and substantiate all adjustments on the bank reconciliation.

The auditor can test cut-off by reviewing the paying-in book and cheque stubs to ensure that receipts and payments have been recorded in the correct period.

Insight – Bank reconciliations

Auditors should consider the length of time it takes for outstanding lodgements to clear after the year end. It is not unusual for it to take seven or eight days after the year end for the balance to clear. This may be because the outstanding lodgement is, in fact, cash in hand at the end of the year, but this is not addressed.

In some cases, cash in hand after the year end is not merely the float, but also includes the takings from the last day of the year or the previous day. This means that there have been cash sales that have been incorporated in the wrong period. Although the difference is unlikely to be material, it still should still be considered.

An auditor will often check all unpresented cheques into the new period. This can be a time-consuming exercise and is an area where sampling can be applied.

Large cash balances

Large cash balances should be critically examined to see if they 'make sense'. Such amounts may be outstanding lodgements, unanalysed expenditure or they may indicate a teeming and lading fraud. Moreover, where there are large cash balances, the auditor should consider whether the balance is adequately insured against loss as a result of a burglary or misappropriation of funds (insured via fidelity insurance).

Presentation and disclosure

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

Both SI 2008/409 and SI 2008/410 stipulate that there should be a minimum amount of netting-off; hence, when there are bank balances in credit and debit (overdraft) with the same bank or different banks, the auditor should ensure that netting-off only occurs where there is a formal right of set-off. Typically, it will not be possibleto offset the two amounts because the company has a separate financial asset and a financial liability with the same counterparty and the criteria for allowing offset of financial instruments in FRS 102 are very strict.

The auditor should review the bank letters for any indication of undisclosed related parties or related party transactions such as guarantees given by the directors and ensure that all necessary disclosures have been made.

3.17 Creditors and accruals

Quick overview

This section explains how to audit creditors and accruals and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.

This guidance relates to section L in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Creditors and accruals

This section deals with the audit of creditors, being the amounts outstanding by the entity, and accruals, being uninvoiced amounts outstanding for goods and services received. FRS 102 refers to payables rather than creditors. However, as the Companies Act formats require reference to creditors,this term will be used instead.

Trade and other similar creditors are financial instruments and will typically fall within the scope of Section 11.They are measured at the undiscounted amount of cash payable to the supplier, unless extended credit terms are offered, in which case they are measured at the present value of the cash payable, discounted at the prevailing market rate of interest for a similar payable.

Accruals represent expenditure that has been incurred because the good or service has been received but which has not yet been invoiced. Accruals commonly arise with contracts for services that are received over a specified period, such as utilities.

~~Further guidance on the accounting requirements for creditors and accruals under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Financial instruments (Sections 11, 12 and 22);
- Small Company (FRS 102 1A) – Financial instruments (Sections 11, 12 & 22);
- Micro Entity (FRS 105) – Financial instruments (Section 9).

This section is primarily concerned with trade creditors although other creditors and accruals are also considered. In all cases, it is assumed that the creditors will be classified as basic financial instruments and carried at amortised cost. The audit of other financial instruments which are generally carried at fair value is addressed in Financial instruments.

The audit of finance leases is addressed in Finance leases.

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so that they can also be considered as audit objectives.

The specific objectives that should be addressed when considering creditors and accruals are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Creditors	To ensure that creditors are complete and have been recorded in correct period.	C, Cut off	Completeness of liabilities
Creditors	To ensure that all liabilities exist and are supported by satisfactory independent evidence.	E, A	Supplier statements, Creditors' circularisation
Accruals	To ensure that accruals exist and are appropriately and completely recorded in the financial statements.	C, E, A, Cut-off	Accruals
Other creditors	To ensure that other creditors are appropriately and completely recorded in the financial statements.	C, E, A	Other creditors
Creditors, Accruals, Other creditors	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates
Creditors, Accruals, Other creditors	To ensure that all creditors are appropriately presented and disclosed in the financial statements.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**

C – Completeness

All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.

E – Existence

Assets, liabilities and equity interests exist.

The entity holds or controls the rights to assets; and liabilities are the obligations of the entity.

For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity.

The existence assertion used in the *~~Navigate~~ Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy

Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation

Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions

Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the *~~Navigate~~ Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Creditors		X	X	X		Cut off, Presentation
Accruals	Y	X	X	X		Cut off, Presentation
Other creditors		X	X	X		Cut off, Presentation

Controls

The following are controls that are relevant to fixed assets and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	**How to test**
All invoices are approved prior to payment.	Select a sample of invoices and confirm that they were appropriately authorised and approved prior to payment.
Appropriate authorisation from suppliers is sought before updating any supplier bank details.	Select a sample of supplier change requests and ensure appropriate support for change of bank details is provided.
There are controls to ensure that discounts are taken wherever possible.	Select a sample of purchases and confirm the requisitioner obtained competitive quotations or discounts where applicable.
Independent supplier statement reconciliations are carried out and appropriately reviewed.	Select a sample of supplier statements and review reconciliations to confirm they have been completed accurately and appropriately reviewed.
Purchase ledger and VAT control account reconciliations are carried out and appropriately reviewed.	Review a sample of purchase ledger and VAT control account reconciliations to confirm they have been accurately performed and appropriately reviewed.
Purchase invoices are checked to pre-numbered goods received notes, which in turn are checked to authorised orders.	Select a sample of purchase invoices and confirm they have been agreed to the corresponding pre-numbered goods received notes and authorised orders.
Invoices are marked when they are being paid to prevent them being entered into the system again.	Select a sample of paid invoices and confirm they have been appropriately recorded in the system.
There is sufficient follow up of any unmatched goods received by an independent individual.	Select a sample of unmatched goods received notes and confirm that adequate follow up processes have been completed.

The controls listed in Cash at bank and in hand will also be relevant for payments made to employees.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It is not appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied.

Completeness of liabilities

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain the year end creditors listing and reconcile back to the nominal ledger.	A
Compare to a prior year listing to identify omissions of creditors.	C
Review purchase year to date information where available to identify major suppliers.	C
Enquire about major suppliers not on the creditors list or with low balances to ensure the creditors listing is complete.	C
Review payments made after period end to ensure transactions have been recorded in the correct period.	C, E, Cut off
Obtain support for a sample of debit balances and ensure they have been appropriately accounted for.	C

Substantive analytical procedures

Creditor days

A common ratio calculated as part of a general analysis of creditors is the creditors' settlement days (or creditor days) ratio. This can be calculated as follows:

(creditors for cost of sales/cost of sales) × 365

The ratio gives the average number of days an entity takes to pay its creditors. However, adjustments have to be made to ensure that the treatment of VAT is consistent.

Changes in this ratio are not as straightforward to interpret as those in the debtor days figure. A reduction in creditor days may indicate a potential understatement of creditors or that creditors are being paid too quickly, which may result in cash flow problems. A significant increase in the ratio may indicate potential solvency problems, as creditors are not being paid as they fall due.

The auditor should discuss the creditor days' ratio with the directors, taking particular note of the figure they would expect the business to have.

The client may understate creditors, either deliberately or in error, by recording creditors in a later accounting period. The auditors should review, where available, monthly figures for purchases, payments to creditors and creditor balances. A significant increase in trade creditors after the year-end could indicate a potential cut-off problem.

Purchase ledger analysis

A comparison of individual creditor balances with previous accounting periods and activity reports may enable the auditor to reduce sample sizes for detailed balances. The procedure is similar to that outlined in the debtors section, with any significant changes being explained by the client and then corroborated. For example, a case where the level of purchases has increased significantly for a particular supplier, but there has not been a corresponding increase in amounts owed to that supplier.

As with trade debtors, digital purchase ledgers may enable the auditor to review purchasing activity for particular suppliers, which can be referred to when comparing individual creditor balances year on year. If the necessary reports cannot be recreated by the system after the year-end, the auditor should ask the client to retain them.

Tests of detail

The auditor should perform the following tests of detail:

- obtain the year end creditors listing and reconcile back to the nominal ledger. Agree reconciling items to support;
- compare to a prior year listing to identify omissions of creditors;
- review purchase year to date information where available to identify major suppliers;
- enquire about major suppliers not on the creditors list or with low balances to ensure the creditors listing is complete;
- review payments made after period end to ensure transactions have been recorded in the correct period;
- obtain support for a sample of debit balances and ensure they have been appropriately accounted for.

Completeness of liabilities testing involves auditors looking for missing items as well as evidence provided by the client to fully consider the possibility of unrecorded liabilities.

Auditors should ensure that multiple tests for completeness are performed, as most tests for completeness of creditors have an inherent weakness(es). For example:

- reviewing post-year end payments will not identify missing invoices that have not yet been paid;
- reviewing post-year end invoices will not identify invoices that have gone missing in the post or been fraudulently hidden or destroyed by the client;
- reconciling supplier statements will not identify missing invoices from suppliers who do not issue supplier statements or where the client has fraudulently hidden or destroyed the statement.

It is therefore advisable to plan at least two tests of completeness of creditors to obtain sufficient audit evidence.

Insight – Directional testing

If an auditor selects creditor samples from the year-end aged creditors report and vouches these to invoices, then items have been selected from the list of creditors rather than the purchase ledger. This test has therefore been performed in the wrong direction, testing existence rather than completeness.

Similarly, checking whether creditors have been paid after the year end (or vouching recorded creditors to purchase invoices) will test for overstatement rather than completeness. The risk of overstatement in creditors is often satisfied by the testing performed on the profit and loss account, so it may duplicate effort.

Supplier statements

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Select a sample of supplier statements (from the list of all suppliers) and agree/reconcile to the creditors' listing.	C, E, A
Where a statement is not available for any supplier(s), consider requesting a copy statement (see creditors' circularisation) or designing alternative procedures.	C, E, A, Cut off

Substantive analytical procedures

Supplier statement verification is an area where substantive analytical procedures are unlikely to provide assurance; nonetheless, the auditor should consider their knowledge of the client and prior years to gain additional audit comfort.

Tests of detail

The principal test in this area is the verification of selected balances by inspection of supplier statements. These can be obtained directly from the suppliers or the client. The auditors can ask the client to retain copies of all such statements in a prepared by client sent before the period end.

The sample for testing should be selected from a source that is most likely to identify all suppliers and could take the form of:

(1) a list of creditors at the previous balance sheet date;

(2) suppliers identified during the latter part of the accounting period as part of the purchases sample;

(3) a review of the cash book in the last few months of the year for details of regular suppliers; or

(4) a purchase ledger report listing total purchases by each supplier.

Differences between the client's records and the supplier statements should be investigated. The auditor would normally expect to find the following items in such reconciliations:

- invoices included on a supplier's statement but not in the client's records. The auditor should check the date of receipt to ensure that the goods were delivered after the year end or that a provision has been made where goods were received before the balance sheet date;
- payments made by the client that do not appear on the supplier statement. These will be payments made a week or so before the year end. The payment should therefore appear in the bank reconciliation as an unpresentedcheque; and
- purchase returns that do not appear on the supplier statement, which are usually returned close to theyear end. The auditor should check that the goods have been returned (e.g. despatch records andcorrespondence) and that it was returned for a valid reason, as a supplier dispute could mean there is still an amount outstanding.

If supplier statements are not available or direct confirmation is not possible, the auditor shouldconsider performing alternative procedures on the balances selected, such as:

- a creditors' circularisation;
- agreeing the opening balance to last year's file and reviewing movements for reasonableness – that is, ensuring thatpurchases were valid and that payments were made; and

- review of invoices received and amounts paid after the year end to see if any represent omitted creditors oraccruals (this can be combined with the accruals testing).

Insight – Accounting records

Supplier statements may not be received by each supplier; therefore, when checking supplier statement reconciliations, it is tempting for the sample to be selected from the available statements rather than from the entire list of creditor balances. However, if the client wished to suppress a liability, it could destroy any supplier statement and it would not be tested.

Therefore, when undertaking this test, the auditor should select the sample from the full list of suppliers. If statements are not available, then alternative procedures should be applied, e.g. circularising the creditors. This can be an effective approach if applied selectively to major creditors where a supplier statement is not available.

Creditors' circularisation

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Select a sample of accounts from a complete list of balances for example an activity report (include nil and debit balances where applicable). Record the details on the Creditors' circularisation – Work paper.	
Confirm with the client the creditors you wish to circularise.	
Obtain explanations where the client does not want you to circularise particular balances and consider alternative procedures that can be applied.	E, A
Consider whether the refusal to allow circularisation of particular balances is indicative of fraud or imposes a limitation of scope on the audit.	E, A
Send the confirmation requests. In respect of each reply:	
• agree or reconcile the balance to that shown in the client's records;	E, A, Cut off
• investigate any exceptions;	E, A, Cut off
• consider whether any of the exceptions are indicative of fraud or other misstatement.	E, A, Cut off
Consider additional procedures when a letter is not received.	E, A, Cut off

Substantive analytical procedures

Creditors' circularisation is an area where substantive analytical procedures are unlikely to apply; nonetheless, the auditor should consider their knowledge of the client and prior year creditor balances to gain additional audit comfort.

Tests of detail

The auditor should consider carrying out a creditors' circularisation to confirm the completeness and accuracy of the main supplier balances:

- select a sample of accounts from a complete list of balances, e.g. an activity report (include nil and debit balances where applicable). Record the details on the standard working paper;
- confirm with the client the creditors they wish to circularise;
- obtain explanations where the client does not want them to circularise particular balances and consider alternative procedures that can be applied;
- consider whether the refusal to allow circularisation of particular balances:

– is indicative of fraud; or

– imposes a limitation of scope on the audit;

- send the confirmation requests. In respect of each reply:

– agree or reconcile the balance to that shown in the client's records;

– investigate any exceptions;

– consider whether any of the exceptions are indicative of fraud or other misstatement; and

- consider additional procedures when a letter is not received.

When undertaking this procedure, the auditor should consider the following:

(a) the sample should be selected from the activity report of purchases in the year that gives the value of the purchase from each supplier in the year, and not the year end aged purchase ledger. The auditor is interested in the accounts that are expected to have large balances – that is, the main suppliers, not just those accounts that happen to have high balances at the year end;

(b) the sample should include a selection of high value and other items, including nil balances;

(c) the supplier should be asked to provide details of the amount outstanding;

(d) the details incorporated in theledger should not be given to the supplier; and

(e) any differences between the balance confirmed by the supplier and the client's records should be investigated. The reasons for any differences will be the same as those outlined for supplier statement reconciliations below. As this test is more time consuming to undertake than a supplier statement reconciliation,it should usually only be carried out where statements are not available. To this end, the auditor should encourage the client to retain statements.

Insight – Creditor's circularisation

Companies are generally quite likely to respond to creditor's circularisation letters (more than debtor's).

The auditor should follow up on differences or reconciling items that have occurred as some reconciling items require adjustments in the client's accounts. Simply accepting that a statement reconciles may result in adjustments not being made or recorded on a schedule of uncorrected items.

For example, an invoice on the supplier statement not recorded by the client is not a straightforward reconciling item: if the goods were delivered before the year end, then the amount should be recognised in the accounts as a purchase and as a creditor.

A template for a creditors' circularization is available in Templates *(CREDITORSW)* ~~and Letters within *Navigate Audit*~~.

Accruals

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain the year end accruals listing and reconcile to the nominal ledger.	A
Select a sample of accruals. Agree to underlying records and reperform any calculations for accuracy and confirm correct period.	E, A, Cut off
Review invoices received after period end to ensure transactions have been recorded in the correct period.	C, Cut off
Review accruals for completeness by comparing the accruals listing to last year's list as well as current year expectations. Obtain explanations for any material changes.	C

Substantive analytical procedures

Accruals should be reviewed for completeness by comparing with last year's list and with the auditor's expectations. Where this procedure identifies accruals that are included on the current year's list, but which appear to be too low, they should be agreed to supporting documentation and have calculations checked. The auditor should also review payments made by the entity after the year end to identify items that should have been accrued.

Where the auditor has reviewed payments and invoices after the year end to identify missing accruals, the necessary audit work will already have been completed. However, it is still useful to compare the accruals with those expected for the client and with the actual accruals in previous years.

Tests of detail

A sample of accruals should be tested by agreeing to supporting documentation and reviewing any calculations for:

- arithmetical accuracy – reperform any calculations;
- confirm it is recorded in the correct accounting period; and

- where an accrual is based on estimation, auditors should design and perform appropriate tests using the estimates working paper for each estimate identified. Please refer to the guidance in *Navigate Audit* on estimates.

The auditors should also review invoices received after period end to ensure transactions have been recorded in the correct period.

Insight – Post-year end payments

A review of payments made after the year end to identify any unrecorded liabilities is very reliant on the chosen length of period post year end to review. Often, the chosen period is only a month or less and so is unlikely to identify missing liabilities for an entity that has longer creditor days than this.

Other creditors

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain the year end other creditors listing and reconcile to the nominal ledger.	A
Select a sample of other creditors. Agree to underlying records and confirm correct period.	E, A, Cut off
Review other creditors for completeness by comparing the other creditors listing to last year's list as well as current year expectations. Obtain explanations for any material changes.	C

Substantive analytical procedures

Auditors can use substantive analytical procedures to develop expectations of other creditors, e.g. where other material creditors have been in existence in the past, but have not been included in the current period, the auditor should ensure that no unrecorded liability exists.

Tests of detail

Typically, an entity will have a range of other creditors such as tax creditors, short-term loans and finance leases. Any other creditors that are material should be vouched to supporting documentation. For example, directors' balances should be confirmed directly with each director concerned.

Taxes

The corporation tax and VAT liability should be agreed to the appropriate sections on the file.

Control accounts should be prepared for PAYE and other deductions to ensure that the correct provision has been made. The year-end balance should also be vouched to the payment made to HMRC after the year-end.

Finance leases

As discussed in further detail in the guidance on auditing Finance leases, the auditor should:

- obtain details of finance lease arrangements;

- examine any new agreements and agree their treatment in the accounts, including classification as a finance or operating lease and calculation using the effective interest method;
- ensure that the amounts carried forward are correctly classified as due within or after one year;
- for existing finance leases, ensure that the correct amount has been charged to the profit and loss account and that the correct balance is carried forward; and
- include on the summary of uncorrected misstatements details of any leases that have not been properlyaccounted for.

Short-term loans

As discussed in further detail in the guidance on auditing Loans and borrowings, the auditor should:

- Any terms of repayment should be reviewed and the auditor should ensure that the liability has been recordedas being payable in the correct period according to the agreement. In the absence of any specific agreement tothe contrary, debt should be presented as being repayable at the earliest date it could be called on for repayment.
- Where an intercompany loan is not due on demand, the auditor should review the amortised cost calculations and assess whether an appropriate rate of interest has been applied. The interest rate should be a market rate ofinterest as at inception of the loan.
- Any intercompany balances should be agreed to the corresponding company's files. Where the firm does not audit some of the companies in a group, confirmation of the balance should be obtained directly from the auditors of those companies.

Estimates

Design and perform appropriate tests for estimates using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

The tests outlined above will all serve to help satisfy this particular objective.

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made.

In particular, the auditor should agree the split between current and non-current amounts to supporting evidence and ensure it is accurately presented in the financial statements.

3.18 Loans and borrowings

Quick overview

This section explains how to audit loans and borrowings and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of Navigate Audit.~~

This section relates to section M in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Loans and borrowings

As financial instruments, loans and borrowings are within the scope of FRS 102:11 and FRS 102:12 and it will therefore be important to understand the contractual terms of each loan to ensure that it is accounted for correctly. Many loans and borrowings will be basic and will therefore be accounted for at amortised cost, but it is important to review the contract carefully for any terms which may cause the loan to fall into FRS 102:12.

~~Further guidance on the accounting requirements for loans and borrowings can be found in the relevant area depending on the accounting framework:~~

- ~~Private Company (FRS 102) – Financial Instruments (Sections 11, 12 and 22);~~
- ~~Small Company (FRS 102 1A) – Financial instruments (Sections 11, 12 and 22);~~
- ~~Micro Entity (FRS 105) – Financial instruments (Section 9).~~

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing loans and borrowings are as follows.

Financial statement area	Objective	Assertion	Audit procedures
Loans and borrowings	To ensure that all material loans and borrowings have been identified.	C	Identify loans and borrowings
Loans and borrowings	To establish that the loans and borrowings exist and are obligation of the entity at the balance sheet date.	E	Confirmations
Loans and borrowings	To ensure that all material loans and borrowings have been accounted for appropriately.	A, V	Calculation of loans and confirmations, Compliance
Loans and borrowings	To ensure that amounts are shown as being payable at the earliest date that payment can be demanded by the lender. That is, amounts are not shown as due after one year when they are in fact payable within one year.	Presentation	Calculation of loans and confirmations
Loans and borrowings	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates
Loans and borrowings	To confirm that all necessary disclosures concerning loans and borrowings have been made and that the information is appropriately presented and described.	Presentation	Compliance, Presentation and disclosures

In the *~~Navigate~~ Audit* tools, the assertions are defined as follows.

Assertion	Definition
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity. The existence assertion used in the *~~Navigate~~ Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the *~~Navigate~~ Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Loans and borrowings		X	X	X	X	Presentation

Loans and borrowings are credit balances and therefore the majority of the audit work undertaken will be checking for understatement.

Controls

The following are controls that are relevant to loans and borrowings and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on sample sizes when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	**How to test**
Loans can only be entered into with the full agreement of the board of directors.	Select a sample of loans and check to board minutes confirming approval by the board.
The terms of loans and significant agreements are minuted and reviewed to	Review a sample of board minutes and check that the terms and conditions of significant loans are regularly reviewed by the board.

ensure that the entity does not breach any conditions imposed on it.	
Regular cash flow forecasts and budgets are prepared to ensure that the financing needs of the entity are known and met.	Select a sample of forecasts and budgets to verify they have been prepared regularly. Ensure that any funding requirements are identified in advance, communicated with management and action taken if required.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

Analytical procedures do not play a significant role in confirming loans and borrowings, however, in certain sections are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not loans and borrowings are fairly stated.

Care should be taken when planning and undertaking the audit in this area. For some companies, the treatment of loans will be straightforward – for example, bank loans that can be identified through the bank letter. However, the amounts involved are frequently substantial and there can be complex contractual terms.

Identification of loans and borrowings

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Ensure that all loans and borrowings have been identified:	
• check bank confirmations received;	C
• review board minutes;	C
• review the client's cash flow forecasts/projections;	C
• consider any 'off-balance sheet' financing; and	C
• discuss completeness with directors.	C

Substantive analytical procedures

There isn't often a substantive analytical procedure which can be performed to identify loans and borrowings. A comparison to the loans outstanding in the previous period may help identify whether debt levels have changed but detailed work will also be needed.

Tests of detail

The auditor can verify whether existing or previous loans and borrowings are still in existence and the period end.

The auditor should also be aware of the possibility of new financing arrangements being entered into during the period. This should be reviewed when looking at the board minutes, cash flows within the business and through discussion with the directors. Reviewing the bank confirmations received may also indicate a new loan or amount borrowed.

The auditor should be aware of the possibility of 'off balance sheet finance'. The *Companies Act* 2006 contains a specific provision for all companies requiring all off-balance sheet arrangements, where either the risks or the benefits are material, to be disclosed in the financial statements.

Calculation of loans and confirmations

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Calculation of loans	
Obtain calculations for loan balances which agree to amounts recognised in the nominal ledger. Check:	
• loans have been accounted for in accordance with the terms of the underlying agreements and the applicable accounting standards;	A, V
• arithmetic accuracy; and	A
• check loan balances have been appropriately classified between long and short term loans.	A, Presentation
Confirmations	
Obtain third-party confirmation for all material loan balances, repayment of principal and interest paid during the period and accrued interest to the balance sheet date. Check that third-party confirmations agree to the client's loan calculations. Investigate any differences.	C, E, A, V

Substantive analytical procedures

Substantive analytical procedures can be performed to gain additional comfort over the calculation of loans and borrowings using the expected repayment amounts and contractual interest rates. The auditor can also compare the current year with their expectations and with the previous period to gain additional comfort on the validity of the figures being recorded within the financial statements.

Tests of detail

Terms of repayment

Many bank loans and overdrafts repaid over extended terms of many years are, in fact, often technically repayable on demand. Financial instruments, including loans, need to be accounted for in accordance with the contractual terms. Accordingly, loans should be treated as falling due on the earliest date that a lender could require repayment if all available options and rights were exercised. Anincorrect analysis can have a material impact on certain ratios, which commonly form part of many banking covenants (see Compliance). If broken, such covenants can result in the withdrawal of banking facilities and the demand for immediate repayment. It is therefore important that such balances are correctly analysed in the financial statements.

Below market rate loans

Where a loan is repayable after more than one year but is not at a market rate of interest, then that loan should be measured at amortised cost using a market rate of interest for an equivalent loan (although there is an exemption for small companies in relation to loans made to the company by a director or directors' close family, as such loans can be measured at the transaction price with no need to impute a market rate of interest). This issue typically arises with intra-group loans (see Intercompany balances) but may also apply to other loans to and from related parties. ~~Further guidance on Financing transactions and off-market loans can be found in *Navigate UK GAAP Accounting*.~~

In practice, establishing a market rate may prove challenging, both for the company and the auditor, especially ifthe loan was first made many years ago, since the effective interest rate should be established at inception of the loan. Often the company will have borrowed from a related party because it would have struggled to borrowon market terms. In these situations, arriving at a market rate will need some work and investigation. This could involve looking back at historic interest rates and seeking input from one or more lenders to establish an interestrate which is, in all material respects, a market rate. In the most complex scenarios, specialist advice may be needed to calculate an appropriate rate.

Classification

The auditor should either calculate or check the allocation between long-term and short-term loans. Where the amount is material, an incorrect allocation could have a significant impact on the view given by the financial statements.

Confirmations

External confirmation for all material loans and borrowings is the best audit evidence. The auditor should seek confirmation of the balance outstanding at the balance sheet date, repayments of principal made during the course of the period and interest paid during the period. The auditor should also ask for confirmation of accrued interest at the balance sheet date, particulars of any security given and of the terms of repayment. This information ensures the liabilities are recorded appropriately in the financial statements and there is correct disclosure of such matters as security.

Compliance

Many bank loans and other financial instruments which are not repayable on demand have covenants built into the terms and conditions. Compliance with such covenants is intended to help reassure the lender of the borrower's ability to repay the capital advanced.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Review loan agreements and consider the implications of any breach of covenants.	V, Presentation
Review the terms of bank loans and overdrafts and consider the position regarding renewal of facilities.	A

Substantive analytical procedures

Analytical procedures can be used to add comfort that covenant ratios have been correctly calculated and complied with.

Tests of detail

Covenants

The auditor should review loan agreements and any specific terms and consider the implications of any breaches of the provisions of the loan. There could be a significant impact if the client has failed to comply with any of the provisions of a loan agreement. Where this has occurred, there should be cross-referencing to the contingent liabilities section to ensure that adequate disclosure is made where necessary.

Covenants are usually in the form of specific financial criteria that the entity must meet periodically, often quarterly or monthly, but they may also include non-financial criteria as well. The entity will usually make its own report to the lender as to the entity's compliance.

Example – Financial and non-financial covenants

Examples of financial covenants include:

- a minimum current ratio;
- a maximum number of debtor days; or
- a minimum profit level and minimum interest cover.

Examples of non-financial criteria may include:

- a requirement to maintain debtor and/or other asset insurance;
- the sending of regular management accounts to the lender; or
- taking out 'key man' insurance.

Numerous other examples are given in Appendix 6 to AUDIT 4/00 (TECH 29/00) Firms' reports and duties to lenders in connection with loans and other facilities to clients and related covenants.

Entities which breach covenants are at risk of their banking facilities being withdrawn, as this would normally be viewed as a default on the loan, so compliance with them is an important part of the auditor's assessment of the repayment schedule as well as of going concern.

The auditor should check whether covenants have been breached in both the current or post-year end periods. When reviewing forecasts or budgets, future compliance with loan covenants should always be considered.

The method for calculating covenant ratios is often defined very precisely in the banking agreement and may differ from that used by the auditor for analytical procedures. The prescribed method of calculating the 'same' ratio can differ both from bank to bank and between different clients of the same bank. The auditor should ensure that the covenant ratios are correctly calculated.

Example – Matters which may adversely affect ability to meet loan covenants

Matters which can have an indirect effect of adversely affecting an entity's ability to meet its loan covenants include:

- a fall in the value of a property;
- impairment charges; and
- unforeseen increases to stock and debtor provisions.

When covenants are tight, there may be a temptation for management to manipulate the figures in the accounts in order to meet covenants. The impact of audit adjustments, including those which do not affect the profit and loss account, should be considered in this context.

The auditor will need to consider the entity's position regarding the renewal of loan and borrowing facilities and the impact on the long-term position of the entity, as this will impact on the auditor's opinion in respect of the going concern of the entity.

Additionally, potential changes in financing arrangements, including critical covenants, may need to be disclosed in the directors' report of medium and large companies. The FRC document *Guidance on the going concern basis of accounting and reporting on solvency and liquidity risks* provides useful information.

Renewal

Whilst looking at the loan agreements, consider when any loans or borrowings are coming towards the end of term and what the renewal status is. This is likely to link into Going concern audit work.

Estimates

Design and perform appropriate tests for estimates, e.g. discount rates on financing transactions, using the **estimates work paper** *available as a template* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available as a template* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements. Also consider whether other matters, e.g. security or collateral, have been appropriately disclosed.

3.19 Provisions, contingencies and financial commitments

Quick overview

This section explains how to audit provisions, contingent liabilities, contingent assets and financial commitments and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to section N in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Provisions

A provision is defined by FRS 102 as a liability of uncertain timing or amount. A liability is defined in FRS 102:2.15(b) as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'.

A provision is recognised in the financial statements when and only when all three of these conditions fromFRS 102:21.4 are met:

(a) the entity has an obligation at the reporting date as a result of a past event;

(b) it is probable that the entity will be required to transfer economic benefits in settlement; and

(c) the amount of the obligation can be estimated reliably.

Provisions are measured at the 'best estimate' of the amount required to settle the obligation at the reporting date. The best estimate is defined as 'the amount an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time'.

Contingent liabilities

A contingent liability is either:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity;or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle theobligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

A contingent liability is not recognised in the financial statements, but detailed disclosures are required, including the nature of the obligation and an estimate of the financial effect.

Contingent assets

A contingent asset is defined as a possible asset that arises from past events and whose existence willbe confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

A contingent asset is not recognised in the financial statements, but disclosures are required, including thenature of the asset and an estimate of the financial effect.

Financial commitments

Financial commitments can include a number of different potential liabilities, such as:

- contractual obligations to acquire fixed assets;
- an obligation to buy or sell items outside of the normal activities of the business;
- an obligation to buy or sell currency or commodities under forward contracts;
- an obligation under operating leases; and
- an obligation to provide pensions (defined benefit pension schemes are considered separately in Defined benefit pension scheme).

Further guidance on the accounting requirements for provisions, contingent liabilities and financial commitments under the applicable standards can be found in *Navigate UK GAAP Accounting*:

- Private Company (FRS 102) – Provisions and contingencies (Section 21);
- Small Company (FRS 102 1A) – Provisions and contingencies (Section 21);
- Micro Entity (FRS 105) – Provisions and contingencies (Section 16).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Auditing standards and guidance

ISA (UK) 501 *Audit evidence – Specific considerations for selected items* sets out requirements and provides guidance for the auditor regarding audit evidence when dealing with pending litigation against the company on which the auditor is reporting.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing provisions, contingent liabilities and financial commitments are as follows.

Financial statement area	Objective	Assertion	Audit procedures
Provisions	To ensure that full provision has been made for all liabilities where an entity has a present obligation as a result of a past event; it is probable that a transfer of economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.	C, E, A, V	Provisions, Litigation and claims
Provisions	To confirm that all necessary disclosures concerning provisions have been made and that the information is appropriately presented and described.	Presentation	Presentation and disclosures
Contingent liabilities	To ensure that all contingent liabilities have been identified, appropriately valued, all necessary disclosures have been made and that the information is appropriately presented and described.	C, A, V, Presentation	Contingent liabilities, Litigation and claims, Presentation and disclosures
Contingent assets	To ensure that all contingent assets have been appropriately presented and disclosed.	C, Presentation	Contingent assets, Presentation and disclosures
Financial commitments	To ensure that all financial commitments have been appropriately presented and disclosed.	C, Presentation	Financial commitments, Presentation and disclosures
Provisions, Contingent liabilities, Financial commitments	To ensure that all accounting estimates recognised or disclosed in the accounts are reasonable in the context of the applicable accounting framework.	A, V	Estimates

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	Definition

C – Completeness
All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.

E – Existence
Assets, liabilities and equity interests exist.

The entity holds or controls the rights to assets; and liabilities are the obligations of the entity.

For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity.

The existence assertion used in the ~~Navigate~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy
Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation
Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions
Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~Navigate~~ *Audit* tools, the audit objectives are illustrated using the following table:

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Provisions	Y	X	X	X	X	Cut-off, Presentation
Contingent liabilities	Y	X	X	X	X	Presentation
Contingent assets		X				Presentation
Financial commitments		X				Presentation

The main objective when looking at provisions and contingencies is to identify unrecorded or under-recorded liabilities. There may be matters that have not been incorporated within the accounting records and which may not be backed up by any formal documentation, this can make provisions and contingences a challenging area to audit.

Controls

The following are controls that are relevant to provisions, contingent liabilities and financial commitments and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	How to test
There is a member of senior management responsible for compliance with all relevant laws and regulations who has a checklist of the relevant laws and regulations to assist in that task. Regular compliance review checks are carried out.	Review a sample of completed compliance review checklists to check they are completed regularly. Check that any issues have been followed up appropriately.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

In practice, it can be difficult to apply substantive analytical procedures to provisions and contingences. However, in certain sections are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not provisions, contingent liabilities, contingent assets and financial commitments are fairly stated.

This is an area of particular focus for regulators and professional bodies when reviewing audit files given the judgements that need to be made and type of evidence available. When looking at provisions, contingent liabilities, the auditor needs to consider not only items that need to be recognised or provided for within the financial statements, but also any possible provisions, contingent assets or liabilities that have been identified during the course of the audit.

The approach to this area requires the auditor to be aware of the possibility of provisions, contingencies, etc. when discussing the audit with the client's staff. The auditor needs to consider whether it is practicable to undertake a review of non-accounting documentation, such as correspondence files, etc. where the audit is not undertaken at the client premises. It may be that some of the work on this area has to be undertaken on those occasions when the auditor attends the stocktake or at other meetings with the client.

Provisions

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain a list of provisions and amounts existing at the balance sheet date which agrees to the nominal ledger. Check the arithmetic accuracy of the list.	A
Check completeness of the list by reviewing:	
• the previous year's provisions and contingent liabilities;	C
• items recorded on the bank certificate;	C
• minutes of meetings;	C
• major contracts;	C
• correspondence; and	C
• compliance with laws and regulations (complete Compliance with laws and regulations audit programme).	C
Discuss with management whether provisions are adequate for warranties, contract losses or other events.	C, V
Confirm that each provision meets the criteria to be recognised as a provision under the appliable accounting standard.	E, A
Confirm that management's assessments in determining the provision are reasonable, including the assessment of the outcome, financial implications and costs involved. Where the provision includes an estimate(s), complete the **Estimates work paper** *available in the templates.*	A, V

Substantive analytical procedures

Provisions is an area that does not lend itself to analytical procedures, except in the role of reviewing anything incorporated within the previous year's financial statements to ensure that it has been accounted for appropriately in the current year.

Tests of detail

The auditor should obtain details of any liabilities and charges, ensure that adequate provision has been made where necessary and ensure that the provisions have been calculated on a reasonablebasis. This procedure can be applied through:

- a review of minutes of meetings;
- a review of major contracts;

- a review of correspondence;
- comparison with the previous year's provisions and liabilities; and
- discussion with the officers and staff of the entity.

The auditor should discuss the subject with the client's staff and directors to ascertain details of any other unrecorded liabilities.

Compliance with laws and regulations

The auditor should determine whether the entity has actually complied with all the relevant laws and regulations. The degree of emphasis placed on this test will depend to a large extent on those laws and regulations and on the information that has been gleaned during the work at the planning stage. The following procedures should be considered:

- ask the directors to identify any laws and regulations that are central to the entity's ability to conduct its business. This should have been done during the planning of the audit;
- ask the directors whether they are on notice of any possible instances of non-compliance with such laws and regulations;
- update the permanent audit file for any changes identified at this stage;
- review the correspondence files with any relevant licensing or regulatory authority for any indications of breaches of laws and regulations;
- where legislation has been identified as central to an entity's ability to continue trading, the auditor should first determine what action, on behalf of the entity, could cause a breach. Second, the auditor should consider what steps are being taken by the entity to ensure that it complies with all relevant laws and regulations. While it is not necessary to become an expert in the field, the auditor should be satisfied that the client has the requisite knowledge and that there are procedures in place to identify and rectify any instances of non-compliance; and
- draft specific representations for inclusion in the letter of representation. These are particularly important where there are specific laws and regulations that are central to the entity's ability to continue trading.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is a separate audit programme for auditing **Compliance with laws and regulations**.

Further guidance on can be found in Consideration of laws and regulations.

Warranty provisions

The auditor should review the client's procedures for determining the amount of any warranty provisions. This is usually done by reference to the client's claims experience in previous years and to the level of sales in the current year. Particular consideration should be given to new product lines andimprovements to existing products, as there will be no claims history to review for such products.

The auditor should consider other evidence which might indicate that the warranty provision is either not sufficient or is excessive. This may include:

- customer correspondence;

- quality control reports;
- significant increases in rectification or repair costs; and
- any increase in the credit period taken by customers (which could be due to dissatisfaction with products).

For products not manufactured by the entity, which acts only as distributor or sales agent, the auditor shouldconsider the extent to which warranty costs can be passed on to the manufacturers.

Where the ongoing cost (of either labour or materials) of warranty repairs and replacements is difficult to identify from the accounting records, this can have a significant adverse impact on the audit of warranty provisions as there may be no past history against which to compare the current year's provision. It is also likely to prevent effective performance of the retrospective review of the warranty provision (see Significant accounting estimates) at the planning stage. This can make it almost impossible to assess management's assertions regarding the magnitude, or in some cases, the absence of the warranty provision. In the most serious cases where no alternative procedures can give sufficient audit evidence, this may result in a limitation on audit scope. It is therefore important that this issue be identified and, if at all possible, addressed at an early stage in the audit process.

Contingent liabilities

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain a list of contingent liabilities existing at the balance sheet date. Check its completeness by reviewing:	
• the previous year's provisions and contingent liabilities;	C
• items recorded on the bank certificate;	C
• minutes of meetings;	C
• major contracts; and	C
• correspondence.	C
Discuss findings with management.	C
Confirm that each contingent liability meets the recognition criteria to be recognised as such under the applicable accounting standard.	E
Confirm that management's assessments in determining the contingent liability are reasonable, including the assessment of the outcome, financial implications and costs	A, V

involved. Where the contingent liability includes an estimate(s), complete the **Estimates work paper** *available in the templates*.

Substantive analytical procedures

Contingent liabilities is an area that does not lend itself to analytical procedures, except in the role of reviewing anything incorporated within the previous year's financial statements to ensure that it has been accounted for appropriately in the current year.

Tests of detail

The auditor should obtain details of any contingent liabilities and charges, ensure that each contingent liability meets the recognition criteria to be recognised as such. The auditor should ensure that all contingent liabilities have been identified by completing the following procedures:

- a review of minutes of board or other management meetings;
- a review of major contracts;
- a review of correspondence;
- comparison with the previous year's provisions and contingent liabilities;
- discussion with the officers and staff of the entity;
- items recorded on the bank statement; and
- the terms and conditions of any major contracts and agreements.

The list should be discussed with the client to ensure that it is complete and adequate disclosure has been made for all contingent liabilities.

The auditor should ensure that management's assessments in determining the status and valuation of the contingent liability are reasonable, including the assessment of the outcome, financial implications and costs involved.

Adequacy of insurance

The auditor should obtain or prepare a schedule of the major insurance policies maintained. This schedule should state the amount insured, the premium payable, the period covered and the date of the last renewal. The schedule can then be used to assess whether the entity is adequately insured. If the auditor identifies an area that is underinsured, this should be highlighted to the client for future consideration. It would not, however, constitute a situation where either disclosure or provision is required within the financial statements, unless there is a possibility of the client suffering loss as a result of being underinsured. The auditor should review the areas set out below. Where there is underinsurance, it is frequently within the following categories (e) and (f).

(a) the difference between the current replacement value of major assets and the sum insured;

(b) the maximum potential losses under third-party insurance;

(c) the level of employers' liability insurance;

(d) the level of insurance over loss of profits;

(e) the level of insurance for cash; and

(f) the level of insurance for stock holding.

Litigation and claims

Example tests

The following tests are the standard tests in the ~~Navigate~~ *Audit* tools.

Audit procedure	Assertion being tested
Identify any possible claims or litigation against the company by carrying out the following:	
• make enquiries of management and those charged with governance;	C
• review board minutes and correspondence with the company's legal advisers;	C
• examine legal expense accounts, bills from solicitors or estimates of unbilled charges.	C
Where actual or potential litigation or claims against the company have been identified:	
• obtain a list of matters referred to solicitors with estimates of the possible ultimate liabilities;	C, V
• consider whether direct communication with the entity's external legal counsel is required;	C
• consider alternative procedures where the legal counsel refuses to reply or where the reply is unhelpful.	–
If permission is refused by management to contact the company's legal counsel directly, or if the legal counsel refuses to reply, consider the impact on the audit opinion.	–
Ensure that provisions have been recognised and/or contingent liabilities disclosed as appropriate in accordance with applicable accounting standards for all known claims.	C, A, V
Obtain written representations that all known actual or possible litigation or claims that might have a material effect on the financial statements have been disclosed to the auditor.	C, A, V, Presentation

Substantive analytical procedures

There isn't often a substantive analytical procedure which can be performed for litigation and claims.

Tests of detail

ISA (UK) 501 specifically requires the auditor to design and perform audit procedures to determine whether a risk of material misstatement may arise from any litigation or claims involving the entity. These procedures must include:

- enquiries of management and, where applicable, others within the entity;
- reviewing minutes of meetings with those charged with governance and correspondence between the entity and its legal advisers; and
- reviewing legal expense accounts.

Procedures the auditor may use to verify the existence of claims, although they will not necessarily provide sufficient evidence of the likely amount that the company may be responsible for, include:

- reviewing the system of recording claims and the procedure for bringing these to the attention of management;
- discussing with management arrangements for instructing solicitors;
- examining board minutes and correspondence for potential claims;
- examining legal expense accounts, bills from solicitors or estimates of unbilled charges;
- obtaining a list of matters referred to solicitors with estimates of the possible ultimate liabilities;
- making enquiries of those charged with governance; and
- obtaining written representations that there are no further matters of which the directors are aware.

The auditor should consider whether it is appropriate to send a letter to the client's solicitor requesting details of all contingent liabilities noted. This is mandatory under ISA (UK) 501 when the auditor considers there to be a risk of material misstatement regarding litigation or claims that have been identified, or where audit procedures performed indicate that other material litigation or claims may exist. The letter, which should be prepared by management and sent by the auditor, should request the entity's solicitor to reply directly to the auditor.

The auditor may make a general enquiry to the legal advisor, asking the advisor to inform the auditor of any litigation and claims of which they are aware, together with an assessment of the outcomes and the financial implications. However, many solicitors will not respond to a general inquiry, as the Council of the Law Society has advised solicitors that it is unable to recommend them to comply with non-specific requests for information. The letter should therefore be as specific as possible, and should include:

- a list of litigation and claims;
- where available, management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved; and
- a request to confirm the reasonableness of management's assessments and provide the auditor with furtherinformation if the list is considered to be incomplete or incorrect.

Once a reply is received, it should be reviewed to ensure that adequate provision is made for all items noted.

Contacting the entity's legal counsel

There may also be situations where the auditor considers it necessary to meet with the entity's legal advisers to discuss the likely outcome of claims. This may be the case where the auditor determines the matter is a significant risk or is complex or if there is disagreement between management and the entity's legal advisers. Where such meetings take place, they usually include a representative of management and they take place with management's permission.

If the solicitor does not reply, the auditor may meet with the solicitor to discuss the matters and to agree a filenote which the auditor would consider as sufficient file evidence to support the treatment in the financial statements.

If the solicitor sends the response directly to the client without sending a copy to the auditor, the auditor shouldread and make notes of the relevant contents of the letter or photocopy it. Equally, where there are matters which are being dealt with by solicitors but the auditor is unable to take photocopies of documents because of legal privilege, he should prepare file notes of the evidence he has reviewed.

If permission to communicate with the solicitor is refused and the auditor is unable to obtain sufficient appropriate evidence from alternative procedures, this would constitute a limitation on scope and ordinarily lead to a qualified opinion or a disclaimer of opinion.

There are occasions when solicitors do not reply directly to requests on the grounds that letters written concerning the merits of litigation involving a client would be discoverable by the other party to the litigation. In such situations, the auditor needs to consider the adequacy of the evidence available to him to support the treatment and disclosure of the issue in the financial statements.

General guidance on confirmations is given in External confirmations and template letters are in Templates ~~and letters.~~

Written representations

The auditor also needs to obtain written representations from management and those charged with governance that all known actual or possible litigation and claims that should be considered in relation to the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

Contingent assets

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain a list of contingent assets and make sure they are adequately disclosed.	Presentation
Review the management minutes and ensure that all contingent assets have been identified and appropriately disclosed.	C, Presentation

Substantive analytical procedures

Contingent assets is an area that does not lend itself to analytical procedures, except in the role of reviewing anything incorporated within the previous year’s financial statements to ensure that it has been accounted for appropriately in the current year.

Tests of detail

The auditor should review any management minutes and after-date invoices to ensure that all material contingent assets have been identified and nature of the asset and an estimate of the financial effect have been disclosed accordingly.

Financial commitments

Example tests

The following tests are the standard tests in the ~~Navigate~~ *Audit* tools.

Audit procedure	Assertion being tested
Review the management minutes after date invoices and schedule of works for any ongoing capital expenditure and ensure that all material capital commitments or other financial commitments have been identified and correctly disclosed.	C, Presentation
Obtain details of future commitments under operating leases and ensure they are correctly disclosed.	C, Presentation
To ensure the completeness of operating lease commitments disclosed, analyse relevant profit and loss expenditure accounts to identify further potential operating leases (e.g. rent, leases, hire purchase, etc.).	C, Presentation

Substantive analytical procedures

Financial commitments is an area that does not lend itself to analytical procedures, except in the role of reviewing anything incorporated within the previous year's financial statements to ensure that it has been accounted for and disclosed appropriately in the current year.

Tests of detail

The auditor should review any management minutes and after-date invoices to ensure that all material capital commitments have been identified.

Operating lease commitments

The auditor should obtain details of future commitments under operating leases and ensure that they are correctly disclosed. Time should be spent identifying potential operating leases when undertaking work on theprofit and loss account expenditure cycle.

FRS 102 requires disclosure of the total commitment under the non-cancellable term of the operating lease, split between less than one year, between one and five years, and after five years. This should not be discounted to present value and should only include those payments that cannot be contractually avoided. For example, if a lease contains a break clause, the disclosure should only include payments up to the date of the break clause, even if the entity does not plan to exercise it. The auditor should therefore review the terms of the lease agreement and agree the amounts disclosed accordingly.

Other commitments

Many smaller companies do not maintain formal management minutes. Where such minutes are not maintained, the auditor should apply alternative means, such as enquiry of the directors. It is essential that such enquiries are made and that they are fully evidenced on the audit file.

Estimates

Design and perform appropriate tests for estimates, e.g. provisions relating to pending litigation, using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

3.20 Defined benefit pension schemes

Quick overview

This section explains the requirements around the audit of defined benefit pension schemes.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to Schedule R5 in the Private Company (PCAS) based audit tools.

Scope and definition

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Defined benefit pension schemes

FRS 102 defines a defined benefit scheme as a post-employment benefit plan other than a defined contribution plan. Usually, the scheme rules define the benefits independently of the contributions payable, and the benefits are not directly related to the investments of the scheme. The scheme maybe funded or unfunded.

This section addresses the accounting requirements for sponsoring employers of pension schemes (i.e. auditing the balances and transactions within the company financial statements); it does not address the accounting for pension schemes themselves. ~~More detail on the requirements for financial statements of pension schemes can be found in the *Pensions Sector Guide*.~~

Due to the complex nature of the figures, this can be a difficult area to audit, and the numbers involved are often very material to the financial statements. As the number of defined benefit schemes continues to decline, audit staff may berelatively unfamiliar with the accounting and auditing principles, and so extra supervision and review of this areamay be needed. This section provides a brief overview of the accounting requirements for defined benefit pension schemes. ~~Further guidance on the accounting requirements for defined benefit schemes under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Employee Benefits (Section 28)
- Micro Entity (FRS 105) – Employee Benefits (Section 23)

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing defined benefit scheme assets, liabilities surpluses and deficits are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Scheme assets, Scheme liabilities, Scheme surplus/deficit	To ensure the scheme has been accounted for in accordance with the applicable accounting standard.	A	Nature of the scheme
Scheme assets	To ensure that scheme assets exist at the balance sheet date and are owned by the scheme.	E	Scheme assets
Scheme assets	To ensure that all assets of the scheme are included.	C	Scheme assets
Scheme assets	To ensure that scheme assets are appropriately valued.	V	Scheme assets
Scheme liabilities	To ensure that scheme liabilities are fully and accurately recorded.	C, A, V	Scheme liabilities, Actuarial assumptions
Scheme liabilities, Scheme surplus/deficit	To ensure that the assumptions underpinning the actuary's calculation of the liabilities are reasonable and appropriate to the circumstances of the entity.	V	Actuarial assumptions
Scheme surplus/deficit	To ensure that the surplus/deficit on the scheme assets has been accurately recorded.	A, V	Recognition of surplus/deficit
Scheme assets, Scheme liabilities, Scheme surplus/deficit	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates
Scheme assets, Scheme liabilities, Scheme surplus/deficit	To ensure correct disclosure of all pension scheme-related assets, liabilities and other information.	Presentation	Presentation and disclosures

In the PCAS tools, the assertions are defined as follows:

Assertion	Definition
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the PCAS tools, the audit objectives are illustrated using the following table:

Financial statement area	Is there an estimate in this balance? (C8)	Assertions to be tested				
	Y or N	C	E	A	V	Other
Defined benefit scheme assets	Y	X	X	X	X	Presentation
Defined benefit scheme liabilities	Y	X	X	X	X	Presentation
Defined benefit scheme surplus/deficit	Y	X	X	X	X	Presentation

Controls

The following are controls that are relevant to the accounting process for defined benefit pension schemes and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on sample sizes when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	How to test
The accuracy of the data provided to the actuary is checked.	Select a sample of data provided to the actuary and obtain evidence of its review. Ensure that it has been accurately and appropriately reviewed.
The actuarial assumptions are reviewed for suitability.	Select a sample of the actuarial assumptions and obtain evidence that their suitability was reviewed and substantiated, with action taken if required.
The scheme asset figures are checked for accuracy.	Select a sample of scheme asset figures and obtain evidence that their accuracy was verified.
An overall review of the final figures is performed to ensure they ‘make sense’.	Obtain evidence of the review, ensure that action was taken on findings if required.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

Due to the unpredictable variances of the stock market and property prices, the surplus or deficit on a defined benefit pension scheme can vary significantly from year to year. However, analytical review techniques can still be extremely useful. In each section are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not defined benefit scheme assets, liabilities and surpluses or deficits are fairly stated.

Using the work of others

Only the largest pension schemes have their own employees, most therefore use third parties (referredto as service organisations) to carry out the administration and maintain the accounting records. For example, the principal employer, scheme administrators and investment managers should all be treated as service organisations where they maintain records on behalf of the scheme (see Service organisations). It is important that reports from service organisations that are maintaining the scheme records are treated as part of a scheme’s systemof control rather than external third party confirmations. If necessary reports should be obtained from the auditors of the service organisations concerning their operations as a means of obtaining evidence about the reports produced.

The auditor’s work is therefore also likely to involve reliance on other auditors and management’s experts, in particular the actuary. Reference should therefore be made to Consolidation and groups and Using the work of management’sexpert respectively.

In *Audit Automation using* PCAS, there are audit programmes for **Using the work of management's expert (Sup2), Using the work of an auditor's expert (Sup3)** and **Service organisations (Sup4)** *available in the templates*.

Reliance on the work of the actuary

Where an actuary has prepared the figures for the FRS 102:28 accounting and disclosures, the use of the work of the actuary should still be assessed in accordance with the guidance given in Using the work of others.

While the auditor is not expected to fully understand detailed actuarial calculations, they should nevertheless review the appropriateness of the assumptions underpinning the actuary's calculations. Remember that while the actuary may give advice to the directors regarding the assumptions to be used, these are ultimately for the directors to decide.

Nature of the scheme

Example tests

The following tests are the standard tests in PCAS.

Audit procedure	Assertion being tested
Consider the nature and terms of the scheme and ensure that it is accounted for in accordance with the applicable accounting standard.	A

Substantive analytical procedures

There isn't often a substantive analytical procedure which can be performed for identifying the nature of the scheme.

Tests of detail

The auditor should consider the nature and terms of the scheme in determining whether the scheme is being accounted for in accordance with the applicable accounting standard. For example, the auditor should:

- where contributions are made to a group plan, check that there is a contractual agreement/stated policy in place and ensure that the entity is accounting appropriately for its share;
- where an entity participates in a defined benefit plan, which is a multi-employer plan that in accordance with FRS 102:28.11 is accounted for as if the plan were a defined contribution plan, and the entity has entered into an agreement with the multi-employer plan that determines how the entity will fund a deficit, ensure that the entity recognises a liability for the contributions payable that arise from the agreement (to the extent that they relate to the deficit) and the resulting expense in profit or loss (measured at present value); and
- where contributions are made to a group plan, check that there is a contractual agreement/stated policy in place and ensure that the entity is accounting appropriately for its share.

Overseas schemes

The way pensions and retirement benefits are structured abroad can differ markedly from those in the UK. In particular, they can often be unfunded. This fact does not preclude them from being accounted for as defined benefit schemes if they meet the definition of such a scheme under FRS 102:28. Extra care should therefore be taken when dealing with overseas subsidiaries to ensure that all such schemes have been identified, accounted for and disclosed correctly.

Scheme assets

The primary audit tests for the scheme assets will be in respect of overstatement, although as noted in Overseas schemes, completeness of assets is also relevant.

Example tests

The following tests are the standard tests in PCAS.

Audit procedure	**Assertion being tested**
Consider the work of the scheme's investment custodian as a service organisation, complete the **service organisations work paper**.	
Obtain direct confirmation from the custodian of the investments and confirm that they are held either in the name of the scheme or as nominee.	E
Obtain a copy of the investment valuation report directly from the investment manager(s) as at the company's year end and agree to the valuation used by the actuary.	E, A, V
For a sample of securities held, vouch their market value per the investment manager's report to third-party data such as the *Financial Times*.	V
Consider whether, other than investments, the scheme is likely to have any other material net assets which should be included. Ensure such assets are valued at market value.	C
Review the latest audited financial statements and/or management accounts of the scheme and identify any assets other than the scheme's investments. Perform additional audit procedures appropriate to the type of asset to ensure these are included where material.	C

Substantive analytical procedures

Whilst the assets can be vouched to the investment manager's report and may also be substantively tested to third-party price data, it can still be useful to assess whether the asset figure 'makes sense' given the movements in the year on the stock market, property markets, etc. Simple 'proof in total' calculations, taking into account starters, leavers, etc. should provide comfort that the assets are in a reasonable range.

Tests of detail

Existence of scheme assets

Consider the work of the scheme's investment custodian as a service organisation (see Service organisations).

Obtain direct confirmation from the custodian of the investments and confirm that they are held either in thename of the scheme or as nominee.

Valuation of scheme assets

Agree the value of the scheme's investments to the investment manager's valuation report.

Agree the valuation of a sample of listed investments to prices listed in the *Stock Exchange Daily Official List,* the *Financial Times* or other reliable source of historic listed instrument prices.

The auditor may also consider using the work of the scheme auditor, especially where the entity and schemehave the same year end.

Completeness of scheme assets

Review the latest audited financial statements and/or management accounts of the scheme, and identify any assets other than the scheme's investments. Some schemes may have material net current assets, i.e. other net assets beside the investment portfolio. These should also be included in the overall net asset value where material, e.g. bank balances not held by the investment manager (and hence excluded from their investment management report).

Perform additional audit procedures appropriate to the type of asset to ensure these are included where material – for example, for debtor balances refer to Debtors and prepayments; for bank accounts held in the scheme's own name, refer to Bank and cash, etc.

As noted above regarding scheme investments, the auditor may also consider using the work of the schemeauditor.

Scheme liabilities

The primary audit tests for the scheme liabilities will be in respect of understatement.

The auditor should obtain a copy of the scheme's trust deed and rules to identify obligations to pay retirement benefits. However, there might also be benefits payable that are not recorded in the rules. For example, there might be:

- legal obligations to pay retirement benefits, which arise from informal agreements rather than from a formal contract;
- constructive obligations (for example, where pension benefits are regularly enhanced beyond the minimum required by statute); or
- statutory requirements that override the original provisions of a scheme.

Example tests

The following tests are the standard tests in PCAS.

Audit procedure	**Assertion being tested**
Ensure that all obligations to pay retirement benefits set out in the scheme's trust deed and rules have been accounted for. Consider if there are further obligations not recorded in the trust deed and rules.	C

Ensure the scheme liabilities have been calculated using the projected unit method as prescribed by the accounting framework.	A, V

Substantive analytical procedures

Analytical procedures do not lend themselves as well to the scheme liabilities and it is likely that, having assessed the assumptions, the liabilities as calculated by the actuary will be relied upon with no further work done, unless the auditor suspects they contain a material error.

Tests of detail

Consider the work of the actuary as management's expert (see Using the work of management's expert).

Obtain a copy of the FRS 102 actuarial report (not the same as the triennial valuation for the scheme's own purposes), ideally from the entity's directors or trustees. The auditor should only contact the actuary directly ifabsolutely necessary, and should first seek the client's permission before doing so.

Discuss with the client their procedures to establish the sufficiency, relevance and reliability of the source data used. If unsatisfactory, the auditor may decide to perform their own procedure, e.g. reconciling data such as thenumber of employees and pensioner members as supplied to the actuary to the scheme records.

Actuarial assumptions

Example tests

The following tests are the standard tests in PCAS.

Audit procedure	**Assertion being tested**
Review the principal actuarial assumptions advised by the actuary or management for appropriateness. Consider whether additional procedures need to be performed.	V
Consider the sensitivity of the calculations to changes in the actuarial assumptions and assess whether any discrepancies identified above may have a material impact on the surplus/deficit.	V

Substantive analytical procedures

Actuarial assumptions should be long-term expectations. As such, they would not normally be expected to vary dramatically from year to year, andso comparing the various assumptions against those used in previous years is a good starting point.

Part of the actuary's report will usually contain information about the sensitivity of the results to changes in the assumptions. Although the directors may take the advice of the actuary, it is their responsibility to agree the assumptions to be used for FRS 102 purposes. In order to do this, they should themselves have requested sensitivity data from the actuary, so this information should be available for the auditor to review without havingto contact the actuary directly.

While the auditor is not expected to have the same expertise as the actuary and cannot necessarily challenge theappropriateness and reasonableness of the assumptions, the following analytical procedures may provide additional evidence.

Discount rate	This can be compared to the yield at the entity's year end on an AA-rated Sterling corporate bond, whose term is equivalent to that of the scheme's liabilities. Bond prices and yields can be obtained on the internet. Bond ratings can be obtained from organisations such as Standard and Poor.
Expected return on assets	Many fund managers and insurance companies publish information on long-term trends and forecasts of the rate of return on various types of asset, especially shares.
Future salary increases	These can be compared to historical data of actual pay rises given by the entity and should be considered in the light of the anticipated level of future inflation (see below) and the directors' intentions.
Future pension increases	Future pension increases are usually laid down in the scheme's trust deed and rules and are frequently the lower of inflation (usually CPI) and a fixed capped amount. Comparison with the long-term expectation of inflation (see below) will indicate whether an inflation figure or the cap should be used.
Mortality rates	Average mortality rates are published on the internet (e.g. by the Government Actuarial Department at www.gad.gov.uk).
Inflation	Inflation can be assessed by comparing the difference in yield between a long-dated fixed-interest bond and an index-linked gilt with the same term or redemption date. Gilt prices are published in *The Financial Times* or similar publications. The yield can then be calculated from the bond price.

Tests of detail

Discuss with the client the main actuarial assumptions for appropriateness and consider whether they appear reasonable given the auditor's knowledge of the client and the scheme (see Substantive analytical procedures above).

Consider the sensitivity of the calculations to changes in the actuarial assumptions, and assess whether any discrepancies identified above may have a material impact on the surplus or deficit.

Recognition of surplus/deficit

If the scheme is in surplus, the auditor should ensure the resulting asset is recognised only to the extent that it is able to recover a surplus either through reduced contributions in the future or through refunds from the scheme.

Deferred tax considerations

Deferred tax in the context of defined benefit pension scheme surpluses or deficits can represent a substantial figure. For any entity with a defined benefit pensionscheme, the issue of deferred tax should be considered at the planning stage, and appropriate testsadded to the audit programme, if necessary, to ensure this is dealt with properly.

The auditor should ensure that any deferred tax asset is presented appropriately in accordance with FRS 102:29, i.e. with other deferred tax balances rather than net of the defined benefit scheme liability.

Gains and losses on remeasurement

The auditor should ensure that the gains and losses on the remeasurement of the net defined benefit liability have been recognised in accordance with FRS 102.

Estimates

Design and perform appropriate tests for estimates using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation using* PCAS, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosure

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

Where disclosures about pension schemes include the directors' opinions regarding actuarial assumptions or other issues, ensure that these opinions are confirmed in the letter of representation.

Current issues and further resources

FRC quality reviews

In July 2018, the FRC published *The audit of defined benefit pension obligations – findings from 2017/2018 quality reviews* , a report summarising its findings and conclusions in relation to the audit of pension balances and related disclosures in 51 of its audit inspections in 2017–18.

Although areas of good practice were identified, the FRC concluded that there was room for improvement in almost half of the audits examined. In many cases, the existence of multiple pension arrangements and/or financial and risk management transactions made valuation judgements and their audit complex.

The FRC concluded that auditors can bring about improvement by:

- assessing the sensitivity of the valuation to changes in assumptions;
- clearly evidencing the work done by actuarial experts and the rationale for conclusions reached;
- considering whether the source data used to calculate the valuation of the defined benefit obligation is materially accurate and complete;
- identifying different categories of investment assets and obtaining sufficient audit evidence to support the valuation of each;
- paying attention to evidence to support the allocation of the defined benefit obligation and pension scheme assets in multi-employer schemes;
- focusing on the completeness and accuracy of the pensions related disclosures, not just the valuation; and

- considering whether given the material nature and risks, the audit work on pensions should be explained in the auditor’s report.

3.21 Share capital, reserves and statutory records

Quick overview

This section considers the audit of share capital, reserves and statutory records. It provides example audit objectives for the section, covers the types of control which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas~~ of *Navigate Audit*.~~

This section relates to schedule O2 in the the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Share capital, reserves and statutory records

Share capital and reserves both fall under equity, part of the residual interest in the assets of the entity after deducting all its liabilities. Share capital comprises the proportion of equity that has derived from the issue of shares. Reserves are the accumulated surpluses or deficits arising from the entity's activities.

Statutory records relate to all core statutory information and records regarding company ownership (or limited liability partnership membership) that are required by relevant legislation and regulations. It is important to ensure that the company has complied with all of its statutory obligations in terms of the maintenance of the statutory books and records. It should be noted that Section A of ISA (UK) 250 (Revised November 2019) (Updated May 2022) *Consideration of laws and regulations in an audit of financial statements* requires the effect on the audit report of any issue of non-compliance with material consequences to be considered.

Further guidance on the accounting requirements for share capital, reserves and statutory records under the applicable standards can be found in *Navigate UK GAAP Accounting*:

- Private Company (FRS 102) – Statement of changes in equity and statement of income and retained earnings (Section 6).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing share capital, reserves and statutory records are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Share capital	To ensure that any changes in share capital are supported by appropriate resolutions and are properly reflected in the accounts.	A, E, Cut off, Classification, Presentation	Share capital
Reserves	To ensure that changes in reserves are properly reflected in the accounts.	A, Classification	Reserves
Dividends and other distributions	To ensure that distributions are lawful and the capital instruments, related interest or dividends are presented in accordance with the substance of the contractual arrangements.	C, A, Presentation, Classification	Dividends and other distributions, Presentation and disclosures
Statutory records	To ensure that the statutory records have been properly maintained and all necessary disclosures concerning statutory information have been appropriately presented and described.	Presentation, Classification	Statutory records, Limited liability partnerships (LLPs), Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity. The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Share capital		X	X	X		Cut-off, Classification, Presentation
Dividends		X	X	X		Cut-off, Classification, Presentation
Reserves		X	X	X		Cut-off, Classification, Presentation
Statutory records						Presentation

Controls

The following are controls that are relevant to debtors and prepayments and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	**How to test**
The entity makes use of an appropriately qualified and independent/external company secretary.	Evaluate the qualification level and independence of the company secretary.
The entity has sufficient authorised and unissued share capital.	Evaluate the entity's levels of authorised and unissued share capital and any relevant policies and procedures.

Authorities for allotting shares are only delegated to specific individuals.	Review the terms of delegated authorities and confirm they have been applied when allotting shares in the period.
Directors’ meetings are formally minuted.	Review a sample of director meeting minutes to confirm formal minuting has been performed. Observe a directors’ meeting and review copies of subsequent meeting minutes.

Audit procedures

When planning the audit, all the available tests should be reviewed to determine those that will most effectively satisfy each of the individual objectives for the client in question. Not all the tests relating to an individual objective need be carried out on each audit. Where the balance includes accounting estimates, refer also to the guidance in Auditing accounting estimates.

Statutory records

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Ensure that all changes in members, directors and secretaries and their interests in shares or debentures have been entered into the relevant official register(s).	Presentation
Agree details in the share register to:	
• the accounts;	Presentation
• the annual return/confirmation statement; and	Presentation
• the directors’ report.	Presentation

Substantive analytical procedures

There isn’t often a substantive analytical procedure which can be performed for statutory records.

Tests of detail

In many private companies, obtaining relevant statutory records may involve undertaking a company search, as the statutory records are often not up to date. A copy of the confirmation statement (previously annual return) submitted to Companies House, which contains details of the information that Companies House has on record, together with information from the directors about any changes that have occurred since the confirmation statement was submitted, will usually suffice. Companies House provides free access to documents filed.

The auditor should ask whether all necessary documents have been filed which should include the confirmation statement, share transfer forms, previous periods’ accounts, any appropriate resolutions and any details of changes in directors or trustees and secretary.

Auditors should confirm that changes in directors and secretary, and their interests in shares or debentures of the company, have been entered into the relevant register.

The auditor should review the minutes of the directors and ensure that all relevant changes have been correctly minuted. Assistance may be required in this area as in many small private companies the directors do not hold formal meetings; therefore, very often the statutory records do not actually reflect the information that is required. Although the auditor is not able to act officially as company secretary, they may be able to support the client, where needed, in complying with all the necessary requirements in respect of the statutory books and records.

The auditor should also ensure that any mortgages and charges created during the year have been entered into the register of mortgages and charges. A company search should also be considered to ensure that all items are properly recorded. The auditor should review the terms within the articles of association and of any loan agreements and ensure that the company has not exceeded any restrictions on borrowing powers imposed within either of these.

The auditor should agree details in the share register to:

- the accounts;
- the confirmation statement; and
- the directors’ report.

Other relevant considerations

The statutory position of an entity does not often change and, as a result, can be straightforward to audit. The auditor should consider whether a change has occurred at the start of the planning, which will help to determine the approach that should be taken in this particular area of the audit. Any changes to the statutory position should be reflected within the permanent audit file.

The auditor should always undertake a full search for a new client and should consider doing so for an existing client if there are any doubts about what is on file at Companies House. Where an event has occurred during the period that would give rise to a statutory reserve – such as the issue of new capital out of premium or the purchase of a company’s own shares – the auditor should consider whether this has been dealt with properly.

In all cases, particularly where there are changes, the auditor should ensure that the Companies Act has been complied with. Areas where this is of particular relevance are outlined in this guide.

Reserves

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Reconcile opening balances to prior period closing balances, profit for the year, dividends paid and proposed.	A
Agree reserve movements to underlying records and ensure they have been accounted for in accordance with the relevant accounting framework. In particular:	A, Classification

• reconcile any movements in reserves to other relevant work programmes, e.g. revaluation reserve movements to the fixed assets work programme (**F**), equity reserve to the financial instruments work programme (**H2**);	A, Classification
• ensure that transfers between reserves are correctly treated and authorised.	A, Classification

Substantive analytical procedures

There isn’t often a substantive analytical procedure which can be performed to audit statutory records.

Tests of detail

Tests of detail auditors should perform on reserves are as follows:

- reconcile opening balances to prior period closing balances, profit for the year, dividends paid and proposed;
- agree reserve movements to underlying records and ensure they have been accounted for in accordance with the relevant accounting framework. In particular:

– reconcile any movements in reserves to other relevant work programmes, e.g. revaluation reserve movements to the fixed assets work programme (**F**), equity reserve to the financial instruments work programme (**H2**);

– ensure that transfers between reserves are correctly treated and authorised.

In the most straightforward of cases, a company will only have ordinary share capital and a profit and loss account reserve. However, within this section, all classes of shares should be considered and there may also be different classifications of reserves. These may include the following:

- share premium account;
- capital redemption reserve;
- revaluation reserve;
- fair value reserve;
- capital contribution reserve; and
- merger reserve.

Where these types of reserves – or any others – are present, the auditor should understand how the reserve has arisen and ensure that appropriate audit procedures are applied.

The auditor should schedule all movements in reserves and ensure that transfers between reserves are correctly treated, authorised and disclosed in the accounts.

Where transfers have been made between reserves, the auditor should ensure that these are appropriate, e.g. there are no classification or statutory reserve restrictions.

Insight - statutory reserve restrictions

Where the client has reserves in addition to the profit and loss reserve, the auditor should consider the terms of the reserve and whether there are any statutory restrictions on its use. Where this is the case, the auditor should ensure that they are familiar with the relevant provisions within the *Companies Act*

2006 .

Share capital

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Record details of any changes in share capital in this period and ensure that these have been properly reflected in the financial statements.	A
Where shares were issued in the period, reconcile amounts to underlying records to confirm they are accurate and accounted for in the correct period, e.g. share certificates. Trace to cash receipts from share issuers.	A, E, Cut-off
For shares issued in the period, have these (or their components) been classified on initial recognition as a financial liability or an equity instrument, in accordance with the substance of the contractual arrangements?	Classification
Agree authorised share capital and nominal value disclosures to underlying shareholding agreements.	Presentation

Substantive analytical procedures

There isn't often a substantive analytical procedure which can be performed for share capital as the issue of shares may not be consistent throughout the period or year on year.

Tests of detail

Tests of detail for share capital are as follows:

- record details of any changes in share capital in this period and ensure that these have been properly reflected in the financial statements;
- where shares were issued in the period, reconcile amounts to underlying records to confirm they are accurate and accounted for in the correct period, e.g. share certificates. Trace to cash receipts from share issuers;
- for shares issued in the period, have these (or their components) been classified on initial recognition as a financial liability or an equity instrument, in accordance with the substance of the contractual arrangements?;
- agree authorised share capital and nominal value disclosures to underlying shareholding agreements.

The first information the auditor should ascertain whether any changes have occurred during the period to assist in deciding whether further testing is appropriate. In addition, where an entity is not incorporated under the Companies Act, the auditor should ensure that the firm has staff with knowledge of the requirements of the relevant legislation.

The auditor should review the accounting treatment and disclosure of instruments such as preference shares and ensure they are appropriately classified as either equity or liabilities in accordance with FRS

102, Section 22.

Any compound instruments such as convertible debt issued also need to be reviewed to ensure that the split between liability and equity has been appropriately calculated.

Further guidance on Identifying a financial instrument can be found in *Navigate UK GAAP Accounting*.

Share issues

It can never be simply assumed that when an entity issues shares, these will automatically be classified as equity; there are specific conditions in place which will, if met, mean that some or all of the amounts relating to the shares are accounted for instead as financial liabilities, bringing them into the scope of either Section 11 or 12 of FRS 102.

As a general rule, whenever an instrument means that the issuer does not have the unconditional right to avoid paying out cash (or another financial asset), that instrument is – or at least contains – a financial liability of the issuer. However, this distinction is not always straightforward and it is important to be familiar with the detail of Section 22 of FRS 102.

There will also be situations where part, but not all, of an instrument is classified as a liability, with the remainder treated as equity; for instance, where an entity issues a debt instrument which is convertible into equity if certain conditions are met (see Compound instruments).

Challenges may arise in ensuring that share issues and other instruments related to shares, such as compound instruments, are appropriately classified and accounted for in line with Section 22 of FRS 102.

Guidance is given in two consecutive paragraphs on the treatment of costs associated with issuing shares: FRS 102:22.8 refers to measuring them at the fair value of proceeds 'net of direct costs' and then FRS 102:22.9 explicitly requires that 'transaction costs of an equity transaction [are accounted for] as a deduction from equity, net of any related income tax benefit'. In a typically simple situation, the transaction costs will be administrative and legal and it will be straightforward to determine which are incremental to the transaction, if this is all that has taken place. More complexity arises though if, for instance, equity instruments such as warrants are issued at the same time as debt or if costs are incurred which seem to be incidental to the issue of the shares.

Compound instruments

Compound financial instruments are defined in the Glossary to FRS 102 as being financial instruments that 'from the issuer's perspective, contain both a liability and an equity element'. The most common example is convertible debt, where the holder pays cash to the issuer and in exchange receives a promise to return the capital, usually a commitment to pay interest either periodically or at the end of the instrument's life and an option to have the capital settled in shares instead of cash (which might be at the holder's or the issuer's option). The obligation to pay interest and redeem the capital gives the liability element, and the possibility of conversion into shares, will often be classified as an equity element, though this depends on the precise conditions.

On initial recognition of a compound instrument, the proceeds are allocated between liabilities and equity by first determining the fair value of the liability component (based on the value of a similar liability without the conversion feature or similar equity component) and then allocating the residual amount to equity. The equity portion is not subsequently remeasured. The liability portion is subsequently measured under Section 11 (or 12 as relevant).

Dividends and other distributions

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Inspect board minutes to identify any dividends declared prior year end.	C
Where a dividend is proposed or has been paid in the period, consider whether the distribution meets the relevant requirements, e.g. Companies Act.	Presentation
Where a dividend is unlawful consider whether:	
• this is adequately disclosed in the accounts;	A, Classification
• a debtor or contingent asset should be shown.	A, Classification
Have distributions to holders of equity instruments been debited directly to equity?	Classification

Substantive analytical procedures

There isn't often a substantive analytical procedure which can be performed in relation to dividends and other distributions.

Tests of detail

- Inspect board minutes to identify any dividends declared prior year end.
- Where a dividend is proposed or has been paid in the period, consider whether the distribution meets the relevant requirements, e.g. Companies Act.
- Where a dividend is unlawful, consider whether:

– this is adequately disclosed in the accounts;

– a debtor or contingent asset should be shown.

- Have distributions to holders of equity instruments been debited directly to equity?

Where a final dividend has been proposed, the auditor should ensure that the accounting treatment is in accordance with FRS 102, Section 32 *Events after the end of the reporting period*, which will usually be non-recognition.

Where a dividend has been paid in the period, the auditor should consider whether the distribution is legal. Where this is not the case, the effect on the audit report should be recorded within the completion section of the file for the partner's attention.

The determination of whether profits are distributable has not always been straightforward and, where there is any doubt, reference should always be made to the ICAEW technical release on distributable profits (TECH 02/17BL).

Limited liability partnerships (LLPs)

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being

	tested
Where the entity is a Limited Liability Partnership (LLP):	
• agree details in the members’ register to the annual return/confirmation statement;	Presentation
• ensure any designated members are disclosed in the members’ report;	Presentation
• review the LLP agreement for details of members’ participation rights and ensure that amounts due to members are analysed as liabilities, unless the LLP has an unconditional right to avoid delivering cash or other assets to the member; that is, unless the right to any payment or repayment is discretionary on the part of the LLP, in which case they should be classified as equity;	Classification, Presentation
• ensure all profits for the year arising from non-equity participation rights are charged as an expense to members’ remuneration.	Classification, Presentation

Substantive analytical procedures

There isn’t often a substantive analytical procedure which can be performed in relation to statutory records for LLPs.

Tests of detail

Where the entity is an LLP, the following tests of detail should be performed:

- agree details in the members’ register to the annual return/confirmation statement;
- ensure any designated members are disclosed in the members’ report;
- review the LLP agreement for details of members’ participation rights and ensure that amounts due to members are analysed as liabilities, unless the LLP has an unconditional right to avoid delivering cash or other assets to the member; that is, unless the right to any payment or repayment is discretionary on the part of the LLP, in which case they should be classified as equity;
- ensure all profits for the year arising from non-equity participation rights are charged as an expense to members’ remuneration.

Estimates

Design and perform appropriate tests for estimates using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all financial statement areas, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made, including verifying statutory information and details regarding the ultimate controlling party.

3.22 Current and deferred taxation

Quick overview

This section explains how to audit current and deferred taxation and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.

This section relates to section P in the *~~Navigate~~ Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Current tax

Current tax is recognised for actual corporation tax payable, whether relating to the current or previous periods. The current tax charge in the financial statements is based on the amounts expected to be paid to, or recovered from, HMRC based on the taxable profit for the year and tax rates and laws that have been enacted or substantively enacted at the reporting date.

Taxable profit is computed by beginning with the profit for the year and adjusting for items treated differently for tax purposes. For example, depreciation is added back and any capital allowances are deducted. Certain types of expenditure are also disallowable for tax purposes and need to be added back.

The tax treatment of research and development (R&D) costs can be one of the more challenging areas in computing and auditing the current tax charge. Types of R&D relief currently available include:

- small and medium-sized enterprises (SME) R&D relief, which allows companies to deduct an extra 130% of their qualifying costs from their yearly profit, as well as the normal 100% deduction and claim a tax credit of up to 14.5% of the surrenderable loss if loss-making; and
- the Research and Development Expenditure Credit (RDEC), which is a tax credit for 13% (from 1 April 2020) of qualifying R&D expenditure.

From an accounting perspective, these two schemes are treated in different ways. The SME R&D relief is taken into account within the corporation tax computation and forms part of the tax charge in the profit and loss account, while companies taking advantage of the RDEC scheme will recognise the tax credit within pre-tax income, essentially in the same way as if it were a government grant under FRS 102:24.

Auditors need to be aware of tax reliefs available or schemes used by the company to ensure that the tax charge is calculated and accounted for correctly.

Deferred tax

The basic principle for recognition is that a deferred tax asset or liability is recognised in respect of all timing differences and never recognised in respect of permanent differences. Timing differences arise when an amount is recognised in profit or loss which is assessed for tax in a different period. Deferred tax is measured with reference to the rates and laws that have been enacted or substantively enacted by the reporting date. Discounting is not permitted under FRS 102.

A timing difference gives rise to a deferred tax liability when income is taxed at a later date than when it is recognised in profit or loss, or when tax reliefs (such as capital allowances) are available in the current period which exceed the related expenditure recorded in profit or loss. For example, an investment property is revalued at fair value through profit or loss in the financial statements, but any increase in the value of the property is not taxed until the property is sold. The gain recorded in the accounts would therefore give rise to a deferred tax liability.

A timing difference will give rise to a deferred tax asset when income is taxed before it is recognised in the financial statements or when expenses are recognised in the financial statements before a tax deduction is available. Unrelieved losses also give rise to deferred tax assets because they represent a future tax benefit.

~~Further guidance on the accounting requirements for current and deferred taxation under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Income tax (Section 29);
- Small Company (FRS 102 1A) – Income tax (Section 29);
- Micro Entity (FRS 105) – Income tax (Section 24).

~~Further guidance on accounting for taxation can be found in the Year-end Tax Accounting Work section of *Practical Corporate Tax*.~~

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives in respect of the audit of current and deferred taxation are as follows.

Financial statement area	Objective	Assertion	Audit procedures
Current tax payable, Current tax expense	To ensure that the current taxation provision is adequate and has been correctly accounted for in accordance with applicable legislation and accounting standards.	C, E, A, V	Current tax

Deferred tax assets/liabilities	To ensure that deferred taxation has been correctly accounted for in accordance with applicable legislation and accounting standards.	E, A, V	Current tax
Deferred tax liabilities	To ensure that adequate provision has been made for deferred tax liabilities.	C	Deferred tax
Current tax payable, Current tax expense, Deferred tax assets/liabilities	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates
Current tax payable, Current tax expense, Deferred tax assets/liabilities	To confirm that all necessary disclosures concerning current and deferred tax have been made and the information is appropriately presented and described.	Presentation	Presentation and disclosures

In the *~~Navigate~~ Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity. The existence assertion used in the *~~Navigate~~ Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related

disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Current tax payable		X	X	X	X	Presentation
Current tax expense		X	X	X		Presentation
Deferred tax assets/liabilities		X	X	X	X	Presentation

Controls

It will often be the case that for smaller audit clients, the firm will also prepare the tax computation, so many of the controls in respect of corporation tax will actually be with the firm itself rather than the client. As this represents a potential management threat to the auditor's independence, most of the client's controls over tax and the presence of informed management should already have been considered as part of the firm's acceptance procedures.

The following are controls that are relevant to current and deferred taxation and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	**How to test**
All returns are completed promptly and submitted to HMRC on time.	Check that corporation tax returns have historically been submitted to HMRC on time.
All necessary tax payments are made by the due date.	Select a sample of corporation tax payments and check that the payments were made on time.
Tax software is regularly updated.	Check that the company is using the latest version of their tax software.
Tax computations are reviewed independently for accuracy, including checking that the figures used are taken from the final version of the draft financial statements.	Check for evidence that the draft tax computation has been reviewed by an appropriately experienced independent person.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

In practice, it can be difficult to apply substantive analytical procedures to current and deferred taxation. However, in each section are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not current and deferred tax balances are fairly stated.

The audit team need to have the appropriate skills and experience, in taxation, to be able to gather sufficient appropriate audit evidence to conclude that the figures are not materially misstated. Taxation is an area which, if not dealt with properly, could lead to significant errors in the financial statements.

Current taxation

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain and check, or reperform the following:	
• draft tax computations;	C, E, A
• an analysis of the corporation tax account; and	C, E, A
• a proof of tax/tax reconciliation.	C, E, A
Ensure profit before tax used in the computation agrees to draft profit and loss account.	A
Agree closing corporation tax liabilities (including on loans to participators) in the financial statements to the latest computations and CT600.	C, E, A
Complete the corporation tax computation checklist on **P3**.	C, E, A, V

Substantive analytical procedures

Analytical procedures alone are unlikely to provide sufficient evidence on the corporation tax balances, however, reviews of the computations and adjustments should give the auditor some comfort that the ultimate liability is reasonable.

The auditor should consider the impact on the ultimate provision of all matters identified elsewhere on the audit.

Tests of detail

The auditor should obtain and check, or reperform the following:

- draft tax computations;

- an analysis of the corporation tax account; and
- a proof of tax or tax reconciliation.

If a member of the audit team is to prepare the computation, the audit principal should ensure that appropriate safeguards are in place to mitigate the resulting independence risks.

The computations should be prepared at a stage when there are unlikely to be further material adjustments to the financial statements. Where significant changes are made to the profit in the interim period, the auditor should ensure that the tax computation is amended accordingly.

The auditor should:

- ensure that the profit before tax in the tax computations agrees with the draft profit and loss account;
- check the arithmetical accuracy of the computations;
- agree the closing corporation tax liabilities to the latest computations and the CT600 return; and
- verify the movement on the corporation tax account to the CT600 return.

The auditor should review the proof of tax/tax reconciliation for unusual items and ensure that the figure in the financial statements makes sense.

Corporation tax computation checklist

In the ~~*Navigate*~~ *Audit* tools, the **Corporation tax computation checklist (P3)** sets out common points to be considered when preparing or reviewing corporation tax computations to ensure that any corporation tax liabilities or available losses are correctly reflected in the financial statements.

The completion of a corporation tax computation checklist is helpful, particularly where the client's tax affairs are complex. Completion of such a checklist will help to ensure that any corporation tax liabilities and/or available losses are correctly reflected in the financial statements. The checklist should set out the common points to be considered when preparing corporation tax computations, but will very rarely be exhaustive. Common areas that need to be considered include:

- complex areas in the trading income computation;
- fixed assets;
- chargeable gains;
- the treatment of losses;
- identification of group companies; and
- close companies and loans to participators.

Complex areas in the trading income computation

The computation should be reviewed to confirm the treatment of more complex areas where the accounting and taxation treatment may be different or where HMRC will look closely at the items involved. This may include consideration of issues relating to:

- revenue recognition;
- inventory and work in progress;

- advertising;
- entertaining;
- repairs and renewals;
- leasing;
- legal and professional fees;
- bad debts;
- subscriptions and donations;
- sundry expenses;
- formation expenses;
- management charges;
- penalties;
- directors' emoluments;
- pension contributions;
- rents;
- royalties paid and received;
- charges and interest; and
- dividends paid and received.

Fixed assets

As the treatment of fixed assets often provides one of the biggest timing differences as far as corporation tax is concerned, the auditor should consider whether fixed assets have been treated correctly within the financial statements and whether all necessary adjustments in the computations have been made.

Chargeable gains

Where chargeable gains exist, the auditor should ensure that these have been identified and properly reflected in the computation.

Treatment of losses

The auditor should go through the provisions in respect of losses to confirm that losses have been utilised in the most effective way by considering the various possibilities, including group relief where available.

This should also include consideration of repayable tax credits where the company has incurred expenditure on research and development, energy efficient plant and machinery, and land remediation.

Groups and associated companies

Identification of associated companies

To ensure that the correct rate of corporation tax is applied, the auditor should consider whether sufficient audit work has been done to identify all associated companies.

Identification of group companies

To ensure that available reliefs are optimised, the auditor should consider whether sufficient audit work has been done to identify all group companies.

Close companies and loans to participators

The auditor should identify whether the client is a close company and whether the balance sheet contains any loans made to participators. The adequacy of any s. 419 liability and the appropriateness of the accounting treatment can then be considered.

Deferred taxation

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Deferred tax liabilities	
Calculate or review the calculation of the full potential deferred tax liability and consider what provision, if any, is necessary. Agree figures to any relevant tax correspondence and/or underlying accounting records.	C, E, A, V
Deferred tax assets	
Calculate or review the calculation of the deferred tax asset. Agree figures to any relevant tax correspondence and/or underlying accounting records.	C, E, A, V
Where a deferred tax asset in relation to unrelieved tax losses has been recognised, perform procedures to assess the recoverability of the asset. This should include:	
• obtain forecasts of profitability and establish whether there is sufficient forecast taxable profit available;	V
• review the assumptions used in the forecast against own understanding of the entity;	V
• verify that there is no restriction on the entity’s ability to carry losses forward.	V
Other procedures	
Confirm that deferred tax is calculated at the rates at which the timing differences are expected to reverse, giving reference only to rates that had been enacted or substantively enacted as at the balance sheet date.	A, V
Review the tax computations for evidence of any timing differences which haven’t been recognised as deferred tax liabilities/assets.	C, E

In the event of a change in accounting policy, ensure that all relevant accounts and taxation timing differences are brought into the deferred tax calculation. C, E

Substantive analytical procedures

Substantive analytical procedures alone are unlikely to provide sufficient evidence on the deferred tax balances, however, reviews of the computations and adjustments should give the auditor some comfort that the ultimate liability/asset is reasonable.

Tests of detail

The auditor should review the calculation of the deferred tax asset/liability and ensure that:

- the figures agree to the underlying accounting records and any relevant tax correspondence;
- deferred tax is recorded in accordance with FRS 102, including on property revaluations and business combinations;
- deferred tax is accounted for correctly in the financial statements (e.g. deferred tax on a revaluation of property, plant and equipment appears in other comprehensive income, following the revaluation itself);
- the deferred tax provision is calculated at the average tax rates that are expected to apply when the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date. ~~Guidance can be found in Identifying the appropriate tax rate;~~
- the tax computations reflect all timing differences; and
- deferred tax assets are only recognised when it is probable that they will be recovered.

The auditor will need to apply judgement to determine whether the entity has appropriately recognised (or not recognised) a deferred tax asset. Where a deferred tax asset has been recognised in relation to unrelieved tax losses, the auditor should perform the following procedures:

- obtain forecasts of profitability and establish whether there is sufficient forecast taxable profit available;
- review the assumptions used in the forecast against own understanding of the entity; and
- verify that there is no restriction on the entity’s ability to carry losses forward.

Where deferred tax is not provided on the grounds of materiality, there should be a calculation on file demonstrating that this is the case and the figure should be added to the list of uncorrected misstatements if not trivial.

Other considerations

Changes in accounting policies

Where there has been a change in accounting policy, the auditor should ensure that all relevant accounting and taxation timing differences are brought into the deferred tax calculation.

Defined benefit pension schemes

Extra care should also be taken where the entity has a defined benefit pension scheme and deferred tax should not automatically be calculated and deducted from the surplus or deficit. Consideration should be given as to whether the entity:

- has the means to meet any increased contributions to cover a deficit and still be profitable and hence benefit from a future reduction in corporation tax; and
- can benefit from a scheme surplus by receiving a refund or reducing future contributions.

Estimates

Design and perform appropriate tests for estimates, e.g. the recoverability of deferred tax assets, using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

The auditor should ensure that any offsetting of deferred tax and assets and liabilities is permitted by the applicable financial reporting framework.

3.23 Income

Overview and definitions

This section explains how to audit income and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to section Q in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

This section looks at the audit of income from all sources. The majority of this will be in respect of the revenue generated by the entity's operating activity, but income also includes items such as interest and dividends receivable, as well as government grants.

Revenue in FRS 102 is dealt with under Section 23 and is defined in the Glossary as 'the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants'.

Income arises from several sources including:

- sale of goods;
- rendering of services;
- execution of construction contracts;
- rental or leasing out of property; and
- the use by others of entity assets yielding interest, royalties or dividends.

As a general principle, revenue arising from the sale of goods is recognised when the significant risks and rewards of ownership transfer to the customer, and revenue arising from the rendering of services is recognised on a percentage of completion basis. Revenue is measured at the fair value of the consideration receivable. Section 23 contains an appendix with application guidance covering specific examples of revenue recognition.

Construction contracts

See Construction contracts for guidance on auditing construction contracts.

Principal vs agent

Revenue only includes amounts that an entity receives from sales made on its own account. FRS 102 states that ‘in an agency relationship, an entity (the agent) shall include in revenue only the amount of its commission. The amounts collected on behalf of the principal are not revenue of the entity’, with an agent defined in the Glossary as being an entity that does not have exposure to the risks and rewards typically associated with its transactions, with an indicative feature being ‘that the amount the entity earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer’.

Accordingly, the auditor will need to understand whether the entity is acting as principal or agent in a transaction and ensure that the appropriate amount of revenue is recorded. FRS 102:23A.38 includes a list of features that indicate that an entity is acting as principal.

~~Further guidance on income under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Revenue (Section 23);
- Micro Entity (FRS 105) – Revenue (Section 18).

Government grants

Government grants are addressed in Section 24 of FRS 102. A government grant is defined in the Glossary to FRS 102 as ‘assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the operating activities of the entity. Government refers to government, government agencies and similar bodies whether local, national or international’.

Government grants, including non-monetary grants, are not recognised until there is reasonable assurance that:

- the entity will comply with the conditions attaching to them; and
- the grants will be received.

Judgement is therefore required to determine when an entity is reasonably assured that the conditions will be met.

The credit entry on initial recognition of a government grant is determined by whether the entity chooses to apply the performance model or the accrual model; this is an accounting policy choice by class of grant.

~~Further guidance on government grants under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Government grants (Section 24);
- Micro Entity (FRS 105) – Government grants (Section 19).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing income are as follows.

Financial statement area	Objective	Assertion	Audit procedures
Revenue	To ensure that income is not understated and all contracts have been included.	C	Understanding different income streams, Sales of goods and services
Revenue	To ensure that income represents the amounts which are able to be charged to date and those amounts are correctly calculated.	E, A, V	Understanding different income streams, Sales of goods and services
Revenue	To ensure that all items are processed in the correct period.	Cut off	Cut-off
Deferred revenue	To ensure that all deferred revenue is identified and correctly accounted for.	C, E, A, V	Deferred revenue
Onerous contracts	To ensure that all loss-making (onerous) contracts have been correctly accounted for.	C, E, A	Onerous contracts
Revenue, Deferred revenue	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates
Revenue, Deferred revenue	To confirm that all necessary disclosures concerning revenue and deferred revenue have been made and that the information is appropriately presented and described.	Presentation	Presentation and disclosures
Revenue	To ensure that, where required, accurate disclosure is given of income by class and/or geographical market.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows:

Assertion	Definition
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations

of the entity.

For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity.

The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy

Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation

Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions

Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, this is illustrated using the following table:

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Revenue		X	X	X	X	Cut-off, Presentation
Deferred revenue		X	X	X	X	Presentation
Onerous contract	Y	X	X	X		Presentation

Usually when looking at a credit balance, the focus is on testing for understatement, ensuring the completeness of revenue. However, revenue is often one area management may try and inflate to meet targets, therefore it is important to look at both understatement and overstatement.

Testing the debtors balances can also provide comfort in the existence of the revenue balances.

Risk of fraud in revenue recognition

ISA (UK) 240 (Revised May 2021) (Updated May 2022) *The auditor's responsibilities relating to fraud in an audit of financial statements* notes that material misstatements due to fraudulent financial reporting often result from either overstatement or understatement of revenues – for example, through premature revenue recognition, fictitious sales or incorrect cut-off. The ISA therefore contains a rebuttable presumption that there are risks of fraud in revenue recognition.

The auditor should therefore consider which aspects of revenue and its recognition may give rise to such risks, and address them accordingly as part of the audit planning and drawing-up of the audit programme for income. ISA (UK) 240: Appendix 3 gives a useful list of example circumstances which may indicate the possibility of fraud, and this could be used at the planning stage.

If the auditor has not identified, in a particular circumstance, revenue recognition as a risk of material misstatement due to fraud, the auditor must document the reasons supporting this conclusion.

See Assessing risk for more discussion on risk assessment.

Controls

The following are controls that may be relevant to sales and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

New customers

There are a number of controls that could be implemented by an entity in order to ensure that customers are appropriately set up and to reduce the likelihood of non-payment of invoices. These may include:

Control in place	**How to test**
New customers are asked for suitable credit references and a search is completed.	Select a sample of new customers, ensure the credit checks have been completed and documented.
Credit limits are set, regularly reviewed and adhered to.	Select a sample of customers, review the approvals for credit limits given. Ensure they have not been breached.

Sales of goods

There are a number of controls that could be implemented by an entity in order to ensure that the figures for sales of goods are fairly stated. These may include:

Control in place	**How to test**
Access to the despatch area is restricted to those staff working within the department.	Review access to despatch area.
Goods are only allowed to leave the premises with a valid despatch note.	Select a sample goods being removed from inventory listing and agree to despatch note.
Regular stocktakes occur to ensure that the records are reconciled to the goods	Select a sample of stocktakes and ensure the reconciliation agrees to stocktake records and to the

despatched and goods received.	system.
Invoices are only raised once a valid order and/or despatch note has been provided.	Select a sample of invoices and confirm a despatch note and/or order has been provided dated prior to the invoice. The details, i.e. price/quantity, all agree.
Any unmatched despatch notes and invoices are followed up independently.	An exception report is viewed showing an appropriate person has followed up on the exceptions.
Invoice pricing is independently checked and reviewed and invoices are within the limits.	Review the process of checking invoice pricing ensuring it has been appropriately reviewed. For a sample of invoices, check that they agree to the price list.
Invoices are sequentially numbered.	Select a sample of invoices and ensure they are sequential.
Segregation of duties exists with invoices being raised in a department separate from the sales department.	Select a sample of invoices and ensure the invoice was raised by a different person to the one who made the sale.
A copy of the despatch note is signed by the customer to confirm delivery.	Select a sample of despatch note copies and check they have been signed for by the customer.
Any non-routine transactions are authorised.	Select a sample of non-routine transactions and check they are appropriately authorised.

Sales of services

There are a number of controls that could be implemented by an entity in order to ensure that the figures for sales from services are fairly stated. These may include:

Control in place	**How to test**
Timesheets are reviewed by an appropriate individual.	Select a sample of timesheets and ensure they have been appropriately reviewed.
Invoice pricing is independently checked and reviewed and invoices are within the limits.	Review the process of checking invoice pricing ensuring it has been appropriately reviewed. For a sample of invoices, check that they agree to the price list.
Invoices are only raised once the work has been performed.	Select a sample of invoices and confirm a timesheet/job sheet has been provided dated prior to the invoice. The details, i.e. price/hours, all agree.
Invoices are sequentially numbered.	Select a sample of invoices and ensure they are sequential.
Segregation of duties exits with invoices being raised in a department separate from the sales department.	Select a sample of invoices and ensure the invoice was raised by a different person to the one who made the sale.
Review uninvoiced time from timesheets.	Select a sample of reports which look at uninvoiced time, check this has been followed up appropriately.

Any non-routine transactions are authorised.	Select a sample of non-routine transactions and check they are appropriately authorised.
Sales contract terms are regularly reviewed and income is only recognised when earned.	Select a sample of contracts and ensure management have considered how and when revenue is to be recognised in accordance with the underlying terms and applicable accounting standards.

Cash receipt process

There are a number of controls that could be implemented by an entity in order to ensure that the figures for cash receipts are fairly stated. These may include:

Control in place	**How to test**
Outstanding statements are sent to customers on a monthly basis. Queries or complaints are appropriately followed up.	Select a sample of the statements to verify they have been performed and any queries have been followed up appropriately.
Overdue debtors are regularly reviewed by an authorised person and agreed action taken to recover the money.	Review the debtors ledger and for a sample of overdue debtor review actions in place to recover money.
Overdue debtors are put on stop until money is received.	Review the debtors ledger and for a sample of overdue debtor; ensure new orders are not being taken.
The detailed debtors’ ledger is regularly reconciled to the sales ledger control account, any differences identified are reviewed and written off as appropriate.	Select a sample of the monthly reconciliations to verify they have been performed and any reconciling items have been followed up appropriately.
Credit notes are appropriately authorised before issuing.	Select a sample of credit notes and ensure they have been appropriately authorised.

Where any of the above controls exist, the auditor may be able to perform tests of operating effectiveness to determine whether or not the control is working effectively, thus facilitating less work during substantive testing.

Audit procedures

Analytical procedures can be extremely useful when auditing revenue. However, Assessing risk discussed the fact that revenue or income will usually be a significant risk area due to the rebuttable presumption of associated fraud risks in ISA (UK) 240. As noted in Significant risks, significant risks cannot be audited by substantive analytical procedures alone. This means tests of detail must also be undertaken where the audit approach is fully substantive and does not involve testing controls (ISA (UK) 330:21 (Revised July 2017) (Updated May 2022) *The auditor’s responses to assessed risks*).

Understanding different income streams

The auditor should first ascertain all the major sources of income, how they are recorded and their respective importance within the financial statements. This information should be recorded on the permanent file. The auditor should then check that no changes have been made to the system and that there are no new sources of income.

Insight – Testing completeness

To test completeness, the auditor is looking to select a sample from a reciprocal population outside of the accounting system. Completeness of income testing should be undertaken by selecting a sample from the earliest point in the income cycle and ensuring that everything has been fully recorded. Unrecorded sales will not be found by testing a sample from invoices which, in such a case, would be a waste of time. However, sometimes this will require a little thought, as the client may not have a conventional system where order records and/or goods despatched records are used. The auditor may need to select items from, for example, diaries, time records or any other source that records the beginning of a sales transaction. In addition, in some cases there may be a very distinct linkage between purchases and the ultimate sale and some work can be done to match these up.

Examples tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Identify all material sources of income and:	
• specify how each source has been audited;	E, A
• ensure recognition of income is in accordance with applicable accounting standards.	E, A
Carry out substantive analytical procedures for each revenue stream by setting an expectation of the current revenue stream based on the prior period figurers. Investigate variances.	C, E, A

Substantive analytical procedures

Analytical procedures can provide strong audit evidence regarding income. Some example procedures are provided below, but will need to be modified depending on the client's circumstances.

Product lines

If the client has a number of different product lines or activities that the turnover figure can be split into, the starting point of any analytical procedures could be to split the sales into the activity categories. These categories should then be compared with those of previous periods.

Such procedures could then be extended, depending on the level of information provided to the auditor by the client's records, to examining the gross profit percentage relating to each individual activity category. This is really an application of the principle that the more disaggregation that can be achieved when conducting analytical procedures, the more reliable the results will be.

Certain activities undertaken by the client may result in increases in turnover. Any variances should be discussed with the client and explanations obtained and corroborated.

Budgets and client expectations

The auditor should review the income figures to ensure they are consistent with any budgets or forecasts prepared by the client. Consistency with the auditor's own expectations should also be considered. Any variances should be discussed with the client and explanations obtained and corroborated.

Tests of detail

The auditor should consider whether the following types of income could be material in the client's accounts and the action to take in each case:

- **sales of scrap materials** – use expected levels to predict likely income;
- **by-products** – use production records to establish the nature and volume of by-products and hence the likely income;
- **rental income** – as already noted, use leases;
- **service charge or interest on overdue accounts** – review sale agreements or contracts to see if the client can and does charge interest on late debts. If so, the auditor should estimate the expected effect by reference to the average overdue debts during the year, the client's aged debt analysis and the interest rates used;
- **income from insurance claims** – consider whether any claims have been made or whether any events have occurred which might have resulted in a claim;
- **grants** – select a sample of grant notifications from correspondence files and vouch to actual monies received;
- **royalties or other contractual rights** – review any legal agreements governing income;
- **investment income** – link with the testing of investments; and
- **bank interest income** – link with the testing of bank and cash.

Where any other material source of income has been identified, it should be vouched to supporting documentation to make sure that it is correctly described and fully accounted for.

Sales of goods and services

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Use analytical procedures by developing an expected turnover figure and comparing it with the actual figures recorded. Expected sales can be computed based on last year's results, adjusting for known changes. Investigate variances.	C, E, A
Review the level of credit notes to actual revenue. Compare this ratio to prior period.	C, E
Where available, select a sample of goods despatched notes and vouch to supporting documentation.	
• Ensure details are correctly reflected on the invoice.	A
• Agree invoices through to the sales ledger and nominal ledger.	E

• Agree invoices through to goods despatched notes (or timesheets), to ensure item accounted for in the correct period.	Cut off
Select a sample of invoices and ensure the cash has been received post-year end.	E

Substantive analytical procedures

In many cases, it is possible to use analytical procedures by developing an expected turnover figure and comparing it with the actual figures recorded. For most commercial companies, expected sales can be computed based on last year's results, adjusting for known changes such as:

- price increases;
- major customers gained and lost;
- changes in credit policy;
- production figures, adjusted for changes in stock levels;
- new products, discontinued product lines or changes in product mix;
- the number of days in the accounting period;
- customer orders; and
- seasonal variations.

This proof-in-total approach also works extremely well for auditing other types of income, e.g. property rental income, school fees and membership income. Any variances should be discussed with the client and explanations obtained and corroborated.

Example substantive analytical procedures

There are many analytical procedures that can be applied to sales. Some analytical procedures that can help the auditor satisfy the key audit objective of completeness of income are listed below. Variations of the below can also be used. Compute expected sales of clearly defined units using the unit price and number of units despatched.

- Compute expected sales of food or wine income using the number of customers and the average amount spent.
- Compute expected levels of apartment or hotel or rental income using the number of rooms or properties; room tariff; annual rent per lease (taking into consideration the average occupancy).
- Compute expected sales of newspaper advertising using the space taken and prices charged (taking into account discounts for larger adverts and regular orders).
- Compute expected levels of freight income using the number of containers lifted, geographical destination and the price list.
- Compute expected levels of fee income in schools using the number of pupils and the fees charged per pupil.

Credit notes – SAP

Another useful ratio to examine is that of the level of credit notes to actual turnover. When compared with previous periods, this will tell the auditor whether or not the client has a potential quality control problem in its goods or services or, potentially, whether or not any unjustified credit notes are being raised. This could raise a question over the client's controls over credit notes and the recoverability of debtors. Ensure variances are investigated and explanations corroborated.

Cash sales – SAP

With many clients, auditing for completeness of sales can be very difficult at best. The auditor may therefore decide that analytical procedures are the best way to assess completeness of income. However, merely looking at the gross profit percentage from a reasonableness point of view is insufficient. A better test is split the sales figures into monthly or weekly figures. These can then be compared to previous accounting periods to identify where unexpected shortfalls have occurred. Explanations should then be sought and substantiated.

Tests of detail

Where detailed tests are to be used, the auditor should ensure that a sample is selected from the earliest stage in the recording process. Such records need to be complete and independent of the sales recording system. Examples of suitable populations include:

- **for manufacturing or finished goods** – goods despatched notes, customer orders or cost of sales if the client records individual transfers from stock;
- **for service industries** – where turnover is effectively time recharged plus overheads, the auditor should consider using time sheets. Alternatively, the auditor could review the contracts files for the client's customers. Where the client receives a commission, select from the cost of the goods being sold and check the calculation of the related commission (e.g. for travel agents, calculate cost of commissions due on holidays sold);
- for building, civil engineering or large engineering businesses – consider using debits to work in progress; and
- **for short-term rental income** – select from the assets generating the income in the first place (but it is often more efficient to use substantive analytical review).

Having established the where to test from, the auditor should select the sample and vouch to supporting documentation ensuring:

- details are correctly reflected on the invoice;
- invoices agree through to the sales ledger and nominal ledger; and
- invoices agree through to goods despatched notes (or timesheets), to ensure the item has been accounted for in the correct period.

Credit notes and returns

The auditor should review sales returns and, where material, select a sample and vouch them to supporting documentation. If an entity wanted to suppress the level of sales, this could be achieved by cancelling genuine sales. Vouching to supporting documentation will include tests on the following:

- making sure the details agree to the original invoice;
- checking the quantity and the description on the credit note to a goods returned note or other documentary proof of receipt of the product;
- vouching the posting to the sales ledger;
- vouching the posting via the sales day book to the nominal ledger; and

- ascertaining the reason for the return and considering whether this is within the entity's policy.

After date cash receipt

The auditor should test whether the cash has been received from a sample of invoices post year end. This work is usual performed when looking at debtors and further guidance is available in Trade debtors – after date cash received.

Cash sales

Where the client deals in cash, the auditor should ensure that cash sales are banked regularly and in accordance with the entity's procedures.

Where there are material cash sales, a cash account should be prepared. The auditor should also select a sample of till rolls or sales dockets and vouch them to the supporting documentation. This will involve:

- checking the additions;
- checking the numerical sequence and investigating any missing items;
- checking the pricing;
- considering the level of no sales on till rolls and making sure that this is acceptable; and
- checking the total cash sales to the cash book.

Cut-off

Examples tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Perform cut-off testing by selecting invoices and credit notes from a period before and after year end and ensure they have been recorded in the correct period.	Cut-off

Substantive analytical procedures

If there are concerns about cut-off, a useful test can be to analyse monthly turnover graphically and compare it with monthly and with previous years. In particular, the monthly trend across the year-end point should be carefully examined.

Tests of detail

The auditor should consider whether there are any factors that could result in turnover not being recognised in the correct period, for example:

- the date when title to goods passes;
- the date that the goods leave the client's premises;
- the contract terms;
- any special arrangements regarding delivery or payment; and

- whether the client has applied a convenient date for cut-off (e.g. the last Friday before the year end) and whether this could have a material effect in relation to the current and preceding year's accounts.

Other tests in respect of cut-off will have been undertaken during the balance sheet work on debtors, stock and creditors.

Interest/dividends received

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Agree a sample of interest received back to bank statement.	E, A
Agree a sample of dividends received back to bank statement.	E, A

Substantive analytical procedures

Where bank interest is material, the expected amount of bank interest can be calculated using the average bank balances during the year and published rates of interest.

Dividends received can be calculated using a similar method.

Tests of detail

Bank interest amounts can be agreed back to bank statement.

Dividends received can also be agreed to bank statements or confirmation.

Onerous contracts

Examples tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Recalculate any onerous contract provision, ensuring all costs have been provided for.	E, A
Review costs to complete to assess if any contracts in progress are likely to make an overall loss.	C

Substantive analytical procedures

An expectation of total costs of a project can be formed based on costs to date. This can be compared to amount the amount of income agreed to identify if any contracts are likely to be onerous.

Tests of detail

The auditor should review costs after the year end, budgets, contract costing and correspondence to assess if any contracts in progress are likely to make an overall loss.

The auditor should review completed contracts to determine the reliability of the client's estimates. It is essential that the auditor considers the costs to completion and looks at these together with the costs to date against the expected income from the project. This is particularly important for contracts based on low margins.

Deferred revenue

Deferred income is income that has been received in advance and has been deferred to a subsequent period because the good or service has not yet been provided. This may be in respect of contracts that straddle the year end or cash paid in advance for future sales. Deferred income is not a financial instrument as it represents an obligation to deliver goods or services, rather than an obligation to deliver cash.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Consider the nature of the client's business and revenue streams and identify whether there is a possibility of deferred income.	C
Review the basis for deferring income and ensure that it is recognised in accordance with the terms of the underlying contract, applicable accounting standards and has been consistently and accurately applied.	E, A, V

Substantive analytical procedures

Analytical procedures do not play a significant role in confirming deferred income. However, it is important for the auditor to compare the current year with their expectations and with the previous period to gain additional comfort on the validity of the figures being recorded within the financial statements.

It is also important to review the long-term position of the entity, as this will impact on the auditor's opinion in respect of the going concern of the entity.

Tests of detail

Identifying deferring income

The auditor should first consider the nature of the client's business and identify whether there is a possibility of any deferred income. Comparison can then be made with the position during the previous period, together with a review of any changes that have occurred during the period. For example, a company may have income paid in advance in respect of contracts that cover a specific period that is different from the year end. A change in the year end would impact on the level of deferred income:

- material receipts during the year should be investigated to assess if there is any unidentified deferred income;
- deferred income should be compared with the previous period to assess if the amounts are comparable;
- explanations should be sought for any significant changes.

The auditor should be alert for any assets purchases through government grants and ensure that any deferred income has been accounted for in accordance with the company's selected accounting policy under FRS 102:24.

Recognition of deferred income

The auditor should review the basis for deferring income in the financial statements and ensure that it is valid and has been correctly and consistently applied.

Estimates

Design and perform appropriate tests for estimates using the **estimates work paper** *available as a template* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available as a template* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

Disclosure of income by class and/or geographical market

For medium-sized and large companies (this disclosure is not required for small companies or micro-entities), the auditor should check the accuracy of:

- the geographical breakdown of turnover where the company supplies geographical markets outside the UK; and
- the market breakdown of turnover where the company supplies substantially different markets.

3.24 Expenditure

Quick overview

This section explains how to audit expenditure and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to section R2 in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Expenditure

This section deals with the general expenses and recording in the profit and loss account. Payroll testing is covered separately in Wages, salaries and other remuneration.

Expenses are defined in Section 2 of FRS 102 as 'decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those in relation to distributions to equity investors'. In the profit or loss account, expenses are typically analysed (in accordance with Format 1 in the Accounting Regulations) between:

- cost of sales;
- distribution expenses; and
- administrative expenses.

The Accounting Regulations offer an alternative presentation in Format 2; however, this is rarely used in practice.

~~Further guidance on the format of accounts under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

~~• Private Company (FRS 102) – Statement of comprehensive income and income statement (Section 5);~~

~~• Micro Entity (FRS 105) – Income statement (Section 5).~~

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing expenditure are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Expenditure	To ensure that expenditure exists and is accurately recorded.	A, E	Expenditure
Expenditure	To ensure that expenditure is accurately classified.	Classification	Expenditure
Expenditure	To ensure that expenditure is recognised in correct period.	C, Cut-off	Completeness
Expenditure	To ensure that all expenditure is appropriately presented and disclosed.	Presentation	Presentation and disclosures
Expenditure	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity. The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
V – Valuation, accuracy and	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have

allocation	been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Expenditure	N	X	X	X		Classification; Cut off; Presentation

Controls

The following are controls that are relevant to expenditure and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	**How to test**
All invoices are approved prior to payment.	Select a sample of invoices and confirm that they were appropriately authorised and approved prior to payment.
Independent supplier statement reconciliations are carried out and appropriately reviewed.	Select a sample of supplier statements and review reconciliations to confirm they have been completed accurately and appropriately reviewed.
Purchase ledger and VAT control account reconciliations are carried out and appropriately reviewed.	Review a sample of purchase ledger and VAT control account reconciliations to confirm they have been accurately performed and appropriately reviewed.
Purchase invoices are agreed pre-numbered goods received notes, which in turn are checked to authorised orders.	Select a sample of purchase invoices and confirm they have been agreed to the corresponding pre-numbered goods received notes and authorised orders.
Invoices are marked when they are paid to	Select a sample of paid invoices and confirm they have

prevent them being entered into the system again.	been appropriately marked as paid.
There is sufficient follow up of any unmatched goods received by an independent individual.	Select a sample of unmatched goods received notes and confirm that adequate follow up processes have been completed.

The controls listed in Cash at bank and in hand will also be relevant for expenditure and payments.

Audit procedures

All the tests set out below should be considered when planning the audit to determine those that will most effectively satisfy each of the individual objectives for the client in question. Not all the tests relating to an individual objective need be carried out on each audit. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

Expenditure

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Perform a substantive analytical procedure of expenditure using the SAP work paper.	E, A
Select a sample from the nominal ledger (or purchase day book, or cash book if there is no nominal ledger). Agree each sample item to supporting documentation (e.g. invoice, goods received note and purchase orders) to confirm:	
• invoice is addressed to the entity and is adequately authorised;	E
• amount is correctly recorded;	A, E
• expenditure is recorded in the correct accounting period;	Cut-off
• expenditure is correctly classified; and	Classification
• VAT has been appropriately treated.	A, Classification

Substantive analytical procedures

Auditors should perform a substantive analytical procedure (SAP) over expenditure using the SAP work paper. The SAP will compare the expenditure figures per the client to the auditor's expectation, based on various inputs including management information, sector specific knowledge and existing results. The following analytical procedures are relevant in creating an expenditure SAP.

Overhead comparison

One form of analytical procedure usually conducted on every audit is comparing the detailed breakdown of the overheads to the comparable figures for previous years. It is important, however, that it is evidenced on the file that this work has been undertaken and that unexpected results are investigated.

Ratios

The gross profit margin is probably the most useful ratio to calculate. This can be done annually or monthly and compared with earlier years, the auditor's expectations and the client's budgets or forecasts. Presenting the information graphically can help identify abnormal months or trends.

Although these ratios may not be useful, it is sometimes appropriate to take administrative expenses and distribution costs as percentages of turnover. These ratios can then be compared to previous periods, with fluctuations again being investigated. This could potentially identify incorrect analysis in the profit and loss account.

The auditor should also consider whether there are any other relationships between categories of expenditure that could be expected to remain consistent. An example of this might be the relationship between fuel costs and vehicle servicing costs.

Insight - Analytical procedures

Many firms rely heavily on analytical procedures when auditing expenditure. Analytical procedures can be highly effective in giving good quality audit evidence when undertaken correctly.

Auditors should also consider the sensitivity analysis, i.e. what is the impact of small annual changes in ratios on the actual figures being audited. For example, when reviewing the gross profit percentage, a small change in gross profit percentage terms may equate to a very large, material movement in cost of sales (or turnover).

Auditor's expectations should be set before expenses are reviewed and any significant unexpected variances should be followed up and the explanations corroborated. This is an area where professional scepticism is especially important and the auditor should consider performing other corroborating procedures in addition to obtaining client explanations.

These procedures are best done by a more experienced member of the audit team.

Tests of detail

When testing this objective, the auditor should determine which tests of detail are appropriate for the particular client.

The following sample test of detail should be performed.

- Select a sample from the nominal ledger (or purchase day book, or cash book if there is no nominal ledger). Agree each sample item to supporting documentation (e.g. invoice, goods received note and purchase orders) to confirm:
- invoice is addressed to the entity and is adequately authorised;
- amount is correctly recorded;
- expenditure is recorded in the correct accounting period;
- expenditure is correctly classified; and
- VAT has been appropriately treated.

When testing for overstatement rather than understatement, the sample should be selected from the last point in the system, i.e. entries in the nominal ledger.

However, where no nominal ledger is maintained, the auditor may wish to select the sample from the purchase day book or cash book. The details should then be vouched to supporting documentation to check the following:

- that payment of the invoice is properly authorised;
- that the invoice is correctly classified;
- that the invoice is properly addressed;
- that the casts and cross-casts on the invoice are correct;
- that the entity has taken any discount it is entitled to;
- that the details on the invoice have been agreed to goods received notes and orders, where appropriate;
- that the item has been paid;
- that there is adequate evidence of authorisation of electronic payments; and
- that where used, the paid cheque, on inspection, is made out to the person, company or entity specified on the invoice, has not been altered and is signed by an authorised signatory or signatories.

Checking the sort codes and account numbers used for electronic payments should be undertaken as a matter of course.

For cash expenditure, the auditor should select a sample of cash purchases from the nominal ledger, cash book or petty cash book and vouch it to supporting documentation. This test should only be undertaken if it is not adequately covered within the tests above.

For purchase returns, the auditor should select a sample, where the returns are material, and vouch them to the supporting documentation, checking as follows:

- vouching details through to the original invoice;
- agreeing details to credit notes;
- vouching the posting to the purchase ledger; and
- vouching the posting, via the day book, to the nominal ledger.

Completeness

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Review payments made after the period end and ensure that the associated expenditure has been recorded in the correct period.	C, Cut-off
Consider the result of work performed in the creditors and accruals work programme (L) to provide assurance over the completeness of expenditure. Where appropriate, design and perform additional procedures.	C, Cut-off

Substantive analytical procedures

Substantive analytical procedures can be performed to obtain audit comfort over completeness, particularly comparing the expenditure per category to the auditor's expectations, based on various inputs including management information, sector specific knowledge and prior period results.

Tests of detail

The following tests of detail can be performed towards completeness and cut-off:

- review payments made after the period end and ensure that the associated expenditure has been recorded in the correct period;
- consider the result of work performed in the creditors and accruals work programme (L) to provide assurance over the completeness of expenditure. Where appropriate, design and perform additional procedures.

The completeness objective for expenditure may have been addressed by audit work undertaken on the creditors' section and part of the main test on expenditure is to ensure that invoices have been accounted for in the correct accounting period (cut-off).

Estimates

Design and perform appropriate tests for estimates using the **estimates work paper** *available as a template* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available as a template* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all areas of the financial statements, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made.

Where applicable, the auditor should check that the following disclosures have been correctly made in the financial statements and that the figures agree with the trial balance:

- auditor's fees for audit and non-audit (medium and large entities only) services, including expenses and any benefits in kind; and
- operating lease rentals.

3.25 Wages, salaries and otherremuneration

Quick overview

This section explains how to audit wages, salaries and other remuneration and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.

This section relates to schedules R3 and R4 in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Employee benefits

FRS 102:28.1 defines employee benefits as 'all forms of consideration given by an entity in exchange for service rendered by employees, including directors and management'. FRS 102:28 identifies four categories of employee benefit:

- **short-term employee benefits** – those benefits (other than termination benefits) which are expected to be settled wholly within 12 months of the end of the reporting period in which the services have been provided by the employees;
- **post-employment benefits** – those benefits (other than termination and short-term benefits) which are payable after the completion of employment. This will primarily relate to pensions;
- **other long-term employee benefits** – all benefits other than short-term, post-employment or termination. This would include longer term incentive schemes; and
- **termination benefits** – those benefits provided in exchange for the termination of an employee's employment.

Employee benefits arising under defined benefit pension schemes and share-based payment arrangements are addressed separately in Defined benefit pension schemes and Share-based payments.

~~Further guidance on the accounting requirements for employee benefits under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Employee benefits (Section 28);
- Micro Entity (FRS 105) – Employee benefits (Section 23).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing wages, salaries and other remuneration are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Wages and salaries, Directors' emoluments	To ensure that wages costs, directors' emoluments and other employment costs are correctly accounted for and represent all employee costs incurred during the year.	C, A, V, Cut-off	Wages and salaries, Other employment costs, Directors' emoluments
Wages and salaries, Directors' emoluments	To ensure that all paid employees exist and work for the entity.	E	Wages and salaries, Other employment costs, Directors' emoluments
Wages and salaries, Directors' emoluments	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates
Wages and salaries, Directors' emoluments, PAYE and National Insurance	To ensure that specific regulations relating to PAYE and National Insurance have been fully complied with.	Compliance	PAYE and National Insurance
Wages and salaries, Directors' emoluments	To confirm that all necessary disclosures concerning wages and salaries, directors' emoluments and other employment costs have been made and that the information is appropriately presented and described.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**

C – Completeness

All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.

E – Existence

Assets, liabilities and equity interests exist.

The entity holds or controls the rights to assets; and liabilities are the obligations of the entity.

For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity.

The existence assertion used in the ~~Navigate~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy

Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation

Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions

Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~Navigate~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Wages and salaries		X	X	X	X	Cut-off, Presentation
Directors' emoluments		X	X	X	X	Cut-off, Presentation

Controls

The following are controls that are relevant to the accounting process for wages, salaries and other remuneration and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	**How to test**
Access to payroll records and processes are restricted to authorised staff only.	Observe that access to payroll records and processes is restricted.
Full personnel records are maintained, including copies of signed employment contracts, written records of notifications in changes in rates of pay, etc.	Select a sample of employees and check that full and up-to-date personnel records are maintained for each individual.
There is a segregation of duties between staff preparing the payroll, recording of payroll expenses, authorisation of the payroll and authorisation of bank payments.	Enquire of the relevant staff what their duties are to check that duties are segregated.
Payroll calculations are checked by an independent individual, particularly in respect of staff working within the payroll department.	Select a sample of payrolls and check for evidence of independent review. Ensure any issues were followed up appropriately.

The controls listed in Cash at bank and in hand will also be relevant for payments made to employees.

Audit procedures

The auditor should select tests from the examples set out below to gain comfort that the objectives have been satisfied. Given the sensitive nature of this audit area, the auditor should take care to ensure lists of sensitive data are not retained on the audit file unnecessarily. Where the balance includes accounting estimates, reference should also be made to the guidance in Auditing accounting estimates.

Wages and salaries expenditure can be the most significant outgoing for an organisation so it is important that the testing is properly planned.

In addition to wages and salaries, other areas of employee costs will need to be assessed, including employee benefits (such as long-term incentives) and share-based payments.

Wages and salaries

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Perform an analytical review of wages and salaries, creating an expectation and investigating any differences. Use the **SAP work paper**.	C, E, V, Cut-off
Obtain a list of employees and directors and their gross pay reconciled to the staff costs expense in the financial statements. Perform the following:	

• for a sample of employees/directors listed in the nominal ledger, check the gross pay to personnel files and payslips; and	C, E, A, V
• agree reconciling items to supporting documentation.	E
Make enquiries into any unclaimed wages and verify their reasonableness.	E, V
Ensure that appropriate provisions have been made for any year-end bonuses.	C
Ensure that liabilities for any employment benefits unpaid at the year end are complete.	C
Complete the PAYE and National Insurance audit programme on **R4**.	

Substantive analytical procedures

Overall review

Analytical procedures can provide strong audit evidence regarding wages, salaries and other remuneration.

Proof-in-total calculations generally give excellent quality audit evidence. A wages proof-in-total calculation starts with the previous year's wages and salaries, and seeks to predict this year's figure by adjusting for starters, leavers, pay rises, etc. It may be worth excluding directors' emoluments and any large one-off bonuses as these may skew the calculation.

The size of acceptable difference should be set; often this will be performance materiality. Any variances should be investigated and corroborated.

However, this approach may be difficult for clients with large numbers of part time staff, clients which pay a substantial amount of overtime or where there is very high staff turnover. This information should be obtained as part of the auditor's background knowledge of the client at the planning stage and carefully weighed up when the planned audit approach is being determined.

An alternative approach (although the quality of evidence is not as strong) is when the auditor obtains a summary of wages and salaries, giving details of the wages and salaries and the number of employees month by month or week by week, and obtain explanations for and verify any material fluctuations from expectations. The auditor should perform the following procedures.

- Complete a weekly or monthly wages analysis, giving the details of the gross wages, deductions, net wages and employer's National Insurance contributions. The list should also include the average number of employees and their average wage.
- Next, ascertain details of pay increases, changes in PAYE and National Insurance, etc. and determine whether the wages and salaries have behaved in the way that they would expect.
- Where there is both a weekly and a monthly payroll or the payroll is split into departments, the auditor may be able to obtain better evidence by looking at these separately.

There are limitations on adopting this approach. For example, in many smaller businesses, where the wages are not split by department or function, calculations such as average wages may be meaningless. However, where the figures are meaningful, the auditor – on achieving good results from this test – could cut down the amount of detailed testing to be undertaken.

Ratios

The ratio of **employer's NICs:wages and salaries** can be useful when compared with previous years. Unless the proportion of employees earning above the upper earnings limit changes significantly, or the rates of National Insurance change, this ratio should remain fairly constant year on year.

Similarly, the ratio of **employer's pension costs:wages and salaries** can also be useful for entities with defined contribution pension schemes with a steady contribution rate by the employer.

Relationship with other expenses

The auditor should consider whether there is a valid connection between the wages and salaries expenditure and other items in the profit and loss account which can be reviewed. For example, in service industries, there will usually be a strong correlation between wages to professional or technical staff and income, similarly there may be a strong connection between these wages and those paid to the administrative staff. Where this is the case, the auditor should calculate the relevant ratios and obtain explanations for any variances from expectations.

Tests of detail

Obtain a list of employees and directors with their gross pay, this can be prepared from the payroll records. This should be reconciled to staff costs in the financial statements, with reconciling items investigated. This may be the only test required if a strong substantive analytical review has been performed.

However, if a substantive analytical review has not been performed or the difference on reconciliation is not acceptable, the auditor should consider alternative procedures. Some alternative procedures are set out below.

Accuracy of payroll costs

The auditor should select a sample of payrolls and undertake the following testing:

- check the arithmetic accuracy;
- check the posting on the nominal ledger;
- check the total net to the cashbook;
- ensure the payroll is authorised by a responsible individual; and
- ensure that PAYE and National Insurance contributions (NICs) are properly accounted for.

The auditor should reperform the wages calculations for a sample of employees (including starters and leavers) by performing the following tests (the same sample can be used for this test as for the test set out above). The test should check:

- that employee details match the personnel records;
- that the rates of pay are authorised;
- that the tax codes match HMRC coding notifications;
- that proper authorisation has been obtained for any deductions other than tax and employees' NICs;
- where applicable, hours against time records;

- where applicable, production against piecework records;
- that all overtime has been authorised; and
- the calculation of gross pay, taxation, employees' NICs, employer's NICs, employer's and employees' pension contributions and net pay.

Existence of employees

The auditor should select a sample of payments being made and agree the details back to the personnel records or another independent source outside of the payroll department. In certain circumstances, the auditor may feel it is appropriate to physically verify the existence of a sample of the employees.

For any new starters, the auditor should ensure that wages have only been paid from the actual starting date.

For any leavers, the auditor should ensure that wages were only paid up to the date of leaving.

The auditor should make enquiries into any unclaimed wages and verify their reasonableness.

Completeness of costs

The auditor should ensure that short-term compensated absences (such as holiday pay) are accrued correctly at the year end. This arises most commonly where the holiday year does not coincide with the accounting year or where holiday is permitted to be carried over into the next year.

The auditor will also need to ensure that the company accrues for any bonus payments where there is a present (legal or constructive) obligation to make payment. Such payments are often linked to profit and will need to be finalised towards the end of the audit.

Other employment costs

The tests to be performed will vary depending on the type of benefits provided to employees but may include:

- confirming that benefits have been agreed to a signed contract;
- confirming benefits have been correctly calculated; and
- confirming benefits have been included in tax calculations where they are benefits in kind.

For termination benefits as well as agreeing the calculation and amounts to support, the auditor will need to review HR information to ensure completeness of obligations and expenditure relating to termination benefits.

Directors' emoluments

The auditor should obtain details of directors' emoluments paid and payable, including benefits in kind, reconciled to amounts in the financial statements and the payroll records. Any reconciling items should be investigated.

The procedures in Wages and salaries, Other employment costs and Compliance with specific PAYE and National Insurance regulations also apply to directors' emoluments.

Compliance with specific PAYE and National Insurance regulations

The auditor should ensure that there have been no PAYE or National Insurance (NI) compliance issues. This is particularly important where there is a large number of people on the payroll and/or a high percentage of casual employees. Substantial penalties may be levied if the entity is not complying properly with all the relevant rules and regulations.

Where any problems are encountered, the auditor should consider the impact on the audit. It is important to note that where the system is not being applied correctly, this will have an ongoing impact. Although an error may not be material in the year in question, cumulatively (and once fines and penalties are added) it could result in there being material error within the financial statements.

In the ~~*Navigate*~~ *Audit* tools, there is an audit programme for **PAYE and National Insurance (R4)**.

The **PAYE and National Insurance checklist (R4.1)** and the **P11D checklist (R4.2)** set out common points to be considered when dealing with PAYE and Class 1 NIC on earnings.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
General	
Understand the system for reimbursing expenditure incurred by employees.	–
Ensure that all relevant forms (e.g. final RTI submissions) have been completed and submitted to HMRC on time.	Compliance
Review the bank ledgers for any unusual payments, e.g. round sums, private bills, etc. Confirm that they are correctly treated for PAYE/NIC purposes.	A
After taking account of the NIC thresholds, consider whether the secondary NIC paid to HMRC each month is in line with expectations.	C
Consider whether there is evidence to show that the PAYE and National Insurance regulations have been correctly applied for all employees (including payments to casual employees, part-time employees, honorariums, commissions, etc.).	E, A
Complete the PAYE and NI checklist on **R4.1**.	–
Directors' emoluments	
Examine directors' emoluments paid and payable, including benefits in kind, to ensure that they have been accounted for correctly and full payment has been made for any liability in respect of PAYE and NICs.	C, E, A
Benefits in kind	
Review P11Ds to ensure that:	

• benefits are properly declared. Check whether any expenses are covered by the statutory exemption for qualifying expenses;	E, A
• there are no apparent omissions; and	C
• NI has been properly dealt with.	C, Compliance
Complete the P11D checklist on **R4.2**.	–
Off-payroll workers and IR 35	
Where the entity uses self-employed individuals on a regular basis, consider whether these people should be classified as employees of the entity.	Compliance
Where the entity falls within the scope of the IR 35 legislation, consider the effect of this on the operation and administration of the entity.	Compliance
PAYE and NI liabilities	
Where the work above highlighted any outstanding liabilities, ensure that these have been recognised in full.	C, A, V

Substantive analytical procedures

After taking account of the NI thresholds, the auditor should consider whether the secondary NIC paid to HMRC each month is in line with expectations.

Tests of detail

The auditor should carry out the following specific procedures:

- check the system for ensuring that all relevant forms have been completed and submitted to HMRC on time;
- review the bank ledgers for any unusual payments (e.g. round sums, private bills, etc.) and confirm that they are correctly treated for PAYE/NIC purposes;
- consider whether there is evidence to show that the PAYE and NI regulations have been correctly applied for all employees, including directors;
- ensure that PAYE and NI have been applied in all relevant cases, including payment to casual employees, part-time employees, honorariums, commissions, etc. Where any of these categories are relevant, particular care needs to be taken to ensure that the client has complied with all of the requirements;
- carefully examine directors' emoluments paid and payable, including benefits in kind, to ensure that they have been accounted for correctly and full payment has been made for any liability in respect of PAYE and NICs;
- review P11Ds to ensure that benefits are properly declared (unless any expenses are covered by a statutory exemption for qualifying expenses or the amounts paid are within HMRC published limits) and that there are no apparent omissions;
- where the entity uses self-employed individuals on a regular basis, consider whether these people should be classified as employees of the entity; and

- where the entity falls within the scope of the IR 35 legislation, consider the effect of this on the operation and administration of the entity. (A brief explanation of IR 35 is given in Taxation.)

The auditor should ensure that any outstanding PAYE and NI liabilities have been recognised in full. Where errors have been identified, the auditor must ensure that any necessary provision for fines and penalties is included within the financial statements and that the client is informed of the action required to rectify the situation.

Estimates

Design and perform appropriate tests for estimates using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosure

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

3.26 Share-based payments

Quick overview

This section explains how to audit share-based payments and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas ~~of *Navigate Audit*.~~

This section relates to schedule R6 in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Share-based payments

FRS 102:26 requires a charge where an entity provides some form of benefit under a share-based payment transaction. This applies whether the benefits provided are in the form of equity (an equity-settled share-based payment) or in cash at an amount that is based upon equity (a cash-settled share-based payment).

The accounting requirements for share-based payments are detailed and complex. It is important that the auditor has an understanding of both the accounting requirements and the specific contractual terms of the share-based payments subject to audit.

~~Further guidance on the accounting requirements for share-based payments under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Share-based payment (Section 26);
- Micro Entity (FRS 105) – Share-based payments (Section 21).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing share-based payments are as follows.

Financial statement area	Objective	Assertion	Audit procedures
Share-based payments	To ensure that all share-based payment transactions have been identified.	C	Identification of share-based payments
Share-based payments	To ensure that share-based payment transactions exist and have been accounted for appropriately.	E, A, V	Calculation and valuation of share-based payments
Share-based payments	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates
Share-based payments	To confirm that all necessary disclosures concerning share-based payment transactions have been made and that the information is appropriately presented and described.	Presentation	Presentation and disclosures

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	Definition
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity. The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other	Cut off – Transactions and events have been recorded in the correct accounting

assertions	period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Share-based payments	Y	X	X	X	X	Presentation

Controls

The following are controls that are relevant to the accounting process for share-based payments and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	**How to test**
A record of all share-based payment awards granted, updated for exercises, cancellations and forfeitures is maintained.	Request to see the record and check details against recent minuted grants and exercises and employee records to verify that it is up to date.
Share-based payment awards can only be granted with the agreement of the board of directors.	Select a sample of share-based payment awards and check to board minutes confirming approval by the board.
The terms and conditions of share-based payment awards can only be modified with the agreement of the board of directors.	Select a sample of modifications to share-based payment awards and check to board minutes confirming approval by the board.
All exercises are minuted and approved by the board of directors.	Select a sample of exercises and check to board minutes confirming approval by the board.
Share-based payment transactions are valued by an independent employee or external valuer with the appropriate expertise.	Enquire as to who performed the valuations and understand what their relevant expertise/qualifications are.
Assumptions used in valuations are	Obtain evidence of the review, ensure that action was

reviewed by management for suitability and accuracy.	taken on findings if required.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

In practice, it can be difficult to apply substantive analytical procedures to share-based payments. However, in certain sections are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not share-based payments are fairly stated.

Given the sensitive nature of this audit area, the auditor should take care to ensure lists of sensitive data are not retained on the audit file unnecessarily.

Identification of share-based payment transactions

Example tests

The following tests are the standard tests in the *~~Navigate~~ Audit* tools.

Audit procedure	**Assertion being tested**
Check the completeness of share-based payments by discussing with the directors and reviewing:	
• minutes of board meetings;	C
• terms of employment contracts;	C
• legal correspondence; and	C
• share issues during the year and post-year end.	C

Substantive analytical procedures

There isn’t often a substantive analytical procedure which can be performed to identify share-based payment transactions.

Tests of detail

The auditor should ensure that all share-based payment arrangements have been identified. For all arrangements identified, the auditor should also ensure that all information regarding the number of awards granted, exercised, cancelled and forfeited during the period is complete, along with the number of awards outstanding at the period end. Completeness can be checked by reviewing:

- minutes of board minutes;

- terms of employment contracts;
- legal correspondence; and
- share issues during the year and post-year end.

Calculation and valuation of share-based payments

Example tests

The following tests are the standard tests in the ~~Navigate~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Calculation of share-based payments	
Ensure that the accounting treatment of any share-based payment transactions is in accordance with the terms of the underlying agreement and the applicable accounting standard.	V
Obtain calculations for share-based payment arrangements and check these agree to amounts recognised in the financial statements.	
• Check the arithmetic accuracy of the workings.	A
• Agree inputs to the terms of the underlying agreements and other source data/documentation.	E, A
• Ensure any vesting conditions (market and non-market) have been correctly accounted for.	V
• Consider the reasonableness of assumptions made (e.g. no. of instruments expected to vest). Take into account the accuracy of forecasts and estimates made in previous years. Complete the **Estimates work paper** where appropriate.	V
• Ensure any modifications to share-based payment arrangements have been correctly accounted for.	A, V
Confirm that an expense has been recognised in the profit and loss account where the company entered into any share-based payment transactions.	
Valuation of share-based payments	
Where share-based payments have been valued with reference to an option pricing model, test the reliability and accuracy of the model used by the company.	V
Where an expert has valued the share-based payments or an element of the calculation, consider the requirements of ISA (UK) 500 (Updated May 2022) *Audit Evidence* and complete the **Management's expert work paper (Sup2)** or the **Auditor's**	V

expert work paper (Sup3) *available in the templates* as appropriate.

Substantive analytical procedures

There isn't often a substantive analytical procedure which can be performed on the calculation and valuation of share-based payments.

Tests of detail

The auditor should ensure that the accounting treatment and method of valuation of each share-based payment transaction is in accordance with the terms of the underlying agreement and FRS 102:26:

- for equity-settled share-based payment transactions, ensure the entity has measured the goods or services received and the corresponding increase in equity either:
  - at the fair value of those goods or services; or
  - if the fair value of the goods or services received cannot be reliably estimated, then by the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted, at the grant date;
- for cash-settled share-based payment transactions, ensure that the entity has measured the goods or services received and the liability incurred at the fair value of the liability;
- for share-based payment transactions where the terms of the arrangement provide either the entity or the counterparty with a choice of settlement method, ensure that the transaction, or the components of that transaction, have been accounted for as either:
  - a cash-settled share-based payment transaction if, and to the extent that, the company has incurred a liability to settle in cash or other assets; or
  - as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

Care needs to be applied in determining whether some arrangements should be treated as equity-settled or cash-settled. Consideration needs to be given to the arrangement as a whole and not just the initial transfer.

The auditor should confirm that an expense has been recognised in the profit and loss account where the entity has entered into any share-based payment transactions.

Calculation and valuation

The auditor should obtain calculations and valuations for share-based payment arrangements and check these agree to amounts recognised in the financial statements. The auditor should perform the following procedures:

- check the arithmetic accuracy of the workings;
- agree the inputs to the terms of the underlying agreements and other source data/documentation;
- ensure any non-market vesting conditions (e.g. length of service or performance targets) and market vesting conditions (e.g. share price increases) have been accounted for in accordance with FRS 102:26;
- ensure any modifications to share-based payment arrangements have been accounted for in accordance with FRS 102:26;

- consider the reasonableness of assumptions made in valuing the arrangement (e.g. no. of instruments expected to vest), taking into account the accuracy of forecasts and estimates made in previous years.

Where share-based payments have been valued with reference to an option pricing model, such as the Black-Scholes option pricing model, the auditor should test the reliability and accuracy of the model used by the company.

Using the work of others

The valuation of share-based payment arrangements can be complex and management may engage an external valuer to assist in the valuation of certain share-based payment arrangements. Where an expert has valued the share-based payments, or an element of the calculation, the auditor should consider the requirements of ISA (UK) 500.

In the ~~*Navigate*~~ *Audit* tools, there is an audit programme for **Using the work of management's expert (Sup2)** *available in the templates*.

Estimates

Design and perform appropriate tests for estimates using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Where the accounting for share-based payment transactions that include the client's estimates of the number of equity instruments expected to vest, or other issues, ensure that these opinions are confirmed in the letter of representation.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosure

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

3.27 Foreign currency, discontinued operations and borrowing costs

Quick overview

This section explains how to audit foreign currency transactions and balances, discontinued operations and borrowing costs and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland (2022)*. These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas of *Navigate Audit*.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Foreign currency

The core concept that FRS 102:30 relies on for its requirements on foreign currency translation is that of the functional currency. This is defined in FRS 102:30.2 as 'the currency of the primary economic environment in which the entity operates' and is a matter of fact, not accounting policy choice. The auditor should ensure that the company has correctly identified its functional currency. Transactions entered into in a currency other than the functional currency are foreign currency transactions.

FRS 102 also allows that a company may present its financial statements in a currency other than its functional currency (e.g. consolidated accounts will need to be presented in a particular currency, even though foreign subsidiaries may have different functional currencies). The presentation currency is an accounting policy choice.

Foreign currency transactions are translated at the spot rate on the transaction date. Since this could be onerous in practical terms, it is acceptable to use an average rate for the week or month, providing this is a reasonable approximation of the daily rate. Subsequent reporting depends on the nature of the item:

- monetary assets and liabilities are retranslated using the exchange rate at the reporting date, with exchange differences recognised in the income statement;
- non-monetary items measured at cost are left at their historical cost, translated at the rate that was originally used (i.e. spot rate at transaction date); and
- non-monetary items measured at fair value first have their fair value redetermined in the foreign currency, then this is retranslated using the rate when fair value was determined.

The standard defines monetary items as 'units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency'.

~~Further guidance on the accounting requirements for foreign currency under the applicable standards can~~

~~be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Foreign currency translation (Section 30);
- Micro Entity (FRS 105) – Foreign currency translation (Section 25).

Discontinued operations

A discontinued operation is defined in the Glossary to FRS 102 as:

'a component of an entity that has been disposed of and:

(a) represented a separate major line of business or geographical area of operations;

(b) was part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or

(c) was a subsidiary acquired exclusively with a view to resale.'

It is important to identify discontinued operations as large and medium-sized companies need to present the results of such operations separately on the face of the profit and loss account. The auditor will therefore need to be aware of such operations and ensure that amounts are presented appropriately.

Further guidance on the accounting requirements for discontinued operations under the applicable standards can be found in *Navigate UK GAAP Accounting*:

- Private Company (FRS 102) – Discontinued operations;
- Small Company (FRS 102 1A) – Discontinued operations.

Borrowing costs

Borrowing costs are defined in FRS 102:25.1 as 'interest and other costs that an entity incurs in connection with the borrowing of funds'. These include (but are not explicitly limited to):

(a) interest expense calculated using the effective interest method (FRS 102:11);

(b) finance charges in respect of finance leases (FRS 102:20 and Audit team planning meeting); and

(c) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

There is an accounting policy choice for borrowing costs:

(a) capitalise those that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset; or

(b) expense them as incurred.

Directly attributable borrowing costs are defined as 'those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made'.

The selected policy must be applied consistently to a class of qualifying assets, with a class of assets being defined in the Glossary to FRS 102 as 'a grouping of assets of a similar nature and use in an entity's operations'. The auditor should identify the accounting policy in use and ensure that borrowing costs are treated in accordance with that policy.

~~Further guidance on the accounting requirements for borrowing costs under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Borrowing Costs (Section 25);
- Small Company (FRS 102 1A) – Borrowing Costs (Section 25);
- Micro Entity (FRS 105) – Borrowing costs (Section 20).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

Foreign currency

The specific objectives that should be addressed when auditing foreign currency are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Foreign currency	To ensure that foreign currency transactions are accounted for correctly.	A, V	Foreign currency
Foreign currency	To ensure that all foreign currency transactions are appropriately presented and disclosed.	Presentation	Presentation

The objectives relating to the completeness (C) and existence (E) of the underlying transactions are dealt with in the relevant section of *Navigate Audit* (e.g. Income, Expenditure, etc.)

Discontinued operations

The specific objectives that should be addressed when auditing discontinued operations are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Discontinued operations	To ensure that discontinued operations have been identified and correctly accounted for.	C, E, A, V	Discontinued operations
Discontinued operations	To ensure that all discontinued operations are appropriately presented and disclosed.	Presentation	Presentation

Borrowing costs

The specific objectives that should be addressed when auditing borrowing costs are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Borrowing	To ensure that borrowing costs exist, are complete and	C, E, A, V	Borrowing

costs	are accounted for in line with the stated accounting policy.		costs
Borrowing costs	To ensure that all borrowing costs are appropriately presented and disclosed.	Presentation	Presentation
Borrowing costs	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates

In the ~~*Navigate*~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity. The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Controls

The following are controls that are relevant to foreign currency, discontinued operations and borrowing costs and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Foreign currency

Control in place	**How to test**
The exchange rates used by the entity are obtained from a reliable source.	Select a sample of exchange rates used by the entity and agree them to published rates.
Foreign currency customer and supplier ledger accounts are clearly identifiable.	Select a sample of foreign currency purchases and sales and trace to entries in the purchase and sales ledger accounts respectively.

Discontinued operations

Control in place	**How to test**
Disposals must be agreed by the board of directors.	Agree discontinued operations to board minutes confirming approval by the board.

Borrowing costs

Control in place	**How to test**
Calculations for borrowing costs and any assumptions are independently checked for accuracy and reasonableness.	Obtain evidence of the review and ensure action was taken on findings if required.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

In practice, it can be difficult to apply substantive analytical procedures to foreign currency, discontinued operations and borrowing costs. However, in each section are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not balances are fairly stated.

Foreign currency

Substantive analytical procedures

There isn’t often a substantive analytical procedure which can be performed for foreign currency transactions. However, depending on the nature, timing and extent of the entity’s foreign currency transactions and balances, it may be possible for the auditor to calculate an expected gain or loss on foreign currency transactions for a period by multiplying the exchange rate variance by the average foreign currency balance, which can then be compared to the actual foreign currency gain or loss recognised by the client.

Tests of detail

Where the entity deals in foreign currencies, the auditor should ensure that the translation has been undertaken properly. This is particularly important where the sums of money involved are substantial and any exchange differences could result in material adjustments to the figures in the financial statements. The auditor should undertake the following tests:

- ascertain that foreign currency transactions have been identified and translated at appropriate rates;
- ensure the proper treatment of monetary and non-monetary items; and
- check that the rates of exchange used match those of a reliable source (e.g. the Bank of England).

The required accounting for forward exchange contracts is considered in more detail in Financial instruments.

The risk of errors arising in accounting for foreign currency transactions can be high. It is important that the auditor properly documents and understands the client's accounting systems and procedures in respect of foreign currency transactions so that any systematic accounting errors can be identified. A walkthrough test of a foreign currency sale and/or purchase can highlight accounting errors. A very common error is to treat stock as a monetary item, when in fact it is a non-monetary item.

Discontinued operations

Substantive analytical procedures

There isn't often a substantive analytical procedure which can be performed for discontinued operations and disposal groups.

Tests of detail

Where the entity has disposed of a component, the auditor should ensure that the results of that component have been correctly identified. The auditor should perform the following tests:

- ensure the disposal has been properly authorised by reviewing board minutes or other supporting documentation;
- obtain the calculations supporting the amounts recognised in respect of discontinued operations and disposal groups in the financial statements. Check:

– arithmetic accuracy;

– timing agrees to underlying decisions (e.g. as documented in board minutes);

– amounts presented for discontinued operations have been calculated in accordance with the applicable accounting standard;

- review board minutes to ensure disposals are complete.

The auditor should also ensure that the discontinued operations and disposal groups are correctly presented in the financial statements.

Borrowing costs

Substantive analytical procedures

Depending on the nature of the borrowings and the qualifying asset (where costs are capitalised), the auditor may be able to calculate the expected borrowing costs by multiplying the average interest rate with the average outstanding balance of borrowings, which can then be compared to the borrowing costs recognised by the client.

Tests of detail

The auditor should perform the following tests:

- obtain workings for borrowing costs capitalised and expensed which agree to amounts recognised in the nominal ledger. Check:
  - the arithmetic accuracy of the workings;
  - the basis on which general borrowings have been attributed to a qualifying asset and that amounts capitalised have been calculated in accordance with the applicable accounting standard;
  - capitalisation rates agree to the terms of the underlying agreements;
  - ensure costs have been capitalised or expensed consistently and in accordance with the entity's accounting policy; and
  - ensure costs have only been capitalised where permitted by the applicable accounting standard.

Estimates

Design and perform appropriate tests for estimates using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

3.28 Related party transactions

Quick overview

This section considers the audit of related party transactions. It provides example audit objectives for the section, covers the types of control which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

This section relates to section X in the ~~Navigate~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

Related party transactions

This section deals with related party transactions. These are defined by FRS 102, Section 33 as:

'a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.'

The definition of a related party under FRS 102 is given in the Glossary as follows:

(1) A person or a close member of that person's family is related to a reporting entity if that person:

- has control or joint control over the reporting entity;
- has significant influence over the reporting entity; or
- is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(2) An entity is related to a reporting entity if any of the following conditions apply:

(i) the entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others);

(ii) one entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member);

(iii) both entities are joint ventures of the same third party;

(iv) one entity is a joint venture of a third entity and the other entity is an associate of the third entity;

(v) the entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity;

(vi) the entity is controlled or jointly controlled by a person identified in (a).

(vii) a person identified in (2)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

(viii) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

Key management personnel is defined as:

‘those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.’

Although this will include the directors, it is not always limited to the directors and care should be taken to ensure that all key management personnel are identified.

There are two exemptions from the application of Section 33:

- First, disclosures are not required of transactions between two parties which are only classified as related by virtue of both being state-controlled.
- Second, disclosures are also not required of transactions between group members, as long as any subsidiary involved is wholly owned.

~~Further guidance on the accounting requirements for related parties under the applicable standards can be found in Navigate UK GAAP Accounting:~~

- Private Company (FRS 102) – Related parties (Section 33);
- Small Company (FRS 102 1A) – Related party disclosures (Section 33).

The first stage in the audit of related party transactions is to identify all related parties, which should be done at the planning stage as part of the risk assessment. Auditors should continue to be vigilant in identifying any transactions with those related parties throughout the audit and execution.

Awareness of related party issues and professional scepticism

Audit staff undertaking the detailed audit fieldwork must be fully aware of the types of issues that require disclosure. It is essential that all staff are fully briefed on the need to disclose related party transactions at the beginning of the assignment and that they review the list of known related parties on the file, so as to be able to identify such matters during the course of the rest of the audit. If the audit team is aware of this at the start of the assignment, it reduces the risk of disclosures being missed.

Related party transactions is an area where the maintenance of ethics and professional scepticism is of crucial importance. Auditors should ensure they do not mentally discount the possibility of unrecorded related party transactions due to a positive long-standing relationship with the client.

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation in addition to those below.

Term	Definition
Arm’s length transaction	A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

Source: ISA (UK) 550 (Updated May 2022) Related parties

Auditing standards and guidance

ISA (UK) 550 (Updated May 2022) *Related parties* sets out requirements and provides guidance for the auditor regarding related party transactions. It covers:

- responsibilities of the auditor;
- risk assessment procedures and related activities;
- identification and assessment of risks of material misstatement;
- responses to risk;
- evaluation of accounting and disclosure;
- written representations;
- communication with those charged with governance; and
- documentation.

This ISA requires a strong emphasis on procedures to identify, assess and respond to risks of material misstatement associated with related parties and a focus in particular on fraud risk factors linked to related party transactions.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives that should be addressed when auditing related party transactions are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
Related party transactions	To ensure that related party transactions are completely identified.	C, Classification	Completeness of related parties, Significant or unusual transactions, Previously unidentified or undisclosed related parties or significant related party transactions
Related party transactions	To ensure that related party transactions exist and are appropriately recorded.	E, A, Cut off	Related party transactions
Related party transactions	To ensure that related party transactions are adequately disclosed in the financial statements.	Presentation	Presentation and disclosures

In the ~~Navigate~~ *Audit* tools, the assertions are defined as follows.

Assertion	**Definition**

C – Completeness

All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.

E – Existence

Assets, liabilities and equity interests exist.

The entity holds or controls the rights to assets; and liabilities are the obligations of the entity.

For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity.

The existence assertion used in the ~~*Navigate*~~ *Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315.

A – Accuracy

Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.

V – Valuation, accuracy and allocation

Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Other – Other assertions

Cut off – Transactions and events have been recorded in the correct accounting period.

Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts.

Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	**Is there an estimate in this balance? (C8.1)**	**Assertions to be tested**				
	Y or N	C	E	A	V	Other
Related party transactions	N	X	X	X		Classification; Cut off; Presentation

Controls

ISA (UK) 550:14 requires the auditor to gain an understanding of three aspects of controls (if any) over related party transactions, namely:

- controls over the identification, accounting for and disclosure of related party relationships and transactions in accordance with the applicable financial reporting framework;

- authorisation and approval of significant transactions and arrangements with related parties; and
- authorisation and approval of significant transactions and arrangements outside the normal course of business.

However, for most private companies, there are unlikely to be many such controls. One of the main sources of information for related party transactions is board minutes, which highlights the importance of maintaining minutes that are signed on behalf of the board as being an accurate record of meetings.

Controls over related party relationships and transactions within some entities may be deficient or non-existent for a number of reasons, such as:

- the low importance attached by management to identifying and disclosing related party relationships and transactions;
- the lack of appropriate oversight by those charged with governance;
- an intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive, e.g. the existence of transactions involving family members of management;
- an insufficient understanding by management of the related party requirements of the applicable financial reporting framework;
- the absence of disclosure requirements under the applicable financial reporting framework.

Where such controls are ineffective or non-existent, the auditor will have to ensure substantive procedures can be used to obtain sufficient appropriate audit evidence about related party relationships and transactions.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor would have to consider the implications for the audit, including the opinion in the auditor's report.

Audit procedures

Related party transactions

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Confirm with management that the information on file and considered at the planning meeting is up to date.	C, A
Enquire of the directors whether the company has entered into any transactions in which one or more of those related parties have an interest. Where this is the case, ascertain the type and purpose of the transaction(s).	C, A, Classification
Where the financial statements state that a related party transaction was conducted at arm's length:	

• agree the transaction back to invoice;	A, E
• obtain evidence to support the statement that the transaction was conducted at arm’s length.	Presentation

Substantive analytical procedures

Analytical procedures can be used to add comfort that all related parties have been identified. Comparison of the information provided by the directors with previous years’ disclosures will help with this. However, substantive analytical procedures alone cannot provide sufficient assurance over related party transactions which are by nature novel, judgemental and material.

Tests of detail

Auditors should confirm with management that the information about the identity of existing related parties is up to date, including any details which have been discussed at planning meetings. If there have been changes, understand what they are.

To understand the related party transactions which have occurred in the current period, the auditors should enquire of the directors whether the company has entered into any transactions in which one or more of those related parties have an interest. Where this is the case, ascertain the type and purpose of the transaction(s). The auditors should understand whether that transaction was conducted at arm’s length or not.

Where the financial statements state that a related party transaction was conducted at arm’s length (ISA (UK) 550:24) this assertion must be audited. This means the auditors should:

(a) agree the transaction back to invoice;

(b) obtain evidence to support the statement that the transaction was conducted at arm’s length.

Completeness of related parties

ISA (UK) 550 requires a strong emphasis on procedures to identify, assess and respond to risks of material misstatement associated with related parties and a focus in particular on fraud risk factors linked to related party transactions. As a result, in 2010, the Audit and Assurance Faculty of the ICAEW published guidance material entitled *The audit of related parties in practice* to assist auditors in implementing the requirements of the ISA. Its recommendations have been incorporated within this guide.

The first stage is to identify all related parties, which should be done at the planning stage as part of the risk assessment. The next stage is then to identify any transactions with those related parties.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Review information provided by those charged with governance and management, identifying the names of all known related parties. Perform the following procedures in respect of the completeness of this information:	
• Review the permanent file and prior year working papers for names of known related parties.	C

- Review the work on the current audit file including the bank and legal confirmations obtained as part of the auditor’s procedures. C

- Review the company’s procedures for identification of related parties. C

- Review invoices and correspondence from lawyers for indications of the existence of related parties or related party transactions. C

- Review all month-end sales and purchase ledger balances to identify any accounts in the names of related parties. C

- Review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register. C

- Review minutes of the meetings of shareholders and those charged with governance and other relevant statutory records such as the register of directors’ interests. C

- Enquire as to the affiliation of those charged with governance and officers with other companies. C

- Enquire as to the interest of the directors in other companies, unincorporated businesses and partnerships. C

- Enquire of the names of all pension and other trusts established for the benefit of employees and the names of their management. C

- Enquire of other auditors currently involved in the audit, predecessor auditors or internal auditors as to their knowledge of additional related parties. C

Ensure that any previously unidentified related party transactions outside the normal course of business are carried to the Risk Assessment Summary (C9.3) as risks.

Substantive analytical procedures

Analytical procedures can be used to add comfort that all related parties have been identified. Comparison of the information provided by the directors with previous years’ disclosures will help with this. However, substantive analytical procedures cannot provide sufficient assurance over related party transactions which are by nature novel, judgemental and material.

Tests of detail

The auditor should apply the following procedures.

Review information provided by those charged with governance and management, identifying the names of all known related parties. Perform the following procedures in respect of the completeness of this information:

- review the permanent file and prior year working papers for names of known related parties;
- review the work on the current audit file including the bank and legal confirmations obtained as part of the auditor's procedures;
- review the company's procedures for identification of related parties;
- review invoices and correspondence from lawyers for indications of the existence of related parties or related party transactions;
- review all month-end sales and purchase ledger balances to identify any accounts in the names of related parties;
- review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register;
- review minutes of the meetings of shareholders and those charged with governance and other relevant statutory records such as the register of directors' interests;
- enquire as to the affiliation of those charged with governance and officers with other companies;
- enquire as to the interest of the directors in other companies, unincorporated businesses and partnerships.
- enquire of the names of all pension and other trusts established for the benefit of employees and the names of their management;
- enquire of other auditors currently involved in the audit, predecessor auditors or internal auditors as to their knowledge of additional related parties;
- ensure that any previously unidentified related party transactions outside the normal course of business are carried to the Risk Assessment Summary (C9.3) as risks.

Completeness of related parties

The auditor should use the register of related parties on the audit file as a reference, remain alert when undertaking all audit procedures, but particularly those involving inspecting records, and identify any transactions during the period with those entities.

This may include performing specific procedures such as reviewing the aged debtors and creditors listings, cash book, etc. but under ISA (UK) 550 must include the bank letter, legal confirmations and minutes of meetings with shareholders and those charged with governance. The auditor should also remain alert to the possibility of identifying undisclosed related parties and transactions therewith.

One of the most common challenges is an incomplete register of related parties on the file. ISA (UK) 550 is unequivocal in requiring the auditor to document the names of all identified related parties, so there should be clear evidence on file of the auditor's attempts to obtain a complete list of all related parties.

The register of related parties should not be limited to a list of the directors and, if relevant, a copy of the group structure. Auditors should consider the possible existence of other related parties, including (but not limited to):

- other persons with significant control over the business;
- other businesses owned and/or managed by the directors;

- close family members of the directors and businesses owned or managed by them;
- significant shareholders who are not also directors; and
- pension schemes and retirement benefit plans.

Directors' loans

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain a schedule of movements on the loan account for each director and other connected person. Agree movements to support.	E
Ensure any loans made to directors meet the requirements of Companies Act.	E, Classification

Substantive analytical procedures

It is unlikely that substantive analytical procedures can be applied for directors' loans.

Tests of detail

Auditors should perform the following tests of detail:

- obtain a schedule of movements on the loan account for each director and other connected person. Agree movements to support;
- ensure any loans made to directors meet the requirements of Companies Act.

Significant or unusual transactions

Material misstatement of financial statements, including fraudulent financial reporting, can arise from significant, unusual or highly complex transactions, especially those that pose difficult 'substance over form' questions, such as transactions not in the ordinary course of business undertaken with related parties. The ISAs give particular attention to the accounting for and disclosure of such transactions in the context of the auditor's identification and assessment of risks of material misstatement, whether due to error or fraud, and the auditor's responses thereto.

When performing testing of significant or unusual transactions, auditors should maintain professional scepticism and ensure that they consider any fraud risk factors in the context of the requirements of ISA (UK) 240 (Revised May 2021) (Updated May 2022) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**

Review the accounting and other records for large or unusual transactions or balances, in particular transactions recognised at or near the end of the financial period and for those outside the normal course of business.	C, Classification
Discuss the nature, purpose and terms of any unusual transactions with management and enquire as to whether related parties are involved.	C, Classification
For any transactions outside the normal course of business, inspect the underlying contracts or agreements, if any, and evaluate whether:	
• related parties are involved;	Classification
• the business rationale suggests they have been entered into to engage in fraudulent financial reporting;	Classification
• the transaction terms are consistent with management explanations;	Classification
• the transactions have been properly accounted for and disclosed;	C, A, Classification
• the transactions have been properly authorised. Where no such formal controls exist, obtain management representations as to the validity of the transactions and consider management involvement in the transaction.	C, Classification
Ensure that any previously unidentified related party transactions outside the normal course of business are carried to the Risk Assessment Summary (C9.3) as risks.	

Substantive analytical procedures

It is unlikely that substantive analytical procedures can be used for significant or unusual transactions which by their nature are not easy to predict.

Tests of detail

ISA (UK) 550:16 specifically requires that where any significant transactions outside the normal course of business are identified whether by the above procedures or otherwise, the auditor must inquire of management about not only the nature of the transaction but also whether any related parties could be involved.

As such, auditors should review the accounting and other records for large or unusual transactions or balances, in particular transactions recognised at or near the end of the financial period and for those outside the normal course of business. Examples of transactions include:

- transactions with abnormal terms;
- transactions that appear to lack a logical business reason for their occurrence;
- transactions in which substance differs from form;
- transactions processed or approved in a non-routine manner;

- high volume or significant transactions with certain customers or suppliers as compared with others;
- unrecorded transactions such as the receipt or provision of management services at no charge;
- sales transactions with unusually large discounts;
- circular transactions – sales with a commitment to repurchase;
- transactions under contracts whose terms are changed before expiry;
- bank and legal confirmations obtained as part of audit procedures;
- minutes of meetings of shareholders and of those charged with governance;
- such other records or documents as considered necessary in the circumstances of the entity.

Related party transactions outside the normal course of business

Where such transactions do involve related parties, ISA (UK) 550:23 requires that they be treated as giving rise to significant risks. The ISA also requires the following procedures to be performed in response – inspect the underlying contracts or agreements, if any, and evaluate whether:

(i) the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;

(ii) the terms of the transactions are consistent with management's explanations;

(iii) the transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

(iv) obtain audit evidence that the transactions have been appropriately authorised and approved.

Previously unidentified or undisclosed related parties or significant related party transactions

Example tests

The following tests are the standard tests in the ~~Navigate~~ *Audit* tools.

Audit procedure	Assertion being tested
Where potential related parties or potential related party transactions are identified that management had not previously identified or disclosed, determine whether the underlying circumstances confirm the existence of the relationship or transaction. Where confirmation of a related party/related party transaction is obtained:	Classification

• promptly inform the audit team of these details;	C
• ask management to identify all transactions with the newly identified related party;	C
• enquire as to why these had not been identified previously and why any controls in place failed to pick them up;	C
• review accounting records for further transactions with this party;	C
• verify the terms of the transactions and ensure that they have been appropriately accounted for and disclosed;	A, Cut-off, Classification, Presentation
• enquire into the nature of the relationship;	A
• ask management whether there are any further undisclosed related parties or transactions;	C
• where management has intentionally failed to disclose related parties and significant related party transactions, evaluate implications for the audit and consider whether it is necessary to re-evaluate the reliability of all management responses and representations.	C, A, Classification, Presentation

Substantive analytical procedures

Substantive analytical procedures will not be relevant to auditing previously undisclosed related parties and/or significant related party transactions which are by their nature novel and material.

Tests of detail

Occasionally, the auditor may identify related parties and/or significant related party transactions during the course of their work (whether at the planning or fieldwork stage of the audit) which have not previously been communicated to the auditor by management. This reinforces the need for the auditor to fully document the names of known related parties and transactions therewith, so it is clear from the file which information was already known to the auditor and which was not.

Should this occur, the ISA is again very specific about the audit procedures that must be performed in response, which are as follows:

(i) promptly communicate the relevant information to the other members of the audit team;

(ii) request management to identify all transactions with the newly identified related parties for the auditor's further evaluation and inquire as to why the entity's controls failed to identify the related party relationship or transaction(s);

(iii) perform appropriate substantive audit procedures relating to the newly identified related parties and/or transactions;

(iv) reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor and perform additional audit procedures as necessary; and

(v) if the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

Written representations

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain a written representation from management about related party relationships and transactions including:	
• the completeness of information provided;	C
• the appropriateness of the accounting treatment;	Classification
• the adequacy of disclosure in the financial statements.	Presentation
Where those charged with governance include people other than those involved in management, include details of any significant matters arising from the audit of related party transactions.	

Substantive analytical procedures

Substantive analytical procedures cannot provide assurance over the area of written representations.

Tests of detail

Auditors should obtain a written representation that management has:

- completely disclosed the identity of related parties, relationships and transactions of which they are aware;
- that related parties and transactions have been appropriately accounted for; and
- that related parties and transactions have been adequately disclosed.

The reliability of management's written representations and their consistency with the results of audit work performed on related party transactions (and throughout the course of the audit engagement) is important to assess. As noted in Previously unidentified or undisclosed related parties or significant related party transactions, where management has intentionally failed to disclose related parties and significant related party transactions, the auditor needs to consider whether it is necessary to re-evaluate the reliability of all management responses and representations.

A template for a letter of representation is available in Templates ~~and Letters within *Navigate Audit*.~~

Presentation and disclosures

Accounts require disclosure of related party transactions in order to draw users' attention to the possibility that the reported financial position and results may have been affected by the existence of material transactions with related parties. ~~Guidance on the disclosure requirements for accounts~~

~~prepared under FRS 102 are contained in Presentation and disclosure in *Navigate UK GAAP Accounting*.~~

Aggregation of disclosure into four categories is permitted except where separate disclosure is necessary for a full understanding of the effects of the related party transactions on the financial statements.

FRS 102, Section 33 does not make any explicit reference to the concept of materiality. As such, it must be assumed that materiality is as relevant a concept as it is everywhere else in the standard, so related party relationships and transactions should be disclosed if '[their] omission or misstatement could influence the economic decisions of users made on the basis of the financial statements' (FRS 102:2.6). It seems best to err on the side of caution in making materiality judgements in such a sensitive area, bearing in mind that related party transactions are typically considered to be qualitatively material.

The auditor should consider the implications of the findings from work performed on related parties and related party transactions for the audit opinion.

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

Treatment of transactions 'in the normal course of business' or 'at arm's length'

A common risk attached to related-party transactions is that the directors may not wish to disclose certain transactions due to their sensitive nature or because they were motivated by something outside ordinary business considerations. It is not relevant whether or not a transaction was in the ordinary course of business; disclosure is still required if it is judged to be material.

As noted in the testing on Related party transactions, ISA (UK) 550:24 requires that, where the financial statements contain the assertion that a related party transaction was conducted at arm's length, this assertion must be audited. This may be challenging to substantiate and thus management should be encouraged not to include such an assertion in the disclosure unless it is necessary for an understanding of the financial statements.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Obtain sufficient appropriate audit evidence as to whether identified related party transactions have been appropriately accounted for and disclosed in the financial statements.	Presentation
Review transactions and balances with directors to ensure they are properly presented as related party transactions. Where a director's loan account is overdrawn, ensure that details of each advance repayment are disclosed (including, where prepared, in the abbreviated accounts).	Presentation
Obtain sufficient appropriate audit evidence that disclosures in the financial statements relating to control of the company are properly stated. This may include obtaining corroboration from the ultimate controlling party.	Presentation

3.29 Subsequent events

Quick overview

This section covers requirements around responding to events which occur between the date of the financial statements and the date of the auditor's report and responding appropriately to facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

This section relates to section T in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of controls and substantive procedures, including analytical review.

Subsequent events

FRS 102:32.2 defines events after the balance sheet date as follows:

'Events after the end of the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue. There are two types of events:

(a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the end of the reporting period); and

(b) those that are indicative of conditions that arose after the end of the reporting period (non-adjusting events after the end of the reporting period).'

Adjusting events

Adjusting events would include such items as:

- the receipt of money in respect of stock or work in progress, which would suggest that the net realisable value is less than the cost incorporated within the valuation in the financial statements;
- the determination after the end of the reporting period of the amount of profit-sharing or bonus payments if the entity had a legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date;
- the insolvency of a debtor post year-end, which may indicate that the debtor was unstable at the year end and provision should be made against amounts receivable;
- the settlement of a court case that confirms that the entity had a present obligation at the balance sheet date; and
- the discovery of fraud or errors that shows that the financial statements are incorrect.

Non-adjusting events

The following items are examples of non-adjusting events:

- a merger or an acquisition;
- the issue of new shares or debentures;
- purchases and sales of fixed assets and investments;
- opening a new trading activity;
- renegotiating the repayment terms of debt or entering into a CVA;
- losses of fixed assets as a result of a catastrophe, e.g. through a fire or a flood; and
- the decline in market value of investments.

Neither of the above lists is definitive but they provide examples of the types of issues that need to be considered.

Note that final proposed dividends declared after the year end should not be adjusted for (accrued) in the financial statements.

Importantly, the reporting period ends at the point that the financial statements are authorised for issue, not when they are approved by shareholders, when public announcements of results are made or any other date. This can be critical when it comes to assessing the effect of a discrete event occurring close to the point of issue of the financial statements.

~~Further guidance on subsequent events under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Events after the reporting period (Section 32);
- Small Company (FRS 102 1A) – Events after the reporting period (Section 32);
- Micro Entity (FRS 105) – Events after the end of the reporting period (Section 26).

Key definitions

Term	Definition
Date of the financial statements	The date of the end of the latest period covered by the financial statements.
Date of approval of the financial statements	The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognised authority have asserted that they have taken responsibility for those financial statements.
Date of the auditor's report	The date the auditor dates the report on the financial statements in accordance with ISA (UK) 700 (Revised November 2019) (Updated May 2022) *Forming an Opinion and Reporting on Financial Statements*.
Date the financial statements are issued	The date that the auditor's report and audited financial statements are made available to third parties.

Subsequent events	Events occurring between the date of the financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report.

Source: ISA (UK) 560:5

Auditing standards and guidance

ISA (UK) 560 *Subsequent Events* sets out requirements and provides guidance for the auditor regarding audit evidence in relation to post balance sheet events where this is material to the financial statements.

The ISA covers:

- events between the period end and the date of the audit report;
- matters of which the auditor becomes aware after the date of the audit report but before the financial statements are issued; and
- matters of which the auditor becomes aware after the financial statements have been issued.

ISA (UK) 560 does not deal with any matters relating to the auditor's responsibilities for other information obtained after the date of the auditor's report. However, it is worth noting that such other information may bring to light a matter that is within the scope of ISA (UK) 560.

Audit objectives

The specific objectives that should be addressed in relation to subsequent events are:

- to ensure that all material adjusting and non-adjusting subsequent events are identified and correctly treated in the financial statements;
- to confirm that all necessary disclosures concerning subsequent events have been made and that the information is appropriately presented and described.

In addition, the auditor needs to respond appropriately to facts that become known to them after the date of the auditor's report, which had they been known at the time would have caused them to amend the auditor's report.

Controls

It is unlikely that controls will exist for the auditor to test in relation to subsequent events. The auditor will need to perform sufficient and appropriate procedures to ensure all material subsequent events are identified and appropriately dealt with in the financial statements.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

Identifying subsequent events

Subsequent event procedures need to be performed to ensure that all material adjusting and non-adjusting subsequent events are identified and correctly treated in the financial statements.

The procedures undertaken during a subsequent events review require review and enquiry in respect of events that have occurred since the balance sheet date.

The subsequent events review should be one of the last exercises undertaken during the audit fieldwork; if it is performed too early, events may not be identified. If there is a delay between the fieldwork being completed, the financial statements being approved and the audit report being signed, a further subsequent events review should be undertaken to ensure that nothing has occurred during the intervening period that would result in adjustments or disclosures being necessary.

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools designed to address the objective of identifying subsequent events:

- Review the following to ensure that nothing has occurred since the year end which should be disclosed or provided for:

  (i) management and/or other interim accounts;

  (ii) the latest budgets, forecasts or other management reports;

  (iii) cash book, invoices and bank statements;

  (iv) correspondence;

  (v) major contracts;

  (vi) searching news/media/online reports.

- Read the management minutes held since the final audit and enquire about matters discussed at meetings for which minutes are not yet available.

- Ensure procedures have been designed to identify subsequent events up to the date of the auditor's report.

- Discuss with management and ensure that all relevant factors have been identified. Consider the following:

  (i) the current status of items that were accounted for on the basis of preliminary or inconclusive data;

  (ii) whether new commitments, borrowings or guarantees have been entered into;

  (iii) whether sales or acquisition of assets have occurred or are planned;

  (iv) whether the issue of new shares or debentures or an agreement to merge or liquidate has been made or is planned;

  (v) whether any assets have been appropriated by government or destroyed, e.g. by fire or flood;

  (vi) whether there have been any developments regarding risk areas and contingencies;

  (vii) whether any unusual accounting adjustments have been made or are contemplated;

  (viii) whether events have occurred or are likely to occur that bring into question the appropriateness of accounting policies used.

The nature and extent of procedures carried out by the auditor will depend on the circumstances and on the auditor's risk assessment. Procedures should be performed as near as practicable to the date of the audit report and must include:

- obtaining an understanding of procedures that management has established to identify subsequent events;
- making enquiries of management and, where appropriate, those charged with governance;
- reviewing minutes of meetings of members, directors and audit and executive committees held since the period end and enquiring about any matters discussed at meetings for which minutes are not available; and
- reading the latest subsequent interim financial statements, if any.

The extent of these procedures will depend on the length of the period between the balance sheet date and the date of the audit report and the records available.

Other procedures may include:

- reviewing the management accounts, cash book, invoices and bank statements, correspondence, minutes of meetings and major contracts to ensure that nothing has occurred since the year end that should be disclosed or provided for within the financial statements; and
- reviewing any available accounting records and identifying whether anything needs to be reflected in the financial statements.

The auditor may also make enquiries into:

- the current status of litigation and claims, including further enquiries of legal counsel, if appropriate;
- the current status of items involving subjective judgement or which were accounted for on the basis of preliminary or inconclusive data;
- whether sales of assets are planned or have occurred;
- whether any assets have been appropriated by government or destroyed, e.g. by fire or flood;
- whether other events have occurred that are relevant to the recoverability of assets;
- whether new commitments, borrowings or guarantees have been entered into;
- whether events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements;
- whether the issue of new shares or debentures or an agreement to merge or liquidate has been made or is planned;
- whether there have been developments regarding risk areas and contingencies;
- whether any unusual accounting adjustments have been made or are contemplated; and
- whether any events have occurred or are likely to occur which might bring into question the appropriateness of accounting policies used in the financial statements,

e.g. any that would bring the validity of the going concern basis of accounting into question.

Going concern

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

- Consider whether the identification of subsequent events has an impact on going concern. Document going concern considerations in the **D** section.

One area which is the frequent subject of specific enquiries by the auditor is the appropriateness of the going concern basis of accounting and consideration of material uncertainties in relation to it. This is considered further in the Going concern section.

Written representation

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

- Ensure that management's representation letter includes representation that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

In all cases, the auditor should request a written representation from those charged with governance, in accordance with ISA (UK) 580 (Updated May 2022) *Written Representations*, that all events occurring subsequent to the date of the financial statements and which require adjustment or disclosure have been adjusted or disclosed. Further guidance can be found in Letters of representation. An example letter of representation for a private company audit is available in Templates ~~and Letters in *Navigate Audit*.~~

Group audits

Example tests

The following tests are the standard tests in the ~~*Navigate*~~ *Audit* tools.

- Ensure that management's representation letter includes representation that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

In a group audit situation, the auditor should make arrangements to ensure that an appropriate review of subsequent events at the component level is carried out either by the group engagement team or by component auditors (if any) up to the date of the audit opinion on the consolidated financial statements and that the results are reported back to the group engagement team for consideration (see Consolidation and groups).

Where subsequent events are identified

Example tests

The following tests are the standard tests in the ~~Navigate~~ *Audit* tools.

- Perform procedures over the identified subsequent event to ensure it is appropriately reflected in the financial statements in accordance with the applicable financial reporting framework.
- Ensure that there is evidence on the file to support all disclosures made for both adjusting and non-adjusting events.

If the auditor identifies any events that require adjustment of, or disclosure in, the financial statements, they must then determine whether each such event is appropriately reflected in those financial statements in accordance with the applicable financial reporting framework.

Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued

Example tests

The following tests are the standard tests in the ~~Navigate~~ *Audit* tools.

- Discuss the matter with management and where appropriate those charged with governance.
- Determine whether the financial statements need amendment and if so inquire how management intends to address the matter in the financial statements.
- If the financial statements have been amended, carry out the audit procedures necessary in the circumstances on the amendment.
- Extend procedures to identify subsequent events to the date of the new auditor's report.
- Provide a new auditor's report on the amended financial statements.

The auditor has no obligation to perform any procedures to review subsequent events after dating their audit report. However, if there is a delay between the issue of the auditor's report and the issue of the financial statements, the auditor may reasonably expect management to inform them of any events discovered which may affect the financial statements. The auditor should then ensure appropriate audit procedures are performed on the identified circumstances.

If, subsequent to the date of the auditor's report but before the financial statements are issued, the auditor becomes aware of facts that, had they been known prior to the date of the auditor's report, may have caused the auditor to amend their report, the auditor should discuss the matter with management and the directors. They should also determine whether the financial statements need amendment and inquire how management intends to address the matter in the financial statements.

Where the directors agree to make the necessary amendments to the financial statements, there are two possible scenarios:

(a) in the simplest case the financial statements are amended and reapproved by the directors, the auditor extends the subsequent review procedures to cover the period from the previous report date and issues a new report dated on or after the date of approval of the amended financial statements;

(b) the directors restrict the amendment of the financial statements to the effects of the subsequent event. In this case, the auditor may either reissue the audit report on a 'dual dated basis' or issue a new report with an appropriate emphasis of matter or other matter paragraph explaining that the auditor's procedures on the subsequent event were restricted to the amendment as described in the financial statements.

If the directors do not amend the financial statements, the auditor needs to consider the implications for their report and issue a qualified report if the original report has not been issued to the entity. When the original report has been issued, the auditor should request management not to issue the financial statements until the necessary amendments have been made; but if the financial statements are issued, the auditor will need to take appropriate action to prevent reliance on the audit report and may need to take legal advice.

Dual dating an audit report

ISA (UK) 560 allows the concept of dual dating where events occur subsequent to the signing of the audit report which require amendment to an element of the financial statements. This concept is not permitted by some laws, regulations or financial reporting frameworks covered by the International ISA, but the UK specific guidance in the ISA (UK) does not restrict its use.

An example of a dual dated report would be:

'[Date of auditor's report], except as to Note Y, which is as of [date of completion of audit procedures restricted to amendment described in Note Y].'

Facts which become known to the auditor after the financial statements have been issued

Example tests

The following tests are the standard tests in PCAS.

- Perform the procedures set at under Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued. Where an amendment is made, review the steps taken by management to ensure anyone in receipt of previously issued financial statements together with the auditor's report is informed of the situation.
- The auditor should include in the new or amended auditor's report an emphasis of matter or other matter paragraph referring to a note to the financial statements that discusses the reason for the amendment of the previously issued financial statements.

In situations where the auditor becomes aware, after the financial statements have been issued, of facts that, had they been known at the time, would have led them to amend the audit report, the auditor should discuss the matter with management, and where appropriate, those charged with governance. The auditor should carry out the audit procedures necessary in the circumstances. They should then determine whether the financial statements need amendment and inquire how management intends to address the matter in the financial statement.

If required, the auditors should provide a new auditor's report on the amended financial statements, dating the new auditor's report no earlier than the date of approval of the amended financial statements.

The auditor includes in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

There is no formal procedure for the withdrawal of an auditor's report once issued but the auditor should consider and review the steps taken by the entity to ensure that anyone in receipt of the financial statements and auditor's report is informed of the situation.

Where financial statements have had a limited distribution, it may be possible to recall the issued copies and for those charged with governance to approve and issue amended financial statements on which the auditor has issued an updated and amended auditor's report, having extended the review of subsequent events to the date of their revised report. To avoid confusion, it may be appropriate for such financial statements and auditor's report to indicate that they replace the originally issued financial statements and report.

Where it is not possible to recall financial statements in this way, e.g. when company financial statements have been filed at Companies House, those charged with governance will need to consider how best to inform users in order to prevent reliance being placed on incorrect financial statements or an inappropriate auditor's report.

In the case of a company, the directors may follow the statutory procedure set out in the *Companies Act* 2006 and regulations thereunder for the revision of defective accounts and reports, which include the provision of an auditor's report. ~~Guidance on this can be found in Audit reports.~~

Auditors of UK companies may also wish to make use of powers under the Companies Act to address a general meeting of the company at which the members consider the financial statements.

In these situations, it may be appropriate for the entity or the auditor (or both) to seek legal advice.

Current issues and further resources

Current issues

Due to the political situation in Russia, Ukraine and surrounding countries additional care will need to be taken over subsequent events.

For companies with 31 December 2021 year ends, the war in Ukraine would be considered a non-adjusting event, since the invasion occurred during February 2022 and so the conditions did not exist at the end of the reporting period. Auditors will however need to ensure that management's disclosures around any material non-adjusting event, and related estimates of its financial effect, are appropriately disclosed in the notes to the financial statements.

ICAEW's Financial Reporting Faculty's article, War in Ukraine: the corporate reporting implications, considers the consequences of sanctions on companies' financial and non-financial reporting, including post balance sheet events.

3.30 Value added tax

Quick overview

This section explains how to audit value added tax (VAT) and provides example audit objectives for the section. In addition, it covers the types of controls which could be tested and relied upon as well as illustrative substantive analytical procedures and tests of detail.

The commentary here deals with the general principles of auditing a single entity or group under UK GAAP, specifically FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022). These principles apply to all FRS 102 audits and as such this area should be used in conjunction with the specialist assignment guidance found in the charity, small company, pension scheme, club and academy areas~~ of *Navigate Audit*.~~

This section relates to section U in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

An auditor's objective is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement. This can be obtained in a number of different ways, in practice, usually a mix of tests of control and substantive procedures, including analytical review.

VAT

VAT is the tax added to the value created for a supply. The audit of this area needs to be undertaken with care as the penalties for serious or persistent misdeclaration can be very significant and can have a material impact on the entity's financial statements.

VAT is addressed briefly in FRS 102:29, which states that 'turnover shown in profit or loss shall exclude VAT and other similar sales taxes on taxable outputs and VAT imputed under the flat rate VAT scheme. Expenses shall exclude recoverable VAT and other similar recoverable sales taxes. Irrecoverable VAT allocable to fixed assets and to other items disclosed separately in the financial statements shall be included in their cost where practicable and material'.

The standard does not specify whether VAT should be included in the cash flow statement but, in practice, cash flows are generally presented net of VAT.

~~Further guidance on the accounting requirements for VAT under the applicable standards can be found in *Navigate UK GAAP Accounting*:~~

- Private Company (FRS 102) – Income tax (Section 29);
- Small Company (FRS 102 1A) – Income tax (Section 29);
- Micro Entity (FRS 105) – Income tax (Section 24).

Key definitions

Key definitions relevant to this financial statement area can be found in Audit evidence and Documentation.

Audit objectives

ISA (UK) 315:A190 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* identifies a number of assertions made in financial statements and categorises them by their effect on transactions, balances and disclosures within the financial statements. The auditor must obtain audit evidence to support the assertions made so they can also be considered as audit objectives.

The specific objectives in respect of the audit of VAT are as follows.

Financial statement area	**Objective**	**Assertion**	**Audit procedures**
VAT payable	To ensure that all potential VAT liabilities have been identified and correctly accounted for.	C, E, A, V	VAT liability
VAT payable	To ensure that all accounting estimates recognised or disclosed in the financial statements are reasonable in the context of the applicable accounting framework.	V	Estimates
VAT payable	To ensure that specific regulations relating to VAT have been fully complied with.	Compliance	VAT compliance
VAT payable	To confirm that all necessary disclosures concerning VAT have been made and the information is appropriately presented and described.	Presentation	Presentation and disclosures

In the *~~Navigate~~ Audit* tools, the assertions are defined as follows.

Assertion	**Definition**
C – Completeness	All transactions and events, assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
E – Existence	Assets, liabilities and equity interests exist. The entity holds or controls the rights to assets; and liabilities are the obligations of the entity. For the income statement, all transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity. The existence assertion used in the *~~Navigate~~ Audit* tools also covers the occurrence and rights and obligations assertions as defined in ISA (UK) 315
A – Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
V – Valuation, accuracy and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately

	measured and described.
Other – Other assertions	Cut off – Transactions and events have been recorded in the correct accounting period. Classification – Transactions and events, assets, liabilities and equity interests have been recorded in the proper accounts. Presentation – Transactions and events, assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

In the ~~*Navigate*~~ *Audit* tools, the audit objectives are illustrated using the following table.

Financial statement area	Is there an estimate in this balance? (C8.1)	Assertions to be tested				
	Y or N	C	E	A	V	Other
VAT payable		X	X	X	X	Presentation

Controls

The following are controls that are relevant to VAT and could, if working properly, enable the auditor to reduce the substantive work required in these areas. The auditor should identify the controls in existence and design tests to ensure that they are operating effectively before reducing the level of substantive testing.

Guidance on **sample sizes** when testing the operating effectiveness of controls can be found in Accounting systems, processes and controls.

Control in place	How to test
All returns are completed promptly and submitted to HMRC on time.	Select a sample of VAT returns and verify that they were submitted to HMRC on time.
All necessary tax payments are made by the due date.	Select a sample of VAT payments and check that the payments were made on time.
VAT return workings and inputs are reviewed independently for accuracy by a responsible person.	Select a sample of VAT returns and check for evidence that the returns and underlying workings were reviewed by an appropriately experienced independent person.

Audit procedures

Detailed below are some individual tests that can be applied in order to help satisfy the objectives noted in Audit objectives. It may not be appropriate to undertake all of the tests; in each case, the auditor should review this bank of tests and determine which are most appropriate for the circumstances of the particular client being dealt with. The auditor should, however, ensure that each objective is satisfied. Where the balance includes accounting estimates, refer to the guidance in Auditing accounting estimates.

Many of the tests to be undertaken on VAT are types of analytical procedure. In each section are some substantive analytical procedures that can be used to give additional audit comfort regarding whether or not VAT payable is fairly stated.

VAT liability

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	Assertion being tested
Carry out analytical procedures using the **SAP work paper** *available in the templates*, forming an expectation of the outputs and inputs on the VAT control account based on revenue and purchases as per the financial statements. Investigate any variations.	C, E, A, V
Obtain and check, or prepare, a VAT control account. Agree the VAT creditor or repayment due to the relevant VAT return.	E, A, V
Obtain a breakdown of turnover by gross, net and VAT and reconcile to the outputs recorded on the VAT returns. Test a sample of items back to invoice. Investigate any variations.	C, E, A

Substantive analytical procedures

Many of the tests to be undertaken on VAT are types of analytical procedure.

Expected VAT liability

The auditor can form an expectation of the outputs and inputs on the VAT control account based on revenue and purchases within the financial statements and then make sure that this can be reconciled to the VAT paid to HMRC.

VAT/turnover reconciliation

The auditor should reconcile the turnover per the financial statements to the outputs recorded on the VAT returns. This is different from the test above, in that the auditor is now looking at the net turnover figures rather than just the VAT element, ensuring that the turnover within the financial statements does actually reflect the position recorded on the VAT returns. Any variations should be investigated.

The reconciliation should be undertaken for all VAT-registered clients, including entities which have a mixture of exempt, zero-rated and standard supplies.

Tests of detail

The auditor should perform the following procedures:

- obtain and check or prepare a VAT control account confirming that the VAT creditor or repayment due has been correctly recorded in the debtors or creditors section of the file;
- vouch the entries on the VAT control account to the VAT returns, making sure that the returns have been correctly completed; and

- obtain a breakdown of turnover by gross, net and VAT and reconcile to the outputs recorded on the VAT returns. A sample of items should be traced back to supporting invoices.

VAT compliance

Example tests

The following tests are used in the ~~*Navigate*~~ *Audit* tools.

Audit procedure	**Assertion being tested**
Review the client's VAT affairs, including any correspondence, and ensure that adequate provision is made for any possible penalties and interest on under-declarations.	C, E
Vouch the entries on the VAT control account to the VAT returns.	A, V
Where considered necessary, complete the **VAT checklist** on **U3**.	C, E, A, V

Substantive analytical procedures

The substantive analytical procedures set out in the VAT liability section above can be useful in identifying issues with VAT compliance.

Tests of detail

The auditor should review the client's VAT returns, including any correspondence, and ensure that adequate provision has been made for any possible penalties and interest on under-declarations.

Entries in the VAT control account should be agreed to company's VAT returns.

The auditor should also check that VAT on private expenses, including car fuel, has been properly accounted for.

VAT compliance checklist

In the ~~*Navigate*~~ *Audit* tools, the **VAT compliance checklist (U3)** sets out common points to be considered when reviewing VAT to ensure that all VAT liabilities, penalties, surcharges, interest charges and repayable amounts of VAT are correctly included in the financial statements.

The auditor should consider the completion of a VAT compliance checklist, which will help to identify whether there is a risk of material misstatements or problems within the financial statements as a result of non-compliance with the necessary requirements. The sorts of issues that should be addressed within the checklist are as follows:

Registration issues

The auditor should consider whether the registration position of the entity is appropriate, and this should be done even where the auditor is dealing with an unregistered entity.

Sales

The auditor should consider whether sales have been subjected to the correct treatment in respect of their VAT rating. This is particularly important where the entity deals in a mixture of standard-rated, zero-rated and exempt supplies. The auditor also needs to consider whether, if there are exports, adequate evidence of despatches and exports is kept to ensure that difficulties do not arise.

Purchases

The auditor should consider whether input tax has only been claimed when evidence is maintained on file and ensure that all invoices are retained and accessible. The auditor should also determine whether there is a working system to identify non-deductible inputs and whether these items have been dealt with properly within the financial statements.

Partial exemption

Where the registered entity is partially exempt, the auditor should ensure that any annual adjustment has been carried out correctly and that any special methods used have been formally agreed with HMRC.

Accounting records

The auditor should consider whether the accounting records are adequate for the purposes of HMRC, whether the records are maintained for the correct period of time and whether the invoices, etc. issued contain all the relevant details.

Groups of companies

Where the entity being audited is a member of a group, the auditor should ensure that VAT between the group companies is being accounted for correctly.

Property sales and development

Property transactions represent one of the more complex areas as far as VAT is concerned, and whenever the entity is entering into such transactions, the auditor should consider whether all aspects have been dealt with correctly and whether reference to a VAT specialist is required. Due to the amounts involved in such transactions, any error is especially likely to be material. Special consideration may be needed where the client is a charity.

Second-hand, retail and other schemes and global accounting

Where the entity has adopted any scheme in respect of the computation and/or payment of VAT, the auditor should consider whether the entity still meets the criteria and, where it is required to maintain any special records to qualify, whether those conditions are being satisfied.

Deregistration

Where an entity has deregistered for VAT, the auditor should consider whether output of VAT has been properly accounted for on assets on hand such as inventory.

Penalties and assessments

Where there have been any penalties or assessments in the period, the auditor should consider whether these have been correctly reflected within the financial statements.

Estimates

Design and perform appropriate tests for estimates, e.g. penalties and interest for late payment of VAT, using the **estimates work paper** *available in the templates* for each estimate identified that is material or contains a risk of material misstatement.

In *Audit Automation* ~~the *Navigate Audit* tools~~, there is an **estimates work paper** *available in the templates* for auditing estimates.

Further guidance can be found in Auditing accounting estimates.

Presentation and disclosures

As with all account balances, the auditor needs to ensure that there is sufficient evidence on the file to support the disclosures made in the financial statements.

3.31 Consolidation and groups

Quick overview

The purpose of this section is to consider the procedures that should be applied when auditing consolidated accounts, including situations where the group auditor relies on work performed by component auditors.

Component auditors may perform work on the financial information of the components for the group audit, and as such are responsible for their findings, conclusions and opinions as reported to the group auditor. However, ISA (UK) 600:11 makes it clear that the group engagement partner is responsible for the direction, supervision and performance of the group audit and for the overall group audit opinion.

Section 9 of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (FRS 102) sets out the requirements for the preparation of consolidated financial statements (which are referred to as group accounts in the Act) by parent companies that are intended to give a true and fair view of the financial position and profit or loss of the group. These are supplemented by the requirements in SI 2008/410, Sch. 4 and Sch. 6.

~~Further guidance on the accounting requirements for consolidated financial statements under the applicable standards can be found in *Navigate UK GAAP Accounting* :~~

- Private Company (FRS 102) – Consolidated and separate financial statements (Section 9); and
- Small Company (FRS 102 1A)– Consolidated and separate financial statements (Section 9)

This section relates to section W in the Private Company (PCAS) based audit tools

Scope and definitions

ISA (UK) 600 (Revised November 2019) (Updated May 2022) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* is effective for periods commencing on or after 15 December 2019.

A revised ISA (UK) 600 was issued in September 2022 which is effective for periods beginning on or after 15 th December 2023. The requirements of this revision are not yet covered in this section.

In accordance with ISA (UK) 600:8, the auditor’s objectives are to:

(a) determine whether to act as the auditor of the group financial statements; and

(b) if acting as the auditor of the group financial statements:

(i) to communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and

(ii) to obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

The auditor also needs to ensure that the consolidation is prepared in accordance with company law and the relevant accounting framework.

ISA (UK) 600 (Revised November 2019) (Updated May 2022) deals with considerations that apply to group audits and provides guidance covering:

- responsibilities;
- acceptance and continuance as group engagement team;
- overall audit strategy and audit plan;
- understanding the group, its components and their environments;
- understanding the component auditor;
- materiality;
- responding to assessed risks;
- consolidation process;
- subsequent events;
- communication with the component auditor;
- evaluating the sufficiency and appropriateness of audit evidence obtained;
- communication with group management and those charged with governance of the group; and
- documentation.

Key definitions

Term	Definition
Component	An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements. This terminology is used throughout this section to refer to both separate legal entities (subsidiaries, associates and joint ventures etc.) as well as branches or divisions of an entity which prepare financial information separately from the remainder of the entity and are included within a group.
Component auditor	An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit. This may be another firm (which may or may not be a member of the group engagement team's network) or may be another office or audit team from the auditor's own firm.
Component management	Management responsible for the preparation of the financial information of a component.
Component materiality	The materiality for a component determined by the group engagement team.
Group	All the components whose financial information is included in the group financial statements. A group always has more than one component.
Group audit	The audit of group financial statements.

Group audit opinion

The audit opinion on the group financial statements.

Group engagement partner

The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm. The group engagement partner is a Key Audit Partner.

Group engagement team

Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Group financial statements

Financial statements that include the financial information of more than one component. The term "group financial statements" also refers to combined financial statements aggregating the financial information prepared by components that have no parent but are under common control.

Group management

Management responsible for the preparation of the group financial statements.

Group-wide controls

Controls designed, implemented and maintained by group management over group financial reporting

Key audit partner

Is defined in UK legislation as:

(i)The statutory auditor designated by an audit firm for a particular audit engagement as being primarily responsible for carrying out the statutory audit on behalf of the audit firm; or

(ii)In the case of a group audit, the statutory auditor designated by an audit firm as being primarily responsible for carrying out the statutory audit at the level of the group and the statutory auditor designated at the level of material subsidiaries; or

(iii)The statutory auditor who signs the audit report.

Significant component

A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

Source: ISA (UK) 600:9-10

Insight – Material subsidiaries

The ISA includes the term 'material subsidiaries' in the definition of a Key Audit Partner (KAP). 'Material subsidiaries' is not defined, but SGN 02/2018 notes that the FRC is of the view that 'a material subsidiary' operates at a lower threshold than a 'significant component'. A component could therefore be 'not significant' but still be 'material'. When considering which subsidiaries are material in the context of a group engagement, the auditor should use the same concept of materiality that is applied in planning and performing the audit, and in the evaluation of misstatements.

Acceptance and continuance of group audits

Before deciding to act for a particular entity, the group engagement partner should consider whether sufficient appropriate audit evidence can reasonably be expected to be obtained in relation to the consolidation process and the financial information of the components on which to base the group opinion.

In order to do this, the auditor should consider:

- the group structure, including both the legal and organisational structure (i.e. how the group financial reporting system is organised;
- components' business activities that are significant to the group, including the industry and regulatory, economic and political environments in which those activities take place;
- the use of service organisations;
- a description of group-wide controls;
- the complexity of the consolidation process;
- whether any of the component auditors are from outside the group engagement team's firm or network and, where relevant, group management's rationale for appointing different firms of auditors;
- whether the group engagement team will have unrestricted access to the management and those charged with governance of both the group and the components as well as the component auditors (including relevant audit documentation sought by the group engagement team);
- whether the group engagement team will be able to perform necessary work on the financial information of the components; and
- whether the group engagement team will be able to be sufficiently involved with the component auditors to the extent necessary to obtain sufficient appropriate audit evidence.

If the group engagement partner concludes that it will not be possible for the group engagement team to obtain sufficient appropriate audit evidence due to restrictions imposed by group management and that this may lead to a disclaimer of opinion on the group financial statements, the group engagement partner should either:

- not accept the engagement, or, in the case of a continuing engagement, withdraw from the engagement, where withdrawal is possible under applicable law or regulation; or
- disclaim an opinion on the group financial statements where law or regulation prohibits the auditor from declining an engagement or where withdrawal from the engagement is not otherwise possible, having performed the audit of the group financial statements to the extent possible.

The group engagement partner is also responsible for agreeing the terms of the group audit engagement.

Overall audit strategy and audit plan

Group audits can be complex, and a failure to adequately plan and communicate upfront is probably the single biggest reason why deadlines are missed, and things go wrong.

The group auditor should:

(a) understand group management's process and the timetable to produce consolidated accounts;

(b) design the group audit process to match management's process and timetable;

(c) clearly communicate expectations and information required, including timetable;

(d) obtain information early where practicable;

(e) keep track of whether reports have been received;

(f) respond to any issues raised in a timely fashion;

(g) conclude on the audit; and

(h) consider possible improvements for the next year's process including management letter issues.

The above is done in practice by the group engagement team formulating an overall audit strategy and audit plan for the group as a whole. ISA (UK) 600:16 specifically requires the overall group audit strategy and group audit plan to be reviewed by the group engagement partner.

In the PCAS based audit tools Schedule C4 (Strategy: Group Audits) assists the group auditor with planning and documenting the audit strategy.

Given the different approaches it is important, when planning a group audit, to ensure that the involvement of component auditors and the role of the group engagement team in directing their work is established and communicated at an early stage and communication is maintained throughout the process. This should involve consideration of the extent to which the group engagement team will want to review the work of the component auditor to ensure that appropriate arrangements can be made for access to staff and workpapers as necessary for this purpose (see Evaluating the component auditor's working papers). Further guidance and templates for communicating with component auditors are in Communications with component auditors.

Understanding the group

ISA (UK) 315 requires the auditor to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment.

Insight – ISA (UK) 315 (Revised)

For financial statements for periods beginning on or after 15 December 2021, ISA (UK) 315 (Revised July 2020) extends this requirement, requiring the auditor to also obtain an understanding of the financial reporting framework and the system of internal control.

ISA (UK) 600 requires the group engagement team to perform procedures to update its understanding of the group, its components and their environments, including group-wide controls, and also to obtain an understanding of management's consolidation process, including the instructions issued by group management to components.

One of the first stages is to identify all components in the group, which will be done by applying the following procedures to update the auditor's knowledge of the group:

- reviewing the permanent file, including details of any standing journals;

- reviewing board minutes, correspondence and results to date, and a note made of any significant issues;
- ascertaining details of any likely future developments of the business; and
- following enquiries, recording details of any changes in group structure, including subsidiaries, joint ventures, associates and branches – details will also be needed of actual and proposed acquisitions or disposals.

The areas requiring an understanding include:

- group-wide controls, including internal audit functions;
- the consolidation process, including:

– the instructions issued by group management to components;

– matters relating to the applicable financial reporting framework;

– the group's processes for ensuring complete, accurate and timely financial reporting by the components;

– the process for recording consolidation adjustments;

– the consolidation adjustments required by the applicable financial reporting framework; and

– procedures for monitoring, controlling, reconciling and eliminating intra-group transactions and unrealised profits, and intra-group account balances.

The auditor should also ascertain details of, and consider the impact on the accounts and audit, of any changes in group accounting policies or the GAAP used by components. In particular, the auditor should:

(a) consider whether the policies applied are the most appropriate for the group; and

(b) view with scepticism any change that is not a result of a new or revised standard, unless it is bringing policies into line with existing accounting standards.

In some groups, particularly where some elements are based overseas, the GAAP and accounting policies used may vary across the group. The auditor needs to gain an understanding of any other GAAPs used, and agree who is responsible for any conversion needed.

The auditor should consider whether the group is exempt from the requirement to prepare consolidated accounts, not only through size, but also because of its activities.

This understanding should be sufficient to confirm, or revise, the group engagement team's initial identification of significant components and to assess the risks of material misstatement to the group financial statements whether due to fraud or error.

Schedule C4 (Strategy: Group Audits) in the PCAS audit tool assists with prompting the actions and documentation required.

Consideration of fraud

ISA (UK) 240 (Revised May 2021) (Updated May 2022) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires the key members of the engagement team to discuss the susceptibility of the entity's financial statements to material misstatement due to fraud. In a group audit, these discussions may include the component auditors. The group engagement partner determines who to include in these discussions based on a number of factors including any prior experience with the group.

Understanding the component auditor

Using component auditors can cause problems, especially when dealing with a foreign entity where it may well be that a statutory audit has not been undertaken or the scope of the audit is different. The auditor needs to gain a thorough understanding of these matters at the planning stage, and plan to perform any additional procedures as considered necessary.

Where it is intended that work performed by components' auditors will be used for the purposes of the group audit, ISA (UK) 600:19 requires the group auditor to gain an understanding of:

(a) whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent;

(b) the component auditor's professional competence;

(c) whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence; and

(d) whether the component auditor operates in a regulatory environment that actively oversees auditors.

If a component auditor does not meet the relevant independence requirements, or the group engagement team has serious concerns about the other matters noted in the previous paragraph, the group engagement team needs to obtain sufficient appropriate audit evidence relating to the financial information of the component without asking the component auditor to perform any work.

Insight – FRC Ethical Standard 2019

Component auditors in the UK should comply with the Revised Ethical Standard 2019. This standard is also the relevant standard for overseas component auditors who are members of the same network as the group auditor and whose work is used in the conduct of an audit of a group containing a public interest entity. In other cases, the relevant ethical requirements are contained in the IESBA Code of Ethics.

The component auditor is also asked to agree to transfer any relevant documentation to the group engagement team during the audit of the group financial statements. If this request is refused, the group engagement team will be unable to rely on the work of the component auditor.

There are various factors that affect the group engagement team's assessment of the component auditors, including:

- previous experience of their work;
- any affiliation of the other firm;
- membership of relevant professional bodies;
- the resources available to the component auditor to perform the necessary work; and
- discussions with the component auditors.

These factors are not mutually exclusive and the group engagement team considers them together when gaining their understanding of component auditors, as shown in the following example.

Example – Obtaining an understanding of the component auditor

The auditor of component A consistently applies quality control and monitoring policies and procedures and a methodology which are in common with the group engagement team's or they operate in the same jurisdiction as the group engagement team.

The auditor of component B does not have quality control and monitoring policies and procedures or a methodology which are the same as those of the group engagement team and/or they operate in a foreign jurisdiction.

The extent of the group engagement team's procedures to obtain an understanding of each component is likely to vary. The procedures for component A's auditor are likely to be less than those required to obtain an understanding of component B's auditor. The nature of the procedures performed in relation to each component is also likely to differ.

Schedule W4 (Component auditor instructions) in the audit tool provides a template for instructions and communication with the component auditor but this should always be tailored to address the issues relevant to the group and components concerned.

Schedule W7 (Example component auditor's confirmation) provides an example letter for tailoring by the component auditor at the planning stage to confirm their understanding of the work needed and acknowledge their responsibilities.

Determining the significance of components

In respect of any component considered to be an individually financially significant component, the plan should include a full audit of the financial information relating to that component. If the component is significant by nature or circumstances, the group auditor may require either an audit of the financial information of the component, or an audit of one of more account balances, classes of transactions, or disclosures relating to likely risks of material misstatement in the group financial statements, or specified audit procedures relating to such risks.

In respect of components that are not significant components, the group auditor should determine the nature and extent of work to be done in order to obtain sufficient appropriate evidence for group audit purposes. This may involve a full audit (for example where an audit is required for local statutory purposes anyway) or it may be limited in scope to relate only to those matters that are considered to be of greatest relevance to the group audit.

For components that are individually and collectively not material, it may be possible for the group auditor to obtain sufficient evidence by the group audit team performing review procedures and making enquiries without involving a component auditor.

Insight – Indicators of significance

Examples of indicators of financial significance might include the overall size of the component's balance sheet or turnover, or the relative size of a component's contribution to a particular item in the group financial statements. The application material to ISA (UK) 600 indicates that 15% of a chosen benchmark (such as group assets or profit) might be chosen by group auditors as indicative of financial significance, but judgement is still required and higher or lower percentages may be appropriate, depending on the composition of the group. Group auditors choosing 15% might well be required to justify that amount in the circumstances.

Examples of indicators of non-financial significance might include the presence in a component of particular risks of material misstatement, such as those relating to estimates of impairments, inventory valuations, and tax provisions. Risks relating to complex areas such as financial instruments, and other highly subjective areas such as contingencies and subsequent events, may also determine non-financial significance.

Insight – Key Audit Partner (KAP)

The significance of the components is also relevant in relation to key audit partners. Significant components require a KAP to be designated. Components which are not material and not significant do not need a KAP. For components which are material but not significant, the issue of whether a KAP is needed depends on whether the auditor requires work to be carried out by a component auditor (where full audit, partial audit or specific procedures) in order to obtain sufficient appropriate audit evidence for the purposes of the group audit. If that is the case, then a KAP will need to be designated.

KAPs in a group audit context are subject to the same rotation requirements as the group engagement partner. For group audits where the parent entity is listed or a PIE, this will mean that all KAPs are subject to five-year rotation periods.

If the group engagement team does not consider that sufficient appropriate audit evidence on which to base the group audit opinion will be obtained from work performed on the significant components, work performed on group-wide controls and the consolidation process, and analytical procedures performed at group level, then the group engagement team will need to select components that are not significant components and perform, or ask a component auditor to perform, one or more of the following:

- an audit of the financial information of the component using component materiality;
- an audit of one or more account balances, classes of transactions or disclosures;
- a review of the financial information of the component using component materiality; or
- specified procedures.

In this situation, the group engagement team must vary the selection of components over a period of time.

Schedule C4.1 can be used to document which components are determined to be significant.

Decision tree - Determining the work to be undertaken on a component

Click here for an interactive decision tree to help you determine what work will need to be undertaken on a component.

~~A PDF of the decision tree is here~~. Relevant audit sections included within the audit tool are available here.

Setting materiality

ISA (UK) 600:21 explains how the group engagement team is required to determine:

- the materiality level for the group financial statements as a whole;

- any materiality level to be applied to particular classes of transactions, account balances or disclosures which are lower than the general materiality level;
- materiality for individual components; and
- the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements. This will normally be the level at which the component auditor will be requested to report any identified misstatements to the group engagement team.

Where a component is also subject to a local statutory audit requirement it is likely that the component auditor will want to use a materiality level lower than that which the group engagement team considers to be appropriate for group purposes. Where the group engagement team specifies a materiality level lower than that which would normally be used by the component auditor, the matter needs to be resolved by discussion between the teams.

~~Schedule C4.2 in the PCAS audit tool~~ *The materiality section of Audit Automation* can be used to document the materiality levels of all group components.

Responding to assessed risks and determining the type of work

Having assessed the risks of material misstatement of the financial statements, the auditor is required to design and implement appropriate responses to address those risks. It is the role of the group engagement team to determine the type of work to be performed by the group engagement team, or the component auditors on its behalf. The group engagement team also needs to determine the nature, timing and extent of its involvement in the work of any component auditors. The type of audit procedures to be performed in relation to components and the level of involvement the group engagement team will have in the component auditor's work will depend on the:

- significance of the component;
- identified significant risks of material misstatement of the group financial statements;
- group engagement team's evaluation of the design of group-wide controls and determination of whether they have been implemented; and
- group engagement team's understanding of the component auditor.

Where individual components are not significant, either in terms of size or a significant risk of material misstatement, ISA (UK) 600:28 requires only that analytical procedures at group level need be performed. The group engagement team may supplement this as required with additional procedures relating to the component, performed either by the group engagement team or the component auditor on their behalf. Further guidance on this is also given in Determining the significance of components.

ISA (UK) 600:25 also specifically requires that if the nature, timing and extent of the work to be performed on the consolidation process or the financial information of the components are based on an expectation that group-wide controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, the group engagement team must themselves test, or request a component auditor to test, the operating effectiveness of those controls.

This flowchart shows how the significance of the component affects the group engagement team's determination of the type of work to be performed on the financial information of the component.

There is also an interactive decision tree to help you determine the work to be performed. Whether or not the group auditor should review the component auditor's working papers is considered further in Evaluating the component auditor's working papers.

Involvement in the work to be performed by component auditors

ISA (UK) 600:30 states that where a component auditor performs an audit of a significant component, the group engagement team must be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements.

The nature, timing and extent of this involvement are affected by the group engagement team's understanding of the component auditor, but include at least:

- discussing with the component auditor or component management those business activities that are significant to the group;
- discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error; and
- reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. This may be in the form of a memorandum that reflects the component auditor's conclusion regarding the identified significant risks.

In practice, the following additional procedures might help to identify potential risks:

- inquiry of group management, internal audit and those responsible for preparing the consolidation;
- application of analytical procedures to the group's and components' financial information; and
- observation and inspection of group-wide controls and those relevant to the consolidation.

If significant risks of material misstatement of the group financial statements have been identified in a component on which a component auditor performs the work, the group engagement team must evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the group financial statements. Based on its understanding of the component auditor, the group engagement team determines whether it is necessary for them to be involved in the further audit procedures. This may include reviewing other relevant parts of the component auditor's audit documentation, either remotely by electronic means or on-site. The latter can obviously be expensive and will have significant implications for the audit budget, so this is an issue that needs careful consideration at an early stage.

Schedule W3 (Audit programme: Component auditors) in *Audit Automation using* ~~the~~ PCAS ~~audit tool~~ provides steps to assist the auditor in meeting these requirements. This programme should be completed in respect of each component auditor. ~~Extra columns may be added to the Excel work~~

~~programme~~ for each different component auditor~~. Whether one copy or several columns are used~~, the audit team must ensure that the documentation is clear to a reviewer.

Schedule W5 (Component auditor questionnaire) *available as a template* provides a questionnaire which the group auditor may choose to send to the component auditor(s) who then returns it completed for the group auditor to review.

The questionnaire should be tailored to the requirements of the particular component in respect of which it is sent and also the significance of the component to the group. This may include requesting the component auditor to perform specific additional procedures and/or provide specific elements of the working papers to the group auditor for review. Simply sending a component auditor questionnaire to every component regardless of its significance to the group does not comply with ISA (UK) 600.

Schedule W6 (Reporting to the group auditor) provides a template that the group auditor may wish to provide to the component as an outline for reporting back. It should be stressed however that this is a template only, with illustrative headings of topics to be covered. The exact content of the report to the group auditor will be driven by the instructions received.

It should be noted that a component auditor will not always be another firm. If different audit teams from the same firm are used to audit the parent and components, then the component auditor programmes within the PCAS based audit tools will still be applicable.

Testing the consolidation process

The group engagement team is required by ISA (UK) 600 to obtain an understanding of group-wide controls and the consolidation process, including the instructions issued by group management to components. The engagement team or component auditor must test the operating effectiveness of the group-wide controls if work to be performed on the consolidation process is based on an expectation that the group-wide controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

The group engagement team is then required to design and perform further audit procedures to respond to the risk of material misstatement of the group financial statements arising from the consolidation process. This includes evaluating whether all components have been included in the group financial statements. The group engagement team's evaluation of the appropriateness, completeness and accuracy of the consolidation adjustments may include:

- evaluating whether significant adjustments appropriately reflect the events and transactions underlying them;
- determining whether significant adjustments have been correctly calculated, processed and authorised by group management and, where applicable, component management;
- determining whether significant adjustments are properly supported by documentation; and
- checking reconciliations and eliminations of intra-group transactions and balances.

The group engagement team should also evaluate whether any fraud risk factors or indicators of possible management bias exist.

Where the financial information of a component has not been prepared in accordance with the same accounting policies applied to the group financial statements, the group engagement team must evaluate whether the financial information of that component has been appropriately adjusted, for purposes of preparing and presenting the group financial statements.

The group engagement team determines whether the financial information on which the component auditor is reporting is the same information that is incorporated in the group financial statements.

If the group financial statements include a component with a financial reporting period-end that differs from that of the group, the group engagement team evaluates whether appropriate adjustments have been made to the component's financial statements in accordance with the applicable financial reporting framework.

Subsequent events

Once the component financial statements have been signed it is not the end of the process. ISA (UK) 600 requires either the group engagement team or the component auditors to perform procedures designed to identify any events that occur between the dates on which they reported on the financial information of the components and the date of the auditor's report on the group financial statements, where those events may require adjustment to, or disclosure in, the group financial statements.

Where component auditors perform work other than audits of the financial information of components, ISA (UK) 600 requires the group engagement team to request the component auditors to notify the group engagement team if they become aware of subsequent events that may require an adjustment to or disclosure in the group financial statements.

Communications with component auditors

When the group engagement team use component auditors, communication between the teams is key. The group engagement team should communicate with the component auditor on a timely basis, setting out the work to be performed, what use is to be made of that work and what form reports back to the group engagement team should take. ISA (UK) 600:40 in requires that the group engagement team should set out certain information for the component auditor and that the component auditor should confirm certain things back to the group auditor.

The group auditor should communicate with the component auditors, agreeing a timetable within the group, and covering the following issues. Items a) to e) are specifically required by ISA (UK) 600:

(a) a request that the component auditor will cooperate with the group auditor;

(b) relevant ethical and independence requirements;

(c) component materiality and group triviality;

(d) identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor, and a request that any such additional risks identified by the component auditor are promptly communicated to the group auditor;

(e) details of identified related parties, again with a request that any additional related parties identified by the component auditor are promptly communicated to the group auditor;

(f) the scope of the work to be performed by the component auditor and the use to be made of that work;

(g) the form and content of communications from the component auditor to the group auditor – this will usually be in the form of a questionnaire; and

(h) practical issues, such as:

    (i) reconciliation of intra-group balances;

(ii) agreement of group tax provisions;

(iii) provision of information for GAAP conversion;

(iv) deadlines for information;

(v) submission of subsidiaries' accounts to the Registrar;

(vi) preparation of draft group financial statements; and

(vii) AGM arrangements. Although these are no longer necessary for private companies under the *Companies Act* 2006, some companies may well choose to continue to hold an AGM.

The group engagement team then request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. Those matters specifically required by the ISA are:

(a) whether the component auditor has complied with ethical requirements that are relevant to the group audit, including independence and professional competence;

(b) whether the component auditor has complied with the group engagement team's requirements;

(c) identification of the financial information of the component on which the component auditor is reporting;

(d) information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group financial statements;

(e) a list of uncorrected misstatements that are above the threshold for group triviality;

(f) indicators of possible management bias;

(g) any significant deficiencies in internal control identified;

(h) other significant matters that the component auditor communicated or expects to communicate to the component's directors, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level or others where the fraud resulted in a material misstatement of the financial information of the component;

(i) any other matters that may be relevant to the group audit, or that the component auditor wishes to draw to the attention of the group auditor, including exceptions noted in the written representations; and

(j) the component auditor's overall findings, conclusions or opinion.

The group auditor can obviously request information about other matters from the component auditors, and should include such requests in planning stage communications with the component auditors.

Schedule W4 (Component auditor instructions) is available *as a template* ~~in the PCAS audit tool~~ to provide a template for instructions and communication with the component auditor. It is vital that this is tailored to address the issues relevant to the group and components concerned.

Schedule W7 (Example component auditor's confirmation) *available as template COMPCON* provides an example letter that could be tailored for the component auditor to confirm their understanding and acknowledge their responsibilities at the planning stage.

If effective two-way communication between the group and component auditors does not happen, there is a risk that the group engagement team may not obtain sufficient appropriate audit evidence on which to base the group's audit opinion.

In addition to two-way communication, cooperation between auditors is also needed. The standard also specifies that the engagement partner is required to take responsibility for reviews being performed in accordance with the firm’s review policies and procedures.

For UK subsidiaries (of a UK group), the component auditors have a statutory duty to communicate such information and explanations as may be reasonably required by the group engagement team. Where there is no such obligation, the component auditors should obtain the permission of the component’s management before giving such assistance.

Where the component auditors have been unable to conclude on a matter, or feel that there is something that should be brought to the attention of the group engagement team, they should do so bearing in mind their statutory obligation as noted in the previous paragraph.

There is no complementary obligation, but the group engagement team may inform component auditors of such matters if they consider it appropriate after due consultation with those charged with governance at the parent entity.

Evaluating the component auditor’s working papers

Once the group engagement team have received reporting from the component auditor they must evaluate the sufficiency and appropriateness of this audit evidence. Group engagement teams should discuss significant matters arising with the component auditor, component management or group management, as appropriate. The group engagement team then needs to use judgement and knowledge of the individual engagement to consider whether it is necessary to review other relevant parts of the component auditor’s audit documentation.

The group engagement team is required to:

(a) **evaluate** and **review** the audit work performed by the component auditor for the purpose of the group audit; or

(b) where the group engagement team is unable to secure agreement of the component auditor for the transfer of relevant audit documentation for the purposes of such a review, the group engagement team takes appropriate measures and informs the relevant competent authority. Such measures shall, as appropriate, include carrying out additional audit work, either directly or by outsourcing such tasks, in the relevant component.

The FRC's *Glossary of Terms* defines ‘evaluate’ as to ‘identify and analyse the relevant issues, including performing further procedures as necessary, to come to a specific conclusion on a matter’. ‘Review’ is defined as ‘appraising the quality of the work performed and conclusions reached by others’.

This requirement, in ISA (UK) 600:42-1 originally introduced by the Audit Directive goes further, therefore, than the requirement, in paragraph 42(b) which allows the auditor to ‘determine whether it is necessary to review other relevant parts of the component auditor's audit documentation’. The Audit Directive effectively mandates a review of the component auditor's work. However neither the original Audit Directive nor ISA (UK) 600 (Revised November 2019) (Updated May 2022) prescribe the nature and extent of the review of the component auditor’s work – this is a matter of judgement.

This judgement should reflect:

- the extent to which the group engagement team has been able to evaluate and review the work performed by the components engagement team and the results obtained;
- the group engagement team’s experience of review of the component’s engagement team in prior periods;
- the relative significance of the component; and

- the nature of risks relevant to that component.

The group auditor's involvement will vary, but could include the following:

- meeting with component management or component auditors in order to understand the component and its environment;
- reviewing the component auditor's overall audit strategy and audit plan (programme);
- performing risk assessment procedures to identify the component's risks of material misstatement. These may be performed with the component auditors, or by the group engagement team;
- designing and performing further audit procedures. These may be performed with the component auditors, or by the group engagement team;
- participating in key meetings between the component auditors and component management;
- reviewing relevant parts of the component auditor's audit documentation and working papers.

If the group engagement team concludes the work of the component auditor is insufficient, the group engagement team determines what additional procedures are necessary, and whether they are to be performed by the group engagement team or the component auditor.

As in any audit, the auditor is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable them to draw reasonable conclusions on which to base their opinion. The group engagement team is therefore required to evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by both the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion.

The group engagement partner evaluates the effect on the group audit opinion of any uncorrected misstatements and any instances where there has been an inability to obtain sufficient appropriate audit evidence.

Schedule W8 (Review of the component auditor’s working papers) in the audit tool gives a number of items that the group auditor should consider when reviewing the component auditor’s files. However, each audit is different and the group auditor should ensure the review is tailored to the circumstances of the engagement.

Significant and/or material

ISA (UK) 600 uses the term 'material subsidiaries' by reference to the definition of a Key Audit Partner (‘KAP’). The ISAs define the KAP as including the auditor responsible for the audit work carried out for group purposes on material components (See Determining the significance of component auditors).

The 02/2018 SGN then notes that for PIE audits, paragraph 36-1 of ISQC (UK) 1 also requires an engagement quality control review to be performed to assess whether the KAP(s) could reasonably have come to the opinion and conclusions expressed in the draft of the group auditor’s report and the additional report to the audit committee. In public interest entities (PIE) audits it is important to identify those components that are ‘material subsidiaries’ as this will affect the nature and scope of the engagement quality control review. ISA (UK) 220 requires (in the case of PIE audits) the engagement quality control reviewer to discuss the results of their review with the KAPs.

‘Material subsidiaries’ is not defined in UK legislation; however, the FRC is of the view that 'a material subsidiary' operates at a lower threshold than a ‘significant component’. A component could be ‘Not Significant’ under ISA (UK) 600 (Revised November 2019) (Updated May 2022), but still be ‘Material’.

The 02/2018 SGN also states that when considering which subsidiaries are material in the context of a group engagement, the firm should use the same concept of materiality that is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Components will therefore fall into one of three categories:

Significant and Material	Where a component is material and significant, the group engagement team is more likely to determine it necessary to review relatively more of the component auditor's working papers. Where a component is significant due to certain account balances, classes of transactions or disclosures relating to significant risks of material misstatement of the group financial statements, the group engagement team would likely focus their review on audit documentation for these areas.
Material but Not Significant	Where a component is material but not significant, the group engagement team would likely limit their review to audit documentation that is relevant to the significant risks of material misstatement of the group financial statements.
Not Significant and Not Material	Where a component is neither material nor significant, the group engagement team is more likely to perform analytical procedures at group level on the component.

Communication with those charged with governance of the group

The group engagement team needs to determine which of the identified deficiencies in internal control need to be communicated to those charged with governance and group management. The group engagement team need to consider deficiencies in internal control:

- identified by the group engagement team that affect the whole group;
- identified by the group engagement team that affect components; and
- identified by component auditors that affect components.

If fraud has been identified by the group engagement team or informed to the group engagement team by any of the component auditors, this should be reported to management of the group on a timely basis.

There may be situations where a component auditor is required to express an audit opinion on the financial statements of a component, and where the group engagement team is aware of a matter of significance to the component’s financial statements, of which component management may be unaware. In this case, the group engagement team requests group management to inform component management of the matter. If group management refuse to communicate the matter to component management, the group engagement team discusses the matter with those charged with governance of the group. If the matter remains unresolved, the group engagement team, subject to legal and professional confidentiality considerations, consider whether to advise the component auditor not to issue the auditor’s report on the financial statements of the component until the matter is resolved.

In addition to those items required by ISA (UK) 260 (Revised November 2019) (Updated May 2022) *Communication with those Charged with Governance*, ISA (UK) 600 requires the group engagement team to communicate the following to those charged with governance of the group:

- an overview of the type of work to be performed on the financial information of the components;
- an overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors of significant components;
- instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work;
- any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted; and
- fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where the fraud resulted in a material misstatement of the group financial statements.

Public interest entities

The ISA specifically notes that for group financial statements of public interest entities, the group engagement partner's firm bears the full responsibility for the additional report to the audit committee as required by ISA (UK) 260 (Revised November 2019) (Updated May 2022).

For public interest entities, there is also certain information regarding the component audits that the group engagement team is also required to include in the additional report to the audit committee. This includes:

- where any of the auditor's activities have been carried out by another firm that is not a member of the same network, confirming that the group engagement team received a confirmation from the other firm (component auditor) regarding the component auditor's independence;
- reporting on any significant deficiencies in the parent undertaking's internal financial control system and/or in the accounting system and stating whether or not the deficiencies reported have been resolved by management;
- explaining the scope of consolidation and the exclusion criteria applied to non-consolidated entities, and whether those criteria are in accordance with the applicable financial reporting framework; and
- identifying any audit work performed by component auditors.

Documentation

The group engagement team must include the following in their audit documentation, as listed in ISA (UK) 600:50:

- an analysis of components, indicating those that are significant, and the type of work performed on the financial information of the components;
- the nature, timing and extent of the work performed by the component auditor and of the group engagement team's involvement in the work performed by the component auditors on significant components, including, where applicable, the group

engagement team's review of relevant parts of the component auditors' audit documentation and conclusions thereon; and

- written communications between the group engagement team and the component auditors about the group engagement team's requirements.

The group engagement team must retain sufficient and appropriate documentation to enable the competent authority to review the work of the auditor of the group financial statements. In addition to the above mandated documentation this may include:

- an assessment of specific factors contributing to the risk of material misstatement in the consolidation or combination process, for example, relative to proper inter-component eliminations and other inherent accounting issues, and the reliability of the underlying data; and
- decisions relative to required communications of audit findings and other matters to those charged with governance.

In addition, the group engagement team must make arrangements to enable them to comply with requests from regulators for access to working papers of component auditors, should the need arise. This does not, however, mean that the group team needs to obtain or retain a complete set of component auditor working papers although the group team may choose to.

Schedule W2 in the PCAS based audit tools is a work programme for documenting the work required on component auditors and on the consolidation.

The W2 programme addresses overall group planning issues and the consolidation process. It sets out the different procedures required by the ISAs in respect of financially significant components, components that are significant due to identified risks and non-significant components. It should be noted that this distinction applies regardless of whether the component is dealt with by the group engagement team or another component auditor.

Where the group engagement team also audit all components in the group this programme is all that is required. Programmes W3 to W8 need not be completed. However, where the group engagement team do not audit all components of the group and other auditors are involved, the work of component auditors must be considered and the group auditor needs to consider which of programmes W3 to W8 are required. The group engagement team must use also their judgement to tailor the programmes according to the significance of the components and the level of work required to be performed.

External monitoring

ISQM (UK) 1 Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements (July 2021) states that where the firm is subject to a quality assurance review or an investigation concerning a group audit, the firm is responsible for complying with, and shall establish policies and procedures which require the group engagement team to comply with, any request by the competent authority:

(a) for relevant audit documentation retained by the group engagement team relating to the work of a component auditor;

(b) to deliver any additional documentation of the work performed by any component auditor for the purposes of the group audit, including that component auditor's working papers relevant to the group audit, where the competent authority is unable to obtain audit documentation of the work carried out by that component auditor.

In order to be able to comply with any such request, the firm must establish policies and procedures that require the group engagement team to either:

(a) obtain and keep copies of the documentation of the work carried out by the component auditor for the purpose of the group audit (including the component auditor's working papers relevant to the group audit);

(b) obtain the agreement of the component auditor that the group engagement team shall have unrestricted access to such documentation on request;

(c) retain documentation to show that the group engagement team has undertaken appropriate procedures to gain access to the audit documentation, together with evidence supporting the existence of any impediments to such access; or

(d) take any other appropriate action.

Detailed audit procedures

The main aim of the audit work on groups is to check the consolidation calculations, and ensure that the appropriate disclosures are made in the accounts. Materiality should be calculated on a group basis using the key components in the group accounts. The following detailed procedures should be undertaken.

Controls

In a group context the auditor would expect to see evidence that the intra-group accounts are regularly reconciled and agreed. In addition, where the client prepares the consolidation and undertakes any GAAP conversion needed, the auditor should consider any controls which operate over the process, particularly those of a checking or reviewing nature. Consolidation can be a complicated procedure, which may require a number of journals, which can increase the risk of both fraud and error, and so controls in this area are important.

Of course, the principal auditor is also interested in the general accounting controls operating over both the holding entity and the subsidiaries, as described earlier in Accounting systems, processes and controls.

Testing the consolidation

Where the client is preparing the consolidation calculations, the auditor should perform the following work:

(a) review calculations to ensure that all group members are included;

(b) trace individual items from the entity accounts into the group accounts to ensure that no items have been excluded;

(c) trace items from the consolidation workings back to the individual entity accounts to ensure that no items are overstated;

(d) check that the financial information included in the component auditor's communications with the group auditor agrees with that in the consolidation calculations;

(e) check any currency calculations, using the published rates ruling at the accounting date (these can be obtained from the financial press, major banks or internet sites);

(f) check the casts and cross-costs;

(g) ensure that all intra-group eliminations have been made where necessary, for example:

(h) inter-company accounts;

(i) unrealised profits on stock or fixed assets bought from other group companies;

(ii) interest paid and received; and

(iii) sales and cost of sales;

(i) ensure that all journal adjustments and reclassifications (including adjustments for alignment of the accounting policies of a component with those of the group, and adjustments for non-coterminous year ends) are valid and posted to the correct balance sheet or profit and loss account heading, and consider whether any fraud risk factors or indicators of possible management bias exist;

(j) ensure that the deferred tax implications of any elimination of unrealised profits are properly accounted for; and

(k) ensure that bank balances and overdrafts are only offset where a legal right of set-off exists.

Where the group structure has changed, the auditor will also need to:

(a) check the calculation of the pre-acquisition reserves for any subsidiaries accounted for as acquisitions;

(b) ensure that goodwill is dealt with according to FRS 102 and that the estimate of useful economic life is a reliable estimate where this life exceeds ten years;

(c) check the fair values used;

(d) ensure that the conditions are met and the calculations properly made where merger accounting is applied (note, under FRS 102, merger accounting is only permitted for public benefit entities or for group reconstructions outside the scope of Section 19);

(e) confirm that the accounting policies of new subsidiaries agree with those of the group or that any necessary adjustments have been made; and

(f) check calculation of profit or loss on the sale of subsidiaries with the contracts for sale, also check to see if sale conditions give rise to any contingent liabilities.

Where a subsidiary's accounts are qualified, the auditor should consider whether the qualification is sufficiently material as to affect the opinion on the group as a whole; and the group tax charge may have to be audited separately from the work on individual companies within the group. Particular attention should be paid to the following:

(a) group relief eligibility – do the surrendering and receiving companies qualify as a group for tax purposes? Has any payment for group relief been treated correctly?

(b) deferred tax – trading losses carried forward in one company cannot be offset against deferred tax in another.

Insight – Intra-group transactions

It is essential that all intra-group transactions are adequately considered, particularly to ensure that intra-group dividends are only recognised when they are earned. The auditor should also ensure that the issue of tax is properly dealt with, especially where there are tax losses transferred between group companies. Finally, the auditor should ensure that details of any cross-guarantees are adequately disclosed and their impact on the individual entity is fully considered.

Reporting by component auditors

ISA (UK) 600 sets out some matters which must be included in communications from the component auditor to group auditor, which in most cases is likely to be via such a questionnaire. These matters are covered in Communications with component auditors.

Once received, the group auditor should review and evaluate the questionnaire or other communication from the component auditor, and consider whether it is necessary to review some or all of the component auditor's other auditor documentation. If the group auditor concludes that the work done by the component auditor is insufficient, they must determine what additional audit procedures are needed, and whether they or the component auditor will perform such procedures. Further detail on the reporting by component auditors is covered in Evaluating the component auditor's workpapers.

Substantive analytical procedures

Once the consolidated accounts have been prepared, the auditor should undertake analytical procedures as outlined in Preparing the file for review, to ensure that the accounts make sense in view of the auditor's knowledge of the client and the audit evidence obtained. In particular, analytical procedures can be applied to ensure that all intra-group trading has been fully eliminated from the consolidated accounts.

Comparisons against group management accounts, budgets and forecasts can also be useful, but the auditor needs to have a thorough understanding of the basis on which they have been drawn up. Group reporting information is no different to that of a single entity in that matters such as tax, accruals, provisions and depreciation may not be very accurate or even included at all, and there is the added risk of consolidation errors being made by the client, all of which may limit the usefulness of comparison with the draft consolidated accounts.

Audit completion

The completion procedures should not be very different from those for a single entity, but some additional information will be required. The auditor should carry out the following specific procedures:

- preparing an overall reconciliation of group reserves and tax to ensure that everything has been accounted for correctly;
- undertaking a subsequent events review for the group as a whole;
- completing an audit highlights report for the group as well as for the individual member companies; and
- preparing a group summary of the errors not adjusted and including it with the audit highlights memorandum.

After the audit is completed, a thorough debrief is recommended, to ensure that any lessons learned can be taken forward to next year's planning.

Current issues and further resources

Current issues

Revision to ISA (UK) 600

In September 2022, the FRC issued a revision to ISA (UK) 600, based on the IAASB revision and effective for periods beginning on or after 15 th December 2023.

The revised standard includes new and revised requirements and application material that better aligns the standard with recently revised standards, such as International Standard on Quality Management 1, ISA 220 (Revised) and ISA 315 (Revised 2019). The new and revised requirements also strengthen the auditor's responsibilities related to professional scepticism; planning and performing a group audit; two-way communications between the group auditor and component auditors; and documentation.

This guidance has not yet been updated for the revised standard.

War in Ukraine

There are likely to be a number of impacts on group audits where one or more components are located in Ukraine, Russia, or Belarus.

ISA (UK) 600 includes a requirement for the group auditor to evaluate and review the work of the component auditor. If this is not possible, then the group auditor is required to undertake other measures and inform the FRC.

Many auditors would usually meet this requirement by visiting the component auditor team to review key audit working papers and attend closing meetings with local management. However, with UK Foreign Office travel restrictions currently in place group auditors will need to consider whether alternative procedures still allow them to meet the requirements of ISA (UK) 600.

In meeting the UK requirements, group auditors have many factors to consider. For example:

- **Identify impacted audits**: Where the group auditor needs to travel overseas, they will need to be aware of local laws and regulations, as well as potential penalties such as fines and/or imprisonment for any breaches.
- **Categorise audits**: Review the impacted components and determine whether they are immaterial, material but not significant, or material and significant for the group opinion. This will allow the group auditor to better understand the risk associated with each engagement.
- **Understand the impact on the component**: The group auditor might need to consider whether the group still controls the component, and if not, whether it should continue to be part of the group audit. Where the component is still part of the group audit, consider to what extent the component's ability to prepare necessary information has been affected.
- **Review the status of work done**: Gain an understanding of what work has been performed to date, for example, as part of planning or interim audit work. Consider whether access to working papers is now restricted.
- **Consider whether the ability to gather evidence has been affected**: For example, bank closures, sanctions on services such as SWIFT, or even mass withdrawals of cash, may result in an inability to confirm cash balances. This may have implications for the ability of the group auditor to form an opinion on the group financial statements.
- **Discuss amending reporting timescales**: The current situation may mean either a delay in the reporting timetable, or even that it may be impossible to obtain information for the audit in time to meet signing deadlines.
- **Consider whether the component audit team is still in place**: Offices in Ukraine will have closed and staff will not be responding to requests for information from group auditors. Some firms have severed ties with their network firms in Russia. This may affect planning of a group audit, where a UK engagement team planned to use the member firm for local auditing in Russia.

- **Review of component team**: If there is still access to component auditors, consider alternative activities to demonstrate the review and evaluation of the component team where originally a visit by the group auditor was planned.

Further resources

Further guidance on the complex area of group audits can be found in ISA (UK) 600, and the FRC's Staff Guidance Note 02/2018 Group audits: determining whether components are significant and/or material, and what that means for key audit partners and engagement quality control reviewers. The FRC issued the Staff Guidance Note 02/2018, in an attempt to clarify a number of issues of interpretation relating to requirements introduced into the ISA. This included guidance on the extent to which the group auditor is expected to review the work of component auditors. Guidance in the SGN was incorporated into the 2019 revision of ISA (UK) 600, although the SGN is still available.

Decision tree

Click here for an interactive decision tree to help you determine what work will need to be undertaken on a component.

~~A PDF of the decision tree is here.~~ Relevant audit sections included within the audit tool are available here.

~~Insight courses~~

~~The following Insight courses include guidance on audit testing:~~

- Group audits – ISA (UK) 600
- Audit testing: Tests of details and selecting items for testing
- Audit testing: Sampling
- Audit testing: Controls; and
- Audit testing: Substantive Analytical Procedures (SAPs).

Schedules available in the audit tools

There are a number of working papers available in the ~~Croner-i~~ *Audit Automation* audit tools to assist the auditor with complying with the requirements of ISA (UK) 600. These are set out in overview here and referred to as relevant throughout this guide.

Schedule	Title	Purpose
Outside of the tools		
Determining the type of work to be performed on components	Flowchart to assist in determining the type of work to be performed on components. Interactive decision tree also available here.	
Planning section		

C4	Strategy: Group audits	Questionnaire to aid in developing an overall strategy for group audits
C4.1 in templates	Group component summary sheet	To prompt the auditor to document conclusions as to which components are considered significant
C4.2 Materiality section within Audit Automation	Group component materiality	A schedule, which allows the auditor to document the materiality levels of all group components.
Consolidation section		
Wi	Index sheet	Index for the W section
W2	Audit programme - group accounts	Work programme for the group auditor to complete on group accounts
W3	Audit programme - component auditors	Work programme for the group auditor to complete with respect to component auditors
W4 in templates	Component auditor instructions	A template for instructions the group auditor may issue to component auditors. This reference is a placeholder in the audit tool ~~and the Word template can be found here.~~
W5 in templates	Component auditor questionnaire	A questionnaire for the group auditor to provide to the component auditor for completion during the audit and then return to the group auditor. The reference in the audit tool is a placeholder ~~and the Excel template can be found here.~~
W6 in templates	Reporting to the group auditor	For completion by the component auditor to collate information to report to the group auditor. This is illustrative however as the component auditor's report will be driven by the group auditor's instructions. ~~The Word template is here.~~
W7 in templates	Example component auditor's confirmation	Template for the component auditor to acknowledge the instructions from the group auditor and the work to be performed. The Word template is here *called COMPCON*.
W8	Review of component auditor's working papers	A checklist the group auditor may find useful for reference when reviewing component auditor's files, noting however that the review of working papers should always be tailored to the component in question.

3.32 Statement of cash flows

Overview and definitions

Under FRS 102, all entities are required to prepare a statement of cash flows unless they are exempt under Section 1A (small companies) or under the reduced disclosure framework in Section 1 (qualifying subsidiaries).

The audit of the statement of cash flows is often done badly, if at all, but its prominence as a primary statement means it is an important audit area.

FRS 102 defines cash as cash on hand and demand deposits, which is in line with the Companies Act terminology of 'cash at bank and in hand'. However, the cash flow statement reconciles cash and cash equivalents at the start and end of the year. Cash equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value. It may be that the total of 'cash and cash equivalents' used in the cash flow statement differs from the amount reported as 'cash at bank and in hand' presented under the Companies Act formats in the balance sheet. Where this is the case, the financial statements will need to include a reconciliation between these two amounts.

Objectives

The major objective of this area is to ensure that the statement of cash flows is prepared and presented correctly in accordance with the requirements of FRS 102.

Audit procedures

The main aim of the audit work on statement of cash flows is to check that all the adjustments needed have been made during its preparation, and to ensure that the appropriate disclosures are made in the accounts. Cash flows should be analysed appropriately as operating, financing or investing in accordance with Section 7 of FRS 102.

The following items should be checked to ensure they have been treated correctly:

(a) fixed asset additions and disposals, including:

- any trade creditors for unpaid purchases and debtors for disposal proceeds; and
- additions acquired under hire purchase or finance lease arrangements;

(b) corporation tax, particularly where the client has made payments on account during the period;

(c) interest accruals and accrued interest receivable;

(d) items disclosed separately on the grounds of materiality;

(e) foreign exchange movements, especially on cash and/or debt;

(f) movements on debt, particularly repayments of borrowings and new financing taken out during the period;and

(g) the classification of cash balances.

Where accounting software has been used to prepare the statement of cash flows and related notes (and hence where there are no actual workings to check), the auditor should consider whether it is more effective to completely rework the statement of cash flows, especially where there are complicated items such as acquisitions or foreign exchange movements.

Substantive analytical procedures

Once the statement of cash flows has been prepared, the auditor should undertake analytical procedures to ensure that it makes sense in view of the auditor's knowledge of the client and the audit evidence obtained.

Controls

There are no relevant controls for dealing with this section, beyond the general business controls that have been outlined in the previous sections.

Common problems

Undue reliance on accounts production software

Given that most firms now prepare statutory accounts using accounts production software, a problemthat often occurs is that the auditor relies on this being the case, and does not actually audit the statement of cash flows.

Accounts software is only as good as the data entry, which is subject to human error, and it is important that thestatement of cash flows is checked to ensure it is correct.

Lack of critical analytical procedures

It is quite possible for a statement of cash flows to balance, and yet contain numerous material errors due to incorrect analysis of balances. An overall review of the statement, to ensure that all the figures that were expected have actually been included, is valuable in ensuring that nothing major has been omitted.

Insufficient knowledge and experience of staff

In many smaller practices, the majority of audits tend to be either entities below the audit threshold (which are having a voluntary audit for some reason), or entities which are above the audit threshold but nevertheless qualify as small companies, and hence do not have to prepare a statement of cash flows. This means that audit staff may rarely come across a statement of cash flows in much of their day-to-day work, and this inexperience can lead to errors going unnoticed in the statement of cash flows. In such circumstances, it is important that a senior member of the audit team reviews the statement of cash flows in detail.

Incorrect classification of 'cash' balances

Care needs to be taken to ensure that cash and cash equivalents are included as required by FRS 102.

4. Completion

4.1 Preparing the file for review

Quick overview

The objective of the auditor is to manage quality at the engagement level to obtain reasonable assurance that quality has been achieved such that:

- the auditor has fulfilled the auditor's responsibilities, and has conducted the audit, in accordance with professional standards and applicable legal and regulatory requirements; and
- the auditor's report issued is appropriate in the circumstances (ISA (UK) 220:11).

Part of this process is reviewing the audit file and this section provides guidance in preparing the file for review.

This section relates to section B in the ~~*Navigate*~~ *Audit* tools.

Scope and definitions

Scope

It is important that the audit staff responsible for the detailed work ensure the audit file is as completeas possible before it is given to the partner or manager for initial review. Reviewing a file that contains incomplete information and unfinished work is much more difficult and time consuming. There is also a risk that the audit will be left incomplete and that potentially important issues will be missed.

Key definitions

Term	**Definition**
Engagement partner	The partner or other individual, appointed by the firm, who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body. For an audit of financial statements, the engagement partner is a key audit partner.
Engagement team	All partners and staff performing the audit engagement, and any other individuals who perform audit procedures on the engagement, excluding an auditor's external expert and internal auditors who provide direct assistance on an engagement.

Source: ISA (UK) 220:12

Completion of the individual audit sections

The individual final statement audit areas are covered in more detail in the sections on Execution. The audit senior should ensure that all the individual sections of the file have been properly completed and signed off. The senior should:

(a) review each section and ensure that the work has been undertaken in accordance with the audit plan, andthat all of the planned work has been done;

(b) check that the file is fully cross-referenced and that every test identified at the planning stage as being necessary has actually been completed. In addition, any further testing that has been identified as being necessary should also have been completed;

(c) make sure that where a test requires a working paper, one has been prepared and properly cross-referenced within the programme; and

(d) ensure that all points within the main body of the file that need to be brought to the reviewer's attention have been brought forward. These should be recorded either on an audit highlights schedule or on a 'Points for partner attention' schedule if the senior cannot clear them.

The ~~*Navigate*~~ *Audit* tools include schedules for documenting Audit highlights (~~B3~~) and Points for partner (~~A3~~) *included in the Notes section*.

Undertaking the review

Review of juniors' work

Where there is a tiered structure within the practice, the senior or the manager must ensure that all original work by junior staff has been properly reviewed. The normal procedure is for the person nexton the 'ladder' to review the work of the person below.

The same review procedures as outlined within Reviewing the file should be applied.

Clearance of queries

The audit senior should ensure that all queries and review points have been adequately cleared before the file is presented for review. Where there are queries that the senior is unable to clear, these shouldbe noted on a separate schedule for the partner to discuss with the client. Similarly, at this stage the senior should complete a schedule of outstanding points, detailing any outstanding work that is required prior to the audit report being signed. A file is not ready for review if this list of outstanding points includes a substantial amount of outstanding work within the main file sections.

Outstanding points

In most circumstances the only outstanding points should be in respect of information that has not yet been provided to the audit staff, such as an outstanding bank letter. Other outstanding points might include a letter of comment being still in draft form, but they should not include an entire section of the audit file being still outstanding.

Insight - Timing concerns

The major problem that arises within audit completion is that the auditor does not leave sufficient time to finish things off. The completion of disclosure, and other, checklists and preparation of an audit highlights report is a time-consuming exercise and often does not seem to require much less time on smaller jobs than it does on larger ones. Therefore, the auditor must allow sufficient time to tidy up the file and make it ready for review, and to clear any review points arising from the review.

Responsibilities of the audit senior

Other matters that should be addressed by the senior in charge of the audit before the file is presented for review are outlined in (a) to (i) below.

(a) Do the working papers record all the work done and do all schedules record the source of information? Thiswill include checking that all key tests contain a clear summary of the results and a conclusion stating what theresults actually mean.

(b) Has the current file been fully cross-referenced? A file that contains either no cross-referencing or inaccurate cross-referencing takes considerably longer to review.

(c) Have the budget and actual time summaries been completed and explanations provided for any variances? Notes with any recommended action for subsequent years should also be made. Indeed, depending on the agreement with the client regarding fees, this could be an essential tool for explaining any budget overrun to theclient and in negotiating a fee increase, if the client takes responsibility for the extra time spent.

(d) Has the permanent file been updated for any changes highlighted during the course of the audit? It is important for the reviewer to check that this has been completed, as the senior involved may not be availablewhen the audit is planned the following year.

(e) Has the planning been updated for any changes highlighted during the course of the audit? If this was the case, and additional audit procedures were planned as a result, have these been performed and documented?

(f) Have any commercial observations on the client's business been recorded on the file for the partner's attention? This is an important issue that is frequently missed. It is also an area that allows the auditor to add value to the service provided to the client.

(g) Have all issues that require inclusion in the letter of representation been recorded on the file? This issue isaddressed in more detail in Letters of representation.

(h) Has a list of points for inclusion in the letter of comment been made, or preferably, has a draft letter beenprepared? This issue is dealt with in more detail in Reports to management.

(i) Has the level of overall materiality been reassessed on the basis of the final financial statements? If any adjustment is deemed necessary, the senior should consider whether the audit work is sufficient in light of the adjusted figure.

The Detailed file completion checklist (**B1**) in the ~~*Navigate*~~ *Audit* tools provides guidance and prompts for the senior completing the audit file.

The Final completion and close down checklist (**A1**) is then for the partner to complete, documenting any matters arising between the issue of the financial statements to the client for approval and signing of the audit report. Once all matters have been dealt with to the partner's satisfaction, the audit report can be signed, and the file closed down and stored in accordance with the firm's procedures. Further guidance on this is in Final completion and planning for next year.

Audit highlights

The audit senior or manager should prepare an audit highlights memorandum. This is an essential partof the audit evidence. It is particularly important within a smaller practice, where very often the logic behind some of the decision-making has not been fully evidenced elsewhere on the file. This is usually as a result of an open-door policy applied within a practice, which means that queries are dealt with asthey arise, and the issues are not always fully addressed within the audit file. The audit highlights memorandum gives the senior or manager an opportunity to review the key issues on an audit, outlining the problems that have arisen, how these have been dealt with and forming an ultimate conclusion on the audit.

When prepared well, an audit highlights report can significantly reduce the amount of time taken by a partner toreview the file, as it directs the partner's attention to the higher risk or problem areas. The main purposes of such a memorandum, therefore, are:

- to assist the partner to efficiently review the audit work and assess the suitability of the conclusions drawn;
- to help to focus the partner's review on the significant areas and issues; and
- to provide a link between the audit plan and the actual work performed.

The memorandum should not record details of all the work that has been undertaken on each individual section,thus regurgitating the entire audit programme. Neither should it be a one-line response for each section, referring the reviewer to each of the individual sections of the file. Its contents should typically include all of the following elements.

(a) **Update to background information** – changes to the entity's results and/or financial position after the year end, any new sector, regulatory and other external factors, changes to shareholders, directors, trustees, etc. andnew accounting systems or changes in controls since the planning was completed and the permanent file updated.

(b) **Audit strategy** – details of and reasons for any changes to the overall audit strategy and plan and overall levelof materiality. This section should also explain any failure to meet relevant ISA objectives and any departures from the requirements of ISAs.

(c) **Results of audit procedures and responses to risk** – work done in response to the key risks identified in the audit plan. How were the identified risks mitigated? This section should also include details of conclusions on theimportant audit and accounting matters arising. Typically, this would involve some commentary on how comfortwas drawn on each individual audit section.

(d) **Uncorrected misstatements** – any significant errors should be summarised and a conclusion given as to whether any need to be adjusted.

(e) **Fraud** – consideration of whether any audit work done or information obtained indicates a risk of materialmisstatement due to fraud, and if so, the response made.

(f) **Related parties** – any previously undisclosed related parties and/or transactions discovered during the audit,and a brief summary of the work done on any related party transactions outside the normal course of business.

(g) **Subsequent events** – a summary of any significant subsequent events, particularly any that impact on going concern, and whether disclosure or adjustment is required.

(h) **Review of financial statements** – brief comments on any significant matters arising from the final analyticalreview, plus any other disclosure or presentation issues.

(i) **Justification of the audit report** – an overall conclusion. If the senior or manager were to sign off the report,what would they say?

(j) **Audit administration and practicalities** – including any significant problems that occurred during the course ofthe audit and how these were dealt with, timetable to completion, clearance meeting arrangements, commentson the client's delivery of any requested schedules and information, etc.

The preparation of this schedule is not a waste of time. It saves expensive partner review time.

In group situations, a separate highlights memo may be needed for the group, or alternatively, each matter covered in a combined memo should contain sub-headings for each component and for the group as a whole.

Insight - Documentation

An example schedule is included in the ~~*Navigate*~~ *Audit* tools (~~Audit highlights~~ (**B3**)), although other formats and wording may be equally used.

This schedule provides a guide to the sort of issues that should be addressed. The senior member of staff should use this to highlight the major issues that have arisen during the audit, the key risk areas, any contentious issues and how they were resolved. It is useful also to summarise the extent of audit coverage in each audit area, and each major balance within that area. This will help the partner to structure the review to ensure that adequate consideration is given to areas of importance.

Summary of significant audit matters

It may be useful for the senior to include in the file a summary of significant audit matters *(Identified Risks)*. The purpose here is to document the work undertaken and the conclusion reached on all significant audit matters including all risks identified at the planning stage and documented on *the Area Risk Assessment* ~~C9.3/C9.4 Risk Assessment Summary~~.

Insight – Documentation

~~An example schedule is included in the *Navigate Audit* tools (Summaty of significant audit matters (B4)).~~

When completing the *Identified Risks* ~~form~~, a narrative summary should always be given for the nature of the matter, the work undertaken and the conclusion and not simply cross references. In this way the schedule will provide a meaningful summary of the work undertaken and conclusions on all matters significant to the audit.

Summary of uncorrected misstatements

General principles

ISA (UK) 450 *Evaluation of misstatements identified during the audit* requires the auditor to consider the impact of the uncorrected misstatements identified during the course of the audit on the audit opinion. Misstatements should be highlighted on one form, which should be filed within the completion section. The auditor should then conclude on whether any correction is necessary. ISA (UK) 450:A6 suggests that the misstatements should be split between factual, judgmental and projected misstatements, and their impact on the profit and loss account and the balance sheet should be recorded. The cumulative potential effect of the misstatements also needs to be noted. Further guidance on misstatement is in Sampling and misstatement evaluation.

Recording uncorrected misstatements

ISA (UK) 450 sets out a number of documentation requirements in relation to misstatements identified during the audit. The requirements are to clearly document on file:

- the amount below which a misstatement would be regarded as clearly trivial;
- all misstatements accumulated during the audit and whether they have been corrected; and
- the auditor’s conclusions as to whether uncorrected misstatements are material individually

or in aggregate, and the basis for that conclusion.

ISA (UK) 450 requires the level of triviality to be documented. As discussed in Assessing materiality, this should be set at the planning stage to help to avoid poor judgement calls being made by less experienced staff during the audit fieldwork.

It is important to note that projected misstatements are not usually adjusted. If the cumulative uncorrected misstatements, including projected misstatements, are such that the auditor feels that an adjustment would benecessary, then it may be necessary to carry out further audit work to ascertain the likely level of the actual misstatement, rather than contemplate adjusting for a projected misstatement within a particular population.

The auditor should ensure that there is proper consideration of the level of uncorrected misstatements. Frequently, there is simply a conclusion to say that no adjustment is necessary, yet on review of the file it becomes clear that there have been stock pricing errors, etc. that have not been recorded within the summary ofuncorrected misstatements.

On completion of the schedule, it should be remembered that the summary should include any errors in the accounting treatment of particular items.

Insight – Immaterial errors representing potential wider problems

Take, for example, the situation where an entity has bought a new computer on hire purchase but has decided not to capitalise it, as it is a relatively small item. The auditor may agree that the potential adjustment to the financial statements is not material. However, the fact that an assetthat should have been capitalised has instead been written off to the profit and loss account and the hire- purchase payments have been treated incorrectly, should be recorded on the summary of uncorrected misstatements.

The auditor should also remember to include uncorrected misstatements in the previous period that would alsohave an impact in the current period.

Insight – Prior period errors being brought forward

For example, an uncorrected sales cut-off error in the prior period would have a compensating effect on reported turnover and profit in the current period which, when taken together with identified errors arising in the current period could be material. This is a mandatory requirement in ISA (UK) 450:11(b).

Insight – Documentation

A suggested format for recording uncorrected misstatements is given in Misstatements (**B5**) in the ~~*Navigate*~~ *Audit* tools. *(Journals and included in the templates)*

This schedule includes space to record both the materiality level and the level below which matters are considered clearly trivial. All errors (except those that are clearly trivial) should be recorded, so that their cumulative impact on the financial statements may be assessed, and so that their disposal may be documented.

Extrapolated errors and actual errors should be clearly identified on the schedule. Errors should not be netted off or judged not material before being carried forward to this form. Any unaudited balances (for example where petty cash expenditure is immaterial and hence has not been audited) should be recorded as potential errors. At the end of the job the total of the unadjusted errors should be compared with materiality and adjustment should be made where necessary. It should be noted that no adjustment should be made in respect of extrapolated errors until such time as further work has been undertaken to determine the extent of the actual error with reasonable certainty.

Consideration of the impact of uncorrected misstatements

Having ascertained the details of the level of error within the financial statements, the auditor should consider whether any adjustment is needed.

The first thing the auditor should do is reassess materiality to ensure it remains appropriate in the context of theentity's final results (ISA (UK) 450:10).

ISA (UK) 450 requires the auditor to consider the effect of uncorrected misstatements on particular classes of transactions, account balances or disclosures as well as the financial statements as a whole. It may therefore beappropriate to group uncorrected misstatements by balance sheet and P&L area.

The auditor should also be aware of areas where errors are likely to be material by their nature and without aggregation, for example the disclosure of directors' emoluments.

In addition to simply aggregating the monetary value of misstatements, the auditor also needs to consider the circumstances surrounding the misstatement as some may be considered to be material, even if they are lower than materiality levels.

Insight - Misstatements that might be material by nature

For example, where the misstatement has an effect on compliance with regulatory requirements or compliance with covenants, or where it affects a value on which management bonuses are calculated, such circumstances would be likely to affect the auditor's consideration of materiality.

The level at which an adjustment is required will depend on the particular client – for example, adjustments maybe made at a fairly low level where the entity is trading at or around the break-even level. In other circumstances, it may be that adjustment is only made when the cumulative error is approaching the level of materiality. Where this is the case, or where the nature or circumstances of the errors identified indicate that further errors may exist, the auditor must also consider whether the overall audit strategy and plan need to be revised. In this context, circumstances may affect the decision as to whether an error needs to be adjusted, evenif it is not material. Examples of such situations are:

- misstatements which have a significant impact on debt covenants; and
- misstatements which relate to inappropriate accounting policies, which although not material in the currentperiod, may become so when compounded in future periods, e.g. not depreciating buildings.

Disclosures

When considering misstatements in disclosures at the completion stage, any misstatements that are not clearly trivial are also accumulated, to help the auditor to evaluate the effect of the misstatements on the relevant disclosures and the financial statements as a whole.

Determining whether a misstatement in a qualitative disclosure is material, and aggregating such misstatements, is a matter that involves the exercise of professional judgement.

Insight – Potentially material disclosures

Some examples of where such misstatements may be material include:

- inaccurate or incomplete descriptions of information about the objectives, policies and processes for managing capital for entities with insurance and banking activities;

- the omission of information about the events or circumstances that have led to an impairment loss (e.g. a significant long-term decline in the demand for a metal or commodity) in an entity with mining operations;
- the inclusion of significant accounting policies that are incorrectly described, not relevant to the entity, or otherwise not presented in an understandable manner;
- the inadequate description of the sensitivity of an exchange rate in an entity that undertakes international trading activities;
- inappropriate or inadequate description of estimation uncertainty in relation to an impairment (or otherwise) of an intangible asset; and
- inclusion of material in the financial statements that is not relevant or that obscures an understanding of the matters disclosed.

Reporting uncorrected misstatements to the client

All misstatements accumulated during the audit, except those which are clearly trivial, should be notified to management, with a request that they be corrected. Uncorrected misstatements, and the effect that they have on the audit opinion, will need to be brought to the attention of those charged with governance, with a request that they be corrected. This includes the effect of any uncorrected misstatements from priorperiods.

The auditor may consider it appropriate to bring corrected misstatements to the attention of those charged with governance as well.

ISA (UK) 450:9 requires the client to justify any misstatements which they refuse to correct.

The auditor should obtain written representations from those charged with governance to confirm their opinion that uncorrected misstatements are immaterial both individually and in aggregate. A summary of the uncorrected misstatements should be included in, or attached to, the letter of representation. Where misstatements that have been reported to those charged with governance remain uncorrected, the auditor should obtain a written representation from those charged with governance as to their reasons for not making the necessary corrections. The auditor also considers whether this is an indication of management bias in financial reporting. Further guidance on this is in Letters of representation.

Final analytical procedures

This is the basic critical review of the financial statements, which should always take place at the end of the audit. ISA (UK) 520 *Analytical procedures* requires analytical procedures to be performed when completing the audit. ISA (UK) 520:6 states:

‘The auditor shall design and perform analytical procedures near the end of the audit that assist the auditorwhen forming an overall conclusion as to whether the financial statements are consistent with the auditor’sunderstanding of the entity.’

This will generally involve the completion of a schedule highlighting key ratios and absolute figures, and comparing these to past accounting periods. However, the critical review of the financial statements does not end with thesimple completion of this form and the calculation of the various ratios. It is imperative that any unexpected variations and, indeed, any unexpected consistencies, are properly followed up, explained and substantiated. Remember that the conclusion the auditor is trying to arrive at in the critical review of the financial statements is that they ‘make sense’. So it is vital that the auditor explains any such variations.

For some types of client, it will not really help the critical review of the financial statements to complete a standard analytical review form, perhaps because the ratios that are calculated when completing the form are notmeaningful for that particular type of business. In these situations, the auditor should develop a bespoke programme with indicators and ratios that should be calculated and critically examined every year.

Key points for the auditor to consider when carrying out final analytical procedures are:

- whether the financial statements adequately reflect the information and explanations previously obtained and conclusions previously reached during the course of the audit;
- whether the procedures reveal any new factors that may affect the presentation of, or disclosures in, the financial statements;
- whether analytical procedures applied when completing the audit, such as comparing the information in the financial statements with other pertinent data, produce results which support the overall conclusion that the financial statements as a whole are consistent with their knowledge of the entity's business;
- whether the presentation adopted in the financial statements may have been unduly influenced by the desire of those charged with governance to present matters in a favourable or unfavourable light; and
- the potential impact on the financial statements of the aggregate of uncorrected misstatements (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period's audit, if any.

The results of analytical procedures may identify a previously unrecognised risk in which case the auditor should revise his assessment of risk and plan and perform additional audit procedures accordingly.

The ISA also states that conclusions drawn from the results of such procedures (that is, that the financial statements make sense) are intended to corroborate conclusions formed during the audit of individual components or elements ofthe financial statements and to assist in arriving at the overall conclusion on the reasonableness of the financial statements.

It is also stressed that this closing analytical review may identify areas requiring further audit procedures. For example, if the critical review of financial statements highlights an unexpected increase in the debtor days ratio, this may cause the auditor to investigate further, whether or not there is a sufficient bad-debt provision in the financial statements.

Many firms have no difficulty in calculating ratios, but interpreting the results and properly following up unexpected fluctuations is often not done well. If relevant notes were made during the preliminary analytical review and no significant changes have been put through the financial statements, the auditor may cross-reference the completion section to the relevant figures and ratios on the planning section of the file. However, preliminary analytical review is aimed at identifying risk for the purpose of focusing the audit effort, whereas final analyticalreview is to ensure that the financial statements fairly reflect the results of the business. Even where there has been no change in variances or ratios since the planning stage, a new conclusion will still need to be drawn at the completion stage as an absolute minimum.

In group situations, final analytical review work should be completed separately for the group as a whole, as wellas being performed for each individual component.

The Final analytical review (B2) in the *~~Navigate~~ Audit* tools covers these issues.

Disclosure checklists

The auditor should ensure that the draft financial statements comply fully with all relevant accounting standards and legislative requirements. The easiest way to do this, even where a computerised financial statements preparation package is being used, is to use disclosure checklists. Not only do the checklists enable the auditor to demonstrate that disclosure has been checked, but they also provide a useful check onwhether everything that should have been disclosed, actually has been.

It is obviously important to ensure that the most up-to-date version of a checklist is utilised and that it is appropriate for the year-end under audit.

Insight: Project management

Time should be allocated in the budget and timetable to ensure that the checklists are filled out properly, andnot just tick-boxed without thought. This is particularly true when a new or revised accounting standard has been issued since some of the disclosure requirements and presentation will be unfamiliar and it will also be necessary to confirm that the accounts preparation software has been set up properly.

With the increasing sophistication of accounts preparation packages, it is not essential that a checklist be completed each year. However, an annual review for proper preparation of the financial statements in accordance with legislation and applicable standards should take place and will form part of the critical review of the financial statements.

Insight – Caution when using online checklists

Completion of a disclosure checklist is important as disclosure requirements become increasingly complex. Many practices rely on the accounting software being used, to ensure that there are adequate disclosures in the financial statements. When using these, it is important for the auditor to confirm that the checklist has been updated to reflect any relevant updates for the accounting period under audit.

In addition, accounts production software is only ever as good as the information given to it. It is not necessarily smart enough to know when certain disclosures are needed, especially narrative disclosures that do not follow directly from a figure in the trial balance, e.g. related party disclosures.

Many firms develop a policy of only completing a disclosure checklist, say, once every three years or if there has been a major change in the intervening period. If a disclosure checklist is not to be used in a particular year, there should nevertheless be some evidence on the file that the disclosures have been checked. There is no substitute for the auditor’s own knowledge of disclosure and experience in reviewing financial statements

It is suggested that a full checklist should be completed as necessary on very small companies and more frequently for larger or more complex companies. It will generally be necessary to complete a new checklist following any major change in disclosure requirements or in the size/operating characteristics of the client in question. ~~*Croner-i Interactive Disclosure Checklist* is a downloadable software tool that provides an efficient way to check the disclosures required by accounting standards and legislation needed for entities preparing financial statements.~~

Insight: Issues with tailoring

Inappropriate tailoring assumptions are the cause of numerous disclosure errors, due to relevant sections being completely tailored out of the checklist in error. Conversely this can also result in wasted time completing irrelevant areas. A brief review of any tailoring assumptions by a more senior member of staff can save considerable time and improve the effectiveness of using disclosure checklists.

Completion of an appropriately tailored disclosure checklist is still no guarantee that the disclosure in the financial statements will be both correct and complete. File reviews often show up poor disclosureson files that contain a completed disclosure checklist. There are two main reasons for this:

- the checklist has been completed on 'autopilot' and the auditor has missed the fact that certain disclosures are missing or incorrect; and
- the auditor has simply answered 'yes' to a question in the checklist without fully understanding the question.This can often arise if staff who are too junior are tasked with completing the checklist. It is generally recommended that the audit senior or higher completes the disclosure checklist.

Justification of the audit report

Drafting the audit report is covered in more detail in Drafting the audit report. However, it is important that the auditor considers the applicability of the audit report that has been attached to the draft financial statements. This should be documented either within the audit highlights memorandum or asa separate schedule on the file.

Group audits can pose documentation difficulties here, especially where the parent's individual financial statements and the group financial statements are audited and documented in one audit file. Separate documentation is required for the justification of the opinion on both the parent's individual financial statements and on the consolidated financial statements.

Another frequent problem is that the audit evidence does not back up the audit opinion. This is not because the opinion is incorrect, but because there is not a full record documented on file of how the opinion was formed. For example, there may be a problem highlighted on file but the resolution of the problem, which gives credenceto the final audit opinion, has not been explained. This is invariably due in part to poor documentation of the discussions of such issues between the partner and the client.

In addition, the auditor should also consider ethical requirements, specifically whether all threats to independence identified have been appropriately mitigated and whether decisions taken with regards to additional fees or services are appropriate and justified. The engagement partner must ensure that all open ethical queries are resolved and sufficient evidence exists to support any judgments made prior to issuing the auditor's report.

Specifically, the auditor should consider the following issues:

(a) What impact will any modified audit report from the previous period have on the current year's opinion?

(b) Have there been any problems with the adequacy of books and records? In particular, the auditor should consider the issues of recording cash sales, the existence of a fixed asset register and whether adequate stockrecords have been maintained.

(c) Have all necessary information and explanations been obtained from the directors?

(d) Have adequate returns been received from any branches not visited during the course of the audit to enablean opinion to be formed?

(e) What is the impact of any potential going concern problems (identified by completion of a going-concernreview) on the audit opinion? Where this is the case, the reasons for the report given should be fully documented on file.

(f) Where the entity is a holding company and exemption has been claimed from preparing group financial statements, is thegroup entitled to this exemption? A specific report is no longer required on this issue, although consideration of the matter should still be fully documented.

(g) Have any other matters (including with regards to ethics and independence) come to light that may affect the audit opinion? Have these been adequately resolved and documented?

The Financial statements and audit report checklist (B6) in the ~~*Navigate*~~ *Audit* tools covers these issues.

Example: Opening Balances

For example, the previous year's audit was qualified on the basis of limitation in scope due to the stocktake not being attended because the auditor had not been appointed until after the year end. In this situation, the auditorneeds to consider the impact this will have on the current year's audit report, due to the opening balance on stock. This would usually lead to the profit and loss account being qualified, but not the balance sheet.

4.2 Reports to management

Quick overview

This section relates to section B in the Private Company (PCAS) based audit tools. A template for a management letter is available in *the templates (MANAGE)* ~~Assignment letters in *Navigate Audit*.~~

Scope and definitions

Scope

ISA (UK) 260 (Revised November 2019) (Updated May 2022) *Communication with those charged with governance* is effective for the audit of financial statements for periods commencing on or after 15 December 2019 and requires auditors to communicate with management and/or those charged with governance on a number of matters relating to the audit.

ISA (UK) 265 (Updated May 2022) *Communicating deficiencies in internal control to those charged with governance and management* is effective for the audit of financial statements for periods commencing on or after 15 December 2010 and deals with the auditor's responsibility to communicate appropriately to those charged with governance and management any deficiencies in internal control that the auditor has identified in an audit of financial statements.

The revisions of these standards issued in May 2022 include the conforming amendments from the revision of ISA (UK) 315 (Revised July 2020).

ISA (UK) 260 sets standards and provides guidance on:

- determining the appropriate person(s) within the governance structure for communications;
- matters to be communicated;
- the communication process; and
- documentation of that communication.

ISA (UK) 265 considers the specific case of reporting significant deficiencies in internal control.

Reporting to management is also referenced in a number of ISAs, a summary of these is provided in Matters to communicate.

Key definitions

Term	**Definition**
Those charged with governance	The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager. In the UK, those charged with governance include the directors (executive and non-executive) of a company and the members of an audit committee where one exists. For other types of entity it usually includes equivalent persons such as the partners, proprietors, committee of management or board of trustees.

Management

The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

In the UK, management will **not** normally include non-executive directors.

Deficiency in internal control

This exists when:

- A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
- A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Significant deficiency in internal control

A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Source: ISA (UK) 260:10 and ISA (UK) 265:6

Aims of reports to those charged with governance

The auditor should aim to develop a constructive working relationship with those charged with governance, whilst retaining their independence and objectivity, and under ISA (UK) 260, one of the auditor's objectives is to promote effective two-way communication with those charged with governance.

The main purposes of such communication are to assist:

- the auditor and those charged with governance in understanding matters related to the audit. This includes communicating clearly the responsibilities of the auditor in relation to the audit and an overview of the planned timing and scope of the work;
- the auditor in obtaining information from those charged with governance that is relevant to the audit. This includes the auditor making enquiries of those charged with governance regarding their knowledge of actual or suspected fraud, non-compliance with laws and regulations and their reasons for not adjusting misstatements in the financial statements detected by the auditor; and
- those charged with governance in fulfilling their responsibilities in relation to the financial reporting process, thereby reducing the risks of material misstatement in the financial statements. This includes communication by the auditor of audit findings and other matters of governance interest.

All reports to the client should be relevant to the particular entity, and the auditor should consider the extent, form and frequency of reports in relation to the size and nature of the client. The attitude of those charged with governance and the importance of the issues to be raised may also affect the format and timing of reports. For example, reports of relatively minor matters to a small client may be best handled orally via a meeting or telephone conversation rather than by a formal written report. Written and oral communications are covered further in Methods of communication.

All reports should be made on a timely basis to allow those charged with governance to take appropriate action. Timely communication throughout the audit contributes to the achievement of robust two-way dialogue between those charged with governance and the auditor. The speed with which the auditor reports will depend on the nature of the issue arising, but matters relating to the qualitative aspects of the entity's accounting and financial reporting will usually be communicated prior to the approval of the financial statements. When ISA (UK) 701 (Revised November 2019) (Updated May 2022) *Communicating Key Audit Matters in the Independent Auditor's Report* applies, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit, and they may also have more frequent communications to further discuss such matters when communicating about significant audit findings.

ISA (UK) 260 acknowledges that law or regulation may restrict or specifically prohibit the auditor's communication of certain matters with those charged with governance, for example where this might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity when the auditor is required to report identified or suspected non-compliance with laws and regulations pursuant to anti-money laundering legislation. In these circumstances, the issues considered by the auditor may be complex and the auditor may consider it appropriate to obtain legal advice. ~~Further information on dealing with such situations can be found in the 'Impact on auditors' section of the Anti-money laundering area of *Navigate Practice Management*.~~

Who to communicate with

ISA (UK) 260 distinguishes between those charged with governance and management, which are defined in Key definitions.

In practice, it is common for the auditor to communicate primarily with a subgroup of those charged with governance, for example, an audit committee, or an individual director or trustee. In this situation the auditor must determine whether to communicate with the governing body as well. This will depend on the nature of the matters being communicated, the effectiveness and appropriateness of communication by the subgroup or individual with thefull governing body and their level of authority.

Similarly, in many instances, all, or some, of those charged with governance are also involved in managing the entity. This is likely to bethe case in owner-managed companies where all the directors are hands-on in running the business. In such cases, if:

- significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and
- written representations the auditor is requesting are communicated with management personnel who also have governance responsibilities,

those matters need not be communicated twice, provided that such communication adequately informs all ofthose with whom the auditor would otherwise communicate in their governance capacity.

ISA (UK) 260:9 also states that the auditor should 'provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process ...'. It is important that the auditor remembers this, as it is quite common to find recorded systems and controls deficiencies within the file which have not been brought to the client's attention. Many firms send a letter of comment to the client along with the final financial statements, which may not be sufficiently prompt under ISAs. For example, if at the planning stage the auditor identifies a significant deficiency in the client's internal controls, an interim report should be issued at that stage, rather than waiting until the end of the engagement.

Insight – Role titles

In some sectors it can be easier to distinguish who is a member of those charged with governance, than others. For instance, in larger organisations those charged with governance would be a board of directors or trustees.

ISA (UK) 260 accepts that in some organisations this distinction is not always clear, and that the auditor may need to discuss who is most appropriate to communicate with at the entity after gaining an understanding of the entity's governance structure.

The auditor cannot always assume who is best to report to solely by role title.

Third parties

Reports issued by the auditor to those charged with governance on the matters referred to in this section will usually be solely for the use of the addressees. If the auditor wishes to disclose its contents to a third party, they should obtain permission from the client before releasing it. In practical terms, once the report has been sent, the auditor has little control over it and it may be given to third parties without the knowledge of the auditor. The auditor should therefore ensure that their report contains an appropriate disclaimer so that any third parties who see the report understand it was not prepared for their benefit.

In the public or regulated sectors, the auditor may have a duty to submit a copy of their report to the relevant regulatory or funding bodies and therefore the disclaimer will not be appropriate. However, any communication with those charged with governance is confidential and the auditor will require prior consent from those charged with governance before sending a copy to the regulator or funding body.

Where reports are required by such third parties, the auditor should show due consideration for the requirements of those bodies when compiling their reports.

Matters to communicate

ISAs (UK) 260 and 265 both set out a number of items the auditor is required to communicate to those charged with governance, which include:

- their responsibilities in relation to the audit of the financial statements (usually covered by the engagement letter);
- the form, timing and expected general content of communications;
- an overview of the planned scope and timing of the audit;
- significant findings from the audit;
- significant deficiencies in internal control;
- certain matters regarding independence and objectivity; and
- (for audits of public interest entities) matters to be contained in an additional report to the audit committee.

In addition to ISAs (UK) 260 and (UK) 265, a number of other ISAs (UK) also contain specific requirements relating to matters to be communicated to those charged with governance in specific circumstances. A summary of theserequirements is provided here:

- ISQM(UK) 1: how the system of quality management supports the consistent performance of quality engagements (when performing audits of listed entities);
- ISA (UK) 240: requires the auditor to make enquiries of those charged with governance to determine whetherthey have knowledge of any actual, suspected or alleged fraud affecting the entity; where applicable to discussreasons for withdrawal from the engagement; and when applicable to inform the entity of any suspected irregularities, including fraud and ask them to take action;

- ISA (UK) 250 Section A: requires the auditor to make enquiries as to whether the entity is in compliance withlaws and regulations; and to inform those charged with governance of any suspected non-compliance;

- ISA (UK) 450: requires uncorrected misstatements and their effects to be communicated;

- ISA (UK) 505: requires communication if management refuse to allow the auditor to send a confirmationrequest and it is considered unreasonable;

- ISA (UK) 510: requires communication if any errors in opening balances result in material misstatements in the current period's financial statements;

- ISA (UK) 540: requires the auditor to consider whether any matters regarding accounting estimates should be communicated;

- ISA (UK) 550: requires communication of any significant matters arising during the audit in connection with the entity's related parties;

- ISA (UK) 560: requires the auditor to:

  – enquire of management and those charged with governance as to whether any subsequent events haveoccurred;
  – discuss with management any facts which become known to the auditor after the date of the audit report but beforethe date the financial statements are issued;
  – in certain situations, to ask those charged with governance not to issue the financial statements;
  – discuss facts that become known after the financial statements have been issued; and
  – communicate circumstances in which the auditor believes the financial statements need to be amended;

- ISA (UK) 570: requires communication of events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern;

- ISA (UK) 600: requires communication of certain matters in a group situation;

- ISA (UK) 610: requires communication about the use of the work of the internal audit function;

- ISA (UK) 700: requires communication where the auditor does not intend to disclose the name of theengagement partner in the audit report;

- ISA (UK) 701: requires communication of key audit matters;

- ISA (UK) 705: requires certain communications where there is an imposed limitation of scope or an inability toobtain sufficient appropriate audit evidence; material misstatements due to the non-disclosure of information;and expected modifications to the opinion;

- ISA (UK) 706: requires communication of an expected Emphasis of Matter or Other Matter paragraph;

- ISA (UK) 710: requires communication where the auditor concludes that a material misstatement exists in priorperiod financial statements on which a predecessor auditor had reported without modification of their opinion; and

- ISA (UK) 720: requires certain communications where misstatements are identified in other information.

The auditor communicates 'audit matters of governance interest' to those charged with governance. These are matters arising from the audit of financial statements and which, in the opinion of the auditor, are both important and relevant to those charged with governance in their role of overseeing the financial statements and disclosure process. Only matters which have come to the auditor's attention as a result of the audit will be reportable, and the auditor is not required to perform additional procedures to identify matters of governance interest.

Planned scope and timing

The ISA states that auditors of all entities should inform those charged with governance of the planned scope and timing of the work they plan to perform, including any limitations thereon. This includes communicating about the significant risks identified by the auditor. Also where the auditor is required or decides to communicate key audit matters, the overview of the planned scope and timing of the audit should include communication about the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditor, including those that had the greatest effect on the overall audit strategy; the allocation of resources; and directing the efforts of the engagement team. Matters that might be communicated in outline include:

- how the auditor plans to address the significant risks of material misstatement, whether due to fraud or error;
- how the auditor plans to address areas of higher assessed risks of material misstatement;
- the auditor's approach to internal control relevant to the audit;
- the concept of materiality and its application to the audit;
- the nature and extent of specialised skill or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor's expert;
- the extent, if any, that reliance can be placed on the internal audit function;
- where relevant, the work to be performed by other auditors and how the auditor intends to ensure the adequacy of the work of those other auditors;
- when ISA (UK) 701 applies, the auditor's preliminary views about matters that may be areas of significant auditor attention in the audit and therefore may be key audit matters; and
- the auditor's planned approach to addressing the implications on the individual statements and the disclosures of any significant changes within the applicable financial reporting framework or in the entity's environment, financial condition or activities.

The nature and detail of the planning information communicated will depend on the size and nature of the entity and precisely how those charged with governance operate. The auditor needs to take care when communicating with those charged with governance about the planned scope and timing of the audit to ensure that they do not compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

Where the audit team considers that there has been no change in this information from one year to the next, there is no requirement to reproduce it. Instead, the auditor need only make those charged with governance aware that no change has taken place.

Significant findings from the audit

The following areas are those that the auditor should communicate to those charged with governance:

- the auditor's views on the qualitative aspects of the entity's accounting practices and financial report – this will include the auditor's opinions on the accounting policies used, the appropriateness of accounting estimates, the potential impact of uncertainties and apparent misstatements in other material issued with the financial statements;

- any significant difficulties encountered during the audit, such as:
- significant delays by management, the unavailability of entity personnel or an unwillingness by management to provide information necessary for the auditor to perform their procedures;
- an unreasonably brief time within which to complete the audit;
- extensive unexpected effort required to obtain sufficient appropriate audit evidence;
- the unavailability of expected information;
- restriction imposed on the auditor by management; and
- management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when required;
- significant matters discussed with management, unless all of those charged with governance are involved in managing the entity, such as:
- significant events or transactions that occurred during the year;
- business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement;
- concerns about management's consultations with other accountants on accounting or auditing matters;
- discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services; and
- significant matters on which there was disagreement with management, except for initial differences of opinion because of incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information.
- written representations the auditor is requesting, unless all of those charged with governance are involved in managing the entity;
- any other significant matters which the auditor considers relevant to the oversight of the financial reporting process, this may include modifications to the overall audit strategy and audit plan, material misstatements of the other information that have been corrected, and other matters considered by the engagement quality reviewer;
- uncorrected misstatements (see following paragraph);
- the final draft of the management letter for signature;
- any circumstances which affect the form and content of the auditor's report, such as expected modifications to the report – to ensure that those charged with governance are aware of the proposed modification, that there are no disputed facts and that those charged with governance have an opportunity to provide further information so that a modification is no longer required;
- significant deficiencies in internal control identified during the audit;
- matters specifically required by other ISAs (UK) to be communicated to those charged with governance; and
- any other matters of governance interest.

ISA (UK) 260 also requires the auditor to explain, where relevant, why significant accounting policies, which are acceptable under the applicable financial reporting framework are not considered appropriate in the particular circumstances of the entity. Examples may include the effect of accounting policies in controversial or emerging areas where there may be a lack of guidance, areas where estimates are significant, or the effect of the timing of a transaction in relation to the period in which they are recorded.

Unadjusted misstatements

Where the auditor finds uncorrected misstatements, they should report them to the entity's management and request that they be corrected. These misstatements should be clearly distinguished as either errors of fact or matters of judgment. There is no requirement to report those misstatements which are 'clearly trivial' or inconsequential whether taken individually or in aggregate.

Where any of these misstatements are not corrected by management they are reported to those charged with governance. If those charged with governance refuse to make any of the adjustments, the auditor should discuss the matter with them and consider the implications for their report. The auditor should also obtain written representations from those charged with governance that explain why they have not been corrected.

Even where management has corrected the misstatements, the auditor may consider that including the details of the misstatement in their communications may assist those charged with governance with their role, including considering the effectiveness of the system of internal control.

Where matters previously reported have not been rectified by those charged with governance, the auditor considers repeating the point. Failing to do so may lead to the auditor giving the impression that they are satisfied that the matter has been addressed.

Guidance on unadjusted misstatements is detailed in ISA (UK) 450 *Evaluation of Misstatements Identified During the Audit* (see Sampling and Misstatement Evaluation for more detail).

Integrity, independence and objectivity

For all companies, listed and unlisted, the Revised Ethical Standard 2019 requires that those charged with governance should be told of any significant facts and matters which may impact the auditor's objectivity and independence.

The communication should include the key issues considered by the engagement partner such as:

- the principal threats, if any, to objectivity and independence identified by the auditor;
- any safeguards implemented with an explanation of why they were thought to be effective;
- any independent partner review;
- the overall assessment of threats and safeguards; and
- information about the general policies and processes employed by the audit firm to maintain independence and objectivity.

Methods of communication

Written and oral communications

Certain communications need to be made in writing. These are:

- agreement to the terms of the engagement (engagement letter);
- in the case of a listed entity:

- – the communications regarding auditor independence; and
- – any contingent fee arrangements for non-audit services provided by the auditor or members of the samenetwork;
    - in the case of a public interest entity:
- – the communications regarding independence;
- – the additional report to the audit committee must be in writing. This report is to be signed and dated by theengagement partner, and submitted to the audit committee no later than the date of submission of the auditreport; and
- – upon request by either the auditor or the audit committee, the auditor shall discuss key matters arising fromthe audit, referred to in the additional report to the audit committee, and in particular any deficiencies communicated;
    - significant deficiencies in internal control; and
    - matters on which the auditor is required to obtain written representations (representation letter).

In addition, the auditor should communicate in writing with those charged with governance regarding significantfindings from the audit if, in their professional judgment, oral communication would not be adequate.

Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor may also consider it necessary to report such matters in writing where not prohibited from discussing such issues by the local legislation.

Other communications may be made orally. However, the auditor may judge that for effective communication a written communication is issued even if its content is limited to explaining that there is nothing the auditor wishes to draw to the attention of those charged with governance. To avoid doubt, where there are no matters the auditorwishes to communicate in writing, they may issue a written communication to that effect; however, this is not a requirement of the ISAs.

Where communication has been made in writing, the auditor should retain a copy as part of the audit documentation.

If matters are to be communicated orally, the auditor is still required by ISA (UK) 260 to document on the audit filethe matters communicated, who they were communicated to and when they were communicated. In many cases, this will be a copy of the minutes of a meeting at which the issue was discussed.

Typically, the auditor will discuss their findings with management or those with direct responsibility for an area, where appropriate to do so, before reporting them to those charged with governance. This should ensure that allfacts are clarified as well as providing management with an opportunity to provide further explanations. Where it will aid the understanding of those charged with governance, the auditor may include details of comments made by management in their final communication.

Style

The style of the letter is very important. The following points should be considered:

(a) the letter should be clear, constructive and concise – in particular, it should:

- use good, simple English;
- avoid accounting jargon; and

- avoid personal remarks;

(b) the letter must be in a professional tone;

(c) the auditor must ensure that the points being raised are factually accurate and specific;

(d) the points being raised must be put into a context that makes them relevant to the client's business;

(e) the auditor must explain the points being raised, and not just provide a comprehensive statement of all the deficiencies found; and

(f) the letter should be prepared promptly and sent at the appropriate time.

Insight - Recommendations

The ISAs do not require an auditor to make recommendations regarding deficiencies in internal control, as the implementation of the control environment is the responsibility of management not the auditor. However, where these are provided, they should be tailored to the size and nature of the entity. It is important that these are not too prescriptive, in order to avoid the risk that the auditor may lose independence if the recommendation is implemented and is insufficient to mitigate the deficiency.

Layout and procedure

The letter should be drafted in a standard format and should include:

(a) an opening paragraph explaining the purpose of the letter;

(b) the body of the letter, with details of the issues described above;

(c) a closing paragraph summarising the action that should be taken by the client and making it clear that the audit is not designed to identify all matters that may be relevant to those charged with governance. The auditormay also use the letter as an opportunity to thank the client and its staff for the assistance given during the audit;

(d) the standard paragraph from ISA (UK) 260.A43, limiting the auditors' liability to third parties in respect of the contents of the letter;

(e) an appendix to the letter, setting out the following points for each of the issues being raised. These points should be drafted in such a way that either the most significant appear first or the points are graded in terms oftheir relative importance (remembering that deficiencies which are not significant should generally be reservedfor communication to management only, and not to those charged with governance):

- a summary of the existing system; and
- the nature of the deficiency and its actual or potential impact (although ISA (UK) 265:A28 notes that such impact need not be quantified);

(f) the auditor should discuss the draft with the client before sending the letter. This is particularly importantwhere the letter is being sent to someone other than the person in charge of the accounts department;

(g) the letter should leave space for the client's responses, confirming the action that the client is proposing; and

(h) a copy of the letter should be carried forward to next year's audit file so that the action can be followed up.

Insight – Including recommendations in the management letter

It is common practice for an auditor to include recommendations within their management letter against the deficiencies that they have highlighted, and is one of the ways that firms can seek to add value to the engagement. However, the auditor should consider their responsibility to remain independent from the client, and as such consider the wording of these recommendations carefully to avoid a potential 'management' or 'self-review threat'.

Where matters are communicated orally, the auditor must document on the file:

- the matters which were communicated;
- to whom they were communicated; and
- the date on which they were communicated.

In view of this requirement, and the importance of reporting significant deficiencies in internal control in writing, many auditors may decide to issue a written management letter to all clients.

It should be noted that under ISA (UK) 260 and ISA (UK) 265 in some circumstances certain matters do not need to be communicated to the client in writing and may be communicated orally. Nevertheless, the letter of comment is a useful by-product of the audit as it gives the auditor an opportunity to add value to the audit process.

Insight – Cost of implementations

Queries around management letters are often raised around the cost of implementing recommendations, and whether this fact should be taken into account when deciding which control deficiencies to report. ISA (UK) 265:A16 is clear that the responsibility for evaluating the costs and benefits of implementing recommendations rests with management and those charged with governance. Accordingly, the requirement to report control deficiencies, whether significant or not, applies regardless of cost or any other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

Insight – Prior year deficiencies

Queries also often arise around whether to raise deficiencies again in subsequent years if they have not been dealt with by the client. Again, the ISA is explicit. ISA (UK) 265:A17 states that reporting a significant deficiency in a previous year does **not** eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken by the client. The auditor may either repeat the matter in the current year or refer to the previous communication.

The ISA goes on to note that the auditor may ask management or those charged with governance (as appropriate) why the significant deficiency has not yet been remedied. Furthermore, the auditor may also need to consider whether the client's failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

However, ISA (UK) 265:A24 states that non-significant deficiencies reported to management in previous years need not be repeated if they have not been dealt with. It may, though, be appropriate to repeat them if there has been a significant change in management personnel.

Effect of the letter on the audit opinion

Sending a letter of comment to the client is not a substitute for any of the following:

- modifying the audit opinion;
- correcting material misstatements in the financial statements;
- maintaining adequate books and records; or
- reporting to any regulatory body on the client's systems of internal control.

Liability arising from letters of comment

In order to avoid the risk of liability arising out of the issue of such a letter, the auditor should seek to put the following protections in place:

(a) the letter should make it clear that it is a confidential report, solely for the client's internal use;

(b) the letter should contain a paragraph making it clear that the audit may not have identified all deficiencies orpotential deficiencies in the system; and

(c) the auditor should find out from the client how the letter is to be used. The client should be informed of the need to obtain the auditor's express permission to issue the letter to any other party.

4.3 Letters of representation

Quick overview

The objectives of the auditor are:

- to obtain written representations from management and those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- to support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations if determined necessary by the auditor or required by other ISAs (UK); and
- to respond appropriately to written representations provided by management and those charged with governance, or to respond appropriately if management/those charged with governance do not provide the written representations requested by the auditor.

This section covers these responsibilities. Example letters of representation are available within the *Templates* ~~*and Letters* area of *Navigate Audit* as well as within the specialist audit areas~~. These example letters need to be tailored to the specific needs of the engagement.

Scope and definitions

Scope

ISA (UK) 580 *Written representations* (Updated May 2022) is applicable for periods commencing on or after 15 December 2019. The latest update includes some conforming amendments relating to the revision of ISA (UK) 315 (Revised July 2020). The ISA covers the need to gain written confirmation of management representations and includes:

- acknowledgement of management's responsibilities;
- representations as audit evidence; and
- the auditor's response where appropriate written representations cannot be obtained.

ISA (UK) 580:9 states that 'The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of thematters concerned.' The letter of representation is a form of audit evidence that can be used to confirm both specific points and also general matters. It is important as it will also serve to reinforce the directors' responsibilities for certain items within the financial statements and because it reduces the possibility of any misunderstanding.

Certain specific representations from management are required to be requested by the auditor. Other ISAs (UK) also require written representation to be obtained on specific matters as set out in Contents of a letter of representation.

Additional guidance on written representations can be found in the ICAEW's technical release 04/02 AAF, *Management Representation Letters: Explanatory Note*, issued in November 2002 and updated in March 2018. The aim of the guidance is to remind auditors of the need to consider the reliability of written representations as audit evidence. The Explanatory Note is considered in Requirement to obtain written representations.

Key definitions

Term	Definition
Written representation	A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

Source: ISA (UK) 580:7

Requirement to obtain written representations

Certain written representations are required by ISAs to be requested from management; in other cases, the auditor may seek written representations to confirm oral representations made by management during the course of the audit or in response to particular enquiries or in support of other audit evidence obtained by them.

References to 'management' in this context include references to those charged with governance as they havethe primary responsibility for the financial statements. In the case of UK companies, written representations required by ISAs will need to be obtained from the directors but the auditor may also seek representations on specific matters from other members of senior management.

Written representations must be obtained in the form of a representation letter addressed to the auditor and signed by one or more persons with the appropriate authority. Usual practice is therefore for the board of directors to discuss the contents of the letter before it approves the financial statements and for it to be signedon behalf of the board by, for example, the Chair. This ensures that all members are aware of the representations on which the auditor intends to rely in expressing their opinion on those financial statements. In these circumstances, it may be appropriate to ask the client to send a copy of the minutes of the board meetingwhere its contents were discussed and agreed.

Alternatively, the auditor may stipulate that all directors should sign it. For many smaller companies, where theyare unlikely to have formal minutes of meetings, this approach is the most favourable.

Layout of the letter

When drafting a letter of representation, the letter should be addressed to the auditors and typed on the client's letterhead. Where the client does not have its own letterhead, the auditor must ensure that all the details that must be contained on a valid company letterhead are included in the letter. This will include:

(a) the full registered name of the company;

(b) the company's registration number and the part of the UK in which the company is registered; and

(c) the company's full postal address, along with telephone and fax numbers.

Confirmation of understanding by the client

The auditor should discuss the contents with the directors prior to sending the letter for signature, in order to ensure that they understand what it is that they are being asked to confirm.

It was noted in the course of the hearing following the collapse of Barings that the Barings director who signedthe representation letter had little knowledge or understanding of Nick Leeson's activities, despite being nominally his boss. However, the director made written statements to the effect that there had been no irregularities involving management or having a material effect on the financial systems, and that the financialstatements were free of material errors and omissions.

Despite this, the director was not found to have been recklessly fraudulent, as it was not established that hesigned the representation letters:

(a) knowing that the statements in the letters were untrue, without an honest belief in their truth, or indifferentas to whether or not they were true; and

(b) knowing that he had no reasonable grounds for making the statements, without an honest belief that he hadsuch grounds, or indifferent as to whether he had or not.

As a result, the Audit and Assurance Faculty of the ICAEW issued AUDIT 4/02: *Management representation letters – Explanatory Note*. This guidance was updated in March 2018.

Directors' ability to make representations

The guidance refers to the application material in ISA (UK) 580 which points out that whilst directors would be expected to have knowledge of the process followed by the entity in preparing and presenting the financial statements, directors may wish to make enquiries of others and may also wish to include qualifying language such as 'to the best of our knowledge and belief'. It also notes that the auditor may request the directors to include in the representations, confirmation that they have made enquiries of others where appropriate.

The illustrative letter in ISA (UK) 580 includes the caveat 'to the best of our knowledge and belief' and a reference to having made enquiries. However, for clarity and in order to avoid giving the impression that use of phrases such as 'to the best of our knowledge and belief' may enable directors not to make proper enquiries, the ICAEW guidance suggests alternative wording along the following lines:

'We confirm that the above/following representations are made on the basis of enquiries of management andstaff with relevant knowledge and experience (and, where appropriate, of inspection of supporting documentation) sufficient to satisfy ourselves that we can properly make each of the above/following representations to you.'

The guidance also recommends that the auditor should ask signatories of the representation letter what steps they took to obtain comfort that a particular assertion had substance or suggest that individual members of management themselves provide specialist representations to the board. In this case, it may be useful for the directors' letter of representation to attach and refer to this specialist representation.

The auditor may also wish to remind directors and other client's staff that it is an offence under the *Companies Act* 2006, s. 501 to knowingly or recklessly make a misleading or false statement to the company's auditor. Similarly under the *Companies Act* 2006, s. 418 , the directors are required to confirm in the directors' report that they have taken all the steps they should have to make themselves aware of any relevant audit information.

Timing

The letter should be sent to the client when the financial statements are despatched for approval, and the client should date it on the day the financial statements are signed. ISA (UK) 580:14 requires the dateof the representation letter to be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The auditor may therefore need to send a new letter if there is a significant delay in signing the audit report. Alternatively, the auditor may obtain written confirmation that the representations made in the original letter remain valid.

It is common to see the representation letter dated after the audit report. This usually arises when the client has omitted to sign and return the representation letter with the signed financial statements, and the auditor has proceeded to sign the audit report without it. ISA (UK) 580 is clear that the auditor must obtain a signed copy of the representation letter prior to signing the audit report, as the auditor is not considered to have obtained sufficient audit evidence without it.

A draft of the letter should be sent to the client, with the letter of comment as explained in Reports to management. The draft should be sent before the final version and the directors given sufficient time to make any enquiries they feel necessary to satisfy themselves that therepresentations can be properly made. The auditor may discuss the representations with those responsible for providing the written confirmation before they sign it to reduce the possibility of misunderstanding.

Contents of a letter of representation

An example letter of representation for a private company audit is available in *Templates* ~~and Letters in Navigate Audit~~. The letter should be tailored to the circumstances of each client and should be used to ask the directors to:

(a) confirm that they have fulfilled their responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation(or a true and fair view), as set out in the terms of the audit engagement (ISA (UK) 580:10);

(b) confirm that the selection and application of the accounting policies used in the preparation of the financialstatements are appropriate (ISA (UK) 580:A10);

(c) confirm that they have made all the accounting records available to the auditor, and have provided the auditor with all relevant information and access as agreed in the terms of the audit engagement (ISA (UK) 580:11);

(d) confirm that all transactions have been included in those records and are reflected in the financial statements (ISA (UK) 580:11);

(e) confirm that all evidence requested relating to other information within the annual report has been provided to the auditors;

(f) confirm the company has satisfactory title to all assets and there are no liens or encumbrances on the assets,except for those disclosed in the financial statements (ISA (UK) 580:A10);

(g) confirm that the methods, significant assumptions and data used by them in making accounting estimates, and the related disclosures, are appropriate to achieve recognition, measurement or disclosure that is in accordance with the applicable financial reporting framework (ISA (UK) 540:37);

(h) confirm that they have no plans or intentions that may materially alter the carrying value and, where relevant,the fair value measurements or classification of assets and liabilities reflected in the financial statements (ISA (UK) 580:A10);

(i) confirm that the company has no liabilities or contingent liabilities other than those disclosed in the financial statements (ISA (UK) 580:A10);

(j) confirm that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been accounted for and disclosed in accordance with the applicablefinancial reporting framework (ISA (UK) 501:12);

(k) confirm that there are no events since the balance sheet date which require disclosure or adjustment in the financial statements, other than those already disclosed or adjusted (ISA (UK) 560:9);

(l)confirm that they have disclosed to the auditor the identity of all related parties and transactions that they areaware of and that all such transactions have been appropriately accounted for and disclosed in the financial statements (ISA (UK) 550:26);

(m) confirm that the company has complied with all aspects of contractual agreements that could have a materialeffect on the financial statements in the event of non-compliance(ISA (UK) 580:A10);

(n) confirm that there have been no possible or actual instances of non-compliance with significant laws and regulations, whose effects should be considered when preparing the financial statements, or – where there havebeen any instances of actual or possible non-compliance – that details have been disclosed (where necessary) together with the actual or contingent consequences which may arise therefrom (ISA (UK) 250A:17);

(o) acknowledge their responsibility for the design, implementation and maintenance of internal controls toprevent and detect fraud and that they believe they have appropriately fulfilled those responsibilities (ISA (UK) 240:40);

(p) confirm that they have disclosed to the auditor the results of their assessment of the risk that the financialstatements may be materially misstated as a result of fraud (ISA (UK) 240:40);

(q) confirm that they have disclosed to the auditor any deficiencies in internal control or that there have been none of which they are aware (ISA (UK) 580:A11);

(r)confirm that they have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving management, employees who have significant roles in internal control or others where the fraudcould have a material effect on the financial statements (ISA (UK) 240:40);

(s) confirm that they have disclosed to the auditor their knowledge of any allegations of fraud, or suspectedfraud, affecting the entity's financial statements communicated by employees, former employees, analysts,regulators or others (ISA (UK) 240:40);

(t)confirm their plans for future actions and thefeasibility of these plans (ISA (UK) 570:12-2);

(u) confirm that the effects of uncorrected misstatements are immaterial, both individually and in aggregate, to the financial statements as a whole. A summary of uncorrected misstatements must be included in or attached to the written representation (ISA (UK) 450:14); and

(v) confirm details in respect of any restatement to correct a material misstatement in prior period financialstatements that affects the comparative information (ISA (UK) 710:9);

(w) confirm any specific representations made during the course of the audit – typically, this will include such matters as the adequacy of any specific provisions for litigation and claims.

There are also a number of points which would usually be included in such a letter but are requirements ofCompany Law rather than the ISAs, e.g. details of directors' loan accounts and remuneration. This may be included within the letter or confirmed within separate letters to the individual directors concerned.

Although not specifically required by ISAs, it is common practise to also include a point confirming that all contractual commitments for capital expenditure have been disclosed in the financial statements.

ISA (UK) 580:11-1 also permits the inclusion of qualifying language to the effect that in respect of points(a), (c) and (d) above, the representations are made to the best of the directors' knowledge and belief. The use of such language does not invalidate the representation as long as the auditor has found no evidence that the representations are incorrect. In addition, in circumstances where the representations are being made by those distanced from the activities involved, e.g. the use of complex financial instruments, the auditor could suggest that the relevant member of management responsible provide specialised representations to the board.

In group situations, acknowledgement of the directors' responsibilities applies to the group financial statements as well as those of the parent undertaking.

Additional guidance on written representations is available in the ICAEW's technical release 04/02 AAF, *Management Representation Letters: Explanatory Note*, issued in November 2002 and updated in March 2018.

Accounting estimates

ISA (UK) 540:A145 also provides a list of written representations for specific accounting estimates which auditors may want to include in the letter. These are as follows:

- that the significant judgements made in making the accounting estimates have taken into account all relevant information of which management is aware;
- about the consistency and appropriateness in the selection or application of the methods, assumptions and data used by management in making the accounting estimates;
- that the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, when relevant to the accounting estimates and disclosures;
- that disclosures related to accounting estimates, including disclosures describing estimation uncertainty, are complete and are reasonable in the context of the applicable financial reporting framework;
- that appropriate specialised skills or expertise has been applied in making the accounting estimates;
- that no subsequent event requires adjustment to the accounting estimates and related disclosures included in the financial statements; and
- when accounting estimates are not recognised or disclosed in the financial statements, about the appropriateness of management's decision that the recognition or disclosure criteria of the applicable financial reporting framework have not been met.

Other issues

Other matters that should be considered when preparing a letter of representation are set out below.

(a) It is essential that a schedule is maintained during the audit, on which the auditor can and does record detailsof any specific representations made during the course of the audit and that these are included within the lettersent to the client for signature.

(b) The letter should be used to corroborate other evidence; it is not a substitute for audit work. Nor should it beused to confirm issues that the auditor has been able to verify through the audit work undertaken. Using the letter to confirm anything and everything can lessen the impact of some of the specific representations that theauditor wishes to rely on.

(c) The auditor must consider whether the representations are reasonable and whether they can be relied on. Inparticular, the auditor must consider whether there is anything that may indicate that the auditor cannot 'trust'what they have been told.

(d) If the representations are the only evidence available and relate to significant matters, the auditor shouldconsider whether specific reference is required in the audit report.

(e) Any contradictory representations should be investigated.

Representations by management as audit evidence

ISA (UK) 580 asserts that, although written representations provide necessary audit evidence, they support other audit evidence obtained and do not on their own provide sufficient appropriate audit evidence about any of the matters with which they deal. Where no other evidence is available, it could lead to a qualification to the auditor's report because of a limitation of scope.

This also applies to cases where there is a genuine limitation of scope and the auditor does not expect any other evidence to be available. For example, where the auditor is appointed after the end of the reporting period and is unable to find any means of verifying material quantities of stock, management representations could never be considered sufficient evidence on their own to support quantities.

There will, however, be instances when no supporting evidence is available and cannot reasonably be expected to be available, and where written confirmation of the representation, when taken into consideration with other information of which the auditor is aware, will constitute sufficient evidence. For example, when auditing a deferred tax provision, the auditor may need to accept representations about management's intentions in regard to future capital spending. Similarly, the classification of financial instruments may depend on management's intentions regarding the use of the instrument. In such cases, the auditor should ensure that nothing conflicts with the representations and that they are consistent with other evidence obtained during the course of the audit regarding management's plans and intentions.

Reliability of representations

If the auditor has concerns about the integrity, competence or diligence of those from whom representations are sought, they need to consider whether this affects the reliability of the written representations and their value as audit evidence.

Where there is an apparent contradiction between the representation and other audit evidence, the auditor should investigate the circumstances through discussions with management and other substantive procedures, and seek to resolve the difference.

Where the auditor concludes that representations are not reliable, they should consider the implications for the audit including the possible impact on the auditor's report. In particular, if the auditor concludes that the required representations regarding management's responsibilities are unreliable they should disclaim an opinion.

What if a client refuses to sign a letter of representation?

In the rare event that a client does not wish to sign the letter of representation, the auditor should take the steps set out below.

(a) The letter of engagement will usually contain a paragraph stipulating that the client may be asked to confirmrepresentations made in writing, which should be pointed out to the client.

(b) The auditor should explain the purpose of the letter and seek to settle the disagreement.

Where the client still refuses to sign a representation that the auditor considers necessary, ISA (UK) 580 makes clearthat this will impact on the audit report. The nature of the impact will depend on which representation(s) the directors refuse to sign. The auditor should also re-evaluate the integrity of management and consider the implications for the reliability of other representations and audit evidence in general.

If the directors refuse to sign any or all of representations (a), (c) and (d), in Contents of a letter of representation, or if there is sufficient doubt as to theintegrity of those signing the letter such that the representations are not reliable, then the auditor must issue adisclaimer of opinion, as these representations effectively underpin the audit as a whole.

In the case of the refusal of the directors to sign other representation points, this may constitute a limitation ofscope that requires an ‘except for’ audit qualification. In such circumstances, the auditor would evaluate any reliance placed on other representations made by management during the course of the audit and consider ifthe other implications of the refusal may have any additional effect on the audit report.

Further resources

An example letter of representation for a private company audit is available in *Templates* ~~*and Letters in Navigate Audit.*~~ Example letters are also available in the specialist audit areas, including *Charities*, *Pensions*, ~~*Clubs*~~ and *Academies*. The letter should be tailored to the circumstances of each client.

4.4 Drafting the audit report

Introduction

The purpose of this section is to look at the requirements of ISA (UK) 700 (Revised November 2019) (Updated January 2020) *Forming an opinion and reporting on financial statements,* ISA (UK) 705 *Modifications to the opinion in the independent auditor's report* and ISA (UK) 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*, and relevant FRC Bulletins, and the specific types of report that may be drafted. The final report should normally be drafted by the senior or manager on the assignment and then agreed by the audit principal.

ISA (UK) 700 (Revised November 2019) (Updated January 2020) *Forming an opinion and reporting on financial statements* was issued by the FRC in January 2020 and is applicable for periods commencing on or after 15 December 2019. The FRC has also issued example reports, the most recent being in its Bulletin dated March 2020: *Illustrative Auditor's Reports On United Kingdom Private Sector Financial Statements* . However, it only covers a limited number of scenarios and further examples have been provided by the Audit and Assurance Faculty of the ICAEW which has issued a number of helpsheets providing guidance on how the examples in the FRC's Bulletin may be modified to cater for entities other than companies and how the reporting principles of the standards may be adapted in other situations.

Further detailed guidance on reporting can be found in Audit reports and example audit reports can be found in *Templates and letters* , available on Navigate Audit.

As with all other ISAs (UK), ISA (UK) 700 applies to the conduct of any audit of financial statements. Paragraph 11 of ISA (UK) 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing (UK)* states that one of the objectives of an audit is to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The two phrases used to express the auditor's opinion, and which are equivalent terms, are 'give a true and fair view' and 'present fairly, in all material respects'.

Basic elements of the auditor's report

Contents of the auditor's report on financial statements

ISA (UK) 700 stipulates that the auditor's report should include the following matters:

(a) an appropriate title, usually using the term 'independent auditor' to distinguish the auditor's report from reports that might be issued by others, or from the reports of other auditors who may not have to comply withthe FRC Ethical Standards for Auditors identifying the person or persons to whom the report is addressed;

(b) details of the addressee(s) of the report;

(c) the auditor's opinion(s) on the financial statements (see Opinion);

(d) basis for the opinion (see Basis for opinion);

(e) a going concern paragraph (see Going concern);

(f) irregularities including fraud (included in the revised ISA (UK));

(g) (where applicable, i.e. for listed entities, public interest entities and other entities that are required, and thosethat choose voluntarily, to report on how they have applied the UK Corporate Governance Code) key audit matters together with the other matters required to be reported under ISA (UK) 701;

(h) the auditor's report on 'other information' in accordance with ISA (UK) 720;

(i) other matters on which the auditor is required to give an opinion (e.g. the strategic report and directors' report or separate corporate governance statement as applicable) (see Opinion on other matters);

(j) details of the auditor's responsibilities to report by exception on certain matters (see Reporting by exception);

(k) the responsibilities of those charged with governance (see Responsibility for the financial statements);

(l) the responsibilities of the auditor (see Auditor's responsibility);

(m)(entities reporting on compliance with the UK Corporate Governance Code) matters the auditor is required toreport on in relation to the Code and, where applicable, the Listing Rules;

(n) (PIEs only) additional matters the auditor is required to address;

(o) the name and signature of the auditor;

(p) the location of the office where the auditor is based; and

(q) the date of the auditor's report.

For entities that report on application of the Code or public interest entities, there are additional matters to bereported on.

Opinion

ISA (UK) 700 requires that the first section of the auditor's report should contain the auditor's opinionon the financial statements and have the heading 'Opinion'.

The opinion may be unmodified or modified. Modified opinions are considered in detail here.

The opinion required from the auditor will be dictated by the applicable reporting framework, including applicable legislation, and will be intended to provide the addressee of the report with reasonable assurancethat the financial statements are free from material misstatement.

The Opinion section of the auditor's report also:

(a) identifies the entity whose financial statements have been audited;

(b) states that the financial statements have been audited;

(c) identifies the title of each statement comprising the financial statements;

(d) refers to the notes, including the summary of significant accounting policies; and

(e) specifies the date of, or period covered by, each financial statement comprising the financial statements.

For UK companies, the *Companies Act* 2006, s. 495(3) requires the auditor to express an opinion as to whetherthe financial statements:

- give a true and fair view of the entity's financial position at the end of the reporting period and of its profit/loss for that period;
- have been properly prepared in accordance with the applicable reporting framework; and
- have been prepared in accordance with the requirements of the *Companies Act* 2006.

The auditor's opinion should indicate the financial reporting framework upon which the financial statements are based. For UK companies, this will normally be stated as:

- applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice);
- applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union; or
- (for consolidated financial statements of fully listed companies) applicable law and International FinancialReporting Standards (IFRSs) as adopted by the European Union and, as regards the consolidated financial statements, Article 4 of the IAS Regulation 1.

Where UK Accounting Standards have been applied, it is usual, in the interests of clarity, for the report to identify the applicable standard, e.g. 'the accounting framework that has been applied in their preparation isapplicable law and United Kingdom Accounting Standards, including [Financial Reporting Standard 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*]/[Financial Reporting Standard 101*Reduced Disclosure Framework*] (United Kingdom Generally Accepted Accounting Practice)'.

Basis for opinion

The ISA requires that the auditor's report includes a section directly following the Opinion section, with the heading 'Basis for Opinion', that:

(a) states that the audit was conducted in accordance with ISAs (UK) and applicable law;

(b) refers to the section of the auditor's report that describes the auditor's responsibilities under the ISAs (UK);

(c) includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. In the UK, this will refer to the Revised Ethical Standard 2016, applied as required for thetypes of entity determined to be appropriate in the circumstances.

(d) states whether the auditor believes that the audit evidence he has obtained is sufficient and appropriate toprovide a basis for the auditor's opinion.

Going concern

The ISA requires the auditor to report in accordance with ISA (UK) 570 (Revised September 2019) *Going Concern*. For most reports, this will require a section in the report entitled 'Conclusions relating to going concern' or other appropriate heading in which the auditor reports by exception regarding the assessment of the appropriateness of management's use of the going concern basis of accounting and whether there are material uncertainties in relation to going concern that should be disclosed in the financial statements. Where a material uncertainty exists and is adequately disclosed in the financial statements, this section of the report will instead be headed 'Material uncertainty in relation to going concern' and will draw attention to the disclosures in the financial statements relating to the uncertainty.

~~Further guidance on this section of the report can be found in Audit reports on Navigate Audit.~~

Irregularities including fraud

The revision to ISA (UK) 700 issued in November 2019 requires the auditor to explain to what extent the audit was considered capable of detecting irregularities, including fraud. This requirement may also be addressed in the 'Other matters the auditor is required to address' section of the auditor's report. The previous ISA (UK) included a similar requirement that was only applicable to PIEs.

The latest *Model Accounts* available from Croner-i include this paragraph.

Opinion on other matters

Under the *Companies Act* 2006, the auditor is required to report on the consistency of the information given in the directors' report and the strategic report with the financial statements. Under ISA (UK) 700, thismust be shown under a separate heading 'Report on other legal and regulatory requirements'.

Reporting by exception

If the auditor is required to report by exception, he should describe his responsibilities under the heading 'Matters on which we are required to report by exception' and include a suitable conclusion(s)in respect of such matters.

For UK companies, under the *Companies Act* 2006, the auditor is required to consider and report by exception if:

- in the light of the knowledge and understanding of the company and its environment obtained in the course of the audit the auditor has identified material misstatements in the strategic report or the directors' report; or

if in his opinion:

- adequate accounting records have not been kept by the company or returns adequate for the purposes of the audit have not been received from branches not visited by the auditor;
- the financial statements are not in agreement with the accounting records and returns;
- certain disclosures of directors' remuneration have not been made (that is the information required under theSmall Companies and Groups (Accounts and Directors' Report) Regulations 2008 or the Large and Medium-sizedCompanies and Groups (Accounts and Reports) Regulations 2008, as applicable); or
- he has not received all the information and explanations he requires for his audit.

Where a small company has prepared its accounts in accordance with the small companies regime or has taken advantage of either of the small companies' exemptions relating to the directors' report or the preparation of a strategic report, the auditor is required to report by exception if, in his opinion, the directors were not entitled todo so.

Responsibility for the financial statements

Those charged with governance are responsible for the preparation of financial statements that give atrue and fair view.

The auditor's report is required to include a section with a heading 'Responsibilities of Those Charged withGovernance for the Financial Statements' or something similar. In the case of companies, the heading mayinstead refer to 'directors'.

This section needs to describe the responsibility of those charged with governance for preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as theydetermine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and for assessing the entity's ability to continue as a going concernand whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of the responsibility of those charged with governance for this assessment should include a description of when the use of the going concern basis of accounting is appropriate.

The statement also needs to include that those charged with governance are responsible for the preparation offinancial statements that give a true and fair view.

This section of the report may also refer to a detailed director's responsibilities statement containing furtherdetail.

The following is illustrative wording of the directors' responsibilities:

'The directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparingthese financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and accounting estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departuresdisclosed and explained in the financial statements;[2]
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.[3]

[2] Large companies only

[3] If no separate statement on going concern is made by the directors

The directors are responsible for keeping adequate accounting records that are sufficient to show and explainthe company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the *Companies Act* 2006. Theyare also responsible for safeguarding the assets of the company and hence for taking reasonable steps for theprevention and detection of fraud and other irregularities.'

Auditor's responsibilities

The ISA (UK) includes detailed requirements of the content of the section headed 'Auditor's responsibilities for the audit of the financial statements' and this detail can be provided either:

(a) within the body of the auditor's report;

(b) within an appendix to the auditor's report, in which case a reference to the appendix must be given from within the audit report; or

(c) by cross referring to 'Description of the Auditor's Responsibilities for the Audit of the Financial Statements' that is maintained on the FRCs website (www.frc.org.uk/auditorsresponsibilities).

Given the required content of this section, option (c) is likely to prove popular in practice in order to limit the length and complexity of the audit report. The FRCs *Compendium* contains examples of each option.

Bannerman paragraph

This now famous case (held in the Scottish Court of Session) decided that it was possible that the auditor owed a duty of care to a creditor (in this case, the bank) if the auditor knew, or ought to have known, that the creditor would be relying on the accounts. In practice, this simply clarified what had previously been inferred.

However, as a result, the ICAEW Audit and Assurance Faculty issued guidance that recommended that a suitably worded disclaimer paragraph be included in the audit report. This is Audit Technical Release 1/03 *The Audit Report and Auditors' Duty of Care to Third Parties*, which was updated to Audit 1/03 in May 2018. The most up- to-date wording of the Bannerman paragraph is available from the ICAEW website. Current guidance suggests that the paragraph be included at the end of the report, immediately before the signature, under a heading 'Useof our report'.

As this disclaimer was issued by the Audit and Assurance Faculty, and not by the FRC, it is not included in any ofthe example reports given in FRCs *Compendium*. All ICAEW firms are recommended to add the disclaimer to themodel reports. It should be noted however that the ACCA strongly suggests that its member firms should not include such disclaimers in their audit reports.

Modified opinions

ISAs use the word 'modified' to describe an audit report where the opinion section has been changed.Note that this does not include an emphasis of matter paragraph (see Date and signature of the auditor's report). There are three types of modified opinion that the auditor may give:

(a) Qualified opinion – this is an 'except for' type of opinion where there is a limitation on the scope of the auditors' examination **or** the auditors disagree with the treatment or disclosure of a matter in the financial statements. In either case, the matter is material but not pervasive, and is generally confined to a specific issueor area of the accounts;

(b) Adverse opinion – here, the auditor disagrees about a matter that is both material and pervasive, such thatthe accounts are no longer considered to give a true and fair view;

(c) Disclaimer of opinion – here, the scale of the limitation on the scope of the audit is so great and pervasive thatthe auditor is unable to give an opinion.

~~More detailed guidance on these scenarios is given in Audit reports available on Navigate Audit.~~

Emphasis of matter paragraphs

In certain circumstances, the auditor may consider it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements. This is done by adding an Emphasis of Matter paragraph to the audit report to highlight the matter and ISA (UK) 706 provides further guidance.

Typical examples given in paragraph A5 of ISA (UK) 706 are:

- an uncertainty relating to the future outcome of exceptional litigation or regulatory action;
- a subsequent event occurring between the date of the financial statements and the date of the auditor's report;
- early application (where permitted) of a new accounting standard (e.g. a new International Financial Reporting Standard) that has a material effect on the financial statements in advance of its effective date.

- a major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

The addition of such a paragraph does **not** affect the auditor's opinion and does not constitute a modified opinion (see Modified opinions). The paragraph should be included in a separate paragraph, using a heading such as 'Emphasis of matter' and would ordinarily refer to the fact that the auditor's opinion is not modified in this respect.

Other matter paragraphs

Where the auditor considers that a matter other than those presented or disclosed in the financial statements is relevant to the user's understanding of the audit, and that it is necessary to communicateit, then ISA (UK) 706 requires that this be done by the inclusion of a paragraph in the auditor's report setting out details of the matter. The information should be included in a separate section under the heading Other Matter or another appropriate heading.

Compliance with relevant accounting requirements

Companies Act 2006, s. 396 requires financial statements to give a true and fair view. Whilst neither SI 2008/409 nor SI 2008/410 specifically state that accounting standards should be followed, paragraph 45 to Schedule 1 of SI 2008/410 requires medium and large companies to:

(a) state whether the accounts have been prepared in accordance with applicable accounting standards; and

(b) disclose particulars of any material departures from applicable accounting standards, together with the reasons for the departure.

Therefore, in order for financial statements to meet the requirements of these Statutory Instruments, they should follow rather than depart from ISAs, and any departure will be regarded as sufficiently abnormal torequire justification.

Departure from an ISA would therefore, where material, result in a modified audit report, unless the departurecan be and is justified.

Date and signature of the auditor's report

Dating the audit report

The auditor should not date the report earlier than the date on which all other information contained in a report of which the audited financial statements form a part have been approved by the directors,and the auditor has considered all necessary available evidence.

The auditor is not in a position to form the opinion until the financial statements (and any other information contained in a report of which the audited financial statements form a part) have been approved by the directors, and the auditor has completed the assessment of all the evidence the auditor considers necessary forthe opinion or opinions to be given in the auditor's report. This assessment includes events occurring up to the date the opinion is expressed. The auditor therefore plans the conduct of audits to take account of the need to ensure, before expressing an opinion on financial statements, that those charged with governance have approved the financial statements and any accompanying financial information and that the auditor has completed a sufficient review of post-balance sheet events.

The date of an auditor's report on a reporting entity's financial statements is the date on which the auditor signed the report expressing an opinion on those statements (ISA (UK) 700.49-1).

The date of the auditors' report is, therefore, the date on which, following:

(a) receipt of the financial statements and accompanying documents in the form approved by the directors forrelease;

(b) review of all documents which they are required to consider in addition to the financial statements (for example, the directors' report, chairman's statement or other review of an entity's affairs which will accompanythe financial statements); and

(c) completion of all procedures necessary to form an opinion on the financial statements (and any other opinions required by law or regulation), including a review of post balance sheet events,

the auditors signed (in manuscript) their report expressing an opinion on the financial statements for distribution with those statements.

If the date on which the auditors sign their report is later than that on which the directors approved the financialstatements, the auditors should take such steps as are appropriate:

- to obtain assurance that the directors would have approved the financial statements on that later date (for example, by obtaining confirmation from specified individual members of the board to whom authority has beendelegated for this purpose); and
- to ensure that their procedures for reviewing subsequent events cover the period up to that date.

Signing the audit report

The audit report must be signed by the 'Senior Statutory Auditor', in the individual's own personal name rather than the firm's name, for and on behalf of the firm. The firm should also be described as a'statutory auditor' and not a 'registered auditor'.

This change was incorporated into the Audit Regulations in 2008, but the scope of this requirement is not extended beyond that of the *Companies Act* 2006. Audit reports of entities outside the scope of the *CompaniesAct* 2006 (such as charitable trusts) will therefore continue to be signed in the name of the firm.

Other information in documents containing audited financial statements

It is sometimes the case that an entity's annual report contains information other than the audited financial statements. This is commonly found with listed companies and some charities, but can alsooccur with private companies – for example, the inclusion of a Chairman's Report.

Whilst the auditor has no obligation to report on such information, the auditor should still read it to identify any material inconsistencies with the audited financial statements – in which case, the auditor should seek to resolvethem.

ISA (UK) 720 *The auditor's responsibilities relating to other information* states that the objectives of the auditor,having read the other information, are to:

• consider whether there is a material inconsistency between the other information and the financial statements;

• consider whether there is a material inconsistency between the other information and his knowledge gained during the course of performing the audit;

- respond appropriately where he believes such inconsistencies exist or where he becomes aware that other information appears to be materially misstated;
- report in accordance with the ISA (UK); and
- form an opinion on whether the other information is consistent with the financial statements and the auditor's knowledge and report in accordance with applicable legal and regulatory requirements.

Except in respect of his responsibilities in respect of statutory other information, the auditor is not expressingassurance on the other information and is not required to obtain audit evidence beyond that which would berequired to form an opinion on the financial statements.

~~The Audit reports area of Navigate Audit provides further detailed guidance and examples.~~

4.5 Reviewing the file

Quick overview

This section explains the review procedures when performing an audit engagement.

Scope and definitions

Scope

Reviewing the audit file

ISA (UK) 220 (Revised July 2021) *Quality management for an audit of financial statements* is effective for the audit of financial statements for periods commencing on or after 15 December 2022, although early adoption is strongly encouraged. ISA (UK) 220 (Revised July 2021) replaces ISA (UK) 220 (Revised November 2019) *Quality Control for an Audit of Financial Statements*. This section is based on the requirements of ISA (UK) 220 (Revised July 2021) and, unless specifically noted, the previous ISA (UK) is not considered here.

ISA (UK) 220 deals with the specific responsibilities of the auditor regarding quality management at the engagement level for an audit of financial statements. The engagement partner is therefore ultimately responsible for compliance with ISA (UK) 220. Managing and achieving quality on an audit engagement will be achieved through the documentation of the design or performance of procedures, tasks or actions undertaken as part of the audit. The review of the audit file will form part of this process.

Additionally, where an engagement quality review (EQR) is required under ISQM (UK) 2 *Engagement quality reviews (July 2021)*, the engagement partner will also need to discuss significant matters and significant judgements arising during the audit engagement, including those identified during the EQR, with the engagement quality reviewer. EQR is dealt with in Engagement quality reviews.

Engagement quality management and audit compliance

Under current Audit Regulations, each Recognised Supervisory Body (RSB) must ensure its members have an adequate system of quality management.

Guidance on quality management is set out in ISQM (UK) 1 Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements (July 2021), which should be read in conjunction with ISA (UK) 220 in so far as compliance with ISQM (UK) 1 requires that file reviews are undertaken to ensure quality management for engagements is adequately and appropriately carried out and documented.

Guidance on ISQM (UK) 1 and ISQM (UK) 2 is available in Audit quality and compliance as well as additional guidance in Engagement quality reviews.

Key definitions

Term	**Definition**
Engagement partner	The partner or other individual, appointed by the firm, who is responsible for the audit engagement and its performance and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate

authority from a professional, legal or regulatory body. For an audit of financial statements, the engagement partner is a key audit partner.

Engagement quality review

An objective evaluation of the significant judgements made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed on or before the date of the engagement report.

Engagement quality reviewer

A partner, other individual in the firm, or an external individual, appointed by the firm to perform the engagement quality review.

Engagement team

All partners and staff performing the audit engagement, and any other individuals who perform audit procedures on the engagement, excluding an auditor's external expert and internal auditors who provide direct assistance on an engagement.

Firm

A sole practitioner, partnership or corporation or other entity of professional accountants, or public sector equivalent.

Network firm

A firm or entity that belongs to the firm's network.

Network

A larger structure:

(i) that is aimed at cooperation; and

(ii) that is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality management policies or procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

Partner

Any individual with authority to bind the firm with respect to the performance of a professional services engagement.

Personnel

Partners and staff of the firm.

Professional standards

International Standards on Auditing (UK) (ISAs (UK)) and relevant ethical requirements.

Relevant ethical requirements

Principles of professional ethics and ethical requirements that are applicable to professional accountants when undertaking the audit engagement. Relevant ethical requirements ordinarily comprise the provisions of the International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) related to audits of financial statements, together with national requirements that are more restrictive.

Auditors in the UK are subject to ethical requirements from two sources: the FRC's Ethical Standard concerning the integrity, objectivity and independence of the auditor, and the ethical pronouncements established by the auditor's relevant professional body.

Response (in relation to a system of quality management)	Policies or procedures designed and implemented by the firm to address one or more quality risk(s): (i) policies are statements of what should, or should not, be done to address a quality risk(s). Such statements may be documented, explicitly stated in communications or implied through actions and decisions; and (ii) procedures are actions to implement policies.
Staff	Professionals, other than partners, including any experts the firm employs.

Source: ISA (UK) 220

The definitions in this table are taken from ISA (UK) 220 (Revised July 2021) , which is effective for audits of financial statements for periods beginning on or after 15 December 2022. The definitions relevant to the previous version of ISA can be found in ISA (UK) 220 (Revised November 2019).

Responsibilities of the engagement partner

Audit regulations require that all audit work be reviewed except that of the responsible individual.

ISA (UK) 220:13 states that the engagement partner shall take overall responsibility for managing and achieving quality on the audit engagement. In doing so, the engagement partner shall be sufficiently and appropriately involved throughout the audit engagement such that the engagement partner ensures the basis for determining whether the significant judgements made, and the conclusions reached, are appropriate given the nature and circumstances of the engagement.

The engagement partner takes responsibility for the direction and supervision of the members of the engagement team and the review of their work. As part of this responsibility, the engagement partner should determine that the nature, timing and extent of direction, supervision and review is:

(a) planned and performed in accordance with the firm’s policies or procedures, professional standards and applicable legal and regulatory requirements; and

(b) responsive to the nature and circumstances of the audit engagement and the resources assigned or made available to the engagement team by the firm.

The latter point is a key consideration. Under the ISA, the engagement partner takes ultimate responsibility for ensuring that the engagement team has sufficient skills, knowledge and experience to complete the assignment, including commissioning external assistance from auditor’s experts as necessary. In situations where the firm or team experiences resourcing issues or delays, communications must be carefully managed with TCWG and management at the client and the partner must ensure that the overall quality of the engagement remains the key consideration. Regulators will typically not factor in resourcing or other related issues into their review of the engagement and therefore practitioners must be willing to have potentially challenging conversations with clients in the event that delays are required. Similarly, where the client is unable to facilitate provision of working papers or availability of staff to assist with the audit, practitioners should think carefully about whether to proceed or reschedule in order to ensure compliance with the ISA.

In addition, for those engagements that require an engagement quality review (EQR), ISA (UK) 220:36 places additional requirements on the engagement partner. These are covered in Engagement quality reviews.

Insight – The relationship between ISA (UK) 220 and ISQM (UK) 1 & 2

This section focuses on quality management within the context of an individual engagement. This is governed by ISA (UK) 220. Quality management at the firm level is governed principally by ISQM (UK) 1, with ISQM (UK) 2 covering engagement quality reviews. Individual firm approaches to quality management in response to the ISQMs may require actions by engagement teams at the audit file level but individual files will be assessed by regulators with reference to ISA (UK) 220 and as such practitioners should be familiar with both standards. ~~More detail on the ISQM framework can be found in Audit Quality & Compliance in *Navigate Audit*.~~ ISA (UK) 220 also includes the responsibility for partners to ensure that information flowing from the Firm's internal quality management processes is filtered down to teams via regular meetings and the review process.

Review objectives

When reviewing the file, other considerations, not directly related to the audit opinion, need to be taken into account, such as 'were the correct staff used on the job?'. The review can also be used to provide training for staff through positive feedback.

With the exception of the training aspects of the file review, the review objectives fall into two broad categories:

(1) ensuring that work on the file is satisfactory; and

(2) identifying what documentation, if any, is missing from the file.

Insight – FRC AQR key findings

The Financial Reporting Council (FRC) issued a report of key findings following the 2020/21 inspection cycle of private sector audits conducted by the seven largest audit firms. The findings identified a number of shortcomings in audits which highlight the particular importance of ongoing audit file reviews to ensure that audit procedures are fit for purpose in order to obtain sufficient, appropriate evidence on which to base the audit opinion.

Review procedures

To ensure the efficiency and effectiveness of the review, the review of work performed as well as the review of the final audit file needs to be systematic. The results of the review may mean that areas are identified where further work is required.

A review of an audit file should ensure:

- the work has been performed in accordance with the audit programme;
- the work performed and the results obtained are adequately documented;
- any significant audit matters have been resolved and are reflected in audit conclusions;
- consultation has taken place wherever necessary and with an appropriate individual;
- the objectives of the audit procedures have been achieved;
- an independent review has been undertaken where required;
- the conclusions expressed are consistent with the results of the work performed and support the audit opinion; and

- any threats to the firm's independence or objectivity were identified and remedial action taken.

The auditor should also consider the following:

- the file should be considered as a whole such that, when looking at one area within the file, the auditor needs to be aware of and consider whether this is consistent with other information;
- the auditor should work systematically, to improve both efficiency and effectiveness of the review;
- if something is identified which indicates a potential problem in another area of the file, the issue should be investigated;
- the extent of the file review that needs to be carried out will depend upon the structure of the file and any previous reviews that others have carried out (see the Review pyramid section); and
- the review objectives can only be achieved if proper planning of the work precedes the review.

Insight – Issues identified

Where a file review identifies issues on an audit file, then the reviewer must raise 'review points' for the audit team to action. The audit team should then action these points within the audit file and the reviewer 'clear' their review point once actioned. When all the review points have been dealt with, the review point schedule can be removed from the file.

In addition, points may have been noted that require alternative action to be taken in future years. In practice, this should be achieved by noting the issues on a 'points forward' schedule which would be reviewed at the planning stage of the following year's audit and the necessary amendments to the approach and the staffing of the job should be made.

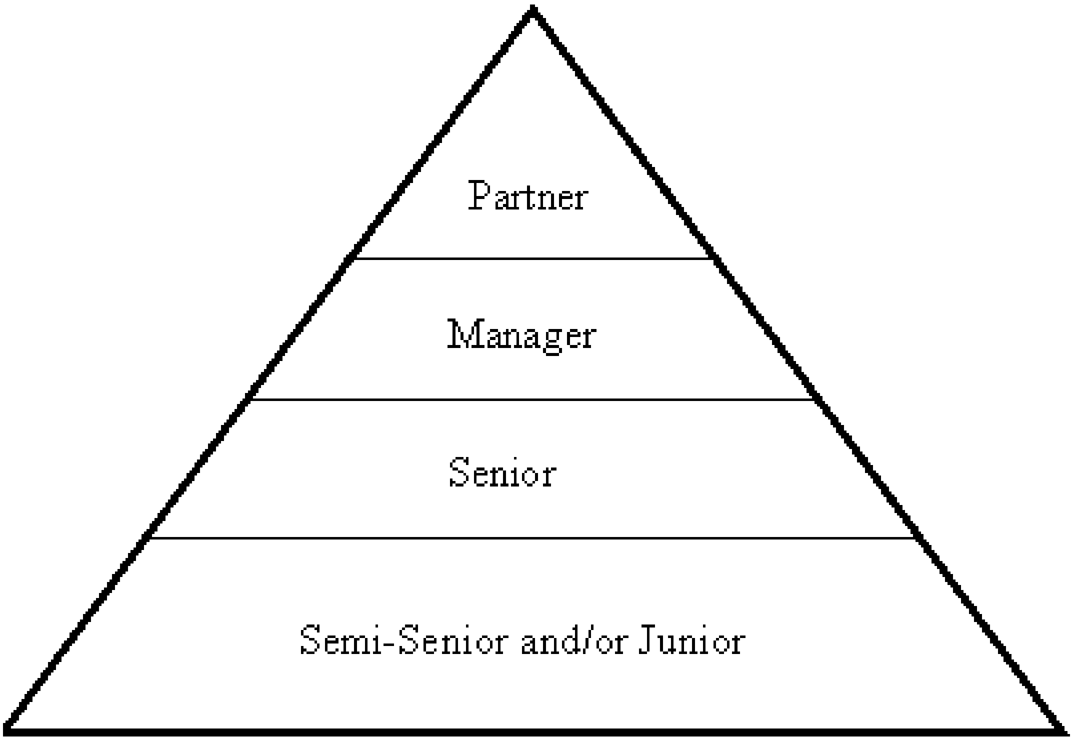
In the ~~*Navigate*~~ *Audit* tools, schedules are available for both review points and points forward.

For audit engagements for which an engagement quality review (EQR) is required, the engagement partner has additional responsibilities as set out in the Engagement quality reviews section.

The review pyramid

When establishing the review procedures in any firm, it is essential that the firm creates clearly defined levels of responsibility. A firm's structure might typically define levels such as manager, senior and junior, but more important than the job title, from a control point of view, is the fact that each assistanton an assignment understands their role precisely, including review responsibilities. In addition, members of staff should also appreciate the role of their peers. The task is more likely to be completed effectively if audit staff members can look at their own role from the position of the reviewer on the next level of the review pyramid.

The review procedure can be considered as a pyramid. In firms with a formal structure, the pyramid might looklike this:



Each level in the hierarchy is responsible for reviewing the work done by the lower level. In this way, someone else reviews all work other than original partner work.

Under the Audit Regulations, thepartner must be a responsible individual (RI) – that is, someone authorised to sign audit reports. Any work performed by a non-RI partner would need to be reviewed by an RI. An RI can be an employee of the practice and therefore their work would not need to be reviewed by the partner. Note that when signing company audit reports, the RI is given the designation 'Senior Statutory Auditor'.

Review by seniors of work performed by juniors

In the structure illustrated in the pyramid, the junior or semi-senior will do most of the basic audit work. In documenting the nature, timing and extent of audit procedures performed, each auditor should record:

- the identifying characteristics of the specific items or matters tested;
- who performed the audit work; and
- the date such work was completed.

The senior should review the work performed by the junior and document the review, for example, by initialling at the top of each page or section reviewed.

The senior is most likely the person who will complete the main completion sections on the file and present the file to the manager for a detailed review. Specific points for further review by the manager should be recorded on a summary schedule which includes space for the manager or partner's subsequent comments.

In the ~~*Navigate*~~ *Audit* tools, section B contains file completion schedules.

Review by manager

Depending on the firm's structure and staff experience, if there is no senior to review the work of the junior, then the manager will be the person to review the junior's work and document this review. The manager will then pull the job together, including completing the detailed completion section of the file for the partner's review.

Where there is a senior who has reviewed the work of a junior then, in this case, the manager should review the work of the senior and record who reviewed the audit work performed and the date and extent of such review before preparing the file for the partner's review.

ISA (UK) 230:A13 provides guidance as to the depth of the audit file review and notes that the requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement simply means documenting what audit work was reviewed, who reviewed such work and when it was reviewed.

Insight – Completion memorandum

Auditors may find it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that:

(1) describes the significant matters identified during the audit and how they were addressed or;

(2) includes cross-references to other relevant supporting audit documentation that provides such information.

Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits.

The preparation of such a summary may also assist the auditor's consideration of the significant matters and may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant ISA (UK) objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Review by partner

Provided there is an ***effective*** manager review then the partner will concentrate their review on specific areas of the file. This may include reviewing areas of judgement, significant risk areas, the financial statements and the completion section of the file. The partner would not need to delve into the detail of the file unless triggered to do so by the completion section prepared by the manager.

The word 'effective' is highlighted since this approach indicates that the partner is putting an extremely high level of reliance on the manager. This approach will also only operate where the manager is independent from the detailed work. If the manager produced any schedules, then these too would need to be reviewed by the partner.

The partner should not automatically assume that any manager review will be effective. The firm will need some form of quality control system to verify this. This can be achieved, for example, either by the partner occasionally re-performing the manager review or by the review being examined under a system of 'cold' file review, either by other members of the firm or by an outside third party.

Many firms will operate without the manager position. A senior and a junior will work on the audit file and report directly to the partner. In this situation, or in a situation where the partner cannot rely on the manager review to be effective, the partner has to carry out not only the partner review, but a manager review as well. The partner will therefore be involved in looking at each of the detailed schedules on the file, other than the junior's schedules, which have been reviewed by the senior (unless referred to such a schedule by the senior following a review point).

Specific ISA requirements

ISA (UK) 220:31 specifically requires the engagement partner to review audit documentation at appropriate points in time during the audit engagement, including documentation relating to:

(a) significant matters;

(b) significant judgements, including those relating to difficult or contentious matters identified during the audit engagement, and the conclusions reached; and

(c) other matters that, in the engagement partner's professional judgement, are relevant to the their responsibilities.

Insight – FRC AQR key findings

The Financial Reporting Council (FRC) report of key findings following the 2020/21 inspection cycle of private sector audits conducted by the seven largest audit firms identified a number of shortcomings in audits, three of which were:

- insufficient evidence obtained to conclude on certain issues;
- inadequate audit procedures to ensure sufficient, appropriate evidence obtained; and
- a lack of challenge of management in particular areas.

These findings highlight the particular importance of ongoing audit file reviews to ensure that audit procedures are fit for purpose in order to obtain sufficient, appropriate evidence on which to base the audit opinion.

On or before the date of the auditor's report, the engagement partner shall determine, through review of audit documentation and discussion with the engagement team, that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

Prior to dating the auditor's report, the engagement partner shall also review the financial statements and the auditor's report, including, if applicable, the description of the key audit matters and related audit documentation, to determine that the report to be issued will be appropriate in the circumstances.

The engagement partner shall also review, prior to their issuance, formal written communications to management, those charged with governance or regulatory authorities.

ISA (UK) 220: A90-A97 sets out in detail a number of steps for the engagement partner review of the audit file. These are summarised as follows:

- timely review of documentation at appropriate stages;
- exercising professional judgement in identifying areas of significant judgement made by the engagement team;
- exercising professional judgement in determining other matters to review;
- the nature, timing and extent of the direction, supervision and review are required to be planned and performed in accordance with the firm's policies or procedures, as well as professional standards and applicable legal and regulatory requirements;
- the approach to direction, supervision and review may be tailored depending on a number of factors;

- identification of changes in the engagement circumstances may warrant re-evaluation of the planned approach to the nature, timing or extent of direction, supervision or review; and
- the engagement partner is required to determine that the approach to direction, supervision and review is responsive to the nature and circumstances of the audit engagement.

Example – review responsive to the circumstances of the engagement

If a more experienced engagement team member becomes unavailable to carry out their planned supervision and review of the engagement team, the engagement partner may need to increase the extent of their own supervision and review of the less experienced engagement team members.

Engagement quality reviews (EQR)

For certain engagements an engagement quality review (EQR) is required, previously known as an engagement quality control review (EQCR). This is required by ISQM (UK) 1:34(f) for:

- audits of financial statements of listed entities;
- audits or other engagements for which an EQR is required by law or regulation;
- audits or other engagements for which the firm determines that an EQR is an appropriate response to address one or more quality risk(s);
- audits of financial statements of public interest entities;
- public reporting engagements carried out in accordance with the Standards of Investment Reporting; and
- engagements for which an EQR is required by the FRC's *Providing Assurance on Client Assets to the Financial Conduct Authority* standard (Revised November 2019).

Where an EQR is required, the engagement partner needs to:

- determine that an engagement quality reviewer has been appointed;
- cooperate with the engagement quality reviewer and inform other members of the engagement team of their responsibility to do so;
- discuss significant matters and significant judgements arising during the audit engagement, including those identified during the EQR, with the engagement quality reviewer; and
- not date the auditor's report until the completion of the EQR.

Whilst not all firms will have listed clients, many more firms will need to perform such a review on public interest entities or those clients meeting the firm's other criteria for a review. Firms should therefore:

- set out criteria, including the requirements of ISQM (UK) 1, against which all audits should be evaluated to determine whether a review should be performed;
- review all clients against these criteria to determine whether any will require an EQR; and
- ensure that planning on the relevant audits recognises that a review will be required.

Even if a review is not required, firms may find it helpful to involve a second partner in reviewing the file and their firm policies may set additional criteria for the involvement of a second partner whilst the involvement of a second reviewer may not be mandatory under legislation or standards, best practice is still for Firms to engage with the process. Second reviews may provide useful insights by enabling RIs to observe each other's work and can provide additional assurance on riskier engagements. For further information, please see the *Spotlight: Have you got your sights set on ISQM (UK) 2?*

If an EQR is to be undertaken, this will involve allocating time at the end of the audit to carry out the review and to deal with any points that arise. This is particularly the case if the review is to be carried out externally.

Further guidance on Engagement Quality Reviews is available in Audit Quality and Compliance and in ISQM (UK) 2. The guidance covers the:

- overview and scope of ISQM (UK) 2;
- appointment and eligibility of engagement quality reviewers under ISQM (UK) 2;
- performance of the engagement quality review under ISQM (UK) 2; and
- documentation of engagement quality reviews under ISQM (UK) 2.

The ~~*Navigate*~~ *Audit* tools contain a specific **Engagement Quality Review / Second Review section** (A5) where the EQR can evidence and document their review. The EQR can also sign off on **Approval of planning** (~~C1~~). Best practice is also to ensure the EQR attends the engagement team planning meeting, or at the very least reviews the minutes. Attendance or confirmation of review of the minutes can be documented at **Notes of engagement team planning meeting** (*template* C10).

Matters arising after the date of the auditor's report

ISA (UK) 230:13 and A20 point out that if, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, then the auditor should document:

(a) the circumstances encountered;

(b) the new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and

(c) when and by whom the resulting changes to audit documentation were made and reviewed.

These exceptional circumstances could, for example, include facts which come to light after the date of the auditor's report but which existed at that date and which, if known, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report.

Changes to the senior statutory auditor

Where the senior statutory auditor for some reason is unable to be present to sign the audit report, the implications of this need to be considered.

Bulletin 2008/6 *The 'Senior Statutory Auditor' under the United Kingdom Companies Act 2006* says that, under *Companies Act* 2006, s. 503(3) , the senior statutory auditor must sign the audit report. Another partner, or responsible individual, is not able to sign for and on behalf of the senior statutory auditor.

If the senior statutory auditor is unable to continue taking responsibility for the direction, supervision and performance of the audit, then the audit firm must appoint a replacement senior statutory auditor. The new senior statutory auditor must review the audit work performed to the date of the change. The review procedures must be sufficient to satisfy the new senior statutory auditor that the audit work performed to the date of the review has been planned and performed in accordance with professional standards and regulatory and legal requirements.

Where there is a change of senior statutory auditor towards the end of the audit, this will necessarily require an extensive review, which will be time consuming and increase costs.

4.6 Final completion and planning for the next year

Quick overview

This section relates to section A in the Private Company (PCAS) based audit tools.

Scope and definitions

Scope

ISA (UK) 230 (Revised June 2016) (Updated May 2022) *Audit documentation* is effective for audits of financial statements for periods commencing on or after 15 December 2019.

International Standard on Quality Management (ISQM) (UK) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services* requires systems of quality management to be designed and implemented by 15 December 2022 with the evaluation of those systems within the following year.

ISA (UK) 230 sets out, among other things, the requirements for assembly of the final audit file as well as confidentiality, safe custody and retention of audit documentation. These areas are covered in this section. ~~Further guidance on other aspects of ISA (UK) 230 are provided in the section on Documentation.~~

ISQM (UK) 1:60-1 requires audit firms to establish policies and procedures that require retention of audit documentation for a period that is not less than any period necessary to satisfy the requirements of any applicable laws or regulation relating to data protection and to meet the requirements for any applicable administrative and judicial proceedings, and that is in any case not less than six years from the date of the auditor's report. ~~ISQM (UK) 1 is covered in Audit quality and compliance.~~

Other ISAs contain documentation requirements and application material relating to specific aspects of the audit. ~~These are covered in the sections of this guide dealing with the relevant topics and are summarised in Other specific documentation requirements.~~

Key definitions

Term	**Definition**
Audit documentation	The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as 'working papers' or 'workpapers' are also sometimes used).
Audit file	One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

Source: ISA (UK) 230:6

Final completion

Once the file has been fully reviewed, the partner should ensure that it goes back to the staff and that they are given sufficient time to clear all the review points. When the file is returned after this review,the partner should make sure that the points have been cleared satisfactorily, at which point the financial statements can be sent to the client for signature.

Guidance on getting the file ready for review is in Preparing the file for review and guidance on reviewing is in Reviewing the file.

When the financial statements come back from the client, having been signed, the auditor needs to consider whether thefollowing questions have been addressed:

(a) Have all outstanding items been adequately dealt with?

(b) Has a signed letter of representation been received?

(c) Where the letter has been received and has only been signed by one director on behalf of the board, has a minute been seen agreeing its contents?

(d) Has adequate consideration been given to whether the directors' representations can be relied upon?

(e) Is the audit opinion reasonable?

(f) Has a letter of comment been prepared?

(g) Has the subsequent events review been updated when necessary?

(h) Do the financial statements comply with all of the legislative requirements and have only those exemptions that areavailable to the entity been taken? Do the financial statements agree with the file?

Once all of the above questions have been answered to the partner's satisfaction, the audit report can be signed and the file closed down and stored in accordance with the firm's procedures.

Insight – Example documentation

~~Example completed schedules are available in the PCAS Model File including a Final completion and closedown schedule.~~

The Final completion and closedown schedule (A1) is available to document any matters arising between the issue of the financial statements to the client for approval and the signing of the audit report.

Where considered necessary or where required by the firm's procedures, an independent partner should review the file and complete the relevant clearance section on this schedule. The firm's procedures made under ISQM (UK) 1 (July 2021) should specify clients where such a review is required and A1 includes provision for sign-off by the second partner where appropriate.

In the case of a sole practitioner seeking consultation with another practitioner or other external agency, it would be appropriate for the other practitioner to complete that section although the audit firm would retain the ultimate responsibility.

Audit Automation provides the ability to scan documents directly into the audit file. Hence, any document that you would have obtained and photocopied to place on the file can be scanned. It is also possible to maintain a paper file of such documents and cross reference them from the on screen programmes and working papers if ascanner is not available. However, it is recommended that you scan documents wherever possible as cross references to documents stored within the system form hyperlinks that when selected result in the document being opened. This makes review of the file much easier. It also means that all documents are stored in a format that is regularly backed up and can be electronically transferred from one location to another.

File close down

ISAs (UK) set out the procedures for closing down audit files on completion of the audit report. The most relevant is ISA (UK) 230. ISQM (UK) 1 and the Audit Regulations also contain requirements and policies regarding ownership, custody and confidentiality of working papers.

Assembly of the final audit file

ISA (UK) 230:14 requires the auditor to assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis. For statutory UK audits this should be no later than 60 days from the date of the auditor's report.

Firms may however set a shorter timescale, for example some firms have a policy of 45 days, or even 15 days for this administrative process to be completed. A shorter period is perfectly acceptable, but the firm should ensureit is achievable within their own workflow so as not to lead to criticism that their own polices are not complied with.

The auditor is required to retain audit documentation and any other data and documents that are important for monitoring compliance with ISAs (UK)and other applicable legal requirements. This includes, during the retention period, being able to:

- retrieve and access the engagement documentation, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time;
- provide, where necessary, a record of changes made to engagement documentation after the engagement files have been completed; and
- enable authorised external parties to access and review specific engagement documentation for quality controlor other purposes.

What does this involve?

Assembly of the final audit file after the date of the auditor's report is an administrative process. It should not involve performing any further audit work or the drawing of new conclusions. The application guidance in ISA (UK) 230 does clarify, however, that changes may be made to the audit documentation during the final assembly process if they are administrative in nature.

Insight: Changes that can be made after the audit report has been signed

The following are examples of changes that can be made to the audit file after the audit report has been signed:

- deleting or discarding superseded documentation;
- sorting, collating and cross-referencing working papers;
- signing off on completion checklists relating to the file assembly process; and
- documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

Other audit documentation must not be deleted or discarded before the end of the retention period.

Where evidence is held electronically, audit firms should ensure that they retain at least one version of any, otherwise superseded, information technology applications required to access old audit documentation. This may include both proprietary word-processing or spreadsheet tools which may have been upgraded, or any internally developed audit tools which have become obsolete or have been replaced or revised. The ability to retrieve working papers and other documentation is also an issue if documentation was originally prepared onpaper and has later been scanned for storage.

It is important that the auditor has procedures in place to ensure that the integrity of data is maintained when itis stored electronically such as introducing appropriate back-up routines and use of restricted passwords.

Where the audit has been documented ~~using one of the tools available from Croner-i~~, it is suggested that a PDFcopy of the file be generated and held as a time/date stamped record. The firm may also wish to keep a copy ofthe Excel programme used during the period to ensure that the Excel file could be opened up in future should it be required by, for example, regulators. The firm is responsible, however, for designing and implementing its own procedures to cover these issues.

Retention of audit documentation

How long should documentation be kept for?

ISQM (UK) 1:60-1 requires that for statutory audits of financial statements, the firm shall establish policies and procedures that require retention of audit documentation for a period that is notless than any period necessary to satisfy the requirements of any applicable laws or regulation relatingto data protection and to meet the requirements for any applicable administrative and judicial proceedings, and that is in any case not less than **six** years from the date of the auditor's report.

This may vary in other countries, however would ordinarily be no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report.

Audit Regulation 3.11 states that 'A Registered Auditor must keep all audit working papers which auditing standards require for an audit for a period of at least six years. The period starts with the end of the accounting period to which the papers relate'.

The actual length of time working papers are kept for will be a matter of judgment based on the auditor's own needs, those of the client and any regulatory requirements. However, Audit Regulation 3.11 suggests that priorto their destruction, a review is carried out to ensure that there is no need to refer to them again.

There is a difference in the start date of the working paper retention period, however, ISQM (UK) 1 requires that for statutory audits, engagement documentation must be retained for at least six years from the date of the audit report.

Matters arising after the date of the auditor's report

If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, ISA (UK) 230:13 requires the auditor to document:

a) the circumstances encountered;

b) the new or additional audit procedures performed, audit evidence obtained, and conclusions reached,and their effect on the auditor's report; and

c) when and by whom the resulting changes to audit documentation were made and reviewed.

Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financialstatements to be amended or the auditor to modify the opinion in the auditor's report. The resulting changes tothe audit documentation are reviewed in accordance with the review responsibilities set out in ISA (UK) 220, with the engagement partner taking final responsibility for the changes.

In circumstances other than those envisaged in ISA (UK) 230:13, where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit filehas been completed, the auditor shall, regardless of the nature of the modifications or additions, document:

a) the specific reasons for making them; and

b) when and by whom they were made and reviewed.

Example - Circumstances when a file can be modified after closing

As per ISA (UK) 230: A24 an example of a circumstance in which the auditor may find it necessary to modify existing audit documentationor add new audit documentation after file assembly has been completed is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.

Group situations

Where two or more different reports are issued in respect of the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files address each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on a component's financial information for groupconsolidation purposes and, at a subsequent date, an auditor's report on the same financial information for statutory purposes.

Where working papers are produced by sub-contractor auditors, Audit Regulation 3.12 requires that 'A Registered Auditor must make arrangements so that if any of its audit work is carried out by another firm, then:

a) all the audit working papers created by that firm are returned to the Registered Auditor; or

b) the other firm agrees to keep those papers as required by Regulation 3.11 and allows the RegisteredAuditor unrestricted access to the papers for whatever reason.'

Working papers of component auditors in group situations are considered in Consolidation and groups.

Firm-level policies and procedures

Under ISQM 1:31(f), audit firms are required to establish policies and procedures for the timely completion of the assembly of audit files.

Policies and procedures should also be established that are designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.

ISQM (UK) 1:34-1(m) specifically says that the firm shall establish policies and procedures designed to:

a) apply adequate provision on confidentiality and professional secrecy in relation to all information anddocuments to which the firm has access when carrying out an engagement; and

b) ensure that the firm complies with applicable legal and regulatory requirements relating to the confidentiality of information received in the course of the engagement.

Further, the application material to ISQM (UK) 1:A84, requires firms to appropriately maintain engagement documentation, such as by preventing alterationor loss of engagement documentation.

~~Example specimen~~ documentation of whole firm procedures ~~can be found in the Audit compliance templates, although it should be noted this is only guidance and~~ needs to be tailored by the firm, to establish the firm's own policies. These policies will need to include how audit files, ~~whether generated using the Croner-i audit tools or other means,~~ are stored. This includes considering whether files are stored in Excel, as PDFs, as paper copies for example, as well as whether and how legacy copies of the tools and Excel are maintained to assist in future review situations.

Restoring electronic files

Where evidence is held electronically, audit firms should ensure that they retain at least one version of any, otherwise superseded, information technology applications required to access old audit documentation. This may include both proprietary word-processing or spreadsheet tools which may have been upgraded, or any internally developed audit tools which have become obsolete or have been replaced or revised. The ability to retrieve working papers and other documentation is also an issue if it was originally prepared on paper and has later been scanned for storage.

It is important that the auditor has procedures in place to ensure that the integrity of data is maintained when it is stored electronically such as introducing appropriate back-up routines and use of restricted passwords.

Working papers of component auditors in group situations are considered in Consolidation and groups.

Planning for the following year

Once the audit has been signed off, a debriefing should occur and consideration should be given as to whether:

(a) the audit engagement can be accepted for the next period – that is, a reassessment should be made of the practice's independence, etc. and whether any issues have occurred during the course of the audit that would put doubt on the auditor's ability to be independent or to properly perform the audit in subsequent years; and

(b) (b)whether anything has occurred during the course of the audit that would impact on the approach that is going to be taken in the following year's audit. It is important that any audit inefficiencies are recorded on a 'pointsforward' schedule to ensure that they do not recur in subsequent years.

Further resources

The FRC has produced a paper on *What Makes a Good Audit? (2021)*, which provides useful information; section A.8 of the report relates to Completion and reporting.

4.7 What’s changed

2023

This table lists, in chronological order with the most recent at the top, the changes made to the Audit methodology area.

Date	What has changed
December 2023	The following sections have been updated to include links to the latest standards ~~and latest Insight courses~~: • Planning overview; and • Scope and framework. Planning overview also includes additional guidance relating to ISA (UK) 220.
November 2023	Guidance in the following sections has been updated to reflect the enhanced requirements of ISA (UK) 220 (Revised July 2021): • Documentation; • Preparing the file for review; and • Reviewing the file. ~~A spotlight article that gives an overview of the revisions to ISA (UK) 220 (Revised July 2021) and the resulting changes to the *Navigate Audit* tools and guidance is available here.~~
November 2023	Guidance in the following sections has been updated, including the addition of further examples and insights relevant to the application of ISA (UK) 240 and ISA (UK) 315: • Accounting systems, processes and controls; • Assessing materiality; • Audit evidence; • Professional scepticism; • Fraud in the audit; and • Audit team planning meeting.
November 2023	Guidance in the Acceptance, continuance and independence section has been updated to reflect the requirements of ISA (UK) 220 (Revised) as well as the latest revisions to schedules C3 and C3.1 in the ~~*Navigate*~~ *Audit* tools.
November 2023	Links and references to the Permanent Audit File schedules in The permanent file section have been updated. ~~The Permanent Audit File schedules previously included within the *Navigate Audit* tools are now available as a separate downloadable Excel file within Audit Tools.~~ *Croner-I have incorporated some previous permanent file information into existing checklists. Where they have now moved some schedules into a separate tool, Audit Automation has added these documents as Background Information.*

October 2023

Guidance in the following sections has been reviewed and updated, including minor editorial amendments~~, updated links to the latest ISAs (UK) and links to additional Insight courses~~:

- Financial instruments; and
- Intangible assets and goodwill.

September 2023

Guidance in the following sections has been reviewed and updated, including minor editorial amendments, ~~updated links to the latest ISAs (UK) and links to additional Insight courses~~:

- Audit evidence;
- Auditing accounting estimates;
- Going concern;
- Related party transactions; and
- Subsequent events.

August 2023

Guidance in the section on Sampling and misstatement evaluation has been reviewed and updated ~~including adding further examples and links to the latest Insight courses.~~

~~June 2023~~

~~Links to additional Insight courses have been added to the section on Reviewing the file.~~

May 2023

Guidance in the section on Sampling and misstatement evaluation has been reviewed and updated, including minor editorial amendments and updated links to the latest ISAs (UK). ~~The sampling tool has also been re-issued with updated hyperlinks.~~

May 2023

Guidance in the following sections has been reviewed and updated, including minor editorial amendments~~, updated links to the latest ISAs (UK) and links to additional Insight courses~~:

- Share capital, reserves and statutory records;
- Current and deferred taxation;
- Income;
- Expenditure;
- Wages, salaries and other remuneration;
- Share-based payments;
- Foreign currency, discontinued operations and borrowing costs; and
- Value added tax.

April 2023

Guidance in the following sections has been reviewed and updated, including minor editorial amendments~~, updated links to the latest ISAs (UK) and links to additional Insight courses~~:

- Fixed assets;
- Finance leases;

- Investment property;
- Investments in group and associated undertakings and other investments;
- Inventory;
- Construction contracts;
- Debtors and prepayments;
- Cash at bank and in hand;
- Creditors and accruals;
- Loans and borrowings; and
- Provisions, contingencies and financial commitments.

March 2023 ~~Two new mind maps have been added to the~~ Consolidation and groups section~~. The first map provides a summary of the requirements of ISA (UK) 600 with links to tools and guidance on the Navigate platform; the second map links the detailed ISA requirements to related commentary. Other~~ minor editorial amendments have ~~also~~ been made to the section.

March 2023 Guidance in the following sections has been updated to include a quick overview, ~~mind map of the section,~~ key definitions, align to the latest version (v4.0) of the Private Company (PCAS) ~~Excel~~ audit tool and incorporates guidance previously in *Implementing GAAS*.

- Preparing the file for review;
- Reports to management;
- Letters of representation; and
- Final completion and planning.

January 2023 A new section Professional scepticism has been written which incorporates guidance previously contained in other areas of the Audit Methodology and *Implementing GAAS*.

5. Pension Scheme

Contents

- Guidance and methodology
- Programmes
- Example letters and reports
- What’s changed

5.1 Guidance and methodology

This area ~~of Navigate Audit~~ supplements the commentary in the main Audit Guidance and Methodology area with matters specific to pension scheme assignments.

These guidance notes are based on the notes provided with the paper version of Practical Audit and Accounts Programme for Pensions. This is to allow existing users to understand the differences between the way that the paper version is used and the way that PCAS is implemented on Audit Automation. Any guidance relating to the paper version that is not relevant, or has been varied to fit in with the automated version, is retained but crossed out with a double strikethrough. Any additional guidance is printed in Blue and italicised.

These notes give a basic introduction to the various types of occupational pension schemes along with the audit requirements. They are not intended to be an exhaustive guide to pension legislation and you should refer to more specialist publications for more detailed information. Practice Note 15 (Revised) ‘The audit of occupational pension schemes in the United Kingdom’ is a good starting point.

Types of pension scheme

Defined benefit schemes

The benefits to be provided under a defined benefit scheme are defined in advance based on earnings and years of service.

The most common form of defined benefit scheme is the final salary scheme. In these schemes the pension payable to the member is expressed as a fraction (commonly 1/60th or 1/80th, but some generous employers may offer 1/40th or 1/45th for example) of the member's final pensionable salary at retirement age, or the date of leaving if earlier, multiplied by the years of completed pensionable service. The maximum pension accrual permitted by HM Revenue & Customs (HMRC) is 1/30th subject to an overall limit of 2/3rd of final salary.

Defined contribution schemes

The benefits payable to a member of a defined contribution or money purchase scheme are secured by the contributions made by the member and employer and subsequent investment returns on the amounts invested. On retirement, the accumulated assets relating to that member are used to buy a pension. The amount of the pension is therefore dependent on the amount invested and the market rates for pension annuities prevailing at the date of retirement, and the pension will, therefore, bear no relation to the member's final salary.

Hybrid schemes

Some schemes are hybrids offering, for instance, final salary benefits to older employees with longer service and money purchase benefits for younger employees.

Master trust schemes

The *Pensions Act* 2017 introduced a new form of pension scheme, called a master trust pension scheme. Under the 2017 Act, a master trust is defined as an occupational pension scheme that:

- provides money purchase benefits;
- is used, or intended to be used, by two or more employers;
- is not used, or intended to be used, only by employers which are connected with each other; and
- is not a public service pension scheme.

In essence, it is a multi-employer scheme where each employer has a separate division within a single master trust arrangement. They may be particularly attractive for employers needing to provide a pension scheme for employees but for whom the costs of setting up an individual scheme may be disproportionate, as the administration and governance costs will be shared across the participating employers.

Funded and unfunded schemes

Funding is the setting aside of money in advance to pay for the provision of pensions and other benefits when they fall due. Typically, as mentioned earlier, the funding monies will be placed in a trust fund independent from the employer's other assets. This trust fund is, therefore, externally funded.

In the case of unfunded schemes, any benefits are paid out of the assets of the employer at the time that the member retires. Unfunded arrangements are common in the case of *ex gratia* pensions for employees who may not have been in a position to build up service in the funded scheme.

Many accounting firms and solicitors established as LLPs have unfunded pensions schemes whereby annuities to former partners are paid out of current profits. Under FRS 102, such commitments must continue to be shown on the balance sheet: but they are still unfunded.

Unfunded schemes do not require an audit.

Insured schemes

For many organisations it is too costly to administer their pension scheme in-house and the size of funds involved may be too small for the scheme to diversify its assets adequately. In such cases many companies turn to insurance companies to administer the funds of their pension schemes. Usually, the contributions of the employer and employee will be paid as premiums to the insurance company who will invest the funds and manage the scheme. The trustees remain responsible for the scheme and an insured scheme is subject to HMRC’s approval as is any other scheme.

The funds are invested in insurance policies. Insured schemes can be defined benefit or defined contribution, although the insurance policy will not always provide the full benefits accrued under the scheme rules.

Small self-administered schemes

A small self-administered pension scheme (SSAS) was defined by HMRC as being a scheme that is self-administered with a small number of members. Such schemes had fewer than 12 members, and at least one member had to be connected with another member, or with a trustee or an employer in relation to the scheme.

These schemes were usually used as a way of combining the provision of a pension with efficient tax planning for directors of family-owned businesses. They were usually money purchase schemes.

They provided considerable flexibility and, subject to HMRC’s rules, the SSAS could invest in the employer by means of loans, purchase and leaseback of company property or an equity stake.

The definition of an SSAS is now no longer applicable. The rules specifically defining them were removed in April 2007. An SSAS is now a trust-based occupational pension scheme which allows the members to direct the investments. The term SSAS is, however, still used for such schemes.

AVC schemes

Additional voluntary contributions (AVCs) are contributions that a member chooses to make in addition to the contributions he or the employer must make in terms of the rules of the scheme. The additional funds are then used to enhance the member's pension or retirement benefit, particularly where their contribution history is poor. Some schemes will allow members to use AVCs to purchase added years.

Earmarked schemes

Earmarked schemes are certain schemes defined under the Audited Accounts Regulations (*Occupational Pension Schemes (Requirement to Obtain Audited Accounts and a Statement from the Auditor) Regulations* 1996 (SI 1996/1975), reg. 2(2)) as occupational schemes under which all the benefits other than death benefits are money purchase benefits and all are secured by one or more policies of insurance or annuity contracts which are specifically allocated to the provision of benefits for individual members or other persons who have rights under the scheme.

Pension scheme accounts

Requirement to produce audited accounts

The Disclosure Regulations (*Occupational Pension Schemes (Disclosure of Information) Regulations* 1996 (SI 1996/1655)) set out the required contents of the annual report, which includes the audited accounts. The Audited Accounts Regulations (*Occupational Pension Schemes (Requirement to Obtain Audited Accounts and a Statement from the Auditor) Regulations* 1996 (SI 1996/1975)) require the trustees to obtain audited accounts within seven months of the scheme year end.

The auditor must state in his report whether the accounts:

- show a true and fair view of the state of the financial transactions of the scheme during the year and the amount and disposition at that date of its assets and liabilities, other than liabilities to pay pensions and benefits after the end of the year;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- contain the information specified in reg. 3A of the Disclosure Regulations, made under the *Pensions Act* 1995.

In addition, the audited accounts must contain certain disclosures about investments as well as a statement of whether the accounts have been prepared in accordance with the relevant financial reporting framework applicable to occupational pension schemes current at the end of the scheme year to which the accounts relate and, if not, an indication of where there are any material departures from this framework. The Irish Disclosure Regulations also require the financial statements to include a statement as to whether they have been prepared in accordance with the SORP and, if not, an indication of where there are any material departures from those guidelines.

Exemption from producing audited accounts

In general, pension schemes that are required by the *Pensions Act* 1995, s. 47(1)(a) to appoint a scheme auditor (subject to the exemptions set out in the Scheme Administration Regulations (*Occupational Pension Schemes (Scheme Administration) Regulations* 1996 (SI 1996/1715), reg. 3) are also required by the Audited Accounts Regulations (SI 1996/1975) to produce audited accounts. The exceptions are as follows.

(a) Under the Audited Accounts Regulations (reg. 2(2)), an ‘earmarked scheme’ which is defined as an occupational scheme under which all the benefits other than death benefits are money purchase benefits and all are secured by one or more policies of insurance or annuity contracts which are specifically allocated to the provision of benefits for individual members or other persons who have rights under the scheme:

(i) it is not a requirement to obtain audited accounts but it is a requirement to obtain an auditor’s statement about contributions under the scheme; and

(ii) each member should be provided, within 12 months of the end of each scheme year, with a statement detailing the contributions credited to them during that scheme year and, if requested in writing, a copy of the most recent accounts published by insurance companies with which the scheme holds earmarked insurance policies or annuity contacts in relation to that person.

(b) Under the Audited Accounts Regulations (reg. 2B), a scheme falling within the Scheme Administration Regulations, reg. 3(1)(c) (an occupational pension scheme which provides relevant benefits and which on or after 6 April 2006 is not a registered scheme) and (1) (i) (an occupational pension scheme with a superannuation fund) which has 100 or more members is required to obtain accounts and an auditor's statement about contributions (but by implication, not audited accounts).

(c) Under the Audited Accounts Regulations (reg. 2B), a scheme falling within the Scheme Administration Regulations, reg. 3(1) (m) (the AWE Pension Scheme) or (1)(o) (the Babcock Naval Services Pension Scheme) is required to obtain accounts and an auditor’s statement about contributions (but by implication, not audited accounts).

Before assuming that your client is entitled to one of the above audit exemptions, you should check the trust deed. Many older schemes are likely to have a provision requiring the accounts to be audited. This would override any exemption given in legislation, in the same way that an otherwise audit exempt company may be required to have an audit by provisions in the Articles of Association. It is possible to alter the trust deed, but this would be best done by either the scheme's legal advisers or the trustees where applicable.

Basis of accounting

Unless choosing to apply EU-adopted IFRS, pension scheme accounts must comply with FRS 102 *The Financial Reporting Standard Applicable in the United Kingdom and Republic of Ireland,* issued by the Financial Reporting Council (FRC). If FRS 102 is applied, the SORP must also be applied (IFRS preparers need not apply the SORP as IFRS does not recognise the status of SORPs; however, it may still offer useful guidance). This product is designed for pension schemes applying FRS 102 and the SORP.

FRS 102 applies to the general purpose financial statements and financial reporting of entities including those that are not constituted as companies and those that are not profit-orientated. Accordingly, it includes certain requirements that relate to specialised activities; these are found in Section 34 of the standard, which includes accounting requirements for retirement benefit plans financial statements. These are further supplemented by the SORP.

The most recent edition of the SORP was published in June 2018 and is effective for periods commencing on or after 1 January 2019. For periods commencing before this date, the previous version of the SORP, published in 2015, should be applied. The 2018 SORP has been designed to align with the latest edition of FRS 102, which was published in March 2018 and takes effect for periods commencing on or after 1 January 2019.

The SORP continues to provide the main guidance on the presentation of pension accounts. It states that accounts should be prepared using the accruals concept and that they should be complete, i.e. they should include all assets and liabilities of the scheme except liabilities to pay pensions and other benefits in the future (which are dealt with by the actuary's statement).

The SORP fully explores the valuation of some specific assets and liabilities and notes that any other items not covered should be dealt with in accordance with normal accounting conventions. It also contains guidance on the application of relevant accounting standards.

Contents of the annual report

Overview

The United Kingdom Disclosure Regulations require trustees to make available to members and others (such as prospective members, beneficiaries and recognised trade unions) on request an annual report within seven months of the scheme's year end (Republic of Ireland Disclosure Regulations require the trustees to prepare an annual report within nine months of the end of the scheme year). The SORP (paragraph 2.1.1) summarises the requirements of the Disclosure Regulations, stating that the annual report must contain, as a minimum:

- the audited financial statements;
- the related auditor's report;
- actuarial information; and
- information in relation to scheme management, membership and investments, usually referred to as the trustees' report.

The report in fact contains much more information than this, based on a mix of legislative, audit and financial reporting requirements, including:

- the auditor's statement about contributions (except as explained below);
- the report on actuarial liabilities for defined benefit schemes (as part of the trustees' report); and
- the chair's statement for relevant schemes within the meaning of the *Occupational Pension Schemes (Charges and Governance) Regulations* 2015 (not in the Republic of Ireland).

Where a UK scheme has 20 or more participating employers at the start of the scheme year, there is no requirement to obtain an auditor's statement about contributions with effect from 1 April 2016, as set out in the *Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) (Amendment) Regulations* 2016 (SI 2016/229), reg. 2.

The SORP sets out recommendations that are intended to represent best practice on the form and content of the financial statements of pension schemes. Although the recommendations of SORPs are not mandatory, the Audited Accounts Regulations require financial statements to state whether they have been prepared in accordance with a relevant SORP. Pension scheme financial statements are also required to be prepared in compliance with FRS 102. If applicable, the financial statements must give:

- a brief description of any departures from the recommended practice set out in the SORP (and FRS 102);
- the reasons why the treatment adopted is judged more appropriate to the scheme's particular circumstances;
- details of any disclosures required by the SORP or FRS 102 that have not been provided and the reason for not providing them.

The recommendations of the 2018 SORP are applicable for scheme years beginning on or after 1 January 2019, with early adoption available provided that the 2018 edition of FRS 102 is also applied. For periods beginning before this, where early adoption is not taken, the recommendations of the 2015 SORP should be followed (see Requirement to produce audited accounts).

Detailed guidance on preparing pension scheme accounts can be found in the *Pensions Sector Guide* and the 2018 Pensions SORP.

Audited Accounts Regulations

The Audited Accounts Regulations and the SORP contain the details to be disclosed in the financial statements and how the various components of pension scheme transactions should be accounted for.

The Audited Accounts Regulations and the SORP set out the form and content of pension scheme financial statements. The financial statements must contain the following:

- a fund account that sets out the transactions with members and returns on investments, effectively all the financial additions to, withdrawals from and changes in value of the fund during the accounting period;
- a statement of net assets available to meet benefits that discloses the size and disposition of the net assets of the scheme as at the period end valued at fair value; and
- notes to the fund account and statement of net assets available to meet benefits.

The SORP contains recommended formats for these statements. Subject to the disclosure of the relevant items being made, there is no compulsory layout or order of the items, unlike those prescribed for other entities, for example, companies.

FRS 102 exempts pension schemes from the requirement to include a statement of cash flows in the financial statements (FRS 102.7.1A) and the SORP does not include any recommendation that a cash flow statement should be prepared. Therefore, pension scheme accounts will not normally contain a cash flow statement.

Actuarial information

Defined benefit schemes are required to include a report on the actuarial liabilities of the scheme in the annual report (FRS 102.34.48). This should include:

- a statement of the actuarial present value of promised retirement benefits, based on the most recent valuation of the scheme;
- the date of the most recent valuation of the scheme; and
- the significant actuarial assumptions made and the method used to calculate the actuarial present value of promised retirement benefits.

The SORP recommends that the above information is disclosed within the trustees' report; however, due to its length, it may be included as part of the trustees' report but at the back of the annual report. The information given should be based on the latest available scheme funding valuation and the information contained in the related Summary Funding Statement and Statement of Funding Principles in the United Kingdom and the Actuarial Valuation prepared under s. 56 of the Irish 1990 Act in the Republic of Ireland. It can also be based on a more recent valuation prepared for other purposes but on a consistent basis to the scheme funding valuation where available, or on a valuation that complies with the technical actuarial standards issued by the FRC which gives assurance on the quality of the work. The SORP also recommends that the net assets of the scheme at the date of the valuation are disclosed.

In addition, the Disclosure Regulations require inclusion of a copy of the latest certificate by the actuary under the *Pensions Act* 2004, s. 227 of the adequacy of the rates of contributions for the purpose of meeting (as applicable) the scheme specific funding.

The objective of these disclosures is to ensure that the backward-looking financial information in the audited financial statements is accompanied by clear disclosure of forward-looking information about the funding status of defined benefit schemes.

For sectionalised defined benefit schemes, actuarial liabilities are often determined for each section because they have different funding positions, regardless of whether the financial statements present the scheme as one. In this scenario, namely the sections have separate funding positions but the financial statements do not present the separate sections, the total assets per section will need to be disclosed in the notes to the financial statements to provide the actuary with an audited asset figure for each section, even if the rest of the financial statements are not segregated per section.

Trustees' report

The contents of the trustees' report are specified in some detail in Sch. 3 to the Disclosure Regulations. In summary, the areas to be covered are as follows:

- details of trustees, their appointment, their advisers and relevant contact addresses;
- details of the scheme's membership at a point during the year;

- information about pension increases;
- a statement about whether transfer values were paid in accordance with the statutory cash equivalent requirements;
- explanations of any failure by the employer to pay over contributions;
- explanations of any employer-related investments;
- details of who managed the investments of the scheme and the extent of delegation of this function by the trustees;
- a statement about the trustees' policy on the custody of scheme assets;
- information about whether the trustees have produced a statement of investment principles and, if so, where a copy of the statement may be obtained;
- an investment report including a review of investment performance and details of any investments that are not in accordance with the statement of investment principles; and
- a statement as to the percentage of the scheme's resources invested in employer-related investments and further information, including the steps taken by the trustees to secure compliance with the restrictions set out in the Investment Regulations (*Occupational Pension Schemes (Investment) Regulations* 2005 (SI 2005/3378)), where that percentage exceeds 5%.

Reporting to the regulator

The Pensions Regulator

The Pensions Regulator is the regulator of work-based pension schemes in the UK. The regulator has wide powers and a proactive and risk-focused approach to regulation.

The Pensions Regulator's codes and guidance are available on the regulator's website (www.thepensionsregulator.gov.uk).

The Pensions Regulator has issued guidance on the requirement to whistle-blow contained in the *Pensions Act* 1995:

- Code of Practice 01 – Reporting breaches of the law; and
- Guidance – Complying with the duty to report breaches of the law.

Both of these are available to download free of charge from The Pensions Regulator's website (www.thepensionsregulator.gov.uk/codes/code-reporting-breaches.aspx).

The guidance applies a traffic light approach with red, amber and green scenarios. A summary of the code and guidance is given below; however, in the event of a report being considered users are urged to consult the original documents as well as guidance from the FRC.

The requirement to report breaches

The decision whether to report requires two key judgments.

(1) Does the reporter have reasonable cause to believe there has been a breach of the law?

(2) Does the reporter believe the breach is likely to be of material significance to The Pensions Regulator?

Implicit in this wording is the fact that not every breach needs to be reported

Reasonable cause to believe

Having a reasonable cause to believe that a breach has occurred means more than merely having a suspicion that cannot be substantiated.

Where the reporter does not know the facts or events around the suspected breach, it will usually be appropriate to check with the trustees or manager, or with others who are in a position to confirm what has happened. However, it would not be appropriate to check with the trustees or the manager or others in cases of theft, or if the reporter is concerned that a fraud or other serious offence might have been committed and discussion with those persons might tip off those implicated or impede the actions of the police or a regulatory authority.

In establishing that there is reasonable cause to believe that a breach has occurred, it is not necessary for a reporter to gather all the evidence which The Pensions Regulator would require before taking legal action.

Likely to be of material significance to The Pensions Regulator

The legal requirement is that breaches likely to be of material significance to The Pensions Regulator in carrying out any of its functions must be reported. What makes the breach of material significance depends on a number of factors.

1. The cause of the breach

The breach is more likely to be of material significance to The Pensions Regulator where it was caused by:

- dishonesty;
- poor governance, inadequate controls resulting in deficient administration, or slow or inappropriate decision-making practices;
- incomplete or inaccurate advice; or
- acting (or failing to act) in deliberate contravention of the law.

On the other hand, The Pensions Regulator will not regard as materially significant a breach arising from an isolated incident, for example resulting from teething problems with a new system or procedure, or from an unusual or unpredictable combination of circumstances. However, in such a situation, it is also important to consider other aspects of the breach such as the effect it has had.

Failure by an employer or the trustees to report a notifiable event is specifically a matter of material significance to the regulator.

2. The effect of the breach

The Pensions Regulator's objectives are to protect the benefits of pension scheme members, to reduce the risk of calls on the Pension Protection Fund, and to promote the good administration of work-based pension schemes. In the light of these objectives, guidance issued by The Pensions Regulator states that the following elements are likely to be of material significance.

In relation to protecting members' benefits:

- substantially the right money is paid into the scheme at the right time;
- assets are appropriately safeguarded;
- payments out of the scheme are legitimate and timely;
- defined benefit schemes are complying with the legal requirements on scheme funding;
- trustees of occupational pension schemes are properly considering their investment policy, and investing in accordance with it; and
- contributions in respect of money purchase members are correctly allocated and invested.

In relation to reducing the risk of compensation being payable from the PPF:

- The Pensions Regulator is informed of notifiable events;
- trustees comply with PPF requirements during an assessment period. This is the period starting with an insolvency event and during which the scheme's eligibility for entry into the PPF is assessed and certain restrictions apply. Reports should continue to be made to The Pensions Regulator during the assessment period.

In relation to promoting good administration:

- schemes are administered properly and appropriate records maintained; and
- members receive accurate, clear and impartial information without delay.

3. The reaction to the breach

The Pensions Regulator has stated it will not normally regard a breach as materially significant where the trustees or managers (or their advisers and service providers) take prompt and effective action to investigate and correct the breach and its causes, and, where appropriate, to notify any members whose benefits have been affected.

However, it is likely to be of concern to The Pensions Regulator, and the breach is likely to be regarded as being of material significance where, after a breach is identified, the trustees and their advisers or service providers involved:

- do not take prompt and effective action to remedy the breach and identify and tackle its cause in order to minimise risk of recurrence;
- are not pursuing corrective action to a proper conclusion; or
- fail to notify members whose benefits have been affected by the breach where it would have been appropriate to do so.

4. The wider implications of the breach

The wider implications of a breach should be taken into account when assessing which breaches are likely to be materially significant to the exercise of The Pensions Regulator's functions. For example, a breach is likely to be of material significance where:

- the fact that the breach has occurred makes it appear more likely that other breaches will emerge in the future because the trustees (or the manager) lack the appropriate knowledge and understanding to fulfil their responsibilities; or
- other schemes may be affected, for example schemes administered by the same organisation where a system failure is to blame.

In forming a judgment on whether a particular breach may have wider implications, the reporter should take into account such general risk factors as the level of funding (in a defined benefit scheme) or how well run the scheme appears to be. Some breaches which arise in respect of a poorly funded, poorly administered scheme will be more significant to The Pensions Regulator than the same breaches would be in a well-funded, well-administered scheme. Such an approach is consistent with the risk-focused approach to regulation adopted by The Pensions Regulator.

As soon as reasonably practicable

If a judgment has been reached that there is reasonable cause to believe that a breach has occurred, and that it is of material significance to The Pensions Regulator, it must be reported as soon as reasonably practicable. It is important that procedures are in place to allow reporters to make a judgment within an appropriate timescale as to whether a breach must be reported.

Guidance states that what is reasonably practicable will depend on the circumstances. In any event the time taken to reach the judgments on reasonable cause to believe and on material significance should be consistent with the speed implied by 'as soon as reasonably practicable'. In particular, the time taken should reflect the seriousness of the suspected breach. In cases of immediate risk to scheme assets, the payment of members' benefits, or where there is any indication of dishonesty, The Pensions Regulator does not expect reporters to seek an explanation or to assess the effectiveness of proposed remedies but only to make such immediate checks as are necessary. The more serious the potential breach and its consequences, the more urgently these necessary checks should be made. In cases of potential dishonesty, the reporter should avoid, where possible, checks which might alert those implicated. In serious cases reporters should consider contacting The Pensions Regulator by the quickest means possible to alert the regulator to the breach.

Reporting on contributions

Requirement to report on contributions

The Audited Accounts Regulations (*Occupational Pension Schemes (Requirement to Obtain Audited Accounts and a Statement from the Auditor) Regulations* 1996 (SI 1996/1975)) require the trustees of most occupational pension schemes to obtain, not more than seven months after the end of the scheme year, an auditor’s statement about contributions under the scheme (the auditor’s statement). In particular, the auditor must state whether, in his opinion, contributions have, in all material respects, been paid at least in accordance with the payment schedule (in the case of a defined contribution scheme) or with the schedule of contributions (for other schemes including defined benefit schemes).

Where a scheme has 20 or more participating employers at the start of the scheme year, there is no requirement to obtain an auditor’s statement with effect from 1 April 2016.

The auditor’s statement

In providing the auditor's statement, the scheme auditor considers whether or not contributions have been materially underpaid or paid late at any time during the year covered by the auditor's statement (the concept of materiality to be applied is audit materiality). If considered material, the auditor qualifies the auditor's statement. Where the impact of the exceptions found is considered by the auditor as both material and pervasive, an adverse statement in the auditor's statement about contributions may be more appropriate; the auditor will also need to consider the impact on the overall financial statement opinion as well. The auditor will also need to consider whether any contributions underpaid or paid late are materially significant to The Pensions Regulator (TPR) (see Reporting to the regulator).

If the trustees have not put in place a schedule of contributions or payment schedule in relation to the whole or part of the scheme year, or the schedule is no longer valid, the auditor's statement shall contain:

(a) a statement as to whether, in the auditor's opinion, contributions payable to the scheme during that year or that part of the year have, in all material respects, been paid at least in accordance with the scheme rules or contracts under which they were payable. Some schemes require their auditor to report on whether payments have been made in accordance with the recommendations of the scheme actuary, and in these cases the wording of the auditor's statement will need to be amended to refer to the relevant requirement(s) of the trust deed; and

(b) if the auditor's statement is qualified, a statement of the reasons.

The auditor's statement is separate and distinct from the auditor's opinion on the financial statements. The auditor provides a statement that is intended to provide the user with reasonable assurance that the reported contributions in all material respects have been paid at least in accordance with the payments schedule or schedule of contributions. In producing this statement, the auditor will draw on the work undertaken on contributions for the audit of the financial statements and will have regard to the requirements of other applicable ISAs (UK) during the course of the work. Guidance on the form and content of the auditor's statement is set out in Practice Note 15 (Revised) including illustrative examples in Appendix 3 therein.

The trustees' summary of contributions

It is important that readers of the auditor's statement are able to understand the contributions on which the auditor is reporting. Typically, these will not be all of the amounts that are disclosed within the caption 'Contributions' in the fund account, which will often include member's additional voluntary contributions (AVCs) and possibly additional payments by the employer that are not covered by the payment schedule or the schedule of contributions (as applicable to the particular scheme). Practice Note 15 (Revised) recommends that trustees should be requested to prepare a summary of the contributions to the scheme which clearly distinguishes contributions due under the relevant schedule from those not covered by the schedule. If the summary is presented as a separate statement, it should be signed by the trustees, but if incorporated in the body of the trustees' report, a specific signature is not required.

Whichever approach is adopted, the auditor's statement will need to contain a cross-reference to where the summary of contributions appears.

Alternatively, the auditor's statement and the trustees' summary could be presented after the financial statements or, in the case of a defined benefit scheme, following the actuarial statements and certificates.

The typical layout of the trustees' summary of contributions is set out below.

XYZ Scheme

Summary of contributions payable in the year	**Contributions payable under the [Schedule of Contributions/Payment Schedule]**
Employers’ normal contributions *	x,xxx
Employers’ deficit funding contributions *	x,xxx
Members’ normal contributions *	x,xxx
Members’ additional contributions *	x,xxx
Total contributions payable under the [Schedule of Contributions/Payment Schedule]	**x,xxx**
Other contributions	
Members’ additional voluntary contributions *	x,xxx
Employer augmentation/additional contributions *	x,xxx
Other contributions [describe] *	x,xxx
Total contributions payable to the Scheme	**x,xxx** **
Signed on behalf of the Trustees ***	
[date] ***	

* descriptions for illustrative purposes and should follow the descriptions of contributions for the scheme

** total to agree with total contributions per the contributions note to the financial statements

*** only required when the summary is presented as a stand-alone statement

Internal controls

Regulations

Article 14(1) of the European Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision 2003/41 (the Directive) specifies that trustees or managers of occupational pension schemes to have ‘sound administrative and accounting procedures and adequate internal control mechanisms’.

The *Pensions Act* 2004, s. 249A, inserted by the *Occupational Pension Schemes (Internal Controls) Regulations* 2005 (SI 2005/3379), gives effect to this requirement. There is therefore a legal requirement in the *Pensions Act* 2004 that trustees or managers of an occupational pension scheme must establish and operate adequate internal controls.

Section 249A(1) states that:

‘The trustees or managers of an occupational pension scheme must establish and operate internal controls which are adequate for the scheme to be administered and managed:

(a) in accordance with the scheme rules, and

(b) in accordance with pensions legislation and any other relevant legislation.’

SI 2005/3379, reg. 3 states that ‘the discharge of the duty imposed by section 249A(1) of the Act is a prescribed matter for the purposes of section 90(2)(k) of that Act (codes of practice)'. The Code of Practice on internal controls, issued by TPR, is available online from their website (http://www.thepensionsregulator.gov.uk/codes/code-internal-controls.aspx). It does not have the force of law; however, in assessing whether the trustees have satisfied the requirement to establish adequate controls, a court or tribunal will take into account the guidance contained in the code.

The current Code of Practice on Internal Controls adopts a high level approach based on a risk framework within which trustees and managers are to focus on the key risks requiring adequate internal controls. The Code is accompanied by Guidance which considers the various steps in a typical risk management process:

- set the key objectives for the scheme: for example, to achieve better control over the payment of benefits to pensioner members;
- identify risks: trustees should have a clear understanding of scheme operations and regularly consider the nature and extent of both internal and external risks;
- define their success criteria: in the above example concerning benefit payments, this could mean reducing the number of incorrect payments or having additional controls in place to prevent such errors arising;
- assess the risks: the trustees should consider a wide range of potential risks specific to their scheme and its circumstances. This will go beyond financial risks to include areas such as dealings with third-party advisers, potential conflicts of interest, scheme funding issues (for defined benefit schemes) or failure to comply with the regulatory requirements for the scheme;
- produce an action plan: this may entail agreeing what the trustees should do where a certain risk is identified (e.g. where the trustees conclude that the scheme's investment strategies are flawed, they could arrange for an independent peer review of current funding advice);
- implement the action plan: once the action plan has been agreed, the trustees must ensure that it is put into practice;
- monitor and review the results: there is no value in having taken all the above steps if the trustees fail to evaluate the results and the appropriate actions to take (e.g. an independent assessment of the scheme's investment strategy might recommend a revised approach with a timescale for doing so; the trustees should discuss the proposals with their advisers and agree how to move forward);
- set the next year's objectives: the process is not a one-off exercise but must be revisited at least annually to ensure that the trustees are aware of the scheme's changing circumstances.

The Code is applicable to all occupational pension schemes except for contract based schemes, unfunded schemes and those schemes where a 'relevant public authority' has given a guarantee or other arrangement to secure the sufficiency of the assets. The statutory requirement is regardless of the size, structure and circumstances of the scheme and whether it is active or in wind-up.

Pension schemes in the UK are audited under International Standards on Auditing (ISAs) (UK). The FRC provides additional guidance in Practice Note 15 (Revised) *The audit of occupational pension schemes in the United Kingdom* to assist with the application of ISAs (UK) in the specific case of pension schemes. The version of Practice Note 15 (PN 15) currently in use was issued by the FRC in November 2017 and so does not cover any of the requirements of the most recent ISAs (UK) which are applicable for periods beginning on or after 15 December 2019.

PN 15 contains guidance to assist auditors in applying the requirements of the ISAs (UK), setting out special considerations relating to the audit of occupational pension schemes. It does not provide detailed guidance on the audits of occupational pensions schemes, so where no special conditions arise from a particular ISA (UK), no commentary is included in the PN.

These special considerations are summarised below.

ISA (UK) 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing

Practitioners should not accept the audit of a pension scheme, unless they have the necessary level of competence, knowledge and experience. Staff involved in the audit of a pension scheme need to have an understanding, appropriate to their role, of the type and status of the scheme, key risks affecting the scheme, the scheme's trust deed and rules, pensions legislation and regulations, relevant TPR Codes of Practice and guidance and the Pensions SORP.

ISA (UK) 210: Agreeing the terms of audit engagements

For a pension scheme, the terms of engagement are agreed with the trustees and the letter of engagement is addressed to the trustees.

The *Pensions Act* 1995, s. 47(1)(a) requires the trustees or managers of most occupational pension schemes to appoint a scheme auditor. To be effective, this appointment must be made in accordance with the *Occupational Pension Schemes (Scheme Administration) Regulations* 1996 (SI 1996/1715), as amended.

The trustees or managers of the scheme forward a notice of appointment to the auditor specifying:

- the date the appointment is due to take effect;
- to whom the auditor is to report; and
- from whom the auditor will take instructions.

The date of appointment does not become effective until the auditor has acknowledged receipt of the notice of appointment, which must be within one month of its receipt, otherwise the notice becomes invalid and the trustees must provide a new notice of appointment.

The *Pensions Act* 1995 (PA 1995) and the Scheme Administration Regulations also require the auditor to confirm in writing that he will notify the trustees or managers immediately the instant he becomes aware of the existence of any conflict of interest to which the auditor is subject in relation to the scheme.

The scheme auditor sets out the nature and scope of its audit obligations under PA 1995 so as to ensure that trustees are aware of the extent of those responsibilities. In particular, the auditor includes reference to its responsibility to report on the contributions payable to the scheme (if applicable) and to the statutory duty to report to TPR in certain circumstances, making it clear that the duty is to report matters if found and does not involve undertaking additional work to identify reportable matters.

Under PA 1995, the scheme auditor does not have a right of access to information held by third parties. Consequently, it is necessary for the scheme auditor to request such information, through the trustees when necessary for the external audit. The scheme auditor therefore includes in the engagement letter a paragraph relating to access to third parties to whom the trustees delegate particular functions and to their records relating to the pension scheme. The scheme auditor may require information from the:

- administrator;
- investment manager(s);
- custodian(s);
- sponsoring employer or employers where there is a multi-employer scheme;
- the sponsoring employer's auditor; and
- scheme actuary.

ISA (UK) 240: The auditor's responsibilities relating to fraud in an audit of financial statements

Auditors of pension schemes are aware that the potential for fraud exists in all schemes. Even if the auditor considers that the nature of pension schemes (not profit-making and not trading) reduces the risk of fraudulent financial reporting, the risk of misappropriation of assets remains. Professional scepticism therefore remains key.

The trustees of a pension scheme are responsible for ensuring that the assets and revenues of the scheme are adequately safeguarded against the effects of fraud through the implementation of appropriate controls.

Some pension-specific examples of conditions or events which may increase the risk of fraud include:

- failure by the trustees to establish and operate adequate internal control mechanisms, as required by legislation;
- trustees or scheme management displaying a significant disregard for the various regulatory authorities;
- trustees or scheme management having little or no involvement in the day-to-day administration of the scheme;
- trustees or scheme management having ready access to the scheme's assets and an ability to override any internal controls;
- trustees or scheme management failing to put in place arrangements to monitor activities undertaken by third parties, including the employer;
- trustees or scheme management displaying a lack of candour in dealings with members, the scheme actuary or the scheme auditor on significant matters affecting scheme assets;
- the sponsoring employer operating in an industry with increasing business failures or itself having financial difficulties;

- significant levels, or unusual types, of related party transactions (including employer-related investments) involving unaudited entities or entities audited by other firms; and
- opaque investment arrangements where the flow of information to the trustees is restricted and therefore making it more difficult to control the investment and understand the position.

The risk of material misstatements arising from fraud is normally most likely to arise in relation to investments as investment transactions and balances are normally much larger than transactions and balances with members. However, in practice, investment related frauds are fairly uncommon. Although member-related fraud is relatively more common, e.g. the continuing payment of benefits to a deceased pensioner, amounts involved are unlikely to be material to the pension scheme financial statements.

Under the requirements of ISA (UK) 240, if the auditor concludes that the risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, he documents the reasons for that conclusion.

Revenue in a pension scheme generally comprises contributions and investment income. Pension schemes are not profit-making entities and pension scheme financial statements are not publicly available. Additionally, unlike sales revenue of a commercial entity, there is little scope to manipulate revenue of a pension scheme, e.g. through false invoicing or misuse of credit notes. Given this, there is normally little incentive or opportunity for revenue to be fraudulently misstated and therefore limited risk of material misstatement arising due to fraud. However, the scheme auditor considers the risks arising in connection with the types of fraud that may occur in a pension scheme and documents his conclusion.

There has been increasing concern over ‘pension scams’ whereby pension scheme members transfer out their benefits to unapproved or inappropriate arrangements. Trustees are required under guidance from TPR to put in place controls to check that transfers out are made to authorised pension schemes and in certain circumstances to check that the member has sought advice before making the transfer. If the auditor becomes aware of a possible scam during the course of their audit work, they raise the matter with the trustees.

ISA (UK) 250 Section A: Consideration of laws and regulations in an audit of financial statements

As well as all the normal legislation applicable to business entities (e.g. employment law, tax, health and safety, money laundering), those involved in a pension scheme audit need a broad understanding of relevant legislation and related regulations, the trust deed and rules, the Pensions SORP and FRS 102, in particular the part relating to financial reporting for pension schemes under ‘Specialised Activities’.

In order to ensure the financial statements give a true and fair view, due regard needs to be given to disclosure of any material non-compliance with the governing document(s).

For most schemes (except those with at least 20 participating employers at the start of the scheme financial year), the trustees are required to obtain from the scheme auditor a statement as to whether the scheme has received contributions in accordance with legislative requirements.

Examples of instances of non-compliance with laws and regulations that may have a material effect on the financial statements for a particular scheme would include those where breaches would have consequences, such as:

- action by the HMRC to rescind registered status (e.g. as a result of a change to the constitution or the nature and value of benefits provided which do not comply with the legislation);
- the penalty regime for breaches of *Finance Act* 2004;
- the penalty regime for breaches of data protection laws and regulations; or
- action by TPR to remove or replace the scheme's trustees. Action to remove trustees can be taken where, in TPR's opinion, a trustee is not a fit and proper person.

The scheme auditor should include a review of correspondence with the Pensions Ombudsman, as well as correspondence with TPR and HMRC, as part of the procedures to assess the risk of non-compliance with laws and regulations which may have a material effect on the financial statements of a pension scheme.

When reporting to TPR, partners and staff in audit firms need to be alert to the dangers of tipping-off under the anti-money laundering legislation. Any knowledge or suspicions of involvement of a pension scheme's trustees in money laundering would normally be regarded as a matter of material significance to TPR and so give rise to a statutory duty to report to TPR in addition to making any necessary report required by legislation relating to money laundering offences.

ISA (UK) 260: Communication with those charged with governance

The emphasis in this ISA is on the need for active two-way communication in order for such communication to be effective.

This is unlikely to be achieved if communication is only by way of written reports. Some trustee bodies of occupational pension schemes operate their relationship with the auditor through individuals such as a professional trustee or the secretary to the trustees. In these circumstances, there may be a tiered approach to communication, with the detailed matters being communicated to an audit committee (or similar group) and less detailed matters being communicated with the trustee body. It may therefore be difficult to ensure that oral communication is transmitted to all trustees and written communication may also be necessary.

The scheme auditor notifies trustees of all breaches, discovered in the course of its work (subject to not 'tipping off'), of duties relevant to the administration of the scheme, regardless of whether the matter gave rise to a statutory duty to report to TPR. Such notification may take place for each individual breach or in a summary of audit matters reported to those changed with governance.

ISA (UK) 265: Communicating deficiencies in internal control to those charged with governance and management

The auditors' consideration of internal control is undertaken as one of the steps necessary to form an opinion on an entity's financial statements.

In the case of pension schemes, PA 2004, s. 249A states that schemes should have adequate internal control mechanisms in place. Therefore, the trustees have a statutory obligation to establish and operate adequate internal controls.

When determining whether individual deficiencies in internal control that are identified during the audit merit the attention of the trustees, the auditor has regard to factors such as the following:

- the significance and nature of the risk(s) to the scheme's activities which are not addressed (adequately or at all) as a result of the deficiency;

- the possible impact of the deficiency on the security of scheme assets;
- the possible impact of the deficiency on the payment of members' benefits;
- the extent to which the operation of controls is informal and undocumented, rather than formal and documented;
- whether detective controls are in operation to compensate for deficiencies in preventative controls; and
- whether aspects of the role of parties such as third-party service organisations compensate for deficiencies in controls operated by the trustees.

The auditor considers the impact, individually and in aggregate, of identified control deficiencies (including controls operated by third-party service organisations) when deciding whether to report them to the trustees. Where the effect and wider implications of a scheme not having in place adequate internal controls, either individually or in aggregate, are likely to be of material significance to TPR, the auditor makes a report to TPR.

ISA (UK) 300: Planning an audit of financial statements

When planning the work to be undertaken in respect of a pension scheme audit, it is important to identify those areas which are key to its operations as reflected in its financial statements. The key areas of most schemes' financial statements would include:

- contributions receivable;
- benefits payable;
- investment return; and
- investment assets.

At the planning stage, where relevant, the scheme auditor's plan also takes account of the steps necessary to obtain sufficient appropriate evidence in order to discharge the auditor's statutory obligation to report on the payment of contributions.

Neither the scope of the audit nor the scheme auditor's assessment of materiality for planning purposes is affected by the duty to report matters that are likely to be of material significance to TPR.

When planning his work, the auditor considers the other information available focusing on understanding investment arrangements, administration, scheme governance and the role of third parties. Possible sources of information include:

- discussions with trustees;
- minutes of trustees' meetings;
- membership records;
- actuarial valuations; and
- discussions with scheme management on changes to the scheme, e.g. in investment strategy, including de-risking initiatives.

The auditor also takes into account the importance of the work of third parties in the administration, investment and accounting on behalf of the trustees and the extent to which third parties provide these services. Where significant functions have been delegated to third parties, the auditor reviews any such service level agreements with third parties as part of the planning process where they are relevant to the audit.

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

The pension scheme auditor’s understanding of the nature of the scheme usually includes obtaining and reviewing information and documentation in relation to:

(a) scheme nature:

- trust deed and rules and amendments thereto;
- the definition of pensionable earnings/pay;
- contribution rates;
- membership profile;
- type of scheme and type of benefits provided;
- scheme booklet; and
- documentation of the scheme’s registered pension scheme status and related correspondence with HMRC;

(b) scheme governance:

- membership of the trustee body and the governance framework;
- statutory chair’s statement and supporting documentation (DC schemes);
- outsourcing arrangements and principal terms of contractual agreements with third-party service organisations;
- availability and use of relevant reports on the internal controls of service organisations including investment managers, custodians and administrators;
- correspondence with TPR/the Pensions Ombudsman/the Pensions Advisory Service (TPAS);
- minutes of meetings of the trustee body and key subcommittees;
- internal dispute resolution procedure and any disputes in progress;
- arrangements for agreeing schedule of contributions or payment schedule with the sponsoring employer and taking actuarial advice where necessary; and
- annual scheme return;

(c) information about sponsoring and participating employers:

- identity of the sponsoring and other participating employer(s);
- relevant covenants and funding arrangements;
- employer and HR payroll arrangements relevant to the remittance of scheme contributions; and
- arrangements for payment of additional voluntary contributions;

(d) actuarial documentation (where relevant):

- letter of appointment;
- valuation reports and details of funding requirements;
- statement of funding principles;
- schedule of contributions;
- recovery plan;
- latest certificates; and
- annual summary funding statement;

(e) approach to scheme administration and finance:

- service level agreements;
- division of administrative and financial responsibilities;
- accounting and membership records;
- stewardship and financial reports provided to the trustees; and
- systems and controls documentation as applicable to the pension scheme;

(f) investments:

- investment strategy and approach to implementation of that strategy;
- statement of investment principles;
- custody arrangements;
- investment management agreements and service agreements with custodians;
- reports provided to the trustees by the investment managers;
- nature of investments and extent of complex and opaque investment structures;
- asset backed special purpose vehicles;
- common investment fund arrangements;
- employer-related investments;
- subsidiaries; and
- AVC arrangements;

(g) other advisers:

- services provided by other advisers.

ISA (UK) 320: Materiality in planning and performing an audit

For pension scheme audits, the auditor needs to consider:

- the financial statement audit;
- the auditor's statement about contributions; and
- regulatory reporting.

For the financial statement audit opinion, net earnings or level of working capital are not among the prime indicators for a pension scheme and therefore, when considering materiality, the focus is directed at scheme assets (mainly investments), contributions, benefits and/or returns on investments. The scheme auditor may also find that different levels of materiality are required for each of the fund account and the statement of net assets. Also where the scheme contains both defined contribution and defined benefit elements, separate levels of materiality may need to be set for each element.

It is also important to distinguish, especially for the benefit of the trustees, that materiality in relation to the audit of the pension scheme's financial statements will not necessarily coincide with the expectations of materiality of an individual member of the scheme in relation to his or her expected benefits. Even in the case of defined contribution arrangements, the scheme auditor's judgments about materiality are made in the context of the financial statements as a whole and the account balances and classes of transactions reported in those statements, rather than in the context of an individual member's designated assets, contributions or benefits.

Where the scheme auditor is also required to provide a statement about contributions, this may then require separate considerations about materiality. This statement about contributions requires assessment of whether specific conditions have been met. This narrower and more factual focus of the report entails close consideration of payment dates and amounts, and hence a different level of materiality to that used in relation to the scheme's financial statements may be appropriate.

The auditor documents the approach and factors considered in the determination of the level of materiality for the statement of contributions separately even if it is the same as that used for the audit of the financial statements. Materiality for the purposes of the auditor's statement is typically considered by reference to those contributions which are subject to the requirements of the schedule and not all contributions.

The scheme auditor also has a duty under PA 1995, if he becomes aware of breaches of law which it has reasonable grounds to believe are 'of material significance' to the exercise of the functions of TPR, to report such matters to TPR. The meaning of the term 'of material significance' differs from 'materiality' in the context of forming an opinion as to whether financial statements show a true and fair view and this is discussed further in Reporting to the regulator.

ISA (UK) 402: Audit considerations relating to an entity using a service organisation

Pension schemes may typically use service organisations in the following areas:

- maintenance of accounting records and/or membership records;
- collection and investment of contributions paid over by the employer;
- custody and management of the scheme's investment assets; and
- calculation and payment of benefits.

Information prepared on behalf of the trustees of a pension scheme by service organisations which is relevant to the audit of the financial statements (which may include investment managers, custodians and scheme administrators) should be considered as being 'produced by the entity' and therefore the auditor is required to obtain audit evidence about the accuracy and completeness of that information as with any other evidence produced by the entity.

The usual requirements of ISA (UK) 402 apply to the auditor assessing the use of service organisations and considering the evidence available. If the auditor is unable to obtain sufficient audit evidence that the trustees operate adequate controls over the service organisation, the auditor will need to supplement that understanding and assessment by making further enquiries about the control arrangements of relevant service organisations. In gathering audit evidence, the auditor considers what information is supplied to the trustees by the organisation, how the trustees monitor activities and performance of the organisation and whether the trustees carry out reviews of available reports by a service auditor on internal control. After considering the information available, he determines whether that is sufficient or whether he needs to consider performing additional procedures at the service organisation.

The auditor may come across the situation where a report by a service auditor on internal control covers a period which is not coterminous with the scheme reporting period. In this situation, the scheme auditor considers alternative procedures to obtain evidence regarding the controls at the service organisation from the date of the service auditor's report on internal control to the end of the scheme reporting period. Such procedures can include, but are not limited to, requesting a bridging letter from the service organisation, discussions with trustees and management on the quality of the services received from the service organisation and/or review of performance reports and other information received from the service organisation.

ISA (UK) 500: Audit evidence

In preparing the financial statements, the trustees may use estimates which have been provided by experts engaged by the trustees or by the employer, e.g. actuaries or investment property valuers. Where the auditor uses information provided by these experts as audit evidence, the reliability of such information is assessed with reference to the competence, capabilities and objectivity of the expert.

As well as being used in providing estimates for the valuation of assets, the scheme actuary will provide an actuarial valuation of the liability to pay pensions after the year end. This, however, is not within the scope of the financial statements, and this valuation will not be used in providing audit evidence in relation to scheme liabilities.

ISA (UK) 520: Analytical procedures

Analytical review techniques are likely to be particularly useful in the audit of pension schemes, not only at the planning and overall review stages of the audit but also as substantive procedures to supplement other evidence concerning the operation of controls or accuracy of individual balances and transactions.

Although a pension scheme's income, resources and expenditure may fluctuate from year to year, for most transactions there are still ways in which the auditor can establish whether the figures are internally consistent and reflect the scheme's operations during the year. Key techniques include comparison of information shown in the financial statements, for example:

- investment income and investment return can be compared with relevant published information;
- monthly and annual patterns of contribution income can be compared to expected amounts using rates set out in the schedule of contributions or payment schedule. However, disaggregation may be required when differing rates of contribution are used for different categories of members;
- monthly and annual patterns of pensions payments can be compared to movements in membership statistics and increases to benefits in payment;

- membership statistics can be reconciled with information from the employer's payroll and information about active pensioners and deferred members;
- bench-marking reports on investment performance can be compared to financial information shown in the financial statements to check for correlation;
- non-financial information contained in documents issued by the scheme, such as summary reports, pensions newsletters, or in management information reports concerning scheme membership can be compared to financial information shown in the financial statements;
- actual income and expenditure can be compared to budgets, prior years' figures and trends; and
- actual expenditure can be compared to the scheme auditor's own expectation of expenditure that would be reasonable for the particular transaction under review, e.g. average pension payment per pensioner.

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

FRS 102 requires pension schemes to report investments at fair value in accordance with its fair value hierarchy. The fair value of annuities is deemed to be the present value of the related obligation. The Pensions SORP provides further guidance on valuing investments in accordance with FRS 102.

Pension schemes may invest in complex financial instruments or illiquid investments for which there may not be an exchange traded price and therefore fair value accounting estimates are made for inclusion in the financial statements. These investments may include:

- non-exchange traded bonds including asset backed securities;
- unquoted securities, including private equity;
- infrastructure;
- investment properties;
- non-exchange traded pooled investment vehicles;
- annuity/buy-ins;
- with-profit insurance policies;
- non-exchange traded derivatives, including options, interest and inflation swaps and forward foreign currency contracts;
- special purpose vehicles such as Scottish Limited Partnerships used for supporting asset backed contribution arrangements;
- longevity swaps; and
- repurchase agreements and reverse repurchase agreements.

PN 15 along with ISA (UK) 540 provides detailed guidance which the auditor should follow.

The most recent version of ISA (UK) 540 (Revised December 2018) (Updated May 2022) *Auditing accounting estimates and related disclosures* defines an accounting estimate as 'a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty' and estimation uncertainty is defined as 'susceptibility to an inherent lack of precision in measurement'.

ISA (UK) 540 requires the auditor to gain an understanding of the entity's accounting estimates when obtaining an understanding of the entity and its environment, including internal control. The procedures are performed to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

In identifying the risks of material misstatement and assessing inherent risk, the auditor needs to take into account:

(a) the degree to which the accounting estimate is subject to estimation uncertainty; and

(b) the degree to which the following are affected by complexity, subjectivity or other inherent risk factors:

  (i) the selection and application of the method, assumptions and data in making the accounting estimate; or

  (ii) the selection of management's point estimate and related disclosures for inclusion in the financial statements.

The auditor also needs to determine whether any of the risks of material misstatement identified and assessed are a significant risk. If the auditor has determined that a significant risk exists, he is required to obtain an understanding of the entity's controls, including control activities, relevant to that risk.

Guidance on estimation uncertainty, subjectivity and complexity is available in the Risk assessment and accounting estimates section of Navigate Audit. The examples below demonstrate such considerations in the context of a pension scheme.

Example – estimation uncertainty

A pension scheme has a litigation provision relating to the outcome of a lawsuit. The amount of this provision relies heavily on the opinion provided by the entity's legal counsel about the likelihood of a settlement and its expected size. There is limited direct historical precedent to its calculation. The size of an expected settlement may also be significantly sensitive to changes in the key assumptions made by the counsel, thereby increasing estimation uncertainty.

Example – subjectivity

Calculation of Guaranteed Minimum Pensions (GMP) equalisation adjustments are complex and highly subjective with actuarial assumptions used to estimate the timing and level of benefits to be paid out in the future. A number of internal and external sources are used and specialised knowledge is required to interpret the valuation report.

Example – complexity

The pension scheme has entered into a derivative financial instrument contract that needs to be measured at fair value. The instrument is not publicly traded and requires the use of a particular specialised model to determine its fair value. The model needs data from a number of internal and external sources and requires specialised knowledge to select the most appropriate data source and to interpret the results.

When obtaining an understanding of how management makes the accounting estimates, auditors should also consider the Pensions SORP, which provides detailed guidance on appropriate accounting policies and measurement bases.

ISA (UK) 550: Related parties

The related parties of pension schemes fall into two broad categories: employer-related and trustee-related.

The Pensions SORP recommends that, for financial reporting purposes, related parties should also be deemed to include other pension schemes for the benefit of employees of companies and businesses related to the employers or for the benefit of the employees of any entity that is itself a related party of the reporting pension scheme.

Under the requirements of ISA (UK) 550, the scheme auditor considers the possibility of related party transactions, e.g. where a pension scheme contracts with the employer or related third parties for the use of a property or for the supply of goods or services to the scheme, even if these result in more favourable terms for the pension scheme than would otherwise be available.

The auditor needs to enquire as to the procedures that the trustees have in place to identify related parties and to authorise and record any related party transactions, including transactions with or loans to the sponsoring employer. Such arrangements might include a declaration of interest file and opportunities at trustees' meetings for trustees to declare interests. The scheme auditor also obtains written representations from the trustees concerning the completeness of information provided regarding the related party disclosures in the financial statements.

It is a general principle of trust law that trustees do not benefit from their trust. However, some individual trustees may be paid for their services and professional trustee organisations may be paid by a pension scheme. This apart, pension scheme trustees are prohibited from transacting directly with the pension scheme, although transactions between pension schemes and businesses in which any of the trustees have an indirect interest (e.g. as a shareholder or a director) are not necessarily prohibited. The pension scheme trustee who is also a scheme member is not necessarily prohibited from benefiting as a scheme member from decisions taken as a trustee.

ISA (UK) 570: Going concern

A pension scheme should prepare its financial statements on the going concern basis unless a decision has been made to wind up the scheme, an event triggering wind up has occurred, e.g. insolvency of the employer, or the scheme has entered the Pension Protection Fund (PPF) assessment period and there is no realistic alternative to the eventual admission of the scheme and the transfer of its assets and liabilities to the PPF.

Example trigger events and considerations in relation to the going concern basis of preparation and material uncertainty disclosure include:

- a formal trustee decision to wind up a scheme;
- notice served by the employer to wind up the scheme;
- termination of contributions by the employer;
- failure by an employer to comply with its duties under the trust deed and rules;
- a wind up order has been received from TPR or one is expected within 12 months, for example because a Freezing Order is in place.

The SORP explains that whilst the pension scheme is in the PPF assessment period and the outcome of the assessment is uncertain, the financial statements continue to be prepared on the going concern basis. Even when the going concern basis is not used, there may not be any impact on the valuation of scheme investments if the timescale of the wind up allows investments to be realised without incurring significant redemption penalties. The SORP states that the basis of preparation of the financial statements does not need to refer to the going concern concept unless the trustees or employer have taken a formal decision to wind up the scheme or there has been a cessation event.

When applying ISA (UK) 570 (Revised September 2019) (Updated May 2022) *Going Concern*, the auditor must ensure they perform an enhanced risk assessment that provides an appropriate basis for the identification of any events that will impact on going concern. A range of audit procedures will need to be performed to challenge the trustee's use of the going concern basis and to determine whether a material uncertainty related to going concern exists.

In the case of a pension scheme, the primary area for the attention of the scheme auditor will be whether circumstances have arisen that have triggered the wind up of the scheme or that provide evidence that a winding up of the scheme (either outside the PPF or on transfer of assets into the PPF) may occur. The pension scheme auditor's evaluation of the trustees' assessment of the scheme's ability to continue as a going concern includes making enquiries of the trustees as to whether circumstances have arisen that mean that the scheme must be wound up or that it may be appropriate to wind up the scheme and will include, where appropriate, evaluating the process of assessment followed by the trustees and reviewing the steps that the trustees have taken to confirm the scheme's ability to continue as a going concern. This may involve reviewing:

- trustee meeting minutes;
- employer communications;
- results of trustee employer covenant review;
- employer communications with trustees;
- employer contribution payment history, including contributions made post-year end;
- employer financial statements; and
- the liquidity of assets held to meet benefits as they fall due.

As TPR has the power to order a scheme to be wound up, the scheme auditor also considers the correspondence between the trustees and TPR in relation to considering whether TPR will wind up the scheme.

The period of assessment needs to be at least 12 months from the date of approval of the financial statements. Triggers and powers of winding up are normally set out in the trust deed and rules. The trustees' assessment is based on information available at the time and would generally be formally documented.

In making their assessment of the scheme's ability to continue as a going concern, the trustees of a defined benefit scheme do not necessarily need to prepare and review forecast financial information in order to confirm that their scheme will be able to meet promised benefits in full as they fall due. However, there may be circumstances where it is important to do so. For example, where a scheme is subject to an unexpectedly high number of early retirements, the trustees may need to prepare information (including forecast cash flows) to provide an assessment of whether there are sufficient liquid assets held by the scheme in order to meet pension payments as they fall due.

Other factors which may impact on the scheme's ability to continue as a going concern include:

- indications of withdrawal of financial support due under the employer covenant;
- non-compliance with TPR requirements;
- pending legal or regulatory proceedings against the scheme that may, if successful, result in claims that are unlikely to be satisfied;

- changes in legislation or government policy expected to adversely affect the entity; and
- issues which involve a range of possible outcomes so wide that an unfavourable result could affect the appropriateness of the going concern basis.

Further information on assessing going concern in pension schemes is available in PRAG's guidance *Pension Scheme Financial Statements and Going Concern* (December 2020).

ISA (UK) 580: Written representations

The body of trustees as a whole is responsible for the contents and presentation of the financial statements and the letter of representation should therefore be approved by the trustee body.

In most pension schemes, day-to-day management is delegated to a scheme management team or provided by a third-party service organisation. In these circumstances, the trustees may wish scheme management or the third-party service organisation to provide a representation to them in relation to some or all aspects of the preparation of the financial statements. However, this is a matter for the trustees and should not impact on the nature or strength of the representations made by the trustees to the auditor.

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

Areas in which the pension scheme auditor may use the work of its own expert to provide audit evidence include fair value valuations of certain investments, e.g. annuities, special purpose vehicles used for asset backed contributions, longevity swaps, unquoted investments, properties, certain derivatives and alternative investment categories.

Practice Note 23 *Special considerations in auditing financial instruments* provides guidance on using experts or specialists in audits involving financial instruments, particularly complex financial instruments. Along with ISA (UK) 500, PN23 also provides guidance on audit considerations in relation to the valuation of financial instruments when a management's expert is used by the audited entity.

The scheme auditor's statutory opinion excludes consideration of liabilities to pay pension and benefits after the end of the scheme year. As a result, the scheme auditor does not ordinarily rely on the work of the scheme actuary to provide audit evidence relating to such liabilities to support the auditor's report on a scheme's financial statements.

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

The form and content of auditor's reports on the financial statements of pension schemes follow the requirements established by ISA (UK) 700, supplemented by the detailed requirements of the Audited Accounts Regulations.

However, because of the complexity of the legal framework, the auditor needs to ensure descriptions of the legislative basis and responsibilities of the auditor and trustees are specific to the circumstances of the scheme audited.

Particular areas to note are:

- the scheme auditor addresses its report on a scheme's financial statements to the trustees of the scheme and to other parties if required by the trust deed and rules;

- the responsibilities of the trustees may vary according to the constitution of the particular pension scheme, subject to overarching requirements which apply to all trustees by virtue of statute or the general law;
- the Audited Accounts Regulations require the scheme auditor to state whether or not in the auditor's opinion the financial statements contain the information specified in the regulations;
- the Audited Accounts Regulations require trustees of a scheme to disclose in its financial statements whether those statements have been prepared following the financial reporting framework current at the end of the year and, if not, to give details of any material departures. The key aspects of the current financial reporting framework for pension schemes include FRS 102 and the Pensions SORP;
- FRS 102 contains specific requirements for pension scheme financial statements as set out in its 'Specialised Activities' section covering the form, disclosures and accounting policies for pension scheme financial statements. These are generally considered necessary for pension scheme financial statements to show a true and fair view;
- although the Pensions SORP's guidance is not mandatory nor a primary accounting standard, the requirement to disclose non-compliance and the general status of a Pensions SORP issued in accordance with the FRC's code has the effect of establishing a strong presumption that financial statements which meet the requirement under PA 1995 and the regulations to show a true and fair view will normally follow the guidance contained in the Pensions SORP;
- the trust deed establishing a scheme may establish additional requirements concerning the contents of its financial statements;
- when determining the nature of the auditor's report, the scheme auditor also assesses whether the evidence obtained over the audit as a whole indicates that a statutory duty to report direct to TPR exists in addition to any report already made in respect of particular matters encountered in the course of their work;
- in addition, a decision by the scheme auditor either to issue a modified or qualified opinion on the financial statements of the scheme or to qualify the auditor's statement about contributions may be of material significance to TPR and, if so, is reported to TPR by the scheme auditor without waiting for the issue of the annual report and financial statements.

For periods beginning on or after 15 December 2019, the FRC has issued a revised ISA (UK) 700 and an updated Bulletin of illustrative audit reports.

The Bulletin addresses companies only and therefore does not include any example reports for pension schemes or any other specialist entities. The ICAEW does have, however, a series of help sheets ~~and the example audit reports included in Audit reports for pension schemes are based on the guidance in those help sheets~~ as to how the requirements apply to pension schemes.

~~The example audit report has been updated for these revisions. The Audit reports area of Navigate Audit provides further guidance and examples both for periods beginning before 15 December 2019 as well as periods beginning after 15 December 2019.~~

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

ISA (UK) 720 deals with the auditor's responsibilities relating to 'other information' included in the 'annual report' that contains or accompanies the financial statements. The auditors need to read all such material to identify whether there are any material inconsistencies between that other information and both the financial statements and the auditor's knowledge obtained in the audit, and if so to seek to resolve them.

The 'other information' which may accompany the financial statements of a pension scheme and examples of areas of potential concern include:

- trustees' report – membership statistics: are the changes in membership numbers consistent with the financial information?
- trustees' report – pension increases: is the rate of increase reflected in the benefit payments?
- trustees' report: is the asset total and investment income/return consistent with the amounts shown in the financial statements?
- FRS 102 requires a report on actuarial liabilities for defined benefit schemes to be reported alongside the financial statements. The SORP recommends this includes the scheme net assets at the date of the actuarial liabilities included in the report. Are the net assets included in the report consistent with the audited net assets at the relevant date?
- governance statement signed by the Chair for DC arrangements – is it consistent with the auditor's knowledge of the scheme?

There is also a legal requirement to include the latest actuary's certificate as to the adequacy of contributions in the annual report which may be different from the certificate applicable to the financial year covered by the annual report. The actuarial report is not required to be audited. However, if the auditor identifies that a material inconsistency appears to exist with the financial statements or the auditor's knowledge obtained in the audit (or becomes aware the other information appears to be materially misstated), the auditor may wish to liaise with the scheme actuary.

The trustees may also distribute other documents together with the financial statements such as personal benefit statements, scheme funding statements, new rules booklets or newsletters. The scheme auditor has no statutory responsibility to consider these documents. They will only be within the scope of ISA (UK) 720 if they are included in the scheme's annual report as defined in ISA (UK) 720.

5.2 Programmes

This master pack is based on the PCAS standard company audit pack. For guidance on mattersthat are common to both companies and pension schemes, please refer to the general PCAS guidance notes above.

Report on contributions programme

Audit programmes

Where a scheme requires an audit, the audit tool also contains programmes for documentation of the work needed to provide the auditor's statement about contributions. For those situations where the scheme does not require an audit, but the auditor still wishes to use these programmes for his work on the statement about contributions, the programmes are provided~~ as PDFs here.~~ Guidance on whether a report on contributions is required is here.

Schedules are available to cover the following areas.

Professional independence questionnaire

The auditor is still required to be independent and meet the same criteria as used for audits under the *Companies Act* 2006 . The professional independence questionnaire available in the audit tool can be used to confirm independence.

Planning memorandum

This form should be completed as a record of the planning carried out at the start of the assignment. Note that it asks you to obtain confirmation of the scheme's entitlement to the exemption from audited accounts from the insurer.

Materiality

You should still calculate a materiality level, even though a true and fair opinion is not being given. You may choose to use the *materiality calculator* ~~relevant parts of the materiality form in the audit tool~~ to calculate an income-based materiality. However, since the report on contributions is more specific and factual than a true and fair opinion, you may consider a lower level of materiality may be appropriate.

Principal completion

This form should be completed when the accounts have been signed and returned by the trustees, before the opinion is given. Where a second principal review was considered necessary (e.g. where potential independence problems were identified at the planning stage), an independent principal, or other independent consultant, should review the file and complete the relevant section on this form.

Contributions work programme

This form gives a number of tests that might be used to consider whether contributions have been paid in accordance with the payment schedule. You may decide that not all of these tests are required in all cases and can tailor the form in the same way as any of the other audit programmes.

Pensions disclosure checklist

Introduction

The disclosure checklist can be used to help with confirming that the correct disclosure has been made in the financial statements.

If you indicate that a disclosure checklist is not required from the Tailoring questions, the disclosure section will not appear in the audit file.

The checklist starts with a series of tailoring questions. These should be answered in the order shown as the answers to earlier questions will automatically determine which of the subsequent questions are included. As you answer each question, the system will, if the question has logic dependencies, refresh the display to bring in or exclude the questions that depend on the question asked. After you have completed the tailoring checklist, you will find that the system will have deactivated any disclosure checklists that are not applicable and only relevant questions will be included in the checklists that remain active.

Some of the questions relate to matters that the system could have determined from examining the contents of the trial balance, or client control data, however, you will be asked to answer these. This is done to provide an independent review of the disclosure requirements and ensure that there is a double check in case there are any processing errors or data has been combined for inclusion in the trial balance.

The checklist is split into the same 35 sections as FRS 102.

The checklist is based on the 2018 edition of the SORP and of FRS 102, which incorporates the changes arising from the FRC's triennial review of the standard. Both are applicable for periods beginning on or after 1 January 2019.

The checklist includes the audit report requirements introduced in the latest revision of ISAs (UK), applicable for periods beginning on or after 15 December 2019.

~~For reference purposes, the previous disclosure checklists can be found in the archive section (see Archive).~~

Using the programmes

The pensions audit tool contains a number of pension scheme specific programmes. ~~These are listed in Programme PDFs. In areas without a specific programme listed, the tool includes a standard company schedule from the Private Company *Navigate Audit* tool.~~

Approach to the pensions specific audit programmes

This section provides the auditor with guidance on how to apply the audit programmes to a pensions audit.

In Audit Automation, tests are available in a standard programme and also within a pool of available audit tests. You are free to customize the standard audit programme to add, remove or edit tests as applicable.

When the work is being completed, you can create working papers, enter comments and raise notes in respect of the test.

Investments

The approach will depend on who manages the investments of the scheme.

- Insurers (for insured schemes) will provide trustees with periodic:

(i) statements of cash premiums paid; and

(ii) valuations of policies.

- Authorised investment managers have to provide periodic information, including:

(i) statements of transactions, to include valuation and details of income; and

(ii) contract notes for each transaction.

These should be used as independent evidence to support valuation, existence and ownership. Where investments or title deeds are held by third parties, you should consider asking for confirmation of the holdings.

Using the work of management's expert

As you will be relying on the work done by management's experts; that is the actuaries, investment managers or insurers, you will need to consider the requirements of ISA (UK) 620. Therefore, you should:

- consider the objectivity, professional qualifications, experience and resources of the expert;
- assess whether the scope of the work is sufficient for the purposes of your opinion; and
- whether the work gives sufficient audit comfort.

In the case of large insurance companies or investment managers, there are likely to be few problems with relying on their work. However, you do need to show that you have considered these points on your audit file.

There is a supplementary programme in the audit tool (Sup2) that considers the above issues *which can be activated via a tailoring question* .

Employer-related investments and loans

Employer-related investments are generally limited by regulations to five per cent of the current market value of the scheme's resources (or net assets). Auditors need to ensure that these limits are not exceeded. The definition of employer-related investments does not include investment in a bank or building society but would include contributions that were unpaid at the scheme year end that were not subsequently paid within the timescales required by the payment schedule or schedule of contributions.

Insurance policies

Insurance policies used by pension schemes typically include unit linked policies, annuities and with-profits policies.

Unit linked policies

The value of unit linked or unitised insurance policies fluctuates directly in relation to the fair value of the asset class or classes that constitute the investments underlying the insurance policies. These policies should be valued on the same basis as pooled investment vehicles. Interests in unquoted pooled investment vehicles which are valued using prices published by the pooled investment vehicle manager are reported at the closing bid price if both bid and offer prices are published or, if single priced, at the closing single price. Private equity, infrastructure and other relatively illiquid pooled investment arrangements are normally reported at the net asset value (NAV) of the fund provided by the pooled investment manager, who uses fair value principles to value the underlying investments of the pooled arrangement.

Annuities

FRS 102 requires insurance policies that exactly match the amount and timing of some or all of the benefits payable under the scheme to be valued. FRS 102 states that these holdings should be valued at fair value, which is defined as the present value of the related obligation. The SORP recommends that trustees adopt a reasonable basis for valuing annuities and apply it consistently from year to year. Options for determining the value of scheme liabilities include the scheme funding valuation basis, the buy-out basis and the basis set out in FRS 102 for employer accounting. If the valuation is carried out by the annuity provider, possible bases also include the actuarial method which would approximate to a scheme funding approach, or the net premium method which approximates to a buy-out basis.

Where trustees become responsible for existing insurance policies, e.g. as a result of a scheme merger or a transfer-in from another scheme, similar considerations apply.

Trustees may decide to purchase annuity policies which are specifically allocated to the provision of benefits for, and which provide all the benefits payable under the scheme to, or in respect of, particular members. These annuity policies are usually in the name of the trustees and remain assets of the scheme. These transactions are generally referred to as ‘buy-ins’. The trustees are not legally discharging the corresponding liabilities. FRS 102 requires such policies to be valued annually at the amount of the related obligation, as noted above.

The trustees may purchase insurance policies in the name of individual beneficiaries or may assign existing policies in the trustees’ name into the names of individual beneficiaries. These transactions are generally referred to as ‘buy-outs’. The trustees’ intention is generally to secure the benefits to those beneficiaries and to secure a legal discharge for the trustees of the corresponding liabilities. The policies in these circumstances are not, or cease to be, assets of the scheme and cannot be included in the scheme’s statement of net assets available for benefits.

With-profits policies

With-profits policies should be reported at an estimate of their fair value. This will normally be the ongoing value of the policy based on the cumulative reversionary bonuses declared and the current terminal bonus. If there is a commitment to redeem the policy, surrender value should be used. FRS 102 requires fair value to be determined on an ‘exit’ value rather than an ‘entry value’ meaning that the use of an actuarial value or premium value would not be appropriate.

Fund account

Contributions

If you are the auditor of both the scheme and the employer, it would make more sense to link the audit of wages and salaries for the employer audit with the audit of contribution income in the scheme. Items selected for testing the over-statement of expenses on the employer’s audit can easily be used as a reciprocal population to test understatement of contribution income in the scheme. You should also use the list of members which the scheme should maintain. Obviously, in a small scheme, the audit of income can be relatively low risk, but larger schemes may have a wide range of income sources. It is important that you address completeness for all material sources of income. The programmes do address the more common types of income whilst you should tailor the programme to meet the specific needs of your client.

5.3 Example letters and reports

This area *describes the* ~~of Navigate Audit contains example~~ letters and reports which are specific to pension schemes. ~~Letters which may be applicable to all entities, including smaller entities, are in Templates and Letters.~~

Pension specific letters

Audit letter of engagement for pension schemes

The letter of engagement forms the basis of the contract between the firm and the client. In the event of any dispute or uncertainty, this will play a vital part in reaching any agreement. It is essential that the letter is both complete and up to date.

Example engagement letters for pension scheme audits are available *in the templates under ENGPEN* ~~by following the links included here~~.

Report on contributions letter of engagement

A letter of engagement should be sent for these assignments in the same way as for any other work that you carry out on a client's behalf.

Example engagement letters for a report on contributions are available ~~by following the links included here.~~ The pension scheme modular engagement letter covers all engagement issues and includes schedules for the report on contributions (2.12), total exemption (4.10) and common services provided to pension schemes.

Template ENGPEN is an example modular engagement letter covering audit of contributions and other services.

Letters of appointment and resignation

In addition to the letter of engagement, the *Pensions Act* 1995, s. 47 imposes a requirement on scheme trustees to formally appoint professional advisers, including the auditors, in writing. The notice of appointment has to specify:

- the date the appointment is due to take effect;
- to whom the auditor is to report; and
- from whom the auditor is to take instructions.

The professional adviser is required to:

- acknowledge the notice of appointment in writing within one month of receipt; and
- confirm, in writing, that he or she will notify trustees immediately he or she becomes aware of any conflict of interest that he or she may have in relation to the scheme. This confirmation can be incorporated in the letter of engagement, but a separate acknowledgement does appear to be required.

Example notice of appointment as auditor to an approved pension scheme

(*to be typed on the scheme's headed paper or normal headed paper used by the scheme*)

APPOINTMW Example notice of appointment as auditor to an approved pension scheme

Example acceptance of acknowledgement of notice of appointment as auditor to an approved pension scheme

APPACKNOWW Example acceptance of acknowledgement of notice of appointment as auditor to an approved pension scheme

Example resignation letter as auditor to an approved pension scheme

RESIGNAUD Example resignation letter as auditor to an approved pension scheme

Letter of representation and trustees' meeting minutes

The specimen letter of representation is included below. It should be noted that the ISAs require the letter of representation to be sent from the client to the auditor. A letter from the auditor on the practice letterhead is no longer acceptable.

The section also includes a specimen minute confirming the contents of the letter where only one trustee is signing the letter on behalf the board.

Example letter of representation

REPAUDW Example letter of representation

Example minute of trustees' meeting to approve contents of letter of representation

DIRMEETW Example minute of trustees' meeting to approve contents of letter of representation

Audit reports

The following section includes an example audit report which can be used for pension scheme accounts for reports for periods commencing on or after 15 December 2019, in accordance with the revisions to ISA (UK) 700 and the FRC Bulletin. It should be noted that the Bulletin does not address reports for audits undertaken under the *Pensions Act* 1995. However, the ICAEW has written a help sheet on 'Preparing an audit report for occupational pension schemes' and this report incorporates that guidance.

~~Further guidance is included in Audit reports.~~

~~For earlier periods, an illustrative report is included in the Archive.~~

Unmodified report for a pension scheme

AUDACCS Unmodified report for a pension scheme (15 December 2019 and post)

Trustees’ statement of responsibilities

STATRESP Trustees’ statement of responsibilities

Note

Audit reports of pension schemes that do not publish their financial statements on a website, or publish them using PDF files, may continue to refer to the financial statements by reference to page numbers.

Report on contributions

Introduction

Guidance on the format of the report and the wording to be used is given in Practice Note 15 (Revised). An example of an unmodified statement on contributions is included below.

As noted at Reporting on contributions, auditors do not have to qualify their reports if there are small discrepancies which have no material effect on the scheme.

Sub-paragraph (a) of regulation 4(1), which sets out the form and content of the auditor's statement, requires:

‘a statement as to whether or not in his opinion contributions have in all material respects been paid at least in accordance with the schedule of contributions or payment schedule.’

Unmodified statement about contributions

AUDCONT Unmodified statement about contributions

5.4 What’s changed

This table lists, in chronological order with the most recent at the top, the changes made to the Pensions area. ~~Changes made over 12 months ago are in the archive.~~

What has changed?

Date	**~~Link to~~ latest documents**	**What has changed**
~~January 2024~~	~~Disclosure checklist~~	~~The pension scheme disclosure checklist has been reformatted for ease of use.~~
November 2023	Programmes	Version 5.0 of the Pension scheme audit tool has been released. ~~A detailed mapping schedule of changes between v4.1 and v5.0 is available here.~~ This update incorporates amendments to audit programs required as a result of the revision to ISA (UK) 220. A number of other amendments have been made to respond to customer feedback and to clarify the requirements of ISA (UK) 240 and ISA (UK) 315. ~~A spotlight article that gives an overview of the revisions to ISA (UK) 220 (Revised July 2021) and the resulting changes to the *Navigate Audit* tools and guidance is available here.~~ Briefly, sections A (Final completion), B (File completion) and C (Planning) have been amended to: • reflect increased focus on the importance of professional scepticism throughout; • clarify leadership responsibilities, particularly in relation to quality management and evidence of RI involvement; • further increase focus on fraud; and • focus on team meetings and communication to enhance audit quality. The audit programmes have been amended to provide further prompts to the auditor to consider the reliability of audit evidence and also to consider the unpredictability of audit testing as part of a robust testing strategy.

November 2023	Permanent Audit File	The Permanent Audit File schedules have been removed from the Pension scheme audit tool. The New Client Checklist is ~~now available in Templates and Letters in *Navigate Audit*.~~ *still available as a checklist within the Audit Automation Permanent file area.* The other schedules are available ~~in a new Permanent Audit File workbook in *Navigate Audit* Tools.~~ *as Background Information documents.*
~~November 2023~~	~~Audit file PDFs~~	~~Audit file PDFs have been updated for those schedules which have changed.~~
November 2023	Guidance and Methodology	A number of sections of the Audit Guidance and Methodology area ~~of *Navigate Audit*~~ have been updated to provide supporting guidance on these changes and the requirements of the latest ISAs. ~~Details of these are in Audit methodology > What's changed.~~
~~November 2023~~	~~User guide~~	~~An updated user guide is also available.~~
~~November 2023~~	~~Audit tool archive~~	~~Version 4.1 of the Pension scheme audit tool has been moved to the Archive.~~
~~August 2023~~	~~Programmes~~	~~Version 4.1 of the Pension scheme audit tool has been released.~~ ~~In this version, links to the Croner-i platform have been updated following some internal development work to enable updates to the platform to be processed more efficiently and quickly.~~
November 2022	Pension Specific Letters	Letters of representation have been updated to reflect the requirements and wording of ISA (UK) 240 (revised May 2021) (Updated May 2022).
~~November 2022~~	~~Disclosure checklists~~	~~The pension disclosure checklist has been updated to integrate Appendix 2 into the Main Checklist.~~
November 2022	Programmes	Version 4.0 of the pension scheme audit tool has been released. ~~A detailed mapping schedule of changes between v4.0 and v3.0 is available here.~~ This version aims to: • reflect significant ISA driven changes to audit requirements primarily from the revised standards ISA (UK) 315 *Identifying and assessing the risks of material misstatement* and ISA (UK) 240 *The auditor's*

		responsibilities relating to fraud in an audit of financial statements. New content has been added and changes made in certain schedules, as well as references and links updated to the latest versions of standards; • address ongoing regulator concerns about auditors' professional scepticism and the need to hold and document robust discussions that challenge management's assumptions, as well as reliance on the work of external experts; ~~• improve understanding and navigation by adding further links within the Excel file to related guidance and standards in *Navigate Audit* and *Navigate Accounting;* and~~ • minor updates to respond to customer feedback on specific schedule
November 2022	Programmes	**Risk assessment procedures** ~~A detailed mapping schedule of changes between v3.0 and v4.0 is available here.~~ New planning schedules have been developed to address the enhanced IT requirements of ISA (UK) 315: • IT risk identification (C7.2); • Assessment of IT risks and general IT controls (C7.3); and ~~• an IT coversheet (C7.2i) has also been provided to guide the user through the new audit programmes.~~ All planning and risk assessment schedules have been reviewed and updated where necessary to help teams document audit risk assessment processes and procedures effectively under the revised standards: ISA (UK) 315 and ISA (UK) 240. Key changes include: • an additional point has been included in *Detailed file completion checklist* (B1) to aid compliance with the new stand-back requirement; • consideration of inconsistencies identified has been included as an additional column in *Summary of significant matters* (*template* B4); • a new question has been included in *Audit strategy and plan* (C2) and Risk assessment (C9) to aid

compliance with the new requirement of making enquiries of any whistle-blowers;

- a new question has been included in Audit strategy and plan (C2) to aid compliance with the new requirement to consider the use of experts or other specialists;

- *Know your client checklist* (PAF04) has been renamed Understanding the entity aide-memoire and moved to the planning section (C4), with significant revisions designed to enhance risk assessment procedures and understanding of the entity;

- *Significant accounting policies* (PAF07) has been moved to the planning section (C4.1) with amendments and additions designed to enhance risk assessment procedures and understanding of the entity;

- *the Internal control aide-memoire* (C7.1) has been significantly revised to address requirements for understanding the system of internal control, including columns for the identification of controls and determining the impact of control deficiencies;

- *Detailed risk assessment* (C9.1) has been updated to include consideration of the need for experts or other professionals with specialised skills where suspected fraud may be a risk factor;

- the *Risk assessment summary is covered by the Identified risks and Area risk assessment* ~~(C9.3) has been split into two separate schedules to ensure full consideration of both financial statement level risks (C9.3) and assertion level risks (C9.4). These sheets have been updated to include:~~

  - ~~consideration of the need for experts or other professionals with specialised skills where suspected fraud may be a risk factor;~~

  - ~~further 'stand back' requirements to document and evaluate risks;~~

  - ~~references to ISA (UK) 315 requirements, including the five inherent risk factors; and~~

  - ~~a section added to document revisions to the risk assessment during the audit.~~

		• Notes of the *engagement team planning meeting* (C10) has been amended to ensure the partner determines the need for communication and the use of experts or other specialists where necessary as well as updating guidance notes and prompts to consider the need for further meetings and discussions of the audit plan. ~~To aid navigation and understanding, hyperlink cross-references to corresponding Guidance and Methodology in *Navigate Audit* have been updated and links added within the audit tool where applicable.~~
November 2022	Programmes	**Further enhancements** In addition to enhancements to risk assessment procedures, the majority of schedules have been updated for minor editorial amendments as well as updates to references and links. ~~A detailed mapping schedule of changes between v3.0 and v4.0 is available here.~~ Several audit programmes contain additional steps where necessary to address the changes driven by the revised ISA (UK) 315 and ISA (UK) 240. Key changes include: • Additional steps have been added to verify client reports or extractions of client reports in all relevant work programmes; • the Register of laws and regulations (PAF05) has been moved into the work programme section for Going concern & regulations (D6) to ensure more detailed and up to date documentation to support the audit file; and the Permanent audit file schedules for related parties (PAF06, PAF06.1 and PAF06.2) have all been moved into the work programme section for Related party transactions (X3, X4 and X5) to ensure more detailed and up to date documentation to support the audit file.
~~November 2022~~	~~Audit files PDFs~~	~~All revised audit file PDFs are available to download.~~
~~November 2022~~	~~User guide~~	~~An updated user guide is also available.~~
~~November 2022~~	~~Audit tool archive~~	~~Version 3.0 of the pension scheme audit tool has been moved to the Archive.~~

~~Audit file~~
~~PDFs archive~~

6. Academies

Contents

- Guidance and methodology
- Programmes
- Academy specific example letters and reports
- What's changed

6.1 Guidance and methodology

These guidance notes are based on the notes provided with the Academies Audit System. This is to allow existing users to understand the differences between the way that the system is used and the way that it has been implemented on Audit Automation. Any guidance relating to the Excel version that is not relevant, or has been varied to fit in with the automated version, is retained but crossed out with a strikethrough. Any additional guidance is printed in Blue and italicised.

This area ~~of Navigate Audit~~ supplements the commentary in the main Audit Guidance and Methodology area with matters specific to academy assignments.

These guidance notes give a basic introduction to Academies, including Multi Academy Trusts (MATs), along with the audit and accounting requirements. They are not intended to be an exhaustive guide and reference should be made to the original source material ~~included in Reference Material~~ for more detailed information.

I.e. Academies Accounts Directions 2022 to 2023,

Supplementary Bulletin to Academies Accounts Direction 2020/21 (still extant),

Academies model accounts 2022 to 2023,

Academy Trust Handbook 2022,

Framework and guide for external auditors and reporting accountants of academy trusts 2022,

Teachers Pension TP05 2022/23 guidance

NAO Communication with component academy auditors 2021

What is an Academy?

An academy is an independent, but state funded, school. All academies must be approved by the Department for Education (DfE) and are funded directly by the DfE rather than by a local authority; although they may also receive additional funding from sponsors.

What's different about academies?

Freedoms

Academies benefit from greater freedoms to innovate and raise standards. These include:

- freedom from local authority control;
- the ability to set their own pay and conditions for staff;

- freedoms around the delivery of the curriculum; and
- the ability to change the lengths of terms and school days.

Sponsors

Some academies, generally those set up to replace underperforming schools, will have a sponsor. Sponsors come from a wide range of backgrounds including successful schools, businesses, universities, charities and faith bodies. Sponsors are held accountable for improving the performance of their schools.

Funding

Academies receive the same level of per-pupil funding as they would receive from the local authority as a maintained school, plus additions to cover the services that are no longer provided for them by the local authority. However, academies have greater freedom over how they use their budgets to best benefit their students.

Academies receive their funding directly from the Education and Skills Funding Agency (ESFA) rather than from local authorities.

Governance

The principles of governance are the same in academies as in maintained schools, but the governing body has greater autonomy.

What does not change with academy status?

Admissions, special educational needs and exclusions

Academies are required to follow the law and guidance on admissions, special educational needs and exclusions as if they were maintained schools.

Collaboration

The trustees of the academy trust must ensure that the school will be at the heart of its community, collaborating and sharing facilities and expertise with other schools and the wider community.

All schools that are performing well and applying for academy status are expected to work with another school to raise standards. Collaboration and partnership are now embedded in the school system, and this is also the case for academies.

Selection

Schools which already select some or all of their pupils will be able to continue to do so if they become academies, but schools becoming academies cannot decide to become newly selective schools.

Freedom of information

The Freedom of Information (FOI) Act 2000 applies to academies as it does to maintained schools.

Types of academy

Academies were first established in 2000. However, the number of academies has increased greatly since the introduction of the *Academies Act* 2010. At the time of writing, the latest data showed that of the roughly 24,500 schools in England, approximately 39% of primary schools and 80% of secondary schools are academies.

Academies are a growing sector, making up 40% of all schools in the UK. As all academies require an external statutory audit this is one area where the audit market is expanding rather than contracting.

Academies are a mix of primary and secondary schools as any school can become an academy. Full details of the application process are included on the Department for Education section of the GOV.UK website. In addition, the site contains a lot of basic information about academies with which auditors should be familiar.

Academies have greater freedom of operation than a local authority school; however, they must still teach a broad and balanced curriculum and they are also subject to inspection by OFSTED.

Academies can take the structure of a single academy trust or sit within a multi-academy trust (MAT); a MAT is a group of schools which are governed by a single set of governors. In the last couple of years, the number of MATs have seen an increase.

This product gives a basic introduction to academies, including MATs, along with the audit and accounting requirements. It is not intended to be an exhaustive guide and reference should be made to the original source material for more detailed information.

Legal background

The Academies Act 2010 received royal assent on 27 July 2010. It made significant changes to the framework for academy schools although the basic form is as established in 2000.

All academies are constituted as companies limited by guarantee and are subject to the *Companies Act* 2006 in the same way as any other company in respect of preparation of accounts, meetings and resolutions, etc. It is important to note, though, that academies are required to have an audit; hence the audit exemption provisions in the Companies Act do not apply to academies. In addition, trusts with a funding agreement and an open academy cannot claim any exemptions that small companies can claim (i.e. through adoption of the small companies regime).

Section 12(1) of the Act came into force on 29 July 2010. Under this section, all academies approved by the DfE are automatically charities. However, since 1 August 2011 academies have been classed as exempt charities (by virtue of the *Academies Act* 2010, s. 12(4)). This means that they are exempt from registration with and regulation by the Charities Commission. Instead they are regulated by the Education and Skills Funding Agency on behalf of the Secretary of State for Education.

Regulation of academies

Academies are charitable companies and are also classified by the Office for National Statistics as central government public sector bodies. Academies are therefore subject to public standards of accountability.

They are required to appoint an accounting officer (generally the principal) who will have personal responsibility to Parliament for regularity (spending money for the purposes intended by Parliament), propriety (handling money honestly and avoiding conflicts of interest) and value for money.

The Academies Trust Handbook 2022 provides advice on the financial systems and controls that academies should have in place to meet the expected standards of accountability.

Within this framework, academies are responsible for their own financial management and are, in particular, expected to operate a balanced budget. However, the ESFA has special responsibility for obtaining assurance on academies' financial health and requires them to submit a copy of their budget to the ESFA each academic year. If an academy has a deficit it will be required to produce a recovery plan for agreement with the ESFA.

Academies are also expected to complete a self-assessment of their financial management and governance. The ESFA may undertake validation of the evidence provided.

All trusts must also complete the School resource management self-assessment tool and submit their completed checklist to ESFA by the specified annual deadline. At the time of writing, the deadline for completion had not been publicised.

Academies are required to prepare annual accounts for each academic year ending 31 August and to have these accounts independently audited and published. This is the case even where the trust is set up partway through the academic year. Academies must submit their audited financial statements and management letter to the ESFA by 31 December each year using the online portal, and publish the audited financial statements on their website by 31 January (the academy trust must maintain at least the two previous financial statements on their website). Under s. 442(2)(a) of the *Companies Act* 2006, the academy trust is also required to submit their audited financial statements to Companies House for placing on the public record, usually by 31 May each year. It is insufficient to provide a link to Companies House website in place of publishing the academy trust's financial statements on its own website.

Constitution

All academies are constituted as companies limited by guarantee and also as charities. They must therefore comply with the Companies Act 2006 and prepare accounts in accordance with the Companies Act 2006 and the Charities' Statement of Recommended Practice (SORP). There is more detail about these requirements at Annual accounts.

Academy Trust Handbook

Handbook version

The version of the Academy Trust Handbook published in August 2022 ('2022 Handbook') applies for periods from 1 September 2022 so is the version used in this product. The 2022 Handbook is available from the Education and Skills Funding Agency (ESFA) website ~~and is also included in Reference material.~~ All references made to the Academies Financial Handbook are to the 2022 version.

The Academy Trust Handbook (Handbook) sets out the financial requirements for academy trusts (ATs). The Handbook, together with the Funding Agreement (FA) sets out the financial relationship between the ESFA and ATs and compliance with the Handbook is a condition of these funding agreements.

The Handbook describes a financial framework for ATs that reflects their accountability to Parliament and the public, and the freedoms that they need over their day-to-day business. Ultimate responsibility and accountability for the financial framework for ATs is retained by the Department for Education (DfE). It also reflects the 'seven principles of public life' (selflessness, integrity, objectivity, accountability, openness, honesty and leadership) to which all public office holders must adhere.

The Handbook is applicable to all variants of the academy model including single academy trusts, multi-academy trusts, traditional sponsored academies, converter academies, free schools, studio schools, university technical colleges, alternative provision and special academies.

The introduction to the Handbook states that it is a key document for ATs that sets out responsibilities and requirements relating to their financial governance and management.

Set out below is a summary of the main changes from the 2021 to the 2022 version:

Main financial reporting requirements

- confirming withdrawal of the Budget Forecast Return Outturn [2.15];

Delegated authorities

- clarifying that prior approval of staff severance payments in accordance with HM Treasury's Guidance on Public Sector Exit Payments applies only to 'special' (non-statutory/non-contractual) payments [5.12];
- confirming that trusts will be able to enter into indemnities which are in the normal course of business without seeking approval [5.19]; and
- extending the scope of religious character from dioceses to all religious authorities, confirming when the 'at cost' requirement is met [5.57].

Other guidance

The ESFA's website includes a lot of guidance concerning academies and should be the starting point for any queries. The guidance available includes the following:

- Academy Trust Handbook (including Part 9 which provides a series of links for further information);
- Academies Accounts Direction 2022-2023 (April 2023);
- Model set of accounts for academy trusts (April 2023);
- Framework and guide for external auditors and reporting accountants of academy trusts (April 2023);
- Letters from Lord Theodore Agnew to academy trust auditors; and
- Letter from David Withey, Chief Executive of the ESFA, to academy trust accounting officers (July 2023).

The guidance and requirements in the model accounts and framework documents have the same status as guidance and requirements in the Accounts Direction and should be read in conjunction with the Direction and any related requirements and guidance published by ESFA.

In May 2019, the Department for Education also launched an academies chart of accounts. This was the first step to automated financial reporting in a bid to improve the quality of reporting at academy trusts. Adopting the academies chart of accounts is voluntary but those who choose to adopt the standard will benefit from being able to run their draft financial statements for 2022/23, using automated data, from September 2023.

The Charity Commission also publishes guidance that is relevant to academies:

- Academy schools: guidance on their regulation as charities;
- CC3: The essential trustee – what you need to know;
- CC8: Internal financial controls for charities; and
- Charities SORP – Second edition October 2019, which consolidates the changes set out in Update Bulletin 1 and Update Bulletin 2 and is effective for periods beginning on or after 1 January 2019 (see Annual accounts).

In addition a Good Practice Library is available as part of a joint initiative with the Institute of School Business Leadership (ISBL). This provides access to material such as policy templates, guidance and factsheets for schools.

Roles & responsibilities

Responsibilities of the Department for Education

The Department for Education (DfE) has ultimate responsibility and accountability for the effectiveness of the financial system for academies. In particular, the DfE is responsible for ensuring there is an adequate framework in place to provide assurance that all resources are managed in an effective and proper manner and that value for money is secured. There is a clear chain of accountability from each Academy Trust (AT), which has its own accounting officer, through the ESFA's accounting officer, to the DfE's principal accounting officer.

Responsibilities of the ESFA

The ESFA is an executive agency of DfE and acts as the agent of the Secretary of State within an agreed authority to take decisions on his behalf. The ESFA's accounting officer is responsible and accountable to Parliament for how the ESFA uses its funds. The ESFA's accounting officer is also personally responsible for the regularity and propriety of all expenditure of its funds and for ensuring value for money. To discharge these duties properly, the ESFA's accounting officer must be satisfied that an AT has appropriate arrangements for sound governance, financial management, securing value for money and accounting, and that the way the AT uses public funds is consistent with the purposes for which the funds were voted by Parliament.

ESFA's chief executive sends a 'Dear Accounting Officer' letter periodically to all AT accounting officers, setting out their key responsibilities and highlighting any changes from previous years. Accounting officers must share this letter with their trustees, and chief financial officer and other members of the senior leadership team, arrange for it to be discussed by the board of trustees and take action where appropriate to strengthen the trust's financial systems and controls.

At the time of writing the last letter issued was from July 2023.

All published letters from ESFA can be found here: www.gov.uk/government/collections/academy-trust-accounting-officer-letters-from-efa.

ESFA Intervention Powers

Where ESFA has concerns about financial management and/or governance in an AT (including a multi-academy trust or constituent academies within a multi-academy trust) it may issue, and publish, a Notice to Improve (NtI, previously Financial Notice to Improve). The trust must comply with all of the terms of an NtI. Failure to comply will be deemed a breach of the funding agreement by virtue of the relationship between the funding agreement and the handbook. Exceptionally, the funding agreement may be terminated due to non-compliance with the terms of the NtI.

Where a trust is subject to an NtI, it must publish the NtI on its website within 14 days of it being issued and retain it on the website until the NtI is lifted by ESFA. Trusts who have had a Ntl in place at some point during the year must declare this and provide more information.

An NtI will set out the actions ESFA requires trusts to take in order to address the underlying concerns about financial management and/or governance. For example, an NtI may be issued where there is a deficit, a projected deficit, cash flow problems, risk of insolvency, other financial concerns (such as irregular use of public funds), or inadequate financial governance and management (including breaches of the duties, principles and requirements governing related party relationships).

If an NtI is issued to a trust, then all of the delegated authorities in section 5 of the Handbook are revoked. All transactions by the trust of this nature, regardless of size, must be approved in advance by ESFA, specifically:

- special staff severance payments;
- compensation payments;
- writing off debts and losses;
- entering into guarantees, indemnities or letters of comfort;
- disposals of fixed assets beyond any limit in the funding agreement;
- taking up a leasehold or tenancy agreement on land or buildings of a duration beyond any limit in the funding agreement;
- carry forward of unspent General Annual Grant (GAG) from one year to the next beyond any limit in the funding agreement; and
- pooling of GAG.

The trust may also be prevented from entering into transactions with related parties without the prior approval of the ESFA. These delegated authorities shall be returned to the trust once the terms set out in the NtI have been complied with, and improvement is sustainable.

Where the ESFA has concerns about the financial management of a trust, but has not issued an NtI, it may require the trust to work with an expert in school financial health and efficiency to support the trust and identify where improvements could be made. The DfE has produced a range of additional information, tools and training to help trusts improve their financial health and efficiency. Working with an expert in school financial health and efficiency can also be prescribed as a condition of an NtI.

The Secretary of State may take action to address concerns about an individual managing an academy trust. Subject to the relevant provisions being present in the trust's funding agreement, the Secretary of State can require the trust to remove a member or trustee. This can include where the individual has been convicted, cautioned or engaged in relevant conduct and, as a result, the Secretary of State considers them unsuitable to take part in management of the academy trust.

The Secretary of State can also make directions under the Education and Skills Act 2008, s. 128 prohibiting individuals from taking part in academy trust management. This could prevent an individual from acting as a member, trustee or executive leader of a trust and could arise in circumstances where the individual is subject to a caution or conviction or has engaged in relevant conduct, and the Secretary of State considers that because of that caution, conviction or conduct that individual is unsuitable to take part in the management of a school.

Where there is a concern, the ESFA may refer trusts to the Charity Commission, reflecting the Commission's interest in addressing non-compliance with legal or regulatory requirements or misconduct or mismanagement in the administration of any charity, and in ensuring that individuals running the charity (in particular, but not limited to, the trustees) do so in compliance with their legal duties.

ESFA may also refer academy trustees, as directors, to the Insolvency Service who may consider whether the conduct of a director is such that they are unfit to be involved in management of a company and whether or not it would be in the public interest for a disqualification order to be sought.

Responsibilities of trustees of the AT

The trustees of the academy trust are both charity trustees and company directors. The Handbook refers to them as trustees. However, in some academy trusts, such as church academies, those on the board are known instead as 'directors'. In church academies, the term 'trustees' is reserved for those on the board of the separate trust that owns the land.

The trust's articles of association will set out conditions determining the minimum number of trustees the trust will have. All trusts should have reserved places for parents, carers or other individuals with parental responsibilities in their governance structure and trusts should hold elections to fill these places, as appropriate.

The trustees should focus on the three core functions of governance:

- ensuring clarity of vision, ethos and strategic direction;
- holding executive leaders to account for the educational performance of the organisation and its pupils, and the performance management of staff; and
- overseeing and ensuring effective financial performance.

The trustees must apply the highest standards of conduct and ensure robust governance, as these are critical for effective financial management. They should follow the Governance Handbook, which describes the following features of effective governance and will aid compliance with the Academy Trust

Handbook:

- strategic leadership that sets and champions vision, ethos and strategy;
- accountability that drives up educational standards and financial performance;
- people with the right skills, experience, qualities and capacity;
- structures that reinforce clearly defined roles and responsibilities;
- compliance with statutory and contractual requirements; and
- evaluation of governance to monitor and improve its quality and impact.

Academy trusts are companies limited by guarantee and exempt charities. The board of trustees is subject to the duties and responsibilities of charitable trustees and company directors as well as any other conditions that the Secretary of State agrees with them. These responsibilities are mutually reinforcing and are there to ensure proper governance and conduct of the trust. The key requirements are reflected in the articles of association, the funding agreement, and the Academy Trust Handbook. Trustees should follow the guidance in the Governance Handbook which sets out the legal duties applying to, and core role and strategic functions of, boards of trustees. Trustees must be aware of the Charity Commission's guidance for trustees *CC3: The Essential Trustee: What you Need to Know, what you need to do*. The Charity Commission website also provides a range of resources on proper conduct and the operation of charities.

The trustees must ensure regularity and propriety in use of the trust's funds, and achieve economy, efficiency and effectiveness – the three key elements of value for money. The trustees must also take ownership of the trust's financial sustainability and its ability to operate as a going concern.

The board of trustees must:

- ensure that financial plans are prepared and monitored, satisfying itself that the trust remains a going concern and financially sustainable;

- take a longer term view of the trust's financial plans consistent with the requirement to submit three-year budget forecasts to ESFA; and
- as part of its management of the trust's funds, explain its policy for holding reserves in its annual report. Information on how the trust must report on reserves is set out in the Accounts Direction.

There is also a good practice guide on going concern, last updated by ESFA in October 2020. The guide is aimed primarily at academy trusts (ATs) but it is also relevant to external auditors.

The chair of trustees is responsible for ensuring the effective functioning of the board and setting professional standards of governance.

The trustees must ensure compliance with the trust's charitable objects and with company and charity law, and adherence to the trust's funding agreement with the Secretary of State. Any newly appointed senior executive leader can only be a trustee if the members decide to appoint them as such, the senior executive leader agrees and the trust's articles permit it. The DfE's strong preference is that no other employees serve as trustees, in order to retain clear lines of accountability through the senior leader.

The board of trustees of the AT must also understand their statutory duties as company directors, which are set out in sections 170 to 181 of the *Companies Act* 2006 and include the duties to:

- act within their powers;
- promote the company's success;
- exercise independent judgement;
- exercise reasonable care, skill and diligence;
- avoid conflicts of interest;
- not to accept benefits from third parties; and
- declare interest in proposed transactions or arrangements.

These duties are especially relevant when entering into transactions with related parties.

As an organisation, the trust has a range of obligations under current legislation and statutory guidance. Trusts obligations include such matters as safeguarding, health and safety and estates management. Ensuring strong governance in these areas is a key priority for the board.

The trustees should identify the skills and experience that it needs, and address any gaps through recruitment, training or other development activities as appropriate. This also needs to be addressed for any local governing bodies that they have put in place. The Governance Handbook identifies a range of training material in this area, including a competency framework for governance that trusts should refer to in determining whether they have skills gaps.

The trustees must provide details of the AT's governance arrangements in the governance statement published within the annual accounts and on the AT's website. This includes its scheme of delegation for governance functions setting out what the board has delegated to its committees and, in the case of multi-academy trusts, to local governing bodies. The scheme of delegation should be reviewed annually, and immediately when there has been a change in trust management or organisational structure. An AT should have a finance committee to which the board delegates financial scrutiny and oversight, and which can support the board in maintaining the trust as a going concern.

Trusts producing accounts which are to be audited for the first time must include in their governance statement what they have done to review and develop their governance structure, and composition of the board of trustees. Established trusts should also include an assessment of the trust's governance, including a review of the composition of the board in terms of skills, effectiveness, leadership and impact.

To help with this, trusts should refer to the six key features of effective governance set out in the Governance Handbook and noted above (strategic leadership, accountability, people, structures, compliance and evaluation).

The board may delegate functions to committees. Each committee of the board (other than those in a multi-academy trust constituted under the articles as a local governing body) must contain a majority of trustees, but it may also include other people the board chooses to appoint.

The board must appoint an audit committee if the academy trust's annual income is over £50 million. Smaller trusts must either have a dedicated committee or can combine it with another committee, in accordance with section 3.6 of the Handbook, to advise on the adequacy of financial and non-financial controls and risk management arrangements, to direct a programme of internal scrutiny and to consider the results and quality of external audit. Audit and risk committees must meet at least three times a year.

Academy trusts must not have 'de facto' trustees (defined in the Charity SORP) or shadow directors (within the meaning of the *Companies Act* 2006, s. 251).

Conflicts of interests

It is vital that governors and senior staff are seen to act impartially. Where the governing body is drawn widely from those in the business and working elsewhere in the public sector conflicts of interest are inevitable. All governors, and as a matter of best practice the head teacher and other senior staff, should complete a declaration of their business interests.

When a matter arises where a governor has a conflict of interest that should declare that interest and withdraw from that part of the meeting. It is the responsibility of the individual governors to declare the interest. The board of trustees must keep the register of interests up to date at all times. The register of interests must include relevant interests of members, trustees, local governors of academies within a multi-academy trust and senior employees, including:

- directorships, partnerships and employments with businesses;
- trusteeships and governorships at other educational institutions and charities; and
- for each interest:
    - the name of the business;
    - the nature of the business;
    - the nature of the interest; and
    - the date the interest began.

From an audit perspective the register of interests is obviously a key document in terms of compliance with ISA (UK) 550 Related *Parties*.

Payment of Governors

It is not permitted for a governor to receive payment in respect of their role as governor other than payment of out of pocket travel and accommodation expenses properly incurred in their capacity as a governor, except where the payment is specifically allowed by the academy's governing document or has express authorisation from the Charity Commission. In addition, no governor may hold an interest in property belonging to the AT or receive remuneration under any contract to which the AT is party.

Payments to governors and related parties is considered more fully at Financial governance and delegated authorities.

Risk Management

The trust must recognise and manage present and future risks to ensure its effective and continued operation. The trust's management of risks must include contingency and business continuity planning.

The governors are responsible for risk management and as with other charities are required to make a statement in the Annual Report confirming that all major risks to which the charity is exposed have been reviewed and systems implemented where appropriate to mitigate those risks.

The sort of the questions the governors should be considering include:

- What are the major risks to the AT?
- What is the likelihood of those risks materialising?
- What would be the potential impact of the risks?
- What systems have been put in place to mitigate and monitor the risks?

The trust must maintain a risk register.

Overall responsibility for risk management, including ultimate oversight of the risk register, must be retained by the board of trustees, drawing on advice provided to it by the audit and risk committee. Other committees may also input into the management of risk at the discretion of the board. Aside from any review by individual committees, the board itself must review the risk register at least annually. Risk management covers the full operations and activities of the trust, not only financial risks.

The academy trust must have adequate insurance cover in compliance with its legal obligations or be a member of the academies risk protection arrangement (RPA). Not all risks are covered in the RPA. The trust should consider the RPA unless commercial insurance provides better value for money. If the trust is not a member of the RPA, it should determine its own level of commercial insurance cover to include buildings and contents, business continuity, employers' and public liability insurance and any other cover required.

Where reasonable recommendations are made by risk auditors, such recommendations must be implemented.

Head Teacher and Staff

In many academies the head teacher (often referred to as the principal) and one or more members of staff are also governors. This is not an issue as they are paid in respect of their services as members of staff of the academy rather than as governors. However, there are specific disclosure requirements under the Charities SORP. As governors the staff concerned are related parties and paragraphs 9.5 and 9.8 of the Charities SORP require remuneration and other benefits received by a trustee for their role as a trustee to be disclosed separately from remuneration and other benefits received for other employment with the academy trust. In relation to ATs, related party disclosures must therefore include remuneration paid to the principal and/or chief executive and other staff in their capacity as staff, clearly stating that their remuneration is in respect of their employment as staff, not in respect of their work as academy trustees. This point is specifically addressed in section 2.161–2.163 of the Accounts Direction 2022 to 2023.

External reviews of governance

An objective independent external review of the effectiveness of the board can be a more powerful diagnostic tool than a self-evaluation. External reviews are particularly important before the board undertakes any significant change, for example before a trust grows significantly, or in cases where concerns around governance arise. The DfE's strong preference is that external reviews of governance are also conducted routinely as part of a wider programme of self-assessment and improvement. Reviews should also consider the interaction between members and trustees, including the extent to which members are able to assure themselves that the trustees undertake their duties effectively. The DfE website provides further guidance on arranging an effective external review

The Role of the Members

The members of an AT have a different status from the trustees. The members are the subscribers to the trust's memorandum of association, and any other individuals permitted to become members under its articles of association. Members have an overview of the governance arrangements of the trust and have the power to appoint trustees and remove these trustees.

Members can amend the articles and may do so to support stronger governance arrangements. For details on making changes to the articles, including circumstances in which Charity Commission approval is required. (See the Charity Commission guidance CC36: Changing your charity's governing documents.) In certain circumstances, members may appoint or remove members and trustees. Members also appoint the trust's auditors and are entitled to receive the trust's audited annual accounts. Members may also, by special resolution, issue direction to the trustees to take a specific action and they also have power to change the name of the company and, ultimately wind up the academy trust.

While members can also be trustees, retaining some distinction between the two layers ensures that members, independent of trustees, provide oversight and challenge. This is especially important in multi-academy trusts in which trustees are responsible for a several academies.

ATs should be established with a minimum of three members, although DfE encourages trusts to have at least five members in total, as this:

- provides for a more diverse range of perspectives to enable robust decision making and reduces the risks of concentrating power; and
- ensures members can take decisions via special resolution without requiring unanimity.

Trusts must ensure that their members are not currently subject to a direction made under section 128 of the Education and Skills Act 2008 which prohibits individuals from taking part in academy trust management, and that they do not appoint as a member, a person who is currently subject to a section 128 direction.

Members must not be employees of the trust, nor occupy staff establishment roles on an unpaid voluntary basis.

The DfE believes that the most robust governance structures will have a significant degree of separation between the individuals who are members and those who are trustees. If members also sit on the board of trustees this may reduce the objectivity with which the members can exercise their powers. The DfE's strong preference is for a majority of members to be independent of the board of trustees.

As the responsibility to conduct the business of the trust in accordance with company and charity law rests with the trustees, members should avoid compromising the board's discretion in exercising its responsibilities. However, if the governance of the trust by the board of trustees becomes dysfunctional the members will have a strong interest in ensuring the board has sufficient plans to address the issues or otherwise to remove the board or individual trustees and reappoint trustees with the skills necessary for effective governance. It is important, therefore, for members to be kept informed about trust business so they can be assured that the board is exercising effective governance. This must include providing the members with the trust's audited annual report and accounts.

Responsibilities of the AT's accounting officer

The board of trustees must appoint a senior executive leader, who may be appointed as a trustee. In ATs comprising a single school, this should be the principal (who acts as the chief executive). In multi-ATs, this should be the chief executive or equivalent. The chief executive has responsibility, under the board of the AT's guidance, for the overall organisation, management, and staffing and for its procedures in financial and other matters, including conduct and discipline.

Each AT must also appoint a named individual as its accounting officer. The individual must be a fit and suitable person for the role. The roles of senior executive leader and accounting officer must not rotate. The accounting officer should be employed by the trust and prior approval from the ESFA must be obtained if, in exceptional circumstances, the AT proposes appointing an accounting officer who will not be an employee. The appointment of an accounting officer does not remove the responsibility of trustees, both individually and as a board, for the proper conduct and financial operation of the trust.

Should the senior executive leader be planning to leave the trust (for example retirement or resignation), the board of trustees should approach their Regional Schools Commissioner (RSC) in advance to discuss their structure and options, including plans for recruitment.

The essence of the role is a personal responsibility for:

1. **regularity** – the requirement that a financial transaction be in accordance with the relevant framework of authorities and should be woven into the academy trust's internal control procedures;
2. **propriety** – is concerned more with standards of conduct, behaviour and corporate governance. "Managing Public Money" defines propriety as the requirement that 'patterns of resource consumption should respect Parliament's intentions, conventions and control procedures, including any laid down by the Public Accounts Committee';
3. **value for money** – a key objective is to achieve value for money not only for the organisation but also for the taxpayer more generally; whilst it involves an academy trust living within its budget and using its resources properly and with probity, value for money is primarily about how it continuously improves both the educational and wider societal outcomes for its pupils, as well as estates safety and management, with the resources available.

The accounting officer must also demonstrate how the trust has secured value for money via the governance statement in the audited accounts. The accounting officer must also complete and sign a statement on regularity, propriety and compliance each year and submit this to ESFA with the audited accounts. The Accounts Direction 2022/23 clarified that the statement on regularity, propriety and compliance also encompasses estates safety and management. The reporting accountant (who is usually the academy trust's auditor) will also report on the accounting officer's statement on regularity, propriety and compliance through a limited conclusion report which is included in the academy's annual report.

The accounting officer also has responsibilities for keeping proper financial records and accounts, and for the management of opportunities and risks.

Whilst the accounting officer is accountable for the AT's financial affairs, the delivery of the trust's detailed accounting processes will be delegated to a chief financial officer, who will perform the role of finance director, business manager or equivalent.

The accounting officer must take personal responsibility (which may not be delegated) for assuring the board that there is compliance with the Handbook and the funding agreement (FA). The accounting officer must advise the board of trustees in writing if, at any time, in his or her opinion, any action or policy under consideration by the governing body is incompatible with the terms of the Handbook or FA. Similarly, the accounting officer must advise the board in writing if the board appears to be failing to act where required to do so by the terms and conditions of the Handbook or FA.

Where the board of trustees is minded to proceed, despite the advice of the accounting officer, the accounting officer must consider the reasons the board gives for its decision. If, after considering the reasons given by the board, the accounting officer still considers that the action proposed by the board is in breach of the Handbook or FA, the accounting officer must advise in writing the ESFA's accounting officer of the position immediately in writing.

More detailed guidance on the role of an accounting officer is set out in Chapter 3 of HM Treasury's Managing Public Money. HM Treasury's handbook, Regularity, Propriety and Value for Money describes what these concepts mean in a financial context. In particular, the latter describes the 'seven principles of public life' which apply to accounting officers.

The ESFA's chief executive will send a letter annually to all AT accounting officers, with updates for new Accounting Officers, setting out their key responsibilities and highlighting any changes from previous years (see Responsibilities of the ESFA).

Chief financial officer

The board must appoint a chief financial officer (CFO), who is the trust's finance director, business manager or equivalent, to whom responsibility for the trust's detailed financial procedures is delegated. The CFO should play both a technical and leadership role. The CFO should be employed by the trust, and the trust must obtain prior ESFA approval if it is proposing, in exceptional circumstances, to appoint a CFO who will not be an employee.

The CFO and their finance staff must be appropriately qualified and/or experienced. Trusts must assess whether the CFO, and others holding key financial posts, should have a business or accountancy qualification and hold membership of a relevant professional body, dependent on the risk, scale and complexity of financial operations. In particular, the ESFA encourages larger trusts (for example over 3,000 pupils) to consider the range of accountancy qualifications available from professional bodies and to take this into account when filling CFO vacancies.

CFOs should also maintain continuing professional development and undertake relevant ongoing training.

Governance professional

The academy trust should appoint a governance professional (previously named clerk to the board) to support the board of trustees who is someone other than a trustee, principal or chief executive of the trust. A governance professional can help the efficient functioning of the board by providing:

- guidance to ensure the board works in compliance with the appropriate legal and regulatory framework, and understands the potential consequences of non-compliance;
- advice on procedural matters relating to operation of the board; and
- administrative and organisational support

Disclosure and barring service checks

In order to comply with the Independent School Standards, and as set out in funding agreements, academy trusts must ensure enhanced Disclosure and Barring Service (DBS) certificates are obtained as appropriate for all staff and supply staff. Similarly all academy trust members, trustees and individuals on any committees including local governing bodies are required to have an enhanced criminal records certificate from the Disclosure and Barring Service (DBS), which does not include a barred list check (unless in addition to their governance duties they also engage in regulated activity).

External auditor and reporting accountant

External auditors are responsible for fulfilling their duties as required by the Companies Act 2006 and by the International Standards on Auditing (UK) (ISAs (UK)). The external auditor will set out their responsibilities as well as the scope and objectives of their work in their letter of engagement to the academy trust.

The external auditor is also the reporting accountant who is required to review and report on the statement on regularity, propriety and compliance prepared by the accounting officer.

Financial governance & delegated authorities

Key principles

Financial governance and delegated authorities are considered in detail in Parts 2, 3 and 5 of the Academy Trust Handbook 2022 and it is essential that auditors are familiar with the contents of these sections of the Handbook. The Academy Trust Handbook is available on the website at Academy Trust Handbook - Guidance - GOV.UK (www.gov.uk).

The key principles that apply are:

- trustees and managers must have the skills, knowledge and experience to run the academy trust.

- the academy trust must prepare and monitor financial plans to ensure ongoing financial health.
- the academy trust must have in place sound internal control, risk management and assurance processes.
- the trust must have in place a process for checking its financial systems, controls, transactions and risks.
- the trust must be transparent with its governance arrangements; and
- the academy trust must be able to show that public funds have been used as intended by Parliament.

These principles are located throughout the Handbook so have been collated here for clarity. The last principle above is addressed more fully in Part 5 of the Handbook: Delegated Authorities which looks at financial freedoms and limits that apply to ATs.

As part of this, the academy trust must submit information to ESFA via the budget forecast return (BFR). For the current period, the deadline for submitting the BFR is 31 August 2023.

The BFR must be approved by the trustees before submission. ESFA has produced guidance on using the online BFR form.

Proper and regular use of public funds

ATs must ensure that:

- spending has been for the purpose intended and there is probity in the use of public funds;
- spending decisions represent value for money, and are justified as such;
- internal delegation levels exist and are applied within the trust;
- a competitive tendering policy is in place and applied, and the procurement rules and thresholds in the *Public Contracts Regulations* 2015 are observed unless alternative arrangements to these regulations are introduced; and
- relevant professional advice is obtained where appropriate, including that of the external auditor where necessary.

Disclosure

Irrespective of whether the Secretary of State's approval is required, ATs must disclose aggregate figures for transactions of any amount, and separate disclosure for individual transactions above £5,000, in their audited accounts for each of the following transactions:

- special payments - compensation;
- special payments – ex gratia;
- writing off debts and losses;

- guarantees, letters of comfort and indemnities;
- acquisition of a freehold of land and buildings;
- disposal of a freehold of land and buildings;
- disposal of heritage assets;
- taking up a leasehold on land and buildings;
- granting a leasehold on land and buildings; and
- gifts made by the trust.

The following transactions must be disclosed in total, and individually:

- special payments – staff severance, of any value.

Other than what is required under financial reporting standards, the Charities SORP and the Accounts Direction, disclosure can be anonymised.

Related parties

ATs must be even-handed in their relationships with related parties by ensuring that:

- trustees comply with their statutory duties as company directors to avoid conflicts of interest, not to accept benefits from third parties, and to declare interest in proposed transactions or arrangements;
- all members, trustees, local governors of academies within a multi-academy trust, and senior employees have completed the register of interests in accordance with the Handbook;
- no member, trustee, local governor, employee or related individual or organisation uses their connection to the AT for personal gain, including payment under terms that are preferential to those that would be offered to an individual or organisation with no connection to the AT;
- there are no payments to any trustee by the AT unless such payments are permitted by the articles, or by express authority from the Charity Commission (which will be given only in exceptional circumstances) and comply with the terms of any relevant agreement entered into with the Secretary of State. ATs will in particular need to consider these obligations where payments are made to other business entities who employ the trustee, are owned by the trustee, or in which the trustee holds a controlling interest;
- the Charity Commission's prior approval is obtained where the trust believes a significant advantage exists in paying a trustee for acting as a trustee; and
- any payment provided to a trustee or related party (see 5.49 of the Handbook for a precise definition) satisfies the 'at cost' requirements (see below).

The board of trustees must ensure requirements for managing related party transactions are applied across the trust. The chair of the board and the accounting officer must ensure their capacity to control and influence does not conflict with these requirements. They must manage personal relationships with related parties to avoid both real and perceived conflicts of interest, promoting integrity and openness.

Trusts must recognise that some relationships with related parties may attract greater public scrutiny, such as:

- transactions with individuals in a position of control and influence, including the chair of the board and the accounting officer;
- payments to organisations with a profit motive, as opposed to those in the public or voluntary sectors; and
- relationships with external auditors beyond their duty to deliver a statutory audit.

The trust must keep sufficient records, and make sufficient disclosures in their annual accounts, to show that transactions with these parties, and all other related parties, have been conducted in accordance with the high standards of accountability and transparency required within the public sector.

Reporting and approval

Trusts must report all contracts and other agreements with related parties to ESFA in advance of the contract or agreement commencing, using ESFA's online form. This requirement applies to all such contracts and agreements made on or after 1 April 2019.

Trusts must obtain ESFA's prior approval, using ESFA's online form, for contracts and other agreements for the supply of goods or services to the trust by a related party agreed on or after 1 April 2019 where any of the following limits arise:

- a contract or other agreement exceeding £20,000;
- a contract or other agreement of any value that would mean the cumulative value of contracts and other agreements with the related party exceeds, or continues to exceed £20,000 in the same financial year ending 31 August.

For the purposes of reporting to, and approval by, ESFA, contracts and agreements with related parties do not include salaries and other payments made by the trust to a person under a contract of employment through the trust's payroll.

Insight – Issues noted by ESFA

The 202/23 Framework reports that continued issues noted by ESFA regarding transactions submitted for approval by academy trusts are failures to:

- follow the academy trust's own procurement policy in relation to related party transactions;
- report related party transactions to ESFA before the contract start date or renewal date; and
- maintain sufficient records to demonstrate accountability and transparency in agreeing related party transactions.

Novel, contentious and/or repercussive related party transactions are subject to separate arrangements. Trusts must obtain ESFA's prior approval for any contracts and other agreements with related parties that are novel, contentious and/or repercussive, regardless of value. Approval must be sought using ESFA's enquiry form, not through the related party on-line form.

Trusts should carefully consider the impact of this requirement and its relevance to transactions involving the chair of the board and/or the accounting officer.

Register of interests

The AT's register of interests must capture relevant business and pecuniary interests of members, trustees, local governors of academies within a multi-academy trust and senior employees, including:

- directorships, partnerships and employments with businesses that provide goods or services to the trust;
- trusteeships and governorships including at other educational institutions and charities irrespective of whether there is a trading relationship with the trust; and
- for each interest: the name of the business, the nature of the business, the nature of the interest, and the date the interest began.

The register must also identify any material interests arising from close family relationships between the academy trust's members, trustees or local governors, and relevant material interests arising from close family relationships between those individuals and employees.

ATs should consider carefully whether to include the interests of other individuals in the register of interests; if in any doubt, they should be included. Boards of trustees must keep their register of interests up-to-date through regular review.

ATs must publish on their websites relevant business and pecuniary interests of members, trustees, local governors and accounting officers. However, ATs have discretion over the publication of interests of other individuals. There is certain information, however, that ATs must make available for public inspection, including agendas for every meeting of the trustees, local governing bodies and committees, meeting minutes and papers from each meeting. The Handbook allows certain information that should remain confidential to be excluded.

The Charity Commission offers guidance on managing potential conflicts of interest in: CC29: *Conflicts of interest: a guide for charity trustees*.

Publication of executive pay

The trust must publish on its website, in a separate readily accessible form, the number of employees whose benefits exceeded £100k, in £10k bandings, for the previous year ended 31 August. Benefits for this purpose include salary, employers' pension contributions, other taxable benefits and termination payments. Trusts may display this information in a tabular form showing in each column salary, pension etc. Where the AT has entered into an off-payroll arrangement with someone who is not an employee, the amount paid by the trust for that person's work for the trust must also be included in the website disclosure where payment exceeds £100k as if they were an employee.

The trust is also required under the Equality Act 2010 (Specific Duties and Public Authorities) Regulations 2017, for organisations with 250 or more employees, to publish information on their website and on the government's reporting website about the gender pay gap in their organisation.

Confidentiality clauses

ATs must ensure that the use of confidentiality clauses associated with staff severance payments do not prevent an individual's right to make disclosures in the public interest (whistleblowing) under the *Public Interest Disclosure Act* 1998.

Whilst not addressed in the Handbook trustees should also ensure that a confidentiality clause does not require the trustees to breach company or charity law when it comes to disclosure in the accounts.

It should also be noted that any confidentiality agreement made by an AT is not binding on the auditor as the auditor is not a party to the agreement. In particular any severance payment or similar to an employee governor would have to be included in the auditor's report if not included in the accounts as this would be the equivalent of non-disclosure of directors' remuneration.

Trading with related parties

The 'at cost' requirement

For contracts:

- agreed by the AT on or after 7 November 2013; and
- exceeding £2,500, cumulatively, in any one financial year (from 1 September 2014)

a trust must pay no more than 'cost' for goods or services provided to it by the following persons ('services' do not include services provided under a contract of employment):

- any member or trustee of the AT;
- any individual or organisation related to a member or trustee of the AT. For these purposes the following persons are related to a member, or trustee:
  a) a relative of the member or trustee. A relative is defined as: a close member of the family, or member of the same household, who may be expected to influence, or be influenced by, the person. This includes, but is not limited to, a child, parent, spouse or civil partner;
  b) an individual or organisation carrying on business in partnership with the member, trustee or a relative of the member or trustee;
  c) a company in which a member or the relative of a member (taken separately or together), and/or a trustee or the relative of a trustee (taken separately or together), holds more than 20% of the share capital or is entitled to exercise more than 20% of the voting power at any general meeting of that company;
  d) an organisation which is controlled by a member or the relative of a member (acting separately or together), and/or a trustee or the relative of a trustee (acting separately or together). For these purposes an organisation is controlled by an individual or organisation if that individual or organisation is able to secure that the affairs of the body are conducted in accordance with the individual's or organisation's wishes;
- any individual or organisation that is given the right under the trust's articles of association to appoint a member or trustee of the AT; or any body related to such individual or organisation;
- any individual or organisation recognised by the Secretary of State as a sponsor of the AT; or any body related to such individual or organisation.

For these purposes, where a contract takes the trust's cumulative annual total with the related party beyond £2,500, the element above £2,500 must be at no more than cost.

In relation to organisations supplying legal advice or auditing services to the AT, the 'at cost' requirement applies where the organisation's partner directly managing the service is a member or trustee of the trust, but not in other cases for those organisations. The Handbook clarifies that the published ethical standard for auditors prevents partners or employees of the audit firm from acting as a trustee of their client trust in any case. However, they may not necessarily be prevented from acting as a trustee of other trusts.

The 'at cost' requirement does not apply to the trust's employees unless they are also one of the parties described above.

In relation to academies with a religious designation, the contributions made by an academy trust to its religious authority for services it receives associated with protecting and developing the academy trust’s religious character and ethos, which only the religious authority can provide, are regarded as meeting the ‘at cost’ requirement.

Any agreement with an individual or organisation referred to above to supply goods or services to the AT must be properly procured through an open and fair process and be:

- supported by a statement of assurance from that individual or organisation to the AT confirming that their charges do not exceed the cost of the goods or services; and
- on the basis of an open book agreement including a requirement for the supplier to demonstrate clearly, if requested, that their charges do not exceed the cost of supply.

For these purposes the cost will be the ‘full cost’ of all the resources used in supplying the goods or services, and must not include any profit. Full cost includes:

- all direct costs (the costs of any materials and labour used directly in producing the goods or services); and
- indirect costs (comprising a proportionate and reasonable share of fixed and variable overheads).

Novel or contentious transactions

Novel, contentious and/or repercussive transactions must always be referred to ESFA for explicit prior authorisation.

- Novel payments or other transactions are those of which the academy trust has no experience, or are outside the range of normal business activity for the trust.
- Contentious transactions are those which might give rise to criticism of the trust by Parliament, and/or the public, and/or the media.
- Repercussive transactions are those which are likely to cause pressure on other trusts to take a similar approach and hence have wider financial implications.

ESFA may also need to refer such transactions to HM Treasury for approval and so trusts should allow sufficient time for proposals to be considered.

Borrowing

In line with funding agreements, ATs must seek ESFA’s prior approval for borrowing (including finance leases and overdraft facilities) from any source, where such borrowing is to be repaid from grant monies or secured on assets funded by grant monies, and regardless of the interest rate chargeable.

Salix loans are interest-free and HM Treasury have already approved such loans, so no additional approval is necessary where the academy trust chooses to take out such a loan. The DfE supports these sorts of loans because repayments are recycled to fund future energy efficiency projects. Examples of such projects where Salix loans are taken out include boiler and heating system upgrades, roof insultation, walls and pipework, windows and draughtproofing and cladding.

Credit cards must only be used for business (not personal) expenditure, and balances cleared before interest accrues

Write-offs and entering into liabilities

The AT must obtain ESFA's prior approval for the following transactions beyond the delegated limits of the two categories set out below:

- writing-off debts and losses and any uncollected fines; and
- entering into guarantees, letters of comfort or indemnities. The delegated limits are:
- 1% of total annual income or £45,000 (whichever is smaller) per single transaction;
- cumulatively, 2.5% of total annual income in any one financial year per category of transaction for any ATs that have not submitted timely, unqualified audited accounts for the previous two financial years. This category now includes new academies that have not had the opportunity to produce two years of audited accounts; and
- cumulatively, 5% of total annual income in any one financial year per category of transaction for any ATs that have submitted timely, unqualified audited accounts for the previous two financial years.

Staff severance payments

Special staff severance payments are paid to employees outside of normal statutory or contractual requirements when leaving employment in public service whether they resign, are dismissed or reach an agreed termination of contract.

Staff severance payments should not be made where they could be seen as a reward for failure, such as gross misconduct or poor performance. The only acceptable rationale in the case of gross misconduct would be where legal advice is that the claimant is likely to be successful in an employment tribunal claim. In the case of poor performance, an acceptable comparison would be the time and cost of taking someone through performance management and capability procedures.

Academy trusts have delegated authority to approve individual staff severance payments provided any non-statutory/non-contractual element is under £50,000 gross (i.e. before income tax or other deductions). Where the trust is considering a non-statutory/non-contractual payment of £50,000 or more, (gross, before deductions), ESFA's prior approval must be obtained before the trust makes any binding settlement offer to staff. ESFA will also need to refer such transactions to HM Treasury and so trusts should allow sufficient time for proposals to be considered. In addition, ATs must obtain prior ESFA approval before making a staff severance payment where an exit package which includes a special severance payment is at, or above, £100,000; and/or the employee earns over £150,000.

Compensation payments

Compensation payments are made to provide redress for loss or injury, for example: personal injuries;

traffic accidents; or damage to property. If an AT is considering making a compensation payment it must base its decision on a careful appraisal of the facts, including legal advice where relevant, and ensure that value for money will be achieved.

ATs have the delegated authority to approve individual compensation payments provided any non-statutory/non-contractual element is under £50,000.

Where the trust is considering a non-statutory/non-contractual payment of £50,000 or more ESFA's prior approval must be obtained.

Ex gratia payments

Ex gratia payments are separate to other classes of special payment such as staff severance payments and compensation payments. Ex gratia transactions must always be referred to ESFA for prior authorisation. HM Treasury approval may also be needed dependent on the nature of the transaction, so sufficient time should be allowed to allow this consideration from HM Treasury. If ATs are in any doubt about a proposed transaction they should seek prior advice from ESFA.

Acquisition and disposal of fixed assets

ATs must seek and obtain prior written approval from ESFA for the following transactions:

- acquiring a freehold of land or buildings;
- disposing of a freehold of land or buildings; and
- disposing of heritage assets beyond any limits set out in the trust’s funding agreement in respect of the disposal of assets generally.

ATs can dispose of any other fixed asset without the approval of ESFA.

Leasing

ATs do not require ESFA’s approval for operating leases except for transactions relating to land or buildings.

ATs must obtain prior approval from ESFA for the following leasing transactions:

- taking up a finance lease on any class of asset for any duration from another party (borrowing);
- taking up a leasehold or tenancy agreement on land or buildings from another party for a lease term of seven or more years; and
- granting a leasehold interest, including a tenancy agreement, of any duration, on land or buildings to another party.

Annual accounts

The reporting framework

ATs are both exempt charities and companies limited by guarantee. This means that:

- as exempt charities they are exempt from registration at the Charity Commission and are instead regulated by the Secretary of State for Education, with the ESFA as agent; and

- as charitable companies they must comply with company law as set out in the *Companies Act*

2006, and with charity law as set out in the *Charities Act* 2011.

One of the key requirements of the *Companies Act* 2006 is for companies to produce annual accounts that are 'true and fair' and to have them independently audited. This applies to academy trusts (Ats). There is a hierarchy of rules and documents that supports the preparation of the accounts:

- the *Companies Act* 2006 – this sets out the statutory form, content and audit arrangements for accounts in broad terms;
- Accounting Standards – the Financial Reporting Council converts the Companies Act's requirements into detailed accounting rules in the form of Accounting Standards. The only standard which may be applied by charities is FRS 102;
- the Charities SORP – the Charity Commission takes Accounting Standards and translates them into a form relevant to the charities sector, called the Statement of Recommended Practice – Accounting and Reporting by Charities; and
- the Academies Accounts Direction – the ESFA takes the Charities SORP and translates it into a form relevant to ATs, as an annual Accounts Direction.

In addition to preparing an annual report and accounts, the AT may also be required to report on its cash position to the ESFA where there are concerns about financial management.

Academy trusts are not permitted to claim small company exemptions under the *Companies Act*

2006 and must report as a ‘larger’ charity in the context of the Charities SORP.

This automated version incorporates the full disclosure checklists for academies, covering the Companies Act requirements, the Charity SORP and the Academy Accounts Direction. The checklists are extensive and are fully interactive. The packs Tailoring Questions allow you to determine whether or not to complete the full disclosure checklists for the current year. If you indicate that the disclosure checklists are not required, the disclosure sections will not appear in the audit file.

The checklist starts with a series of tailoring questions. These should be answered in the order shown as the answers to earlier questions will automatically determine which of the subsequent questions are included. As you answer each question, the system will, if the question has logic dependencies, refresh the display to bring in or exclude the questions that depend on the question asked. After you have completed the tailoring checklist, you will find that the system will have deactivated any disclosure checklists that are not applicable and only relevant questions will be included in the checklists that remain active.

Some of the questions relate to matters that the system could have determined from examining the contents of the trial balance, or client control data, however, you will be asked to answer these. This is done to provide an independent review of the disclosure requirements and ensure that there is a double *check in case there are any processing errors or data has been combined for inclusion in the trial balance.*

The annual Accounts Direction issued in the spring each year is the Education and Skills Funding Agency's (ESFA's) guidance pack for ATs and their auditors when preparing and auditing the trust's annual reports and financial statements. It is based on the Charities SORP and FRS 102. Note that the second edition of the Charities SORP (October 2019) consolidates the changes set out in Update Bulletin 1 and Update Bulletin 2 and is effective for periods beginning on or after 1 January 2019.

The Accounts Direction is issued by the ESFA each year as the agent of the Secretary of State for Education. The Department for Education (DfE) has ultimate responsibility and accountability for the financial framework for ATs, which it describes in the Handbook. The Accounts Direction supplements the Handbook and has the same status as the Handbook in that it derives from requirements set out in ATs' funding agreements with the Secretary of State.

A model set of accounts for academies (Coketown Academy) and a separate Auditor Framework and Guide have been issued to accompany the Accounts Direction. The Auditor Framework and Guide is primarily aimed at academy trust external auditors and reporting accountants (but may also be of interest to accounting officers, chief financial officers and trustees).

What has changed in the 2022 to 2023 Accounts Direction?

The 2022 to 2023 edition does not introduce any new requirements and the changes made only provide clarification on existing requirements. The ESFA have:

- clarified how trustees should use the Direction (introduction);
- clarified the expectations for interim arrangements, in the absence of key signatories, such as the accounting officer (paragraph 1.18);
- updated feedback on non-compliance with the Direction (paragraph 1.21) and updated the themes arising from ESFA’s assurance work (paragraph 1.22);
- in response to school buildings’ safety risk:
  - clarified that the trustees’ report on principal risks and uncertainties should consider those risks impacting on trustees’ responsibilities to ensure the trust’s estate is safe, well maintained and complies with relevant regulations (paragraph 2.14);
  - clarified that the review of value for money statement encompasses estates safety and management (paragraph 2.40);
  - suggested that accounting officers should consider demonstrating how they have effectively used relevant funding to ensure the trust’s estate is safe, well-maintained, and complies with relevant regulations, as one of their value for money examples (paragraph 2.42);
  - clarified that the statement on regularity, propriety and compliance encompasses estates safety and management (paragraph 2.60);
- updated the guidance on the treatment of loans (paragraph 2.113);
- reminded academy trusts of the need to separately disclose material income sources in note 4 (paragraph 2.130); and

- clarified that teaching assistants are categorised as support staff in the staff costs note (paragraph 2.137).

Period of account

AT accounts must be produced for the 12-month accounting period ending on 31 August as a condition of their funding agreement unless the DfE has specified, exceptionally and in writing, that another date can be adopted. The 12-month period applies to all trusts that have previously published at least one set of accounts. The accounts to which this current edition of the Accounts Direction applies will therefore cover the period from 1 September 2022 to 31 August 2023.

It is not permissible to defer an academy's first set of accounts and where a new AT is incorporated mid-year, they must prepare their first set of accounts for a short period ending 31 August.

Timetable for submission and publication of accounts

Action required by 31 December 2023 - reporting to the ESFA

The following documents must be submitted to the ESFA by 31 December 2023:

- a copy of the audited accounts, including the reporting accountant's report on regularity
- a copy of the audit findings report (management letter) from the auditor to those charged with governance – this should usually contain the:
  - findings, including ratings of the importance/risk, e.g. high/medium/low
  - their views about significant qualitative aspects of the academy trust's accounting practices, including accounting policies, accounting estimates and financial statement disclosures;
  - significant difficulties, if any, encountered during the audit;
  - significant matters, if any, arising from the audit that were discussed, or subject to correspondence with, management and the written representations the auditor is requesting;
  - other matters, if any, arising from the audit that, in the auditor's professional judgement, are significant to the oversight of the financial reporting process;
- an accounts submission cover (online form); and
- an annual internal scrutiny report.

Academy trusts must also ensure that they comply with the Companies Act 2006, s.423 requirement duty to circulate copies of annual report and financial statements and send a copy of its annual report and financial statements to every member of the company and to every person who is entitled to receive notice of general meetings.

The accounts and management letter must be submitted to ESFA electronically in accordance with ESFA's submission guidance.

Timely submission of accounts is essential for giving assurance to Parliament that ATs have used public money for the purposes intended. ESFA takes compliance with the deadline of 31 December seriously and may consider action against trusts that do not comply including issuing a Notice to Improve (previously Financial Notice to Improve). Academy trusts can also be 'named and shamed' if they submit their financial statements late.

The board of trustees should prepare, and agree with their auditor, an accounts preparation and audit timetable that enables the 31 December deadline to be achieved.

The timetable should incorporate the date of the trustees' meeting at which the accounts will be approved and signed.

The board should consider arrangements in the event of the departure or long-term absence of key signatories, including the accounting officer. The board should decide what interim arrangements are required, as at all times the trust is required to have an accounting officer. If the trust's accounting officer leaves before the accounts are signed there should be sufficient briefing and/or information available to enable the new accounting officer to understand the key issues in the previous year, and to ensure the relevant reports accompanying the accounts are signed on time.

Action required by 30 January 2024 – submission of accounts return

ATs must submit an accounts return to allow their financial statements to be consolidated using the online form; usually this is due by mid-January (although this date can change and is usually issued when the accounts return portal opens in September). For the August 2023 year end, the portal opens on 12 September 2023 and the deadline for submission is 30 January 2024. The AT's auditor must sign off the accounts return and it must reflect opening and closing balances of the AT.

Academy trusts which close or transfer to a new trust between 1 September 2022 and 31 August 2023 should submit a final accounts return; ESFA will contact these trusts directly.

Action required by 31 January 2024 – publication of accounts on trust's website

ATs must publish their accounts, in full, on their website. To maximise transparency and openness this should be done as soon as possible after the accounts are signed, but no later than 31 January. The inclusion of a link to the Companies House website is considered insufficient by ESFA and therefore does not remove the requirement for full accounts to be published on the trust's website.

The trust should retain accounts in respect of at least the previous two years on its website. For example, the accounts for the periods ending 31 August 2021 and 2022 should remain on the website when the accounts for 31 August 2023 are uploaded.

Action required by 31 May 2024 - reporting to Companies House

Under CA 2006, s.442 (2a), accounts must also be filed with Companies House within nine months of the end of the accounting period. For the majority of ATs this will be no later than 31 May 2024.

Companies House levy an automatic penalty of at least £150 if accounts are filed late. This penalty is doubled if the accounts were filed late in the previous year as well.

Model financial statements and commentary

To support the Accounts Direction 2022 to 2023, a model set of accounts for academies is available and is commonly known as the 'Coketown model'. These model accounts illustrate the required format of accounts and the document has the same contractual status as the AD, as compliance with both is a requirement of an academy trust's funding agreement. A copy of the Accounts Direction 2022 to 2023 and the model accounts can be found at https://www.gov.uk/government/publications/academies-accounts-direction.

Feedback from ESFA to academies

Each year the ESFA reviews academy trust accounts, audit management letters and internal scrutiny reports and this exercise has identified a number of areas where compliance with the Direction could be improved.

It is the responsibility of trustees to ensure the content of their accounts fairly reflects their academy trust's performance and circumstances and is compliant with the financial reporting framework. Academy trusts should consider these points when preparing their 2022–23 accounts to improve compliance:

- the annual report must fairly reflect the circumstances and performance of the academy. Issues arise when:
  - example text from the Coketown model accounts is copied;
  - text has not been updated from the previous year; or
  - there are inconsistencies, either within the report or between the annual report and other documents, for example the external audit or internal scrutiny reports;
- be mindful of the need to forward plan to ensure the submission deadlines are achieved, particularly when changes to key staff are expected or plans are in place to expand the academy trust; and
- where the Direction and/or the model accounts state points that must be covered, the trust should not omit these sections. The ESFA noted a number of areas relating to the trustees report, governance statement and the trustees remuneration note where not all academy trusts provide the relevant disclosures, despite the Direction requiring it.

Academy auditors as well as the trusts should be aware of this feedback and auditors should encourage and support their clients to comply with all the requirements of the direction.

Auditors should also note the themes arising from ESFA's assurance work including that:

- the percentage of qualified financial statements for the 2020–21 year was 0.5% (2019–20: 0.5%). The main reasons for the qualified opinions were Local Government Pension Scheme (LGPS) valuations and the accounting treatment for land and buildings; and
- the percentage of modified regularity opinions in the 2020–21 year was 7.9%, which was lower than in the previous year (2019–20: 8.5%). The most common themes of modifications were internal financial reporting and related party transactions.

Taxation

Corporation tax

The provision of free education by a charity is not a trading activity and is therefore not normally subject to corporation tax. However, to benefit from this tax relief, the academy must be recognised by HMRC as a charity for tax purposes. An application for registration with HMRC can be found on GOV.UK here.

However, as with other charities, academies must carefully monitor any trading activities as these may potentially be liable to corporation tax and the academy may be required to complete a corporation tax return.

Trading means the selling of goods or services to customers. Usually, this involves selling on an ongoing commercial basis, but sometimes a one-off or occasional venture may be treated as trading for tax purposes. Even if there are 'trading profits', they may still be exempt from corporation tax if they are used for charitable purposes only and any of the following apply:

- The trading is part of (or closely associated with) the academy's primary purpose - for example, selling text books to students, the 'primary purpose' test, see 815-380.
- The trading is mainly carried out by the people who benefit from the academy - for example, a shop that is mainly operated by the students. The 'work done' test, see 815-380.
- The trading turnover amounts to less than 25% of the academy's total annual income or £8,000 whichever is the greater, and in all cases less than £80,000 - see 815-390.
- The income constitutes profits from qualifying fundraising events or charity lotteries. See 815- 400.

VAT

Academies are subject to the same rules as any other supplier of goods and services and can register for VAT voluntarily, or if they exceed the VAT threshold they must register.

However, education provided for no charge is not 'business' for VAT purposes and the education provided and any closely related goods or services provided are outside the scope of VAT. The sales of other goods or services are taxed in the normal way for VAT purposes and so, as for corporation tax above; any trading activities must be carefully identified.

Ordinarily VAT cannot be recovered on purchases, acquisitions or imports made in relation to non-business activities, such as the provision of free education. However, the VAT Refund Scheme allows academies to recover the VAT incurred on those goods and services that they purchase, and on those goods that they acquire from another member state or import, which are used in connection with the education they teach for no consideration. They can also recover the VAT incurred on purchases made on or after 1 April 2011 on acquisitions and imports which are used for any other non-business activities. The legal basis is in VATA 1994, s. 33B.

The process for claiming a refund depends upon whether the academy (or MAT) is registered for VAT purposes. Registered academies can make the claim on their VAT return. Non- registered academies should use the VAT126 online service.

Academies have been able to recover the VAT referred to above retrospectively in respect of purchases made on or after 1 April 2011, subject to the normal time limits for claiming (four years).

Further information can be found in the information sheet: VAT Refund Scheme for academies (VAT

Information Sheet 09/11).

See also: Education and vocational training Notice 701/30.

Payroll taxes

A PAYE scheme must be in place and operated in the same manner as for any other employer.

Audit Requirements

Academy Trusts (ATs) are subject to audit and review to give assurance to Parliament and the public that public funds are being used for the purpose intended.

The audit process can support trusts by helping identify key areas that may require improvement. The board of trustees must ensure there is an appropriate, reasonable and timely response by the trust to any findings by auditors, taking opportunities to strengthen the trust's systems of financial management and control.

Auditors should refer to the *Framework and Guide for External Auditors and Reporting Accountants of Academy Trusts (the 'framework and guide')* which is issued to support external auditors with their obligations to issue an audit opinion on the financial statements, and to support reporting accountants with their report on regularity. The framework and guide should be read in conjunction with the latest Accounts Direction. Any 'must' statements in this document must be adhered to by reporting accountants; any 'should' statements are expected to be adhered to as good practice by reporting accountants and external auditors.

What has changed in the 2022 to 2023 Framework?

The 2022–23 edition incorporates several changes to the requirements and guidance for external auditors and reporting accountants, the ESFA have:

- clarified that ESFA is not requiring reporting accountants to perform any additional procedures regarding trusts' compliance with estates safety and management requirements (paragraph 2.17);
- updated the feedback provided by ESFA to academy trusts on compliance with the Direction, which external auditors should review (paragraph 3.10);
- updated the themes arising from ESFA's latest assurance reviews (paragraphs 3.12 and 4.1) and ESFA investigations (paragraph 4.2);
- updated the most common issues regarding related party transactions from ESFA's approval and review process (paragraph 4.9);
- clarified ESFA's expectations for reporting matters of irregularity (paragraph 4.20);
- updated the National Audit Office (NAO) contact email address (paragraph 4.21);
- clarified the use of Practice Note 10 (Revised 2022) as a useful reference document (paragraph 4.27);

- updated the framework of authorities for academy trusts to recognise the HMT publication 'Guidance on Public Sector Exit Payments: Use of Special Severance Payments' (paragraph 4.29);
- updated the reference from SRMSAT to SRMSAC (paragraph 4.31); and
- throughout the document, updated references and links to ISAs (UK) and ISAE (UK) 3000 and included document publication dates.

Internal scrutiny

Every AT must have in place a process for independent checking of financial controls, systems, transactions and risks.

Ideally this process should be driven by an audit and risk committee appointed by the governing body, but the ESFA recognises that this may not be a practical position for every AT, especially for those that are smaller or where there is a limited pool of potential governors to provide the necessary direction. The ESFA has, therefore, provided for a system which allows some flexibility as to how any particular AT discharges these requirements.

The internal scrutiny of ATs must focus on:

- evaluating the suitability of, and level of compliance with, financial and non-financial controls. This includes assessing whether procedures are designed effectively and efficiently, and checking transactions to confirm whether agreed procedures have been followed;
- offering advice and insight to the board on how to address weaknesses in financial and non-financial controls, acting as a catalyst for improvement, but without diluting management's responsibility for day to day running of the trust; and
- ensuring all categories of risk are being adequately identified, reported and managed.

The trust must identify on a risk-basis (with reference to its risk register) the areas it will review each year, modifying its checks accordingly. This may involve greater scrutiny where, for example, procedures or systems have changed.

Audit and risk committees

ATs must establish a committee, appointed by the board of trustees, to provide assurance

over the suitability of, and compliance with, its financial systems and controls. Subject to the points on composition below ATs have flexibility over how this is achieved, but must establish either:

- a dedicated audit and risk committee; or
- an existing committee whose combined remit includes the functions of an audit and risk committee. This could be an addition to the terms of reference to an existing committee, such as a finance committee.

Within these principles:

- all ATs with an income of over £50m must have a dedicated audit and risk committee; and
- other ATs (including multi-academy trusts) which do not exceed the above size criteria, must have either a dedicated audit and risk committee, or can combine it with another committee.

The committee should meet at least three times a year. The audit and risk committee must:

- direct the trust's programme of internal scrutiny;
- ensure that risks are being addressed appropriately through internal scrutiny; and
- report to the board on the adequacy of the trust's internal control framework, including financial and non-financial controls and management of risks.

Audit and risk committee functions should be established in such a way as to achieve internal scrutiny which delivers objective and independent assurance, which means that:

- staff employed by the AT should not be members of an audit and risk committee, but may attend to provide information and participate in discussions; and
- where the AT operates a combined finance, audit and risk committee, staff may be members but should not participate as members when audit matters are discussed; they may remain in attendance to provide information and participate in discussions.

The accounting officer, chief financial officer and other relevant senior staff should attend to provide information and participate in discussions. The chair of trustees should not be chair of the audit and risk committee. In addition, where the finance committee and audit and risk committee are separate, the chair should not be the same.

The committee's work must focus on providing assurances to the board of trustees that risks are being adequately identified and managed by:

- reviewing the risks to internal financial control at the AT; and
- agreeing a programme of work to address, and provide assurance on, those risks.

In multi-academy trusts the audit and risk committee's oversight must extend to the financial and non-financial controls and risks at constituent academies.

The internal committee's oversight must ensure that information submitted to DfE and ESFA that affects funding, including pupil number returns and funding claims completed by the trust and (in the case of a multi-academy trust) by constituent academies, is accurate and complies with funding criteria.

The outcome of the work should inform the governance statement that accompanies the trust's annual accounts and, so far as is possible, provide assurance to the external auditors.

External audit oversight and findings and the audit and risk committee

The audit process can support trusts by identifying areas that may require improvement. The board of trustees, taking advice from the audit and risk committee, must ensure there is an appropriate, reasonable and timely response by the trust's management team to findings by external auditors, taking opportunities to strengthen systems of financial management and control.

Specifically, the audit and risk committee must:

- review the external auditor’s plan each year;

- review the annual report and accounts;

- review the auditor’s findings and actions taken by the trust’s managers in response to those findings;

- assess the effectiveness and resources of the external auditor to provide a basis for decisions by the trust’s members about the auditor’s reappointment or dismissal or retendering. Considerations may include:

- the auditor’s sector expertise;

- their understanding of the trust and its activities;

- whether the audit process allows issues to be raised on a timely basis at the appropriate level;

- the quality of auditor comments and recommendations in relation to key areas;

- the personal authority, knowledge and integrity of the audit partners and their staff to interact effectively with, and robustly challenge, the trust’s managers;

- the auditor’s use of technology; and

- produce an annual report of the committee’s conclusions to advise the board of trustees and members, including recommendations on the reappointment or dismissal or retendering of the external auditor, and their remuneration.

Delivering assurance through independent challenge (internal audit)

ATs should manage this programme of risk review and checking of financial and non-financial controls in the way that they deem most appropriate to their circumstances. Options include:

- the appointment of an internal audit service (either in-house or bought-in from a firm, other organisation or individual with professional indemnity insurance);
- the appointment of a non-employed trustee with an appropriate level of qualifications and/or experience to check the trust's internal controls, who neither charges, nor is paid by the AT for their work. This appointment is not mandatory but is one way in which ATs can conduct their internal checks; and
- a peer review, with the work being performed by the chief financial officer, or a

suitably qualified or experienced member of the finance team, from another AT, as an independent reviewer.

The trust may combine the above options. The trust may also use other individuals or organisations where specialist non-financial knowledge is required. The trust must confirm in its governance statement, accompanying its annual accounts, which of the options it has applied and why. The outcome of the work should also inform the accounting officer’s statement of regularity in the annual accounts. The findings from the above programme of work must be made available to all trustees promptly. The trust must submit its annual summary report of the areas reviewed, key findings, recommendations and conclusions to ESFA by 31 December each year when it submits its audited accounts. If the trust uses additional individuals or organisations where specialist non-financial knowledge is required, the summary document submitted to ESFA must include their findings, recommendations and conclusions. The trust must also provide ESFA with any other internal scrutiny reports if requested. The requirements of this programme of internal scrutiny apply to all trusts.

Trusts should note that the Financial Reporting Council’s Revised Ethical Standard states that a firm providing external audit services to an entity shall not also provide internal audit services to it. In order to minimise threats to objectivity and independence in the internal scrutiny of academy trusts, ESFA considers that the term internal scrutiny should be viewed in the same way as internal audit.

Whistleblowing

Academy trusts must have appropriate procedures in place for whistleblowing. The trustees must agree the whistleblowing procedure and publish it on the trust’s website. The trust should appoint at least one trustee and one member of staff who other staff can contact to report concerns. The trust must make sure all staff are aware to whom they can report their concerns, and the way in which such concerns will be managed. Staff should know what protection is available to them if they report someone, what areas of malpractice or wrongdoing are covered in the trust’s whistleblowing procedure, and who they can approach to report a concern.

The trust must ensure that all concerns raised with them by whistleblowers are responded to properly and fairly. ESFA has published procedures for dealing with complaints about academies.

Accounting officer’s statement

An accounting officer's statement on governance, regularity, propriety and compliance must be included in the AT's annual report. This is a formal declaration by the AT's accounting officer that they have met their personal responsibilities to Parliament for the resources under their control during the year. It includes a responsibility to ensure that public money is spent for the purposes intended by Parliament (regularity) and a responsibility to ensure that appropriate standards of conduct, behaviour and corporate governance are maintained when applying the funds under their control (propriety), a responsibility to ensure good value for money and for the efficient and effective use of all the resources in their charge (value for money). The accounting officer also has a responsibility to advise the governing body and the ESFA of any instances of irregularity or impropriety, or non-compliance with the terms of the AT's funding agreement. The format of the statement is included within the Accounts Direction which is issued annually.

Report on regularity

In addition to an auditor's report expressing an opinion on the financial statements, a report providing a conclusion on regularity must be produced by a reporting accountant. The reporting accountant must be the same person as the external auditor. The reporting accountant's conclusion on regularity must be addressed jointly to the AT and to ESFA as ESFA will draw formal assurance from the work carried out by the reporting accountant on regularity.

The accounting officer statement on regularity, propriety and compliance should form the basis of the work on regularity that will provide assurance to both the AT and ESFA on the use of the AT's funds. Although the AT’s responsibilities for estates safety and management are disclosed in the accounting officer’s statement of regularity, propriety and compliance, reporting accountants are not required to include this non-financial area within the scope of their engagement.

The format of the regularity report is included within the model accounts and is also in Annex B of the *Framework and guide for external auditors and reporting accountants of academy trusts*. The report is in the form of a ‘limited’ assurance report, covering the regularity of both income and expenditure and also governance and control arrangements that oversee it. As the work on regularity is a limited assurance engagement, no ‘opinion’ is issued; instead, the reporting accountant expresses a limited assurance ‘conclusion’. The reporting accountant will set out “an informative summary of the work performed as the basis for the practitioner’s conclusion” in accordance with paragraph 69(k)(i) of ISAE (UK) 3000 (July 2020) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*.

Where a subsidiary is consolidated into academy trust accounts, the regularity assurance report must extend to this. Further details of this scope are set out in paragraphs 4.11–4.12 of the *Framework and guide for external auditors and reporting accountants of academy trusts* .

Under Practice Note 10 (Revised 2022) *Audit of Financial Statements of Public Sector Bodies in the United Kingdom* regularity is an implied assertion, in addition to those identified in ISA (UK) 500 (Updated May 2022) *Audit Evidence*. Although Practice Note 10 focuses on reasonable assurance opinions when discussing regularity and acknowledges that academy trusts are instead subject to a limited assurance engagement it nevertheless is a useful reference document. In conducting their regularity work, reporting accountants should have regard to this document and in particular the sections dealing with regularity.

The tri-partite relationship

To allow the ESFA to draw assurance from the reporting accountant’s regularity report the ESFA must be bound into the contract between the AT and the external auditors. Whilst the trust and their auditors should continue to be party to a letter of engagement in the normal way, to avoid bureaucracy there is no expectation that the engagement letter would also be signed by the ESFA. Instead the terms of references the ESFA has adopted as a party to the regularity engagement are set out in Annex A to the *Framework and guide for external auditors and reporting accountants of academy trusts*. ESFA requires that academy trusts and reporting accountants must adopt these terms of engagement and any substantial changes must not be made without ESFA’s prior written consent.

Additionally, a standard paragraph must be included within the letter of engagement between the AT and the external auditors that acknowledges their duty to the ESFA. The standard wording is set out below.

The Secretary of State for Education acting through the Education and Skills Funding Agency has adopted the Standardised Terms of Engagement included within the extant Accounts Direction. We will report to the Secretary of State for Education acting through the Education and Skills Funding Agency in accordance with those Standardised Terms of Engagement for Independent Reporting Accountants’ Reports. The Secretary of State for Education acting through the Education and Skills Funding Agency will not be required to sign this engagement letter.

The cap for liability in respect of the work on regularity is set within the standard terms of engagement at £1m per academy within each trust. MATs, therefore, will have a liability of £1m multiplied by the number of academies, but this is limited to £5m in aggregate. These limits apply to each period for which the reporting accountant is providing their report.

Irregularity within ATs' accounts

ESFA's analysis of irregularity within academy accounts from previous years identify a number of common themes. Accounting officers should have regard to these in making their statement on regularity, propriety and compliance and reporting accountants should have regard to these in assessing risk in their audits. The themes were:

- management accounts not shared with the board with sufficient frequency, and/or being of poor quality;
- financial management issues (including where AT's did not document their review of trade debtors, creditors and bank reconciliation);;
- governance issues (including financial statements not being published on the academy trust's website);
- failure to submit one of the mandated financial returns to ESFA on time; and
- related party transaction issues.

There have been other occasional incidents of irregularity and impropriety which the accounting officer and reporting accountant will need to bear in mind, and ESFA investigation reports on these have been published. These include:

- failure to ensure a competitive tendering process is in place and applied;
- breach of capital funding terms and conditions;
- use of public funds for personal benefit;
- lack of appropriate authorisation for expenditure, including failure to obtain ESFA approval where appropriate;
- inappropriate authorisation, Chair of Governors and/or the Accounting officer acting beyond powers to authorise contracts/payments;
- conflicts of interest not properly managed;
- irregular expenditure not for the purpose intended, for example:
  - alcohol purchased from trust funds for consumption outside of religious services;
  - any excessive gifts including those purchased from unrestricted funds; and
  - significant additional benefits paid over and above the standard contract of employment.

Transactions with related parties and not for profit principles

The requirements relating to goods or services provided by individuals or organisations related to the AT are discussed at Trading with related parties.

For transactions with related parties, section 5.58 of the Handbook requires trustees to ensure that agreements to supply goods or services to the trust are subject to proper procurement, supported by a statement of assurance and are on the basis of an open book agreement.

These requirements apply to contracts that are agreed or renewed on or after 7 November 2013. Existing arrangements apply to contracts in place prior to this date.

‘At cost’ must not include an element of profit, but can include:

- directly attributable materials and labour: and
- a proportionate share of fixed and variable overheads.

The Handbook grants a specific annual de minimis limit of £2,500 in respect of ‘at cost’ transactions.

For reporting accountants the focus is on confirming trustees have met their obligations rather than reviewing whether the objective of the Handbook requirements are achieved. Reporting accountants are not required to audit information provided by the related party.

If the reporting accountant does not believe the requirements have been met this will lead to a modified conclusion including full disclosure of those matters within the assurance report. If the reporting accountant is uncertain as to whether the requirements have been met they are to consider whether this is a limitation of scope.

Reporting and approval considers the requirements for reporting and seeking approval of related party transactions in advance of the contract or agreement commencing. Particular issues noted by ESFA regarding transactions submitted for approval are a failure to:

- follow the trust’s own procurement policy in relation to related party transactions;
- report related party transactions to ESFA before the contract start date or renewal date; and
- maintain sufficient records to demonstrate accountability and transparency in agreeing related party transactions.

Work required on regularity

The Framework and guide for external auditors and reporting accountants of academy trust includes specific guidance for the auditor in respect of the report on Regularity. This is largely the same as in previous years.

Assessing risk

The reporting accountant will need to undertake a risk assessment to determine the level of work required to form their conclusion, specifically regarding the risk that the financial statements include a material irregularity.

In a limited assurance engagement the approach to business understanding and materiality is the same as reasonable assurance and the reporting accountant should therefore refer to ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* and ISA (UK) 250A (Revised November 2019) (Updated May 2022) *Section A – Consideration of Laws and Regulations in an Audit of Financial Statements*. However, less evidence is required to form a conclusion and this will be a matter of professional judgement for the reporting accountant.

It is likely that a newer AT will have a heightened risk profile as controls and procedures may not have been in place for the full financial period or may need further refinement. The accounting officer may still be developing an understanding of their role and the governance structure in a new AT may not yet be fully developed.

Areas that the reporting accountant may consider to be higher-risk for an established AT could include:

- culture, attitude and values;
- a change in accounting officer, chief finance officer or significant changes in the board of trustees;
- an expansion of the number of academies within the academy trust; or
- major changes to accounting or reporting systems.

In determining the areas where material irregularity is more likely to arise, it is imperative to understand how the academy trust itself perceives risk. Reviewing the audit and risk committee and internal scrutiny findings, together with an analysis of their risk management processes can help to gain this understanding.

Materiality

The assessment of materiality is the same for a limited assurance engagement as a reasonable assurance engagement and includes both quantitative and qualitative measures.

Some issues of irregularity will be related to specific transactions while others may be across the AT's activities. For the former, an assessment of materiality by value will be possible, but an assessment of materiality by nature will still need to be made.

Where the issue is across the AT's activities and not related to specific transactions the reporting accountant will need to consider whether the issue is so fundamental to its activities that it is material. For example, if the AT had not put in place a system for independent checking (e.g. non-employed trustee with an appropriate level of qualifications and experience (previously known as the 'responsible officer' or internal audit) and no work had been undertaken in the period of account we would consider this to be material.

The judgement of materiality will also need to have regard to the number of issues identified. A number of issues which might not be material in isolation may, taken together, be material, and these in turn will need to be reported within the management letter and assurance report as appropriate.

ESFA considers any breach by value of the transactions for which the AT has delegated authority through the Handbook to be material.

Where issues of propriety arise then the assessment of materiality may need to be reconsidered. Whilst a transaction leading to a personal benefit may be deemed to be material by nature, regardless of value, there may be more scrutiny if the benefit is received by a senior member of staff or trustee.

Basis and timing of testing

The reporting accountant needs to determine the extent of procedures that will need to be undertaken to obtain sufficient, appropriate audit evidence to provide the regularity engagement conclusion. ISAE (UK) 3000:A3 states that as 'the level of assurance obtained in a limited assurance engagement is lower than in a reasonable assurance engagement, the procedures ... are less in extent'. The review of regularity is primarily in relation to internal control procedures and whilst the *Framework and guide* suggests potential, the reporting accountant should have regard to the entity and develop the testing as appropriate. The nature and volume of work to be performed should then be communicated to the accounting officer. It is generally more efficient to perform the regularity review work in conjunction with and at the same time as the statutory 'true and fair' audit.

Reliance on internal scrutiny work

As set out in section 4.15 of the Handbook, the reporting accountant has an obligation to provide a report to ESFA. The reporting accountant should consider whether they can rely on the work of a third party who has performed assurance reviews relevant to the objective of the regularity assurance engagement.

For example, section 3.17 of the Handbook stipulates that an AT must have an independent check in place of the financial controls and systems, whether that is in the form of:

- internal audit (in-house or bought-in);
- independent checks by a non-employed trustee with an appropriate level of qualifications and experience; or
- peer review.

The reporting accountant should consider whether it might be effective and efficient to use the results of testing already undertaken by this function to alter the nature, timing or extent of work they perform in forming the assurance conclusion on regularity and to minimise any duplication of work.

In such cases the reporting accountant should assess the independence, objectivity and competence of the function and the nature, scope and subjectivity of the work performed. Where the work is used, the reporting accountant may evaluate and perform testing on that work to determine its adequacy for regularity reporting. The reporting accountant should also consider making reference to the internal auditors and the extent of the use of their work in the regularity assurance report.

Documentation and access to working papers

Reporting accountants can keep separate audit files for the report on regularity but do not need to; they can be kept within the statutory audit file. However, the objectives, method and conclusion will need to be clearly documented.

ESFA does not require access to the reporting accountant’s working papers; instead it places reliance on the work carried out by the reporting accountant. However, ESFA may wish to discuss the conduct and outcomes of the report on regularity with both the reporting accountant and accounting officer.

Where ESFA has concerns about financial management and/or governance at an AT, it may wish to obtain from third parties information or documentation about the trust which ESFA considers relevant for the purposes of its investigation. In such cases, ATs must provide ESFA with written authority giving permission for any third party to provide such information and documentation to ESFA or its agents on request of ESFA.

Fraud

As part of the ‘true and fair’ audit, the reporting accountant must address the requirements of ISA (UK) 240 (Revised May 2021) (Updated May 2022) *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, specifically assessing the risk of fraud. Any identified fraudulent transactions over £5,000 must be reported to ESFA. Any unusual or systematic fraud, regardless of value, must also be reported.

Reporting on potential irregularities and non-compliance

Issues identified by the reporting accountant will, in the first instance, be raised with the AT's accounting officer and they should be able to demonstrate to the reporting accountant's satisfaction the regularity of the transaction in question. ESFA should only be consulted where there is significant disagreement between the reporting accountant, trustees and AT accounting officer. The reporting accountant will need to consider whether and to what extent additional testing may be required in relation to any potential irregularities or non-compliance identified.

When the reporting accountant concludes:

- that there are matters of material irregularity, by virtue of value or nature of a financial transaction, this will lead to a modified regularity conclusion including full disclosure of those matters within the report, including the monetary amounts if known;
- that there are matters of irregularity, but they are either:
  - not material (by virtue of value or nature); or
  - not in respect of a financial transaction,

these should be reported in the audit findings report (i.e. their management letter).

Where the reporting accountant has modified their report they must notify ESFA via its online enquiry form. The National Audit Office (NAO) must also be made aware of any modifications by e-mailing academyreturns@nao.gov.uk. Auditors should discuss fully the issues leading to the modification with the academy trustees before notifying ESFA or NAO.

The audit findings report should also include reporting of irregularities that are material by nature but are not in respect of transactions underlying the financial statements.

Audit findings report

The audit findings report reports significant matters arising from the statutory 'true and fair' audit of the financial statements and should also cover findings relating to regularity. This is to allow ESFA to have full information for all regularity issues to draw an overall conclusion on the AT.

Where irregularity is identified but the reporting accountant concludes it is not material by virtue of value or nature, the issue will be reported in the reporting accountant's 'management letter'.

The audit findings report should document each regularity issue as follows:

- issue (including a rating of the risk/importance and financial impact);
- implication/consequence;
- recommendation; and
- management response (including timescale for change).

A template Audit findings report is available in ~~example~~ templates *(COMMENTA)* ~~and reports~~.

Whistleblowing (reporting to ESFA)

The requirement as set out in the *Charities Act* 2011 (s. 156(2), 159 and 160) is that auditors (reporting accountants) should report matters of 'material significance' to the principal regulator, being ESFA on behalf of the Secretary of State for Education (to whom the Charity Commission discharge their duties). The Charity Commission has produced specific whistleblowing guidance which sets out a list of nine matters which are considered to be of material significance. The guidance is available here:

https://www.gov.uk/government/publications/guidance-for-auditors-and-independent- examiners-of-charities.

The principles of reporting to the Charity Commission apply in the case of academies, but it is important to remember that the reporting accountant has a duty of care regarding confidentiality and may therefore disclose client confidential information only when there is a right or obligation to do so (or where disclosure is in the public interest, although it is recommended to seek legal advice before disclosing confidential information for this reason). Ethical issues surrounding confidentiality are discussed further in section 140 of the IFAC Code of Ethics, on which the ICAEW/ACCA Code of Ethics is based.

In the first instance of identifying matters of 'material significance' the reporting accountant should contact ESFA via its enquiry form: http://www.education.gov.uk/kc-enquiry-form.

Evidence to support conclusions

The guidance here is provided to assist reporting accountants in determining the types of tests that can be used to provide evidence on the regularity report. It is not an exhaustive list.

Delegated authorities

Part 5 of the Handbook details the freedoms ATs have. As such, the evidence of prior approval from the Secretary of State is required for:

- write-offs over 1% of total income or £45,000 (whichever is smaller);
- acquisitions or disposals of freehold land and buildings;
- disposal of heritage assets;
- taking up a finance lease;
- taking up a leasehold on land and buildings over seven years; and
- any novel and contentious payments e.g. honorarium payments.

If an AT has made special payments to staff, including compromise agreements has there been regard to the following:

- prior approval has been sought for:
  - non-contractual elements of £50,000 or more;
  - an exit package which includes a special severance payment and is at, or above £100,000;
  - an exit package to an employee who earns over £150,000;
- payments are not used as a substitute for taking appropriate action under the academy’s misconduct or performance management procedures; and
- payments are in line with the severance guidance published by ESFA and by HM Treasury.

The AT must not have sought borrowings (in the form of loans, overdraft facilities or finance leases) contravening section 5 of the Handbook.

An AT may have been issued with a ‘minded to’ letter, which stipulates requirements to be met. These letters are not published. If these are not met a Notice to Improve (NtI) is issued.

Where an NtI has been issued this restricts the freedoms given to an AT. In these circumstances the AT would need to seek prior approval for a wider variety of transactions.

Similarly, where an AT is funded on an estimate basis the funding agreement requires prior approval for a number of transactions and this should be identified during planning.

Disclosures of the transactions noted above must be in line with the Accounts Direction 2022 to 2023.

Transactions with related parties

In accordance with the AT's internal processes and paragraphs 5.35 to 5.59 of the Handbook, the reporting accountant needs to ensure that:

- declarations of business interests have been completed (for those able to influence the AT, including key staff) and published on the AT’s website;
- contracts with related parties have been procured following the AT’s procurement and tendering process;
- where contracts are entered into or renewed on or after 7 November 2013 the AT has obtained statements of assurance (confirming no profit element was charged) and the AT has followed their internal processes in reviewing this;
- the academy has requested, under the open book arrangement, a clear demonstration that the charges do not exceed the cost of supply;
- governors who provide consultancy services to the academy are not receiving a profit for their services and the correct procurement and tendering process is being followed;
- no related party gains from their position by receiving payments under terms that are preferential;
- if employees are providing external consultancy to another organisation, and the work was performed within the academy’s normal working hours, that the income is being received by the AT and recognised in its financial statements; and
- related party transactions have been either notified to, or approved by, the ESFA as appropriate according to the requirements of the Handbook.

Governance

In relation to governance the reporting accountant needs to consider whether:

- the academy trust has a minimum of three members;
- the board of trustees has met at least three times in the year;
- where the board has met less than six times a year, there is a description in its governance statement, accompanying its annual financial statements, how it maintained effective oversight of funds;
- new academy trusts have reviewed and developed their governance structure and composition of the board;
- there is a written scheme of delegation of the Board’s financial powers that maintains robust internal controls;
- management accounts are shared with the chair of trustees monthly, with other trustees six times a year and considered by the board when it meets;
- there is a risk register in place;

- there is Board oversight of capital expenditure and funding, ensuring it is used appropriately for capital purposes;
- the academy has established an audit and risk committee or a committee fulfilling the functions of an audit and risk committee whose activities are underpinned by written terms of reference;
- provision for internal audit / scrutiny is independent and objective;
- the audit and risk committee or equivalent has received reports on the effectiveness of internal control;
- factors determining executive pay are clear and recorded;
- there are whistleblowing procedures approved by the trustees;
- minutes of the various committees, and management accounts, have been reviewed for indications of irregular transactions;
- the board of trustees and accounting officer have given formal representations of their responsibilities; and
- the board of trustees has appointed the senior executive leader as accounting officer, and a Chief Financial Officer.

Internal controls

In relation to controls the reporting accountant needs to identify the AT's policies, review their effectiveness and test whether they are operating effectively. Areas to consider include whether:

- the general control environment has regard to the regularity of underlying transactions, including reference to fraud management;
- significant changes within the control environment have led to potential weaknesses that could impact the regularity of underlying transactions;
- property is under proper control to prevent loss or misuse;
- gifts and hospitality, such as long service awards and other benefits are given and received in line with the AT's policies;
- the use of expense claims or credit cards adheres to internal control principles (and are supported by receipts);
- expenditure does not contravene the funding agreement; and
- items claimed on expenses or purchased on credit cards are not for personal benefit.

Procurement

In relation to procurement the reporting accountant needs to identify the AT's policies, review their effectiveness and test whether they are operating effectively. Areas to consider include:

- confirm through enquiry and sample testing that the lines of delegation and the limits set both internally and by ESFA have been adhered to;
- consider whether tendering procedures have been administered through *Find a Tender* where appropriate, in accordance with PPN 08/20;
- consider whether formal contracts are in place, where required;
- consider whether tendering policies have been adhered to;
- consider whether procurement activity has been in accordance with Annex 4.6 of Managing Public Money;
- ensure that employees have not benefited personally from any transaction; and
- consider whether goods and services have been procured openly and transparently.

Income

In relation to income the reporting accountant should consider any specific conditions that attach to grant income, including whether such income has been used for the purpose for which it was given.

Cybercrime

ATs must be aware of the risk of cybercrime, put in place proportionate controls and take appropriate action where a cyber security incident has occurred. Trusts must obtain permission from ESFA to pay any cyber ransom demands. ESFA supports the National Crime Agency’s recommendation not to encourage, endorse, or condone the payment of ransom demands. Payment of ransoms has no guarantee of restoring access or services and is likely to result in repeat incidents.

Audit of financial statements

ATs are required by law to produce audited accounts and therefore the board of trustees must appoint an auditor to certify whether the accounts present a true and fair view of the trust’s financial performance and position (appointment being by the members, other than where the Companies Act permits the trustees to appoint – for example, for the trust’s first period of account). In addition, the AT should retender their external audit contract at least every five years and must consider the relevant points in External audit oversight and findings and the audit and risk committee when evaluating.

Letter of engagement

The contract for the audit must be in writing and take the form of a letter of engagement. The letter of engagement must only cover the external audit. If additional services are purchased, these must be covered by a separate letter of engagement which specifies the requirements of the work and the fees to be charged.

The AT's management must prepare any financial information required for consolidation into the Academies Sector Annual Report and Accounts (SARA). AT's auditors will be required by ESFA to audit certain information, and this requirement should be incorporated within the terms of engagement.

As noted above, the engagement letter must also include the required wording in respect of the report on regularity as this is included within the remit of the external auditors.

The letter of engagement must provide for the removal of auditors before the expiry of the term of office in exceptional circumstances, notwithstanding the other terms of the contract. Proposals to remove auditors must require a majority vote of members of the trust board. If the auditors resign, there must be a requirement for them to provide the trust with an explanation within 14 days of their resignation.

The board of trustees must notify ESFA immediately of the removal or resignation of the auditors. In the case of removal, the trust's board must notify ESFA of the reasons for the removal. In the case of resignation, the trust must immediately copy to ESFA a statement of explanation from the auditors. This is in addition to any obligation to notify Companies House and the recognised supervisory body (e.g. ICAEW) as set out in CA 2006, s. 519–525.

A template engagement letter schedule covering the statutory audit of an academy is available in the ~~*Engagement Letter Tool* and the Engagement letter~~ templates *(ENGACAD)* ~~in *Navigate Practice Management*~~.

Senior Statutory Auditor

As with other charitable companies the auditor's report of an academy audit under the Companies Act 2006 should be signed in the personal name of the Senior Statutory Auditor.

Wording of auditor's report

The auditor's report should follow the normal form for a charitable company audited under the Companies Act except that reference is required to the Accounts Direction. The Accounts Direction 2022 to 2023 includes the following guidance.

The auditor's opinion must address whether the financial statements:

- give a true and fair view of the state of the charitable company's affairs at 31 August 2023 and of its incoming resources and application of resources, including its income and expenditure, for the period then ended;
- have been prepared in accordance with United Kingdom Generally Accepted Accounting Practice (including FRS 102);
- have been properly prepared in accordance with the requirements of the Companies Act 2006; and
- have been prepared in accordance with the ESFA's Academies Accounts Direction 2022 to 2023 and the Charities SORP.

The auditor must comply with ISA (UK) 700 (Revised November 2019) (Updated May 2022) *Forming an Opinion and Reporting on Financial Statements* and include the following headings:

- opinion;
- basis for opinion;
- going concern;
- irregularities including fraud;
- other information (covers the Reference and Administrative Details, the Report of the

Directors and Strategic Report and the Governance Statement);

- opinion on matters prescribed by the *Companies Act* 2006;
- matters on which we are required to report by exception;
- responsibilities for the financial statements;
- the auditor's responsibilities for the audit of the financial statements (including how the audit was designed to detect irregularities, including fraud);
- name of the senior statutory auditor; and
- signature, address and date.

An unqualified audit report is included as a template in the pack (UNQAUDAC).

Group auditors and whole of government accounts

DfE consolidates the annual accounts of each academy trust into a sector annual report and accounts (SARA). DfE generates the SARA by using audited 'accounts returns' and other information. The SARA is audited by the National Audit Office (NAO) on behalf of the Comptroller and Auditor General (C&AG). The audit is carried out in accordance with HM Treasury's Financial Reporting Manual, which largely follows International Standards on Auditing. The NAO undertakes appropriate procedures in accordance with that framework to satisfy the C&AG that these accounts are true and fair.

As a result of this arrangement, each trust represents a component of the SARA and the trust must prepare the financial information requested by DfE for this purpose. Academy trusts'

auditors are therefore required by DfE to audit certain information, and this requirement should be incorporated within the terms of engagement. The C&AG must reach an opinion on regularity for ESFA's own accounts, and for this will draw on the regularity opinions expressed by trusts' auditors.

Reporting to the Teachers' Pension Scheme

The auditor is also required to report to the Teachers' Pension Scheme (TP) on the payment of pension contributions. The auditor reports on completion of the End of Year Certificate (EOYC) which is prepared to 31 March each year and which must be completed by 30 September each year.

The EOYC includes details of the pension contributions paid to TP. The auditor is entitled to form an opinion without qualification where he has carried out the specified procedures and is satisfied:

- that teacher and employer contributions have been correctly calculated for all of those required to contribute to the scheme, based on the pensionable salaries paid and the appropriate contribution rates; and
- that the correct amount has been paid.

When the auditor considers that he is unable to form an opinion without qualification, he should:

- where the amendments are simple and agreed with the employer, make them in red on the form EOYC and include ‘subject to the amendments in red’. No report is required; or
- where there are uncertainties or disagreement with the employer, set out the reasons for concern and any matters in dispute in the form of a formal letter to TP.

Details of the procedures required are given on the TP website:

http://www.teacherspensions.co.uk/employers/managing-members/contributions/end-of-year-certificate.aspx

The auditor’s involvement in checking the EOYC should be agreed and reflected in the engagement letter.

The auditor must also ensure that the supporting work undertaken is properly evidenced and recorded. The TP website includes specific procedures that must be undertaken when reporting on the EOYC so it should be evident from the file that these have been followed.

Schedule SUP6 *Reporting to TPS on the EOYC* is a work programme for these procedures.

Controls in an academy

Understanding internal control

The auditor is required to obtain an understanding of all internal controls operated by the academy relevant to the preparation of the financial statements. This includes undertaking a review of their design and implementation, regardless of whether the auditor intends to rely on those controls or not.

Detailed guidance on obtaining an understanding of the system of internal control, which is applicable to all entities, is provided in Accounting systems, processes and controls. This section provides further academy-specific examples of controls that the auditor should consider.

The **C7.1** *Internal control aide-memoire* in the Academy audit tool guides the auditor through the content required to obtain an understanding of the academy’s system of internal control.

The academy’s control environment

The control environment in Audit Guidance and Methodology sets out the requirements of ISA (UK) 315 in relation to understanding the control environment and provides detailed guidance applicable to all entities.

Further example controls, processes and structures relevant to the control environment of an academy are noted below. Note that this is not an exhaustive list, and these examples should be considered alongside the guidance in the main Audit Guidance and Methodology area.

How management’s oversight responsibilities are carried out

- The academy governor body meets at least once a term.

The independence of, and oversight over the academy’s system of internal control by, the trustees and senior management

- Procedures are in place to identify any inter-relationships between trustees (e.g. husband and wife).

- Procedures are in place to ensure that for each governor, any potential ongoing conflicts of interest (e.g. employed family members; regular supplier where governor involved) are considered, and the academy has a policy for managing such conflicts.
- The board has arrangements for ensuring that there is adequate coverage in the event of the departure or long-term absence of key signatories.
- All members of the governing body, the head teacher and other senior staff are required to complete declarations of their business interests. Consider:
  - Do the declarations include all business and pecuniary interests such as directorships, shareholdings and other appointments of influence within a business organisation?
  - Do they also include the interests of related persons such as parent, spouse, child, cohabite and business partner where influence could be exerted by that person over a governor or a member of staff?
- Trustees and staff are required to keep their declarations of business interests up to date at all times, and to amend or update them as necessary.
- The meetings of trustees and senior managers include a standing agenda item for attendees to declare any changes to their declarations of interests.
- Any appointments or changes to terms and conditions are authorised by the governing body.
- The governing body has agreed a formal schedule of matters reserved for their decision.

The academy's assignment of authority and responsibility

- There is a clear organisational structure with identified lines of reporting for all operations.
- The responsibilities of the governing body and academy personnel are clearly defined, documented and allocated.
- The roles of the governing body, its committees, the non-employed trustee, the accounting officer, and other staff are defined in writing. This includes stating the respective responsibilities of the governing body and staff, limits of delegated authority and channels for reporting.
- The academy has established a Finance Committee to which the board delegates financial scrutiny and oversight, which can support the board in maintaining the trust as a going concern, and which reports as appropriate to the governing body.
- The governing body has established separate committees with clearly defined responsibilities to deal with specific areas of academy business. In relation to the sub-committees:
  - each sub-committee is chaired by a governor;
  - the majority of the members of each sub-committee are trustees; and

  the governing body receives adequate feedback on the work and decisions of all the sub-committees.
- The accounting officer is a responsible individual with appropriate experience in a senior position.

How the academy attracts, develops and retains competent individuals

- The academy has established policies and procedures to ensure that:
  - personnel, including trustees, are competent, suitably qualified and trained to perform at a level commensurate with their responsibilities;
  - clear statements of criteria for personnel selection and formal job descriptions are

    maintained;
  - finance staffing levels are adequate; and
  - there are effective arrangements to deal with the absence of key financial personnel - this should also include the board itself to assess whether there is a skills gap, and if necessary, create a plan to fill this.
- Personnel management procedures have been established and approved in relation to:
  - recruitment (including references and police checks);
  - performance appraisal and review;
  - equal opportunities;
  - disciplinary (including absence policies);
  - grievance; and
  - staff expenses.
- There is a robust, evidence-based process to determine executive pay (including salary and any other benefits) which is operated within the academy.

The academy's risk assessment process

The entity's risk assessment process in Audit Guidance and Methodology sets out the requirements of ISA (UK) 315 in relation to understanding how an entity identifies and responds to business risks and their consequences and provides detailed guidance applicable to all entities.

Example controls relevant to the risk assessment process to consider for academies include:

- The trustees maintain a "risk register" which demonstrates the results of the risk assessment process.
- The "risk register" is reviewed by the board at least annually.

Insight – Risk register

The maintenance of a risk register is mandated by the Academy Trust Handbook (ATH).

Overall responsibility for risk management, including ultimate oversight of the risk register, must be retained by the board of trustees, drawing on advice provided to it by the audit and risk committee.

Other committees may also input into the management of risk at the discretion of the board.

Aside from any review by individual committees, the board itself must review the risk register at least annually.

Risk management covers the full operations and activities of the trust, not only financial risks.

Note that this is not an exhaustive list, and these examples should be considered alongside the guidance in the main Audit Guidance and Methodology area.

The academy's process for monitoring internal control

All academy trusts must have a programme of internal scrutiny to provide independent assurance to the board that its financial and non-financial controls and risk management procedures are operating effectively.

Taking into account the differing risks and complexity of their operations, all trusts with an annual income over £50 million must have a dedicated audit and risk committee whilst all other trusts have flexibility to establish either a dedicated audit and risk committee, or to include the functions of an audit and risk committee within another committee. The committee's work must focus on providing assurances to the board of trustees that all risks are being adequately identified and managed with particular regard to reviewing the risks to internal financial and non-financial control at the trust and agreeing a programme of work to address, and provide assurance on, those risks.

In multi-academy trusts the audit and risk committee's oversight must extend to the financial and non-financial controls and risks at constituent academies.

Oversight must ensure that information submitted to DfE and ESFA that affects funding, including pupil number returns and funding claims completed by the trust and (in the case of a multi-academy trust) by constituent academies, is accurate and in compliance with funding criteria.

The outcome of the committee's work should inform the governance statement that accompanies the trust's annual accounts and, so far as is possible, provide assurance to external auditors.

The trust must also provide ESFA with any other internal scrutiny reports if requested.

Example controls to consider for academies relevant to monitoring the system of internal control applicable to the preparation of the financial statements include:

- The trustees carry out an annual review of the internal financial and non-financial controls.
- The trustees consider the need to appoint an internal auditor or set up an audit and risk committee.
- There is a programme of internal scrutiny (whether an in-house internal auditor, a bought-in internal audit service from a firm, other organisation or individual with professional indemnity insurance, a non-employed trustee, or peer review) which uses an appropriately qualified and experienced individual not on the academy staff, with the necessary financial interest and skills to be able to perform the role competently.
- The internal scrutiny programme includes the review and checking of some transactions to ensure that correct procedures have been applied in the following areas:
  - review that bank reconciliations have been carried out each month, including a review of validity of reconciling items;
  - review of the monthly payroll to ensure that any changes have been appropriately authorised;
  - check of a sample of orders to delivery notes and invoices to ensure that the documentation is complete and has been appropriately checked and authorised;
  - check of a sample of payments back to invoices, orders and delivery notes to confirm they are bona fide purchases;
  - review of a sample of expense claims to ensure there is appropriate documentation to support the claim and that the claim is appropriately authorised;
  - review the returns to the DfE to ensure the information supplied is consistent with the underlying accounting records and internal management reports;
  - carry out spot checks of petty cash balances and supporting vouchers; and
  - review all major contracts and ensure formal tendering procedures exist and are being adhered to.

The ESFA have issued a good practice guide for Internal scrutiny in academy trusts which provides suggestions on how internal scrutiny/audit arrangements can be implemented to meet the requirements of the Academy Trust Handbook.

See Monitoring the system of internal control in Audit Guidance and Methodology which sets out the requirements of ISA (UK) 315 for further guidance.

Control activities

Control activities in Audit Guidance and Methodology sets out the requirements of ISA (UK) 315 in relation to understanding the control activities component and provides detailed guidance applicable to all entities.

Example controls within the control activities component to consider specific to academies are noted below. Note that this is not an exhaustive list, and these aspects should be considered alongside the guidance in the main Audit Guidance and Methodology area.

Budgeting

Example controls to consider for academies include:

- The academy's annual budgeting process incorporates the following features:
  - written procedures allocating responsibility for budget preparation;
  - a timetable which ensures that an approved, firm budget can be submitted to the DfE by the end of June for the following financial year;
  - approval by the Head teacher and the governing body;
  - a requirement to ensure that planned expenditure for each financial year does not exceed the available income received during the year, except where this is due to non-recurring expenditure which can be financed from funds carried forward; and
  - a profiled budget reflecting likely spending and income patterns.
- The academy benchmarks its costs against comparable institutions, for example by establishing links with other academies or by using data available on maintained schools held on the DfE website.
- Monthly reports detailing actual income and expenditure against budget, variation to budget report, cash flows and balance sheet, and highlighting any unusual or exceptional items are available for distribution within 2 weeks of the month end to which they relate. At least two levels of report are produced:
  - a detailed statement, designed for individual budget holders, setting out the amount spent and committed to date against budget;
  - a summary income and expenditure report which summarises the financial position of the academy.
- The monthly reports are reviewed by appropriate individuals.
- Procedures are in place to ensure that, where necessary, corrective action is taken to ensure the authorised budget is not exceeded.
- Financial reports are submitted to both the Finance & General Purposes Committee and the governing body. The reports include:
  - details of actual income and expenditure against budget for each main type of cost (as set out on form GAG 2) and each cost centre;
  - a forecast of the likely out-turn for the remainder of the financial year;
  - a monthly balance sheet;
  - a narrative explanation of significant variations from the approved budget, together with how they are being managed; and
  - a statement which summarises progress on current capital projects.

Note: The trustees should receive at least quarterly reports.

Assets

See Fixed assets for example controls relevant to the accounting process for fixed assets applicable to all entities, and guidance on how to test those controls.

Further example controls to consider for academies include:

- A capitalisation limit for assets has been set by the governing body.
- There is a clear definition of the assets to be included in the academy's asset register and an explanation of the reasons for the omission of particular types of assets.
- All items in the asset register are permanently marked as the academy’s property.
- All assets purchased using grant from the Secretary of State are clearly noted as such in the asset register and the proportion of grant indicated.
- Physical counts against the academy’s register are undertaken at least annually. Discrepancies between the physical count and the registers are investigated promptly and if significant reported to the governing body.
- Stores and equipment are secured by means of physical and other security devices.
- A policy for the disposal of assets has been established by the governing body which ensures the best value for the academy.
- A procedure has been established for obtaining permission from ESFA to acquire/dispose of relevant assets.
- The governing body has established a policy for the disposal of assets, which ensures the best possible value is obtained from the disposal.
- The policy for asset disposal includes controls to ensure that the asset is no longer of use to the academy (is obsolete), and that obsolete stocks are destroyed to ensure they are not illegitimately procured and then resold.
- The fixed asset register records the following information:
    - type and description of asset;
    - cost of asset;
    - location (if the academy covers more than one site);
    - officer or budget holder responsible for the asset;
    - amount and date of grant;
    - proportion of grant used to finance acquisition;
    - expected useful life of asset;
    - date of disposal / change of use;
    - proceeds of disposal / current market value and change of use;
    - amount returned to DfE on disposal or change of use; and
    - date of receipt of disposal proceeds; or
    - date of approval to retain receipt; or
    - date of a approval to change use.
- Minutes are maintained of all trustees' meetings and management meetings, authorising capital expenditure and also disposals.

Income

See Income for example controls relevant to the accounting process for income applicable to all entities, and guidance on how to test those controls.

Further example controls to consider for academies include:

- The responsibility for identifying and recording sums due to the academy is separated from the responsibility for collecting and banking monies received.
- Official pre-numbered receipts are issued, or other formal documentation maintained, for all income collected.
- Transfers of money between staff are signed for.
- Receipts, tickets and other records of income are securely retained.
- All incoming post is opened in the presence of two unrelated people.
- All incoming cheques and cash are recorded immediately.
- Cash and cheques are locked away to safeguard against loss or theft.
- Income collected is paid promptly and in full into the appropriate bank account.
- Only the governing body can give approval to write off debts not collectable (the Secretary of State's prior approval is also required if debts to be written off are above the value set out in the annual funding letter).

Cash at bank and in hand

See Cash at bank and in hand for example controls applicable to all entities, and guidance on how to test those controls.

Further example controls to consider for academies include:

- The opening and closing of bank accounts is authorised by the governing body, who should set out the arrangements for the operation of the accounts including any transfers between accounts.
- There is a limit to the maximum amount of any individual transaction without the approval of the governing body.
- All funds surplus to immediate requirements are invested in accordance with the Trustees' investment policy.
- Arrangements have been made to ensure that any earmarked grants or other restricted income is ring-fenced from the other funds of the academy.
- The level of petty cash held by the academy is appropriate and its use is properly controlled.
- The withdrawal of petty cash is approved at the time rather than retrospectively.

Expenditure

See Expenditure for example controls relevant to the accounting process for expenditure applicable to all entities, and guidance on how to test those controls. Controls over Cash at bank and in hand and Creditors and accruals will also be relevant to expenditure.

Further example controls to consider for academies include:

- Written, pre-numbered orders are used for all purchases made by the academy, except utilities, rent, rates etc., and all orders are authorised by nominated signatories.
- A record of signatories and their authorisation limits for expenditure is kept and updated at suitable

intervals.

- There are controls in place to ensure that the procurement rules and thresholds in the Public Contracts Regulations 2015 and Find a Tender service are observed. There are written procedures in place in which:
  - the threshold value of goods and services above which a tender should be sought has been specified by the governing body;
  - the minimum number of tenders which need to be received and considered is specified;
  - the levels of delegated authority in decision making, for example the financial limits above which all quotations or tenders must be reviewed by the governing body is specified;
- Controls are in place to ensure that any instance where a tender or quotation other than the lowest has been accepted is documented and reported to the governing body.
- There are written procedures for the submission, receipt, opening and recording of tenders.

Payroll

See Wages, salaries and other remuneration for example controls relevant to the accounting process for payroll expenses applicable to all entities, and guidance on how to test those controls.

Further example controls to consider for academies include:

- Appointments or changes to terms and conditions are authorised by the governing body.
- Where payroll services are bought in:
  - there is a formal contract in place between the academy and the bureau; and
  - there is a formal monitoring of the service and information provided by the bureau.
- There is a contract between the academy and the payroll bureau which addresses the following:
  - job specifications;
  - responsibility for making returns to HMRC and the dates by which these returns should be made;
  - details on ownership of programs and data files;
  - responsibilities for the control and accuracy of data;
  - details of authorised signatories for payroll amendments;
  - back up provisions;
  - a schedule of reports to be sent to the academy for financial and personnel monitoring purposes;
  - an agreement as to the response time and costs that will be charged for any additional data or reports required by the academy; and
  - provision for access for academy staff and auditors.
- Whether the payroll service is provided by academy staff or by a payroll bureau the academy system should contain adequate controls to ensure:
  - payments are only made to bona fide employees;
  - payments are in accordance with an individual's conditions of employment;
  - payments are only made for services provided to the school;
  - any severance or compensation payments to staff are in accordance with the Handbook and Accounts Direction, and the required approval is obtained before making any binding

commitments to staff;

  - deductions, including income tax and national insurance, are properly administered;
  - all, and only, authorised amendments are made to the payroll; and
  - amendments to the payroll are promptly and properly processed.

- Payroll control account reconciliations are regularly carried out.
- Procedures are in place to gain ESFA confirmation for special payments to current or former employees where required.

6.2 Programmes

Disclosure checklist

Introduction

With the increasing sophistication of accounts preparation packages, it is not essential that a checklist be completed each year. However, an annual review for proper preparation of the accounts in accordance with the relevant Charities SORP and other applicable requirements should take place and will form part of the critical review of the accounts.

FRS 102

The checklist covers the disclosure requirements of FRS 102, the Charities SORP (October 2019), the Academies Accounts Direction 2022 to 2023, the Academy Trust Handbook 2022 , the *Companies Act* 2006 and applicable regulations.

The checklist also includes disclosure requirements from the 2020–21 Supplementary Bulletin, clearly identified as such. The Bulletin was published in July 2021 and provides guidance to trustees, accounting officers and external auditors on matters arising from Covid-19 and remains extant.

The ESFA does not intend to issue a further supplementary bulletin for the year 2022/23

Using the programmes

Introduction

The Academy audit tool provides everything you need to audit the accounts of an academy.

The tool is very flexible, allowing you, through the planning, to decide the best approach to reporting on each of the relevant sections. This enables you to comply with all the relevant standards as efficiently and effectively as possible.

All working papers generated during the course of the audit or documents filed on the audit working paper file should be referenced and cross-referenced to facilitate review.

The tool contains detailed indices for all sections.

6.3 Academy specific example letters and reports

Academy specific letters

Letters of representation

Letters of representation should be obtained from the governors of the academy on an annual basis to support any representations made during the course of the audit. The example accounts letter *(see template REPACAD)* has been drafted in the form of a letter which is sent from the trustees on the academy's letterhead as required by ISA (UK) 580. The trustees should then be asked to send a signed copy to the auditors as confirmation that they agree the contents.

Where the letter has been signed on behalf of the trustees by only one or two then there should be a minute of a meeting of the trustees agreeing its contents. This ensures that all trustees are aware of those representations.

You may also need to obtain representations from the head teacher. If this is the case, you should ensure that the contents of any such letter are reviewed by the governors. Again, this highlights relevant representations to the governors.

The tendency in recent years is away from the full letter where the trustees make representations about all the assets, liabilities and other items affecting the accounts. Instead, the letter should be restricted to those areas where the auditor is unable to obtain independent evidence and could not reasonably expect it to be available. Provided no other evidence exists that conflicts with the representations by trustees, the auditor should obtain written confirmation of the representations.

The representations in respect of regularity have been drafted as a separate letter, but these could easily be combined under separate headings in one letter *(see template REPACRG)*.

Audit findings letter

ISA (UK) 260 Communication with those charged with governance states that one of the objectives is:

To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process.

Under ISAs (UK) 260 and 265, in some circumstances, certain matters may be communicated to the client orally rather in writing. However, for academies this option is not available since the Accounts Direction requires a written management letter to be submitted to the ESFA.

It is important that the auditor remembers that the ISAs require that the auditor should provide 'timely observations arising from the audit...', as it is quite common to find recorded systems and controls deficiencies within the file which have not been brought to the client's attention. Only sending an audit findings letter to the client along with the final accounts may not be sufficiently prompt to comply with the ISAs. For example, if at the planning stage the auditor identifies a material weakness in the client's internal controls, an interim report should be issued at that stage.

Additional requirements for academies

In addition to the content required by ISAs (UK) 260 and 265 the Accounts Direction requires that the audit findings letter addresses:

- findings, including ratings of the importance/risk, e.g. high/medium/low;
- their views about significant qualitative aspects of the academy trust's accounting

practices, including accounting policies, accounting estimates and financial statement disclosures;

- significant difficulties, if any, encountered during the audit;
- significant matters, if any, arising from the audit that were discussed, or subject to correspondence with, management and the written representations the auditor is requesting; and
- other matters, if any, arising from the audit that, in the auditor's professional judgement, are significant to the oversight of the financial reporting process.

The Academies Handbook requires trusts to implement reasonable risk management audit recommendations that are made to them by risk auditors.

The audit findings letter should also address findings related to regularity. These should be included as a separate section in the audit findings letter.

In respect of each regularity issue, include:

- the issue (including a rating of the risk/importance and financial impact);
- implication/consequence;
- recommendation; and
- management response (including timescale for change).

A proforma audit findings letter (letter of comment) is included ~~below~~. *See template COMMENTA.*

Note. The PCAS system generally refers to an audit findings letter as a letter of comment. However,as the Accounts Direction refers to an audit findings letter, that term has been used here to avoid any confusion.

Audit letters of engagement for an academy

The letter of engagement forms the basis of the contract between the firm and the client. In the event of any dispute or uncertainty, this will play a vital part in reaching any agreement. It is essential that the letter is both complete and up to date.

In an academy, the board of governors will be the appointing body and the letter should be addressed to them. The auditor should check the governing document to make sure that this is the case. You should also send a copy of the letter to the Head or other persons responsible for the day-to-day management.

Example engagement letters for academy audits are available *in the templates (ENGACAUD)* ~~by following the links included here.~~.

Other template letters included in the pack

As well as those above, the following templates have been included in the academies pack:

- *Request for bank report (BANKSTD,BANKFAST, BANKINC, BANKACK)*
- *Letter of resignation (RESIGW)*
- *Related party checklist (FRS 102) (RPQFRS8)*

- *Cover letter for related party checklist (RPQCOVER)*

Audit reports for academies

The following section includes reports applicable to 2023 year-ends.

Senior Statutory Auditor and signing audit reports

As with other charitable companies the client's copy of the audit report of an academy audit under the *Companies Act 2006* must be signed in the personal name of the Senior Statutory Auditor. Other copies such as those filed at Companies House or posted on the academy's website may be signed in the name of the firm with the name of the senior statutory auditor stated beneath.

For an unqualified accounts audit report - see template UNQAUDAC

For an unqualified report on regularity - see template UNQREGAC

For Statement of Trustees' responsibilities (formerly Governors statement of responsibilities) – see template STATRESP

Filing accounts and audit reports

The copy of the accounts made available on the academy's website does not need to be a copy of a physically signed set of accounts. It can simply show the relevant names typed in. However, as noted above if the governors choose to file or otherwise distribute signed copies of audit report then it is acceptable for the audit report to be signed in the firm's name provided that the name of the senior statutory auditor is also stated. Only the client's own copy must be physically signed by the statutory auditor in their own name.

6.4 What’s changed

This table lists, in chronological order with the most recent at the top, the changes made to the Academies area *over the last 12 months as taken from Croner-i.*

Date ***What has changed***

July 2023

Version 4.0 of the Academy tool released.

This version implements the changes required by the Academies Accounts Direction 2022 to 2023, the Framework and guide for external auditors and reporting accountants of academy trusts 2022 to 2023 and the Academy Trust Handbook 2022.

In addition, this version:

- reflects significant ISA driven changes to audit requirements primarily from the revised standards ISA (UK) 315 *Identifying and assessing the risks of material misstatement* and ISA (UK) 240 *The auditor’s responsibilities relating to fraud in an audit of financial statements*. New content has been added and changes made in certain schedules, as well as references and links updated to the latest versions of standards;
- address ongoing regulator concerns about auditors’ professional scepticism and the need to hold and document robust discussions that challenge management’s assumptions, as well as reliance on the work of external experts;
- ~~improve understanding and navigation by adding further links within the Excel file to related guidance and standards in *Navigate Audit* and *Navigate UK GAAP Accounting*~~; and
- minor updates to respond to customer feedback on specific schedules.

July 2023

Risk assessment procedures

~~A detailed mapping schedule of changes between v3.1 and v4.0 is available here.~~

New planning schedules have been developed to address the enhanced IT requirements of ISA (UK) 315:

- IT risk identification (C7.2);
- Assessment of IT risks and general IT controls (C7.3); and
- ~~an IT coversheet (C7.2i) has also been provided to guide the user through the new audit programmes.~~

All planning and risk assessment schedules have been reviewed and updated where necessary to help teams document audit risk assessment processes and procedures effectively under the revised standards: ISA (UK) 315 and ISA (UK) 240. Key changes include:

- an additional point has been included in *Detailed file completion checklist* (B1) to aid compliance with the new stand-back requirement;

- consideration of inconsistencies identified has been included as an additional column in *Summary of significant matters* (B4);

- a new question has been included in Audit strategy and plan (C2) and Risk assessment (C9) to aid compliance with the new requirement of making enquiries of any whistle-blowers;

- a new question has been included in *Audit strategy and plan* (C2) to aid compliance with the new requirement to consider the use of experts or other specialists;

- *Know your client checklist* (PAF04) has been renamed *Understanding the entity aide-memoire* and moved to the planning section (C4), with significant revisions designed to enhance risk assessment procedures and understanding of the entity;

- *Significant accounting policies* (PAF07) has been moved to the planning section (C4.1) with amendments and additions designed to enhance risk assessment procedures and understanding of the entity;

- the *Internal control aide-memoire* (C7.1) has been significantly revised to address requirements for understanding the system of internal control, including columns for the identification of controls and determining the impact of control deficiencies;

- *Detailed risk assessment* (C9.1) has been updated to include consideration of the need for experts or other professionals with specialised skills where suspected fraud may be a risk factor;

- the *Risk assessment summary* (C9.3) has been split into two separate schedules to ensure full consideration of both financial statement level risks (C9.3) and assertion level risks (C9.4). These sheets have been updated to include:

  - consideration of the need for experts or other professionals with specialised skills where suspected fraud may be a risk factor;

  - further ‘stand back’ requirements to document and evaluate risks;

  - references to ISA (UK) 315 requirements, including the five inherent risk factors; and

  - a section added to document revisions to the risk assessment during the audit.

- *Notes of the engagement team planning meeting* (C10) has been amended to ensure the partner determines the need for communication and the use of experts or other specialists where necessary as well as updating guidance notes and prompts to consider the need for further meetings and discussions of the audit plan.

~~To aid navigation and understanding, hyperlink cross-references to corresponding Guidance and Methodology in *Navigate Audit* have been updated and links added within the audit tool where applicable.~~

July 2023 **Further enhancements**

In addition to enhancements to risk assessment procedures, the majority of schedules have been updated for minor editorial amendments as well as updates to references and links.

~~A detailed mapping schedule of changes between v3.1 and v4.0 is available here.~~

Several audit programmes contain additional steps where necessary to address the changes driven by the revised ISA (UK) 315 and ISA (UK) 240. Key changes include:

- additional steps have been added to verify client reports or extractions of client reports in all relevant work programmes;
- the *Register of laws and regulations* (PAF05) has been moved into the work programme section for *Going concern & regulations* (D6) to ensure more detailed and up to date documentation to support the audit file; and
- • the Permanent audit file schedules for related parties (PAF06, PAF06.1 and PAF06.2) have all been moved into the work programme section for Related party transactions (X3, X4 and X5) to ensure more detailed and up to date documentation to support the audit file.

July 2023 An updated user guide is available.

July 2023 The disclosure checklist has been updated to include the requirements of the Academies Accounts Direction 2022 to 2023 and the Academy Trust Handbook 2022.

July 2023 The guidance notes in the following sections have been updated for changes in the Academies Accounts Direction 2022 to 2023, the Framework and guide for external auditors and reporting accountants of academy trusts 2023 and the Academy Trust Handbook 2022:

- Academy Trust Handbook;
- Roles and responsibilities;
- Financial governance and delegated authorities;
- Annual accounts;
- Taxation; and
- Audit requirements.

A new guidance section on Controls in an academy has been added to aid users in obtaining an understanding of the internal controls in an academy relevant to the preparation of the financial statements.

July 2023 — Editorial amendments made to the Letters of representation and Audit findings letter.

July 2023 — Example Unmodified report for an academy, Unqualified report on regularity and Statement of Trustees' responsibilities updated in line with the Academies Accounts Direction 2022 to 2023.

August 2022 — ~~Version 3.1 of the Academy tool released including~~ a minor editorial amendment to the conclusion on sheet Sup7.

August 2022 — Version 3.0 of the Academy tool released.

This version implements changes required by the Academies Accounts Direction 2021 to 2022, the Framework and guide for external auditors and reporting accountants of academy trusts 2021 to 2022 and the 2021 Academy Trust Handbook.

In addition, this version aims to:

- address regulator concerns about auditor scepticism and the need to hold and document robust discussions that challenge management's assumptions, as well as reliance on the work of external experts;
- make the tool easier and more streamlined to use, saving time on audits;
- improve understanding and navigation by adding links within the Excel file and with related guidance in Navigate Audit and Navigate Accounting;
- add new audit programmes on specific areas likely to be useful in practice; and
- encourage best practice by preparing the content for the significant ISA-driven changes required next year for (ISA (UK) 315).

August 2022 — **Scepticism and experts**

The following new workpapers have been added to help teams hold and document more robust discussions:

- Understanding accounting estimates (C8);
- Going concern forecast work paper (D3);
- Testing the operational effectiveness of controls (S4);
- Testing journal entries work paper (V3);
- Accounting estimates work paper (found *in the templates* ~~at the end of the workbook~~); and

- SAP work paper (found *in the templates* ~~at the end of the workbook~~).

The schedules for using a management's expert, an auditor's expert and a service organisation have been updated to a more free-form template to better prompt the discussion and documentation process. These are renumbered as Sup2, Sup3, Sup4 *in the templates*. It is recommended the auditor copies these work papers to all relevant areas of the audit file where reliance is placed on the work of others.

August 2022

Efficiency and linkage

Overall approx. 15% worksheets have been removed where the content has been moved to other sheets or deleted as it is duplicated elsewhere. ~~A detailed mapping schedule is available here.~~

Key efficiency improvements include:

- ~~cells have been unmerged where possible to aid editing;~~
- ~~input cells have been formatted with text-wrapping to aid documentation and review;~~
- checklists and audit programmes streamlined to remove repetition between sheets, saving documentation and review time; and
- default audit tests provided have been reviewed and streamlined, with references to the assertions likely to be covered by each test added.

~~To aid navigation and understanding, hyperlink cross-references and links to relevant audit and accounting guidance in the Navigate platform have been added to the Excel tool.~~

August 2022

Enhancements

New audit programmes have been developed for:

- Compliance with laws and regulations (D5);
- Investment properties (F3);
- Finance leases (F4);
- Hedge accounting (H3);
- Income (Q2);
- Employee benefits (R section);
- Journals (V section); and
- Related party transactions (X2).

An Additional test schedule is available *in the templates* ~~at the end of the workbook~~ containing supplementary tests that are not always necessary. Where required these can easily be copied to the relevant audit programme.

August 2022 **Preparing for ISA (UK) 315 Identifying and assessing the risks of material misstatement**

~~The audit objectives sheets have been combined with the related audit programmes, providing better links between the risks identified and the work planned and performed.~~

Relevant assertions have been added to the audit programmes to make it clearer which assertions are addressed by each procedure and so help the auditor to mitigate risks with specific procedures more efficiently.

August 2022 S4 provides a clear work paper to document testing the operational effectiveness of controls, encouraging auditors to consider tests of control as a part of their audit strategy.

August 2022 W4 *Component auditor instructions* has been updated to refer to International Accounting Standards as adopted by the UK.

August 2022 An updated user guide is also available.

August 2022 The disclosure checklist has been updated to include the requirements of the Academies Accounts Direction 2021 to 2022 and the Academy Trust Handbook 2021.

August 2022 The guidance notes have been updated for changes in the Academies Accounts Direction 2021 to 2022, the Framework and guide for external auditors and reporting accountants of academy trusts 2022 and the Academy Trust Handbook 2021.

These changes primarily affect the following sections:

- Academy trust handbook;
- Roles and responsibilities;
- Financial governance;
- Annual accounts; and
- Audit requirement

August 2022 Example reports updated in line with the Academies Accounts Direction 2021 to 2022.

August 2022 Minor editorial amendments to refer to latest published guidance.

7. Charity

Contents

- Guidance and methodology
- Programmes
- Example letters and reports
- What’s changed

7.1 Guidance and methodology

This area of ~~Navigate Audit~~ provides guidance which supplements the commentary in the main Audit guidance and methodology area with matters specific to charity assignments.

Introduction to charities

These guidance notes give a basic introduction to the various types of charity along with the audit ~~and independent examination~~ requirements. They are not intended to be an exhaustive guide to charity legislation.

There are a number of different regulators with responsibility for charities throughout the UK. The Charity Commission regulates charities in England and Wales, the Office of the Scottish Charity Regulator (OSCR) regulates charities registered in Scotland and also, to some extent, English or Welsh charities operating in Scotland. Northern Ireland also has its own Charity Commission, the CCNI. This section mainly addresses the regime governing English and Welsh charities. *(This pack has a disclosure checklist which covers Scottish charity requirements also)*

What is a charity?

Charities can take many legal forms, the most common being trusts, limited companies and charitable incorporated organisations (CIOs and SCIOs in Scotland), and this affects the format of their annual report and accounts and the level of independent scrutiny that is required.

In each part of the UK, all charities are subject to the relevant charities law. In England and Wales, this is the *Charities Act* 2011 (CHA 2011), in Scotland it is the *Charities and Trustee Investment (Scotland)* Act 2005 (CTISA 2005) and in Northern Ireland it is the *Charities Act (Northern Ireland)* 2008 and 2013 (CANI 2008).

Under the *Charities Act* 2011, a charity is defined as a body or trust which:

- •is for a charitable purpose; and
- •is for the public benefit.

Charitable purposes

The *Charities Act* 2011 includes descriptions of the 13 main purposes that are charitable. The last is a catch-all, which means that everything that is currently charitable is included. The purposes are:

- the prevention or relief of poverty;
- the advancement of education;
- the advancement of religion;
- the advancement of health or the saving of lives;
- the advancement of citizenship or community development;
- the advancement of the arts, culture, heritage or science;
- the advancement of amateur sport;
- the advancement of human rights, conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity;
- the advancement of environmental protection or improvement;
- the relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage;
- the advancement of animal welfare;
- the promotion of the efficiency of the armed forces of the Crown or the efficiency of the police, fire and rescue services or ambulance services, and
- any other purposes charitable in law.

Categories of charity

You need to establish which type of charity client you are dealing with as the accounting and reporting requirements are different.

Registration category

All charities in England and Wales which exceed certain thresholds are required to register with the Charity Commission, unless they are specifically **excepted** or **exempt** from registration. Charitable incorporated organisations (CIO) derive their legal status from registration with the Commission so they are all registered whatever their income level and even if they would otherwise be excepted. The minimum requirements for non-CIO registrations are as follows:

Income threshold	> £5,000
Permanent endowment	Not relevant
Use or occupation of land	Not relevant

Excepted charities

Excepted charities are relieved from the duty to register by regulations made by the Home Secretary or Charity Commissioners or are below the registration thresholds.

Excepted charities include many religious institutions and some Scout and Guide groups. Although not required to register, such charities can register voluntarily.

Since implementation of the relevant sections of the 2006 Act, excepted charities with an annual income of £100,000 or over must register with the Commission. Excepted status for charities with an annual income of below £100,000 will continue until 31 March 2031 as a result of SI 2021/55. However, those under the £100,000 threshold still come under the jurisdiction of the Charities Commission. The Hodgson Report on the implementation of the *Charities Act* 2006 recommended that the income threshold should be lowered to £25,000.

It is worth noting that an excepted charity such as a church whose income is normally well below the income threshold of £100,000 per year, but which receives a substantial legacy or grant that causes it to exceptionally exceed the threshold, can apply to the Charity Commission for a written determination. However, recent anecdotal evidence suggests that the Commission is not currently inclined to grant such determinations in most cases.

Exempt charities

An exempt charity is one identified in the third Schedule to the *Charities Act* 2011. This includes universities, academies and many of the national museums and galleries. These charities were regulated by other public bodies, such as the Financial Conduct Authority or Higher Education Funding Council for England and thus did not need to register with the Charity Commission. Under the *Charities Act* 2011, those charities whose regulator has agreed to continue in the role will continue to be exempt and will remain regulated by their current regulator, now known as a ‘principal regulator’. However, the Charity Commission will be able to investigate these charities where requested by their principal regulator, and where a suitable regulator does not exist or is not willing to continue, then a previously exempt charity will become excepted, and so in line with the above rules, those with income above £100,000 now have to register with the Charity Commission.

Housing associations (previously known as registered social landlords) can either be registered as a co-operative and community benefit society (previously an industrial and provident society), in which case they are exempt (regulated by the Homes and Communities Agency from 1 April 2012 (previously the Tenant Services Authority)), or with the Charity Commission. They are outside the scope of this publication, though guidance in this area may be found in Practice Note 14: The Audit of Housing Associations in the United Kingdom (Revised March 2021) published by the Financial Reporting Council.

Constitution category

Charities can also be categorised by their legal constitution, the most common of which are as follows.

(1) **Charitable trust** – Established under a trust deed.

(2) **Charitable association** – An association established for charitable purposes but with no trust deed. It will have a constitution and members.

(3) **Incorporated under the Companies Act** – As with any other company, these can either be limited by guarantee or limited by share capital, but the former are more usual. Since the *Companies Act* 2006 and the *Charities Act* 2006, small charitable companies have been governed by the *Charities Act* 2011 for financial scrutiny (i.e. whether they are required to have an audit or an independent examination), but in all other aspects (including the accounts preparation) by the Companies Act. The audit report for small charitable companies who claim audit exemption under the Companies Act but require an audit under the Charities Act will therefore now refer to both the *Companies Act* 2006 and *Charities Act* 2011. The incorporated charity will also be controlled by the provisions in its Articles of Association.

(4) **Incorporated under the Charities Act** – The 2006 Act created a new charitable vehicle – the Charitable Incorporated Organisation (CIO). A CIO has the advantages of a corporate structure, such as reduced personal liability for trustees, without the burden of dual regulation, plus sole regulation by the Charity Commission. The secondary legislation required before CIOs can be formed in England and Wales was laid before Parliament on 10 December 2012 (*Charitable Incorporated Organisations (General) Regulations* 2012 (SI 2012/3012)), and the Commission started to accept registration applications from that date. It should be noted that all CIOs must register with the Commission. The threshold for exemption from registration does not apply to a CIO.

Specimens of a trust deed, constitution and articles can be obtained from the Charity Commission. This also includes two model constitutions for CIOs, i.e. an association or a foundation.

Implications of different categories of charity

Registered charity

The full weight of the legislation applies.

Excepted charity

Where voluntarily registered, the same rules apply as for a registered charity. Where not registered, the annual accounts do not have to:

•include an annual report; or

•be filed with the Charity Commissioners (although they are entitled to request that the charity does submit a set of accounts and an annual report to them).

However, accounts should still be prepared, and audited if required (see Audit and reporting requirements).

Exempt charity

Exempt charities are not able to refer to themselves as registered charities or quote a registered charity number. As a result, they are largely outside the jurisdiction of the Commissioners. They are excluded from many of the provisions of the 2011 Act, but are covered by the provisions that:

- the public has a right to request (in writing) accounts direct from the charity;
- the rules over disqualification and who may not act as trustees are the same; and
- likewise, the rules over public collections, the activities of professional fundraisers and ex gratia payments also apply to exempt charities.

Accounting requirements

Accounting requirements

The following legislation and Regulations govern the format of the accounts and the reporting requirements:

(1) for all charities in England and Wales, the *Charities Act* 2011;

(2) for charitable companies, the *Companies Act* 2006 and the relevant Regulations under this Act;

(3) the Charities (Accounts and Reports) Regulations 2008 (SI 2008/629) – see below;

(4) for accounting periods ending on or after 31 March 2015, the *Charities Act 2011 (Accounts and Audit) Order* 2015 (SI 2015/321) and the *Charities Act 2011 (Group Accounts) Regulations* 2015 (SI 2015/322) which only amend the audit and group account thresholds;

(5) non-company charities (including CIOs) with income of less than £250,000 can follow the Charity Commission guidance CC16 which is an accounts packs for receipts and payments accounts;

(6) for accounting periods beginning on or after 1 January 2019, the second edition of the Charities SORP (FRS 102); and

(7) for CIOs preparing receipts and payments accounts, the *Charitable Incorporated Organisations (General) Regulations* 2012 (SI 2012/3012), reg. 62.

Checklists are included in this product dealing with the disclosure requirements of the Charity SORP. This checklist includes applicable requirements of FRS 102 and the Companies Acts as well as the Charity Accounts Regulations. This checklist also includes the requirements of Scottish Accounts Regulations.

~~Checklists applicable only to earlier periods can be found, for reference purposes, in the archive in Reference material.~~

This automated version incorporates a full disclosure checklist for charities (English, Welsh and Scottish) covering the Charities SORP (FRS 102), Companies Act requirements and the current CharityAccounting Regulations (English & Welsh and Scottish).

The checklist is extensive and is fully interactive. The pack's Tailoring Questions allow you to determinewhether or not to complete the full disclosure checklist for the current year. If you indicate that the disclosure checklist is not required, the disclosure section will not appear in the audit file.

The checklist starts with a series of tailoring questions. These should be answered in the order shown as the answers to earlier questions will automatically determine which of the subsequent questions areincluded. As you answer each question, the system will, if the question has logic dependencies, refresh the display to bring in or exclude the questions that depend on the question asked. After you have completed the tailoring checklist, you will find that the system will have deactivated any disclosure checklists that are not applicable and only relevant questions will be included in the checklists that remain active.

Some of the questions relate to matters that the system could have determined from examining the contents of the trial balance, or client control data, however, you will be asked to answer these. This is done to provide an independent review of the disclosure requirements and ensure that there is a double check in case there are any processing errors or data has been combined for inclusion in thetrial balance.

Background

The *Charities (Accounts and Reports) Regulations* 2008 continue to set out the requirements for preparation of accounts in respect of English and Welsh charities. Guidance has been issued by the Charity Commission on their application in conjunction with the FRS 102 SORP. Whilst all charities must prepare accounts, the impact of these regulations depends on the threshold requirements as set out in the 2011 Act and on whether the charity is registered or not. These requirements can be summarised as follows:

- registered charities with gross income and total expenditure of £25,000 or less, and charities which are not registered, are not required to submit annual reports or accounts to the Charity Commission, unless requested to do so. All registered charities must prepare an annual report, even if they are not requested to submit it to the Charity Commission;
- non-company charities with gross income of £250,000 or less may prepare a receipts and payments account and a statement of assets and liabilities; and

- all charitable companies and non-company charities that exceed this £250,000 threshold must prepare accounts on an accruals basis to give a true and fair view. Certain additional disclosure requirements are placed on charities whose gross income exceeds the audit exemption threshold.

The SORP applies only to accruals accounts. Separate guidance, including pro forma accounts and report packs, have been published by the Charity Commission for charities that prepare cash-based receipts and payments accounts. Trustees will be able to rely on these packs as providing comprehensive guidance and do not need to refer to the SORP in preparing their accounts and reports.

The SORP provides illustrative disclosures and pro forma layouts in table form for the primary statements, i.e. the SOFA and Balance Sheet. These should assist those preparing accounts by providing examples of how particular disclosures may be set out.

Charities and UK GAAP

FRS 100 'Application of Financial Reporting Requirements' and FRS 101 'Reduced Disclosure Framework' were first published by the FRC on 22 November 2012 and latest versions published in 2018. FRS 100 notes that charities are prohibited by law from applying International Financial Reporting Standards (IFRS) and hence FRS 101 is also not applicable to charities.

FRS 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland' replaces the previous UK GAAP standards and applies to accounting periods commencing on or after 1 January 2015.

Charity-specific accounting requirements can be identified in FRS 102 by the prefix 'PBE'.

Small non-charitable companies can prepare accounts with reduced disclosures in accordance with FRS 102 Section 1A (2018).

This option is not available to small charitable companies which must follow the FRS 102 SORP (2019) in full. However, the FRS 102 SORP (2019) has exemptions from disclosure for smaller charities. For these purposes, smaller charities are those with a gross income of £500,000 or less.

The Charities SORPs and other guidance

For reporting periods starting on or after 1 January 2019, all charities must follow the second edition of the Charities SORP (FRS 102). Published in October 2019, this version of the SORP incorporates the changes made by Update Bulletin 1 (published in February 2016) and Update Bulletin 2 (published in October 2018) into the previous version of the SORP (referred to as the 2015 SORP). It also makes minor amendments to update legal references in the Republic of Ireland and Northern Ireland (SORP Appendix B44–B46).

Update Bulletin 1 amended the content of the 2015 SORP to reflect changes made to FRS 102 and to charity law.

Update Bulletin 2 became effective for periods commencing on or after 1 January 2019 and amended the 2015 SORP to reflect amendments and clarifications set out in *Amendments to FRS 102 – Triennial review 2017 – Incremental improvements and clarifications* , issued by the Financial Reporting Council (FRC) in December 2017.

In addition to the SORP, the regulators have at the time of writing also published the following:

- Information Sheet 1: Implementation Issues (published April 2017);
- Information Sheet 2: Accounting for gift aid payments made by a subsidiary to its parent charity where no legal obligation to make the payment exists (published January 2019);
- Information Sheet 3: The Companies (Miscellaneous Reporting) Regulations 2018 and UK Company Charities (published September 2019);
- Information Sheet 4: Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Multi-employer defined benefit plans (published November 2019);
- Information Sheet 5: The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 – UK, as applied to Charitable Companies (reissued September 2020); and
- Information Sheet 6: Irish Charities – Merger Accounting and Republic of Ireland Company Law.

Charities that are subject to alternative legislative requirements to the Charities Act (such as the Companies Act for larger charities that are limited companies) or alternative SORPs to the Charities SORP (e.g. Registered Providers of Social Housing) should follow the accounting and auditing requirements in the alternative legislation or SORP.

Note that charities established in Scotland register separately as Scottish charities and charities registered in Northern Ireland are required to register separately as Northern Irish charities.

Dual registered charities preparing accruals accounts (i.e. registered with the Charity Commission and with the OSCR and/or with the Charity Commission for Northern Ireland) need to comply with the FRS 102 SORP, but the audit requirement, annual report and trustees' responsibilities need to reflect the legal requirements of all countries in which they are registered. This guidance deals mainly with charities applying the FRS 102 SORP and subject to the *Charities Act* 2011 accounting and auditing requirements.

~~The SORPs and Information Sheets are included in the Accounting Standards area of Croner-i Tax and Accounting and further information can be found in the Charity section of *Navigate UK GAAP Accounting* and the *Charities Sector Guide* .~~

Trustees' report

The SORP presents the recommendations for the trustees' report using the following sections:

(1) Objectives and Activities.

(2) Achievements and Performance.

(3) Financial Review.

(4) Structure, Governance and Management.

(5) Reference and Administrative details.

(6) Exemptions from Disclosure.

(7) Funds held as Custodian Trustee (this section only applies occasionally).

Medium and large charitable companies must also provide a Strategic Report (or business review) as required by the *Companies Act 2006 (Strategic Report and Directors' Report) Regulations* 2013 (SI 2013/1970). This will entail including a separate section in the Trustees' report headed Strategic Report, containing the information required by the *Companies Act* 2006, s. 414C , in particular:

- a fair review of the charitable company's operations;
- a description of the principal risks and uncertainties facing the charitable company; and
- a balanced and comprehensive analysis of the development and performance of the charitable company's operations during the financial year, and the position of the charitable company's operations at the end of that year, consistent with the size and complexity of the charity.

For periods commencing on or after 1 January 2019, charitable companies that are large companies for company law purposes are required to have a statement in their strategic report setting out how the trustees as the company's directors have complied with their duty to have regard to the matters in the *Companies Act* 2006, s. 172(1) , i.e:

- the likely consequences of any decision in the long term;
- the interests of the company's employees;
- the need to foster the company's business relationships with suppliers, customers and others;
- the impact of the company's operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct; and
- the need to act fairly as between members of the company (CA 2006, s. 414CZA).

This statement must also be made available on the company's website (CA 2006, s. 426B).

Further guidance on this is available in Information Sheet 3: The Companies (Miscellaneous Reporting) Regulations 2018 and UK Company Charities.

The relevant audit report and the trustees' statement of responsibilities have been amended based on the Regulations and will be updated if necessary when the FRC issue updated versions.

Directors’ report statements for large companies

The *Companies Act* 2006 requires large companies to make statements about certain issues in their directors’ report. Large charities will therefore need to make these statements in their trustees’ report. Generally, these requirements relate to the trustees’ consideration of wider interests and in many cases are likely to be things that they would have covered in the trustees’ report anyway if relevant, but some of the requirements are quite specific so the details of what is required should be checked.

For periods commencing on or after 1 January 2019, charitable companies that exceed the medium-sized company limits in company law, but not entities that are large for accounting purposes only because they are in one of the categories excluded from the medium-sized companies regime (in CA 2006, s. 467), are required to include a statement in the directors’ report summarising how the directors have engaged with suppliers, customers and others in a business relationship with the company (SI 2008/410, Sch. 7, Pt. 4, para. 11B). Further guidance on this is available in Information Sheet 3: *The Companies (Miscellaneous Reporting) Regulations 2018 and UK Company Charities*, which recommends that charities consider expanding the statement to cover the charity’s relationship with other stakeholders, e.g. service users, beneficiaries, funders and the wider community.

For periods commencing on or after 1 April 2019, additional environmental reporting requirements apply to large companies, including charitable companies. These are included in the directors’ report. For these purposes, an entity is large if it exceeds the medium-sized company limits in company law or if it is a parent entity and its group exceeds the medium-sized group limits. Entities that are large for accounting purposes only because they are in one of the categories excluded from the medium-sized companies regime (in CA 2006, s. 467) are not large for these purposes. In addition, the reporting requirements do not apply to subsidiary companies if their parent company complies with the requirements on a group basis.

The requirements are contained in the *Companies (Directors’ Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations* 2018 (SI 2018/1155) and are included in the ~~Croner-i~~ Charities Disclosure checklist.

Entities are also exempt from the requirements if their energy consumption in the UK is 40,000kWh or less, but they must state that the disclosures have not been made for that reason.

Annual accounts

The trustees are required to prepare an annual statement of accounts which complies with the relevant regulations in respect of each financial year of the charity. Charitable companies are outside the scope of the legislation in this particular respect as they are primarily governed by the *Companies Act* 2006, though small charitable companies are now covered by the *Charities Act* 2011 for financial scrutiny only. Charitable companies must, however, comply with the above Statement of Recommended Practice by supplementing the accounting information required by the *Companies Act* 2006. Similar considerations apply to other charities which are governed by other specific legislation (e.g. Friendly or Co-operative and Community Benefit Societies (previously Industrial & Provident Societies)).

Accounts have to be filed with the Charity Commission within 10 months of the period end.

The accounts are then a matter of public record although members of the public can, upon written request and the payment of a reasonable fee (if demanded), request a copy of the most recent accounts directly from the charity trustees. Such accounts must be supplied within two months from the date the request is made.

Charitable companies also need to file accounts with Companies House within nine months of the accounting period end.

Smaller charities

All charities are required to comply with the disclosure requirements in the Charities SORP (FRS 102), therefore FRS 102:1A for small charities will not, in practice, provide a reduction in disclosure as the SORP imposes requirements over and above this Section. Therefore, whilst small charities can in theory apply FRS 102:1A, in effect it is irrelevant. However, only larger charities under the SORP need to prepare a statement of cash flows. A 'larger charity' in the SORP is one with gross income exceeding £500,000, being different from the audit threshold which is £1m for accounting periods ending on or after 31 March 2015 (or also where income is £250,000 or more and net assets exceed £3.26m).

Receipts and payments accounts

These consist of a summary of money received and paid during the financial year concerned. No adjustments are made for debtors and prepayments or creditors and accruals. The accounts would not include a balance sheet, but the charity has to prepare a statement of assets and liabilities, which simply lists those assets and liabilities (including debtors and creditors) held by the charity at the end of the accounting period.

As the accounts are not intended to give a true and fair view, this option is only available to small unincorporated charities, including CIOs, with recorded gross income from all sources of not more than £250,000 in that financial year.

This product includes disclosure checklists for the preparation of receipts and payments accounts. ~~Further guidance on receipts and payments accounts can be found in the charity section of *Navigate UK GAAP Accounting* under financial statement guidance.~~

Charity Commission's accounts packs for small unincorporated charities

To assist the trustees of smaller unincorporated charities in preparing their annual report and accounts, the Charity Commission has issued the following publications:

- CC15d Charity reporting and accounting: the essentials (November 2016);
- CC16 Receipts and Payments Accounts Pack (April 2013); and
- CC17 Accruals Accounts Pack – SORP FRS 102 (September 2016).

CC17 is suitable for charities wishing to analyse their expenditure by charitable activity.

CC16 is only applicable to unincorporated charities, including CIOs.

In addition to pro forma financial statements, the packs contain a specimen trustees' report and, where relevant, an independent examiner's report.

Group accounts

The 2011 Act requires a parent charity to provide group accounts that include its subsidiaries and hence provides a statutory backing to the SORP. In essence, group accounts need not be prepared where the parent charity is itself a subsidiary of another charity and will be included in its ultimate parent's group accounts. Nor are group accounts required where the gross income for the group falls below the threshold set by the Regulations. The threshold for accounting periods ending on or after 31 March 2015 is £1m net of consolidation adjustments.

A decision tree setting out the process that should be followed in determining whether group accounts need to be prepared or not is included here.

A ~~PDF~~ copy of the decision tree is available *in the templates (FCGROUP)* ~~here~~.

If group accounts must be prepared, they must be audited – there is no option for an independent examination of group accounts.

A decision tree to help determine whether a group is a small group for Companies Act purposes is available *in the Audit Planning area as checklist GRPST* ~~here~~. If the group qualifies as a small group under Companies Act, it may be required to prepare consolidated accounts under the Charities Act as set out above.

Audit and reporting requirements

Charity Commission publications

The Charity Commission have issued several publications to assist in this area.

(1) CC15d Charity Reporting and Accounting – the Essentials (updated June 2023)).

(2) CC31 Independent Examination of Charity Accounts: Trustees' Guide (updated July 2021).

(3) CC32 Independent Examination of Charity Accounts: Directions and Guidance for Examiners (updated July 2021).

CC32 updates the Charity Commission's previous publications for changes introduced following the implementation of those parts of the *Charities Act* 2011 dealing with the external scrutiny of charity accounts. Revised CC32 is applicable to all independent examination reports signed and dated on or after 1 December 2017.

Decision tree

The following decision tree works through the reporting requirements for both incorporated and unincorporated (including CIOs) charities although reference should always be made to specific legislation. It does not cover the requirements for other specialist entities that may also be registered charities, such as housing associations, co-operative and community benefit societies (previously industrial and provident societies) and clubs. Other entities are outside the scope of this publication and you should refer to any relevant legislation.

Click here for an interactive decision tree to help you determine the reporting requirements.

A ~~PDF~~ *checklist* of the decision tree is ~~here~~ *available under the Audit Planning area as REPTYPE*.

~~Additional decision trees and flowcharts~~ *Within the Audit Planning area, checklist SMLST is available as well as templates FCMED and FCSML* to help determine the size of a company under the Companies Act ~~are available in the private company section of *Navigate Audit*.~~ A charitable company could qualify as small but still require an audit under the Charities Act as set out ~~in the decision tree~~ above.

Thresholds of the current reporting regime

The *Charity Accounts and Audit Order* 2015 (SI 2015/321) sets the financial thresholds determining whether charity accounts must be audited or examined, at a gross income limit of £1m for accounting periods ending on or after 31 March 2015 (or also where income is £250,000 or more and net assets exceed £3.26m). The threshold for preparing group accounts is currently set at £1m gross income (SI 2015/322). However, the threshold of what constitutes a larger charity was left unchanged at £500,000 by Bulletin 1 to the Charities SORP (FRS 102), which was incorporated into the second edition of the Charities SORP (FRS 102) published in October 2019.

Definition of gross income

'Gross income' is defined in s. 353(1) of the *Charities Act* 2011 as ' *gross recorded income from all sources including special trusts'*.

The Charity Commission's publication 'Independent Examination of Charity Accounts: directions and guidance for examiners' (September 2017), appendix 2, states that:

'on the accruals basis gross income should be calculated as:

- the total incoming resources as shown on the Statement of Financial Activities (prepared in accordance with the SORP) for all funds but:

- excludes any gains on revaluation of fixed assets or gains on investments;
- excludes the receipt of any endowment; and

only for accruals accounts purposes would include any amount transferred from endowment funds to income funds during the year so as to be available for expenditure.'

As the SORP excludes from total incoming resources gains on revaluation of fixed assets or gains on investments, these do not form part of 'gross income'. Similarly, donations made to permanent or expendable endowment (including property to be retained as endowment) do not count as gross income, unless transferred to income funds during the year where they do count for accruals accounts purposes.

Using this approach, for accruals accounts gross income, which should be calculated before deduction of any costs or expenses, can be defined as follows:

Includes	**Excludes**
Donations, grants, gifts, legacies, and subscriptions	The receipt of a loan by, and loan repayments to, the charity
Tax refunds	The proceeds of sale of investment assets and tangible assets for use by the charity
Investment income (including interest receivable, dividends and rents and gains or losses on disposal of own use assets)	Gains on revaluation of fixed assets or gains on investments
Money received from the sale of goods or services in furtherance of the charity's objectives	Capital receipts when they first come into the charity (i.e. endowments), such that the donor expects will, or may, be retained for investment by the charity, and other capital donations (for example, gifts of land and buildings to be retained and used for a particular charitable purpose)
Gross proceeds from fundraising	
Other income, including when trustees decide to spend expendable capital	
A charity can approach the Charity Commission for audit exemption if they consider the excess over the audit threshold	

is a one off

For receipts and payments accounts, CC32 states *gross income is the total receipts recorded in the statement of accounts excluding the receipt of any endowments, loans and proceeds from sale of investments or fixed assets.*

Charities – Thresholds

Companies Act: Statutory Audit Thresholds		
Incorporated charities	Periods ending on or after 1 October 2012	Fails to qualify as small
Charities Act: Statutory Audit Thresholds		
All charities, including charitable companies and CIOs	Gross income over £1m for accounting periods ending on or after 31 March 2015 Gross assets over £3.26m and gross income over £250k	
Charities Act: Independent Examination Thresholds		
All charities, including charitable companies and CIOs	Gross income less than £1m for accounting periods ending on or after 31 March 2015 and total assets less than £3.26m	
Qualified examiner required	Gross income over £250k	
Charities Act: Total Exemption Threshold		
All charities, including charitable companies and CIOs	Gross income less than £25k	
Receipts and Payments Accounts		
Unincorporated charities, e.g. trusts, CIOs	Gross income less than £250k	
Companies Act 2006: Small		

Company Thresholds

Gross income	Not more than £10.2m for financial years beginning on or after 1 January 2016
Gross assets	Not more than £5.1m for financial years beginning on or after 1 January 2016
Number of employees	50

Companies Act 2006: Small Group Thresholds

Net income, asset & employees limits	See small company thresholds above
Gross income	£12.2m for financial years beginning on or after 1 January 2016
Gross assets	£6.1m for financial years beginning on or after 1 January 2016
Number of employees	50

Charities Act: Group accounts threshold

All charities, including charitable companies and CIOs	Net income (after consolidation adjustments) over £1m for periods ending on or after 31 March 2015

Charities Act: Registration Thresholds

All CIOs must be registered regardless of the level of income	
All other charities	Gross income over £5,000
Excepted charities, e.g. churches	Gross income over £100k
Exempt charities, e.g. education	Gross income over £100k and no alternative principal regulator to the Charity Commission

Audits

The flowchart and thresholds~~ in the decision tree section ~~apply to registered charities and excepted charities. When dealing with exempt charities such as housing associations, reference should be made to any specific applicable legislation. Such charities are outside the scope of this guidance.

CIOs prepare accounts and are audited under the *Charities Act* 2011, and as such should be audited like any unincorporated charity.

Independent examinations, compilation reports and total exemption

The trustees of smaller charities may elect for an audit in place of an independent examination.

The independent examiner must be 'an independent person who is reasonably believed by the trustees to have the requisite ability and practical experience to carry out a competent examination of the accounts'. However, if the gross income exceeds £250,000, then the independent examiner must also be a member a professional accountancy body listed in the Charities Act.

The independent examiner's report to the charity's trustees is intended to provide a moderate level of assurance (negative assurance) and should:

- specify that it is a report in respect of an examination carried out under the Charities Act and in accordance with any directions given by the Commissioners which are applicable;
- state whether or not any matter has come to the examiner's attention which gives him reasonable cause to believe that in any material respect:

– accounting records have not been kept in accordance with the Act;

– the accounts do not accord with the records; or

– the accounts do not comply with the regulations;

- state whether or not any matter has come to his attention which should be drawn to the attention of the trustees;
- disclose any material expenditure or action which appears not to be in accordance with the trusts of the charity; and
- disclose any information or explanation provided or any information in the accounts which is materially inconsistent with the trustees' report.

The only charities that have total exemption from an audit or independent examination are those with gross income less than £25,000. However, they still need to prepare annual accounts which must be made available to the public, even if a small charge is required to cover photocopying and postage.

Who can do an independent examination?

An independent examiner is defined as ‘an independent person who is reasonably believed by the trustees to have the requisite ability and practical experience to carry out competent examination of the accounts’. The Charities Act 2011 went on to define independent as having ‘no connection with a charity's trustees which might inhibit the impartial conduct of the examination’.

The independent examiner will need to have good analytical and communication skills to be able to raise questions and to interpret and challenge responses. Also, the individual chosen should have practical experience which should be indicated by involvement with the financial administration or independent examination of similar charities.

Although the independent examiner should be familiar with accountancy methods, the examiner need not be a practising accountant if the charity's income is under £250,000 (except for independent examinations of Scottish charitable companies, where a professional accountant is always required). Someone with a professional qualification, especially a qualified accountant, is strongly recommended by the Charity Commission, particularly for a larger charity or cases where accruals accounting is adopted. Where the charity's income exceeds £250,000 (and for all Scottish charitable companies) it is mandatory for the independent examiner to be a member of a specified accountancy body or a Fellow of the Association of Independent Examiners. Members of the ICAEW who do not hold a practising certificate will be ineligible to act as an independent examiner if the charity's income is over £250,000.

It is the trustees' responsibility to satisfy themselves that the independent examiner is appropriately qualified. The trustees will need to ask the prospective examiner to provide evidence of their experience and/or qualifications.

Practice Note 11

The version of Practice Note 11 (PN 11) currently in use was issued by the Financial Reporting Council in November 2017.

The Practice Note provides a useful summary of the legislative and regulatory framework including an appendix setting out in detail the accounting and audit requirements applicable to charities in the UK. It also provides guidance on the application of ISAs (UK) in the specific context of a charity and contains a separate section on reporting matters of material significance to charity regulators. PN 11 does not provide guidance on independent examinations; instead the Charity Commission provided the guidance in CC32 Independent Examination of Charity Accounts: Directions and Guidance for Examiners (September 2017).

The Practice Note only covers those ISAs where special considerations arise with regard to charities. In summary, 18 of the 38 ISAs are mentioned, highlighting the complex nature of charity audits. These are summarised below along with other useful guidance.

Note that Practice Note 11 does not reflect the latest revisions to the auditing standards, which are effective for periods beginning on or after 15 December 2019. The ISAs themselves and related commentary in the Audit methodology ~~section of *Navigate Audit*~~ should therefore also be referred to.

Guidance on ISA (UK) 540 (Revised December 2018) (Updated May 2022) *Auditing accounting estimates and related disclosures* in the context of charities can be found in Auditing accounting estimates. More general guidance on the revised ISAs, covering auditing accounting estimates and going concern, is available in the Audit Guidance and Methodology section of Navigate Audit.

ISA (UK) 210: Agreeing the Terms of Audit Engagements

The auditor reports to the trustees, not senior management, though the latter may be engaged in defining the terms of the engagement and resolving any audit queries. Hence the engagement letter will be addressed to the trustees, though a copy will often be sent to senior management.

Where the charity's constitution, organisation or funding arrangements require reports from the auditor in addition to the auditor's report on the statutory financial statements, it is the responsibility of the trustees to determine what is required and to instruct the auditor accordingly. It is not practicable for the auditor to check the documentation for all funds received by a charity to determine the need for additional reporting. Non-audit work undertaken on behalf of the charity or its trustees should be the subject of a separate engagement letter(s).

Matters to be included in the engagement letter include the following.

(1) The legislative framework under which the financial statements are prepared and the audit conducted. If there are material changes, as has been the case and will be for some time (e.g. *Charities Act* 2011 being implemented; *Companies Act* 2006; updated SORP, etc.), then a new letter should be sent.

(2) The statutory duty to report to the Charity Commission matters of which the auditor becomes aware that may be of material significance to the regulator, including charitable companies (see notes on ISA (UK) 250 Section B).

(3) The auditor's right to report relevant matters to the respective regulators.

(4) Access to information, especially where subsidiary undertakings are concerned given the statutory requirement to prepare consolidated accounts in many instances.

(5) Whether summary financial statements are covered, often used by charities to raise funds.

(6) Grant funders often require special reports of how their grant was spent, certified by the auditors. This requirement would be included in a separate engagement letter for non-audit work undertaken.

The example engagement letters available *in the templates* reflect these points.

ISA (UK) 220: Quality Control for an Audit of Financial Statements

The auditor must comply with the FRC's Ethical Standard (Revised 2019). Particular issues relating to charities include:

- self-interest – the auditor needs to be aware of other interests in the charity which may affect the conduct or outcome of the audit. The auditor therefore ensures that none of the audit team is in any way dependent upon the charity or provide significant support to the charity;

- self-review – auditors will often be asked to provide additional help and advice, often on a pro-bono basis. The provision of this service is regarded in the same way as other non-audit services in assessing whether there is a threat to objectivity;
- other relationships, e.g. if the audit firm has made significant donations or provided other support for the charity, this could be considered to be another relationship impacting the independence as described in the Ethical Standard; and
- persons in the audit firm acting as trustees.

As well as ensuring that the engagement team has an appropriate level of knowledge of the charity sector, the engagement partner also satisfies himself that the members of the engagement team have sufficient knowledge, commensurate with their roles in the engagement, of:

- the type of charity being audited;
- key risks affecting the charity;
- the FRS 102 SORP;
- the governing document of the charity;
- the legal responsibilities and duties of charity trustees;
- the regulatory framework within which charities operate; and
- the guidance issued by charity regulators regarding matters that should be reported to them by auditors.

The auditor also considers if an engagement quality control review is required based on the nature of the engagement, including the extent to which it involves a matter of public interest. What is a matter of public interest is difficult to define: factors that may apply to a charity include:

- the size of the charity;
- its national or local profile; and
- its source of funds, including the extent to which the charity receives public funds.

ISA (UK) 240: The Auditor’s Responsibilities relating to Fraud in an Audit of Financial Statements

The auditor needs to understand and review the process adopted by the trustees in assessing the risks facing the charity. It is envisaged that this process will involve more than simply discussing the issues with the trustees, particularly when a separate senior management team exists.

Completeness of income is identified as a key risk. Predicting the levels of voluntary income is very difficult, and the emphasis is on the controls and systems that the trustees have implemented. The presumption in ISA (UK) 240 that there are ordinarily fraud risks associated with income recognition is just as relevant to charities as to other entities. The ISA gives a commercial example of when this presumption may be rebutted. Practice Note 11 gives a charity example, namely that of a public sector body which is funded from central government directly by grant-in-aid income where reporting on expenditure and outcomes is also required.

Restricted funds can give rise to considerable problems. Spending the funds outside the restriction is a breach of trust law, even if it was not deliberate, and could give rise to the funds having to be repaid to the donor. Again the focus is on systems and controls.

Some charity-specific factors which may increase the risk of fraud are:

- due to their voluntary nature, the limited involvement of the trustees in key decision making or monitoring of transactions and limited engagement with charity staff;
- widespread branches or operations, especially in countries where there is no effective system of law and order, making management challenging given cost constraints;
- reliance on and poor/limited supervision of volunteers and staff, especially for donation processing and a lack of segregation and rotation of duties;
- high level of cash transactions, e.g. donations, collection tins;
- unpredictable patterns of giving by the public, e.g. DEC appeals, legacies, donations at shops, banks and branches;
- informal movements of funds across international boundaries, often in countries with limited, if any, banking networks;
- inconsistent regulation across international borders;
- international transfer of funds; and
- diversion of grants payable.

Where the trustees have produced a risk register, the auditor should have regard to it when compiling the risk assessment for the audit.

The charity’s records may also be incomplete as a result of fraud – one common type of fraud being diversion of donations or non-routine income. Where a suspected or actual fraud gives rise to a significant loss or a major risk to the charity, the auditor must report without delay to the Charity Commission and other authorities including the National Crime Agency if there is a suspicion of money laundering.

ISA (UK) 250 Section A: Consideration of Laws and Regulations in an Audit of Financial Statements

Auditors here must be aware of, in particular, the *Charities (Accounts and Reports*

Regulations) 2008, the *Charities Accounts (Scotland) Regulations* 2006, the *Companies Act* 2006 and the Charities SORP. In addition, charities may also be subject to other laws and regulations such as those which relate to housing associations.

Charities also have to consider trust law (e.g. restricted funds, endowment funds) and the requirements of their governing document, which are generally more restricted than a normal trading company's articles. The auditor should be alert to new or unusual transactions which may not be in accordance with the governing documents (ultra vires). The auditor should check whether charities' governing documents contain any special provisions as to the disclosure of information in the financial statements or reporting requirements. In addition, all accounts presenting a 'true and fair view' must comply with the Charities SORP.

Non-compliance with charity legislation could result in a material impact on the financial statements, but this may also arise from breaches of laws and regulations relating to the activities of charities, e.g. charities providing residential care. In particular, failure to comply with tax laws and regulations could have a direct or material effect on the determination of financial statement amounts, such as a charity incorrectly taking advantage of a VAT or other tax relief; or having expenditure considered as non-charitable from a tax perspective as could occur with overseas grants; or breaching 'trading' thresholds in the charity. The auditor must ensure that all specific legislation having a significant impact on the operations of charities is therefore identified and the implications on the audit report arising from any such non-compliance or the need to whistle-blow to a regulator.

Other laws and regulations that may be relevant include:

- Charities Act requirements relating to fundraising, property and borrowing transaction;
- laws on raising funds through lotteries;
- laws relating to house-to-house or street collections;
- Trustee Act;
- Children Act requirements;
- Registered Homes Act;
- Environmental Protection Act; and
- food safety and hygiene regulations.

Auditors should be aware that identified or suspected instances of non-compliance with laws or regulations may be indicative of money laundering and should be reported to the auditor's MLRO in accordance with anti-money laundering and terrorist financing procedures. Auditors should also be careful to avoid 'tipping off' in such situations.

ISA (UK) 260: Communication with Those Charged with Governance

The emphasis in this ISA is on the need for two-way communication in order for such communication to be effective. Communications from the auditor need to be understandable, clear and written for an audience of volunteer trustees who may have different skills and experience than those found in a commercial board of directors. Certain communications may be oral and others may need to be in writing. Housekeeping points may be better reported just to the senior management team, and where sub-committees such as audit committees exist, the auditor reporting duty may be fulfilled by reporting to these committees.

As well as communicating with those charged with governance, the auditor also should consider whether any of the matters communicated should also be reported to the charity regulators as required by the auditor's statutory duty in this regard. See Reporting matters of material significance to charity regulators.

ISA (UK) 265: Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

Trustees' responsibility to implement effective systems and controls can be informed by using Charity Commission guidance and specifically their checklist in CC8 *Internal financial controls for charities*. This publication is also useful to auditors in assessing the adequacy of a charity's control environment. Any significant deficiencies may give rise to questioning the integrity of management and the need to report to the regulator a matter of material significance.

ISA (UK) 315: Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

To effectively plan a charity audit, it is essential that the auditor has sufficient knowledge of the charity's activities, governance, operating structure, sources of income and the existence of restricted/endowment funds.

Particular issues the auditor considers at the planning stage include:

- the applicable reporting framework including:
  - the legislative requirements, e.g. the *Companies Act* 2006 or, in England and Wales, the *Charities Act* 2011 or, in Scotland, the *Charities and Trustee Investment (Scotland) Act* 2005;
  - the relevant Charities SORP (or sector specific SORP where one applies);
  - the governing document for the charity, which may also include specific reporting requirements. Auditors should also be aware of the changes introduced to the *Charities Act* 2011 by the *Charities and Social Investment Act* 2016;
- governance arrangements, including planning with the trustees, the form and timing of communications;
- operating structures, branches and overseas operations including:
  - the extent to which the charity's activities (either of a fundraising or a charitable nature) are undertaken through branches or overseas activities and the impact this has on the auditor's required knowledge of the business (for laws and regulations applicable to the charity's overseas operations), the auditor's risk assessment and sources of audit evidence; and

- the structure and management of any related or connected entities, in particular the degree to which the entities are managed and controlled by the trustees and management of the charity;
    - the charity's activities in the context of its stated objects and powers, including any limitations within the charity's governing document, or terms and restrictions placed on material gifts or donations received;
    - the likely impact on the financial statements of the charity of the activities of any related or connected entities (e.g. a separate limited company set up to undertake commercial activities for the charity);
    - the statutory duty to report matters to the charity regulators including whether members of the audit team have sufficient understanding (in the context of their role) to enable them to identify situations which may give reasonable cause to believe that a matter should be reported to the regulator; and
    - whether other auditors' reports are required, e.g. special reports to funders of the charity, grant donors or EU agencies.

Identifying and assessing risks of material misstatement

The auditor will need knowledge of the special features of charity audits, and in carrying out a risk assessment, he will need to be aware of the following:

- the existence of special regulations governing the conduct of charities;
- sources of income which may include grants from public authorities or funds held on trust. Breaches of the conditions relating to the use of such income can have serious implications to the charity;
- tax relief dependent upon a charity complying with the governing document submitted to HMRC;
- activities of the charity which bring it within the scope of other regulations, as well as those relating to charities;
- the level of involvement in the administration of the charity which can be expected of trustees; and
- the way in which the charity is managed on a day-to-day basis.

Control environment

ISA (UK) 315 (Revised July 2020) requires the auditor to obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. There is a wide variation between different charities in terms of size, activity and organisation so that there can be no standard approach to internal control and risk. Even large national charities with sophisticated control systems may have local branches that are run by voluntary staff on an informal basis.

Maintenance of an effective system of internal control is as important for charities as it is for other entities. Trustees have responsibility for ensuring that an adequate system of internal control is maintained to ensure proper administration of the charity and that assets are properly safeguarded.

The auditor of certain charities may be subject to specific reporting requirements in respect of internal controls (e.g. friendly societies, registered social landlords and charitable non-departmental public bodies). Where this is the case, the auditor should plan his work bearing in mind the duty to report if a satisfactory system of internal control is not maintained.

The auditor should also assess the charity's governance structure and overall control environment. This includes assessment of the skills of trustees and management, the extent of their involvement in the activities of the charity and the policies and procedures established by them.

Larger charities are required by the SORP to include in the annual report a summary of the risk and uncertainties faced by the charity, together with any plans for managing those risks. The auditor should consider the trustees' risk management process in order to gain an understanding of the principal risks identified by the trustees and consider the implications for the audit.

Accounting policies

The auditor must review accounting policies and ensure these are in line with the applicable accounting framework including the Charities SORP. Policies that may require particularly careful consideration include those for the recognition of:

- legacies receivable;
- grants receivable as voluntary income;
- grants receivable or payable on performance related conditions;
- liabilities resulting from constructive obligations;
- gifts in kind and donated services; and
- heritage assets.

For group audits, the auditor should consider the consistency of policies applied in the preparation of financial information of components of the group.

Risk of misstatement

Appendix 1 of PN 11 includes examples of events or conditions that may be of particular relevance to charities and may indicate the existence of risks of material misstatement in the financial statements which should be considered in the assessment of risk of the audit assignment. This appendix is reproduced below.

CONDITIONS AND EVENTS THAT MAY INDICATE RISKS OF MATERIAL MISSTATEMENT

The following are examples of conditions and events given in Appendix 1 of PN 11 that may indicate the existence of risks of material misstatement in the financial statements. The examples provided may be of particular relevance to charities and are in addition to the broad range of conditions and events included in the ISAs (UK); however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

General

- Evidence of failure to act in accordance with those objects and powers in the charity's governing documents.
- Extent and nature of non-primary purpose trading activities.
- Difficulties of the charity in establishing ownership and timing of voluntary income where funds are raised by non-controlled bodies.
- Overseas operations. In particular:

– Significant aspects of a charity's business may be conducted in conditions or locations which impede access to the accounting records.

– Transactions may be in a number of different and volatile currencies.

– Due to the location of the activities management may have reduced oversight and limited ability to monitor activities and transactions.

– Governance, responsibility and accountability may be unclear regarding branches, joint ventures and the use of partners in overseas locations.

– Non-compliance with local laws and regulation.

– Conduit funding, or informal banking arrangements.

– The risk of a tax liability arising if HMRC consider that reasonable steps have not been taken to ensure overseas payments are being allocated to charitable purposes only.

Classes of transactions, account balances and disclosures

- Allocation of costs between different expenditure categories in the Statement of Financial Activities (SoFA).
- Restricted funds which require special considerations as to use and accounting, including clawback of restricted grants or contracts.
- Grants payable or receivable.
- Contracts with performance related conditions.
- Donations in kind (i.e., donated goods, facilities and services including goods for resale, use by the charity or distribution to a third party).
- Legacies.

  - Heritage assets.
  - Events or transactions that involve significant measurement and recognition uncertainty, including accounting estimates, and related disclosures. In particular:

- Defined benefit pension schemes, including the complexity of allocating pension deficits/assets between funds and the effect of these deficits/assets on their free reserves.
- Multi-employer defined benefit pension scheme liabilities, including the recognition of an agreed deficit recovery plan.
- Investments (including social investments) whether financial or programme-related investments.
- Properties which are partly used for the charity’s operations and partly for investment purposes.
- Loans where there is a material arrangement calculated using the ‘effective interest method’ (i.e., by applying a constant ‘interest’ rate to the outstanding amount).
- Fair value of assets and liabilities acquired where acquisition accounting is applied (in this situation, the due diligence process may only provide limited information on the fair value of some assets such as land and buildings and heritage assets).
- Recognition of second hand goods received for resale or goods for distribution and stock (if applicable).
- Recognition of other donations in kind at a reasonable estimate of their gross value to the charity and donated services and facilities at a reasonable estimate of the value to the charity of the service or facility received.
- Other arrangements which are offered or received on extended terms of more than twelve months discounted to their present value (using the market interest rate for an equivalent debt instrument, usually investment return to the charity). This can include:
    - Donations and grants.
    - Long term grant commitments.
    - Accrual for legacies receivable.

at their present value in the balance sheet.

- Taxation matters including income from gift aid and the gift aid small donations scheme, the identification of tainted donations and the recognition of irrecoverable VAT.
- Commitments and liabilities, including constructive obligations.
- Restricted and unrestricted reserves.
- Departures from the Charities SORP.

Issues concerning revenue recognition are likely to give rise to significant risks affecting all charity audits. With regard to donation income and the uncertainty and unpredictability over such income, there is limited reliance which can be placed on substantive analytical techniques. Such as forecasting voluntary income or establishing a relationship between income and expenditure, akin to a company's gross profit margin. However, analytical review can still be useful, especially when trends are reviewed over a number of years, for example:

- comparing generated fundraising income to fundraising costs;
- comparison of income and expenditure to prior years' results;
- comparison of actual to budget;
- statistics for response rates for charities in general such as responses to mail shots (i.e. donations received), and industry norms such as sales per square foot for trading operations in different areas; and
- comparison of key ratios to similar charities, e.g. percentage spend on charitable activities, fundraising efficiency ratios, and shop profitability.

The Charities SORP requires charities subject to a statutory audit to include a statement in the trustees' Annual Report confirming the identification and review of major risks, disclosure of the major risks to which the charity is exposed and the systems established to manage those risks.

PN 11 requires the auditor to inquire to management and, where appropriate, those changed with governance as to whether the trustees have made a serious incident report to a charity regulator, and there is a requirement for auditors to also report on these matters advised to charity regulators even where there is no impact on the financial statements themselves.

ISA (UK) 320: Materiality in Planning and Performing an Audit

The general principles underlying the consideration of materiality apply to audits of charities in a similar way to other entities. Judgements about materiality are affected by the information needs of users and in general this will be the trustees although auditors should consider whether there are other users who are relevant in the particular circumstances of the charity.

For a charity, materiality for the financial statements as a whole is often assessed as a percentage of income, expenditure or net assets.

Areas requiring special attention for setting materiality levels include:

- transactions with trustees;
- use of restricted or endowment funds;
- sensitive areas such as overseas activities;
- allocation of support costs between charitable activities and costs of raising funds; and
- branch results, as often not known until sometime after year end.

The ISA requires auditors to consider whether lower levels of materiality should be set for specific balances, transactions or disclosures. Factors to consider include the degree of accuracy expected in the case of certain statutory disclosures, e.g. transactions with trustees are likely to be considered to be material by nature, even if not material by size. Also, particular disclosures or expenditure categories may be sensitive and warrant extra attention, for example, costs of raising funds.

There is no presumption that the auditor will set a different monetary materiality level for restricted funds. However, one of the factors in the ISA to consider when setting lower levels of materiality for individual items is whether lower amounts than materiality could reasonably be expected to influence the economic decisions of users of the accounts.

Further guidance on determining materiality is available in the Materiality and charities section.

ISA (UK) 330: The Auditor's Responses to Assessed Risks

ISA (UK) 330 (Revised July 2017) (Updated May 2022) *The Auditor's Responses to Assessed Risks* requires the auditor to design and implement responses to the identified risks of material misstatement in the financial statements. Practice Note 11 provides guidance in relation to a number of risks commonly encountered in the charity sector including:

- completeness of income;
- overseas operations;
- restricted funds;
- heritage assets; and
- grants payable.

Completeness of income

Typically, income from charities comes from a number of different sources, such as grants and public donations, and its amount and timing is often difficult to predict. Trustees cannot be expected to have responsibility for funds until they are, or should be, within the control of the charity, but as soon as this happens, trustees should implement procedures to ensure appropriate recording and safeguarding of the funds.

The Practice Note suggests that the auditor should consider:

- tax effective giving – for most tax effective schemes there are required procedures and detailed rules to prevent abuse;

- completeness of income – often difficult to substantiate, especially where cash is involved. The auditor may wish to consider the effectiveness of controls in this area;

- recognition of income from third party fundraisers – the auditor should consider the agreement between the charity and the fundraiser and other documents supporting the transfer of funds to the charity;

- income from branches, associates or subsidiaries – the auditor should review arrangements to determine the point at which it is appropriate to recognise funds;

- legacy income – at what point is it appropriate to recognise this and how much. Subsequent events may provide evidence of the existence, completeness and amount. Review of legal documentation may assist in understanding terms attached to legacies and there are agencies who can provide charities with notification when probate is granted;

- grants or contractual income – review of legal documentation and correspondence may assist in determining the appropriate accounting treatment. The auditor may wish to obtain direct confirmation form the provider;

- non-cash donations – the auditor needs to consider how to obtain assurance over completeness.

Overseas operations

Overseas operations may be conducted through a variety of organisational structures. The financial statements nevertheless need to reflect the results of all the charity’s operations.

The Practice Note suggests the following procedures:

- consideration of control procedures put in place by the charity and how adherence to procedures is monitored;

- obtaining evidence from field officers’ reports as to work undertaken;

- comparison of accounting returns of expenditure with field reports and plans for consistency and reasonableness;

- analytical review of accounting returns received from overseas branches or local agents;

- consideration of any inspection or internal control visit reports undertaken by any internal audit function;

- consideration of audit work undertaken by local auditors and consideration of any audit reports carried out on behalf of international donors, e.g. government departments; and

- evidence from the audit work of another audit firm.

Where material assets are held or material funds are applied by overseas operations, the

Practice Note suggests that the auditor may seek observational evidence by way of site visit.

Where a charity makes a grant to an autonomous overseas charity, the auditor ensures:

- receipt of the funding; and
- that the charity has exercised reasonable diligence in ensuring that the funds are used for charitable purposes in order that adverse tax consequences are not suffered.

In some cases, it may be appropriate to arrange for an overseas component auditor to carry out audit work on the financial information of a component, especially where the operations form a significant part of the charities activities. In this case, the requirements of ISA (UK) 600 (Revised November 2019) (Updated May 2022) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* apply.

Restricted funds

Restricted funds which are subject to specific rules about their application may give rise to a significant risk of material misstatement. The auditor should consider:

- the terms or conditions attached to the restricted funds;
- any funds in deficit;
- any income funds held in illiquid assets, preventing application of the fund; and
- capital being expended without authority.

The Practice Note suggests the following audit procedures:

- consideration of internal control procedures put in place by the charity to identify restricted funds;
- consideration of the methods used in cost allocation;
- comparison of expenditure with the terms of the restricted funds;
- consideration of the future funding to recover negative balances;
- consideration of the validity of the transfer between funds;
- consideration of the ability of the fund to meets its obligations in view of its underlying assets; and
- consideration of whether the capital of an endowed fund has been expended without express authority.

Heritage assets

Factors to consider include:

- sufficiency of information available to value heritage assets, including availability of experts and valuations of comparable assets;

- completeness of heritage assets – the auditor may consider the controls adopted by the entity and perform searches to identify significant or high profile movements;
- existence/rights and obligations – the auditor considers what documentary or other evidence may be available to support ownership.

Grants payable

Where charities make grants to third parties, auditors may consider factors such as:

- internal controls and processes including oversight by those charged with governance;
- diversion of grants to inappropriate recipients – the auditor may choose to obtain confirmation of receipt from recipients.

ISA (UK) 402: Audit Considerations Relating to an Entity Using a Service Organisation

Charities may typically use service organisations in the following areas:

- maintenance of accounting records;
- payroll services;
- professional fundraising or donor fulfilment;
- custodianship of assets;
- investment management services.

There are two key areas that the auditors must consider when a service organisation is involved.

(1) Consider whether the trustees have the authority under the governance document to utilise a service organisation.

(2) Review the control exercised by the trustees over the service organisation, including the contractual arrangements.

ISA (UK) 510: Initial Engagements – Opening Balances

Care is needed when an unincorporated charity changes from the receipts and payments basis to the accruals basis of accounting. Suggested procedures for checking opening balances include reviewing after date bank transactions, and a physical examination of fixed assets and stocks if relevant. The prior year comparatives will need to be adjusted for the purposes of analytical review procedures.

Extra care will also be needed when a charity exceeds the audit threshold for the first time, previously having had an independent examination.

Where the prior year accounts were audited by a predecessor auditor, the auditor must consider the professional competence, as well as independence, of that firm such as if they are a charity specialist.

Predecessor auditors of a charitable company have a statutory duty to provide the auditor with access to all relevant information concerning the charitable company, including information about the most recent audit. Where there is no statutory obligation, such as is the case for non-company charities, the auditor may nevertheless request access to the predecessor auditor's working papers. In some circumstances, the predecessor auditor may be prepared to consider granting such access. Where access is not granted, the auditor performs alternative procedures in order to obtain sufficient appropriate audit evidence regarding opening balances.

ISA (UK) 540: Auditing Accounting Estimates and Related Disclosures

The areas where estimates are often used and thus judgement required, sometimes leading to fair value measurements, are:

- the allocation of support costs between charitable activities and costs of raising funds;
- the life of assets in volatile situations, such as the developing world and war zones;
- the valuation of certain assets, such as gifts in kind, assets received for onward distribution, heritage assets, donated services, investments with no market price;
- discounting and the quantification of future charitable commitments and constructive liabilities, e.g. legacies receivable or multi-year grants awarded; and
- recoverability of loans made to beneficiaries.

The Charities SORP allows certain valuations to be undertaken by trustees or employees of the charity, providing that for property valuations they are suitably qualified. The auditor must therefore assess the reasonableness of such valuations based on the relevant experience of the valuer.

Certain items in the financial statements are required to be discounted and the Charities SORP gives some guidance on rates that may be used (e.g. for legacies receivable using the interest rate, the charity anticipates it would earn on a comparable deposit over a similar period or, for provisions, it is the rate which reflects the cost of money to the charity). The auditor assesses whether the discount rate applied is appropriate in the circumstances, taking into account the guidance in the Charities SORP and considering other factors, such as the return on investments foregone. For example, a charity which only receives interest may use an interest rate as a discount factor, whereas a charity invested in stocks and shares could use the rate of return on those assets instead – which would mean that these two rates could vary considerably.

There is considerable emphasis in the ISA on the possibility of bias. In the charity sector, management may be biased in their accounting estimates in order to achieve certain results for the year, although the Practice Note points out that bonuses based on results are not common. Management bias may arise from:

- a desire to meet trustee expectations on the results for the year;
- a desire to demonstrate growth;

- a need to meet covenant obligations attached to bank loans; or
- wanting to avoid repayments of grant funds if they are not fully utilised.

Management bias may also extend to those charged with governance.

Refer to Auditing accounting estimates for further guidance on ISA (UK) 540 (Revised December 2018) (Updated May 2022) *Auditing accounting estimates and related disclosures*. There is also a detailed section on auditing accounting estimates in the Audit Methodology section of Navigate Audit.

ISA (UK) 550: Related Parties

ISA (UK) 550 (Updated May 2022) *Related Parties* notes that many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances. The charity sector has such a framework and the Charities SORP has its own definition of 'related parties' which combines the requirements of charity law, company law and FRS 102.

The auditor must remain alert for any transactions involving trustees, however immaterial and the Practice Note states that any transaction involving a trustee or other related party is always considered material by nature, regardless of its size. Transactions are permitted with trustees, such as payments for goods and services providing there is a clear benefit to the charity, the governing document does not prohibit it and the trustees have had due regard to the guidance from charity regulators. However, disclosure is always required for all remuneration, expenses or benefits paid to trustees or persons connected with them.

Some related party transactions not requiring disclosure are specifically highlighted in paragraph 9.18 of the Charities SORP, for example, donations without any attached conditions.

The ISA requires the auditor to document the controls operated by the charity over the identification of related parties and related party transactions. The charity regulators issue guidance (the Charity Commission guide 'Conflicts of interest: a guide for charity trustees' (CC29)) on the relevant controls they expect management to put in place to authorise and approve significant related party transactions. The auditor is expected to have regard to this guidance, and form an assessment of the controls necessary to arrive at proper disclosure.

In designing their policies, procedures and systems, auditors should be aware that the Charity Commission recommends charities take a three-step approach to managing conflicts of interest. These three steps are:

(1) identify conflicts of interest;

(2) prevent a conflict of interest from affecting the decision; and

(3) record conflicts of interest.

Auditors may wish to review whether charities have the following in their related party policies and procedures:

- open and timely disclosure of the interests that management and those charged with governance have in related party transactions;

- the assignment of responsibilities within the entity for identifying, recording, summarising and disclosing related party transactions; and
- clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest.

In conclusion, auditors must record (on their permanent file):

- all related parties (even those with no transactions);
- the nature of the relationship; and
- the type and purpose of any transactions with related parties.

The auditor also considers whether any circumstances relating to conflicts of interest or related party transactions require the auditor to report a matter of material significance to the charity regulator.

ISA (UK) 570: Going Concern

A charity should prepare its accounts on a going-concern basis unless it is being liquidated or has ceased operating. The concept does not apply to accounts prepared on a receipts and payments basis, though the auditor should still consider the matter and, if relevant, include an explanatory paragraph in their report though not qualifying their opinion on the accounts themselves.

Where material uncertainties related to events or conditions cast significant doubt on the charity's ability to continue as a going concern have been identified, FRS 102 and the Charities SORP require disclosure of those uncertainties in the financial statements. The Charities SORP also requires that where there are no material uncertainties about the charity's ability to continue as a going concern, the financial statements should state this.

Charity specific indicators of events or conditions that may cast significant doubt over the charity's ability to continue as a going concern include:

- inability to finance its operations from its own resources or unrestricted funds;
- transfer to, or takeover by, another entity of the charity's activities;
- deficits on unrestricted funds;
- loss of clients (e.g. where a public authority ends a practice or contract to refer (and pay for) clients to the charity);
- loss of operating licence (e.g. for a residential care home);
- significant changes in strategy of major funders and significant decline in donations by the public;
- investigation by a charity regulator;
- claw-back of grant received and Gift Aid refunds;
- reliance on major donors;

- failure to meet reserves policy targets or carrying reserves insufficient for the current scale of activities (after having regard to any guidance on reserves issued by the respective charity regulator); and
- persistent failure to meet the requirement for public benefit, leading to withdrawal of funding or tax liabilities.

Where a charity fails to meet the public benefit requirement either in whole or in part, the auditor also considers the implications of actions taken, or likely to be taken, by the regulator, and assesses the implications on the auditor's opinion. Although the auditor has no duty to assess whether the charity's activities are for the public benefit in order to establish that the charity is a going concern, persistent failure by a charity to meet its public benefit requirement may have an implication for the auditor's assessment of going concern.

The Practice Note expands on matters which can complicate the assessment of the going concern basis, namely:

- income: the auditor needs to consider the charity's income sources, their regularity and predictability and degree of risk attaching to each. Future public goodwill in giving cannot be relied on solely as evidence of going concern. Grant funding is dependent on compliance with grant conditions so the auditor must assess the effect of compliance with grant conditions or other evidence where such withdrawal or disallowance could be fundamental to the charity. It is important that projections and cash flows distinguish between restricted and unrestricted funds in order to demonstrate that the charity is not drawing down on restricted funds, the effect of delays in approval of or payment of funding where reimbursed in arrears or the impact of constructive liabilities or obligations on future cash flows;
- reserves: the need for the auditor to consider the level of reserves and reserves policy in the trustees' report in the context of the charity's operations and business model. Concerns about the level of reserves held need to be considered by the auditor as to whether it is a relevant matter to report the respective charity regulator.

Charity auditors also have to consider whether any of the circumstances relating to going concern require them to report a matter of material significance to the charity regulator. In particular, the auditor has a duty to report matters to the charity regulatory, where the auditor:

- includes a separate section in the auditor's report entitled 'Material Uncertainty Related to Going Concern';
- expresses an adverse opinion where the use of the going concern basis of accounting is inappropriate in the circumstances;
- expresses a qualified or adverse opinion where adequate disclosure of the material uncertainty has not been made in the charity's financial statements; or

- in extremely rare circumstances, expresses a disclaimer of opinion in situations involving multiple material uncertainties that are significant to the charity's financial statements as a whole.

Refer to Going Concern within the Audit Methodology section ~~of *Navigate Audit*~~ for further guidance on ISA (UK) 570 (Revised September 2019) (Updated May 2022) *Going Concern*.

ISA (UK) 580: Written Representations

The trustees are collectively responsible for the contents and presentation of the financial statements. Consequently, the financial statements and letter of representation may be discussed by the trustee body, together with senior management where appropriate, before their approval. Where day-to-day management of the charity is delegated to senior management by trustees and representations are taken from those staff, the auditor should ensure that the staff involved have the necessary authority and all such representations are considered and approved by the trustees.

Auditors often find it useful to attend this meeting and encourage discussion of significant issues, including unadjusted errors, which arose in the course of the audit.

In addition to representations required by ISAs (UK), the Practice Note also recommends inclusion of certain other representations within the letter where these are relevant to the charity, namely that:

- all income has been recorded;
- the restricted funds have been properly applied;
- constructive obligations for grants have been recognised;
- all correspondence with regulators has been made available to the auditor, including, in England and Wales, any serious incident reports and any notifiable events reports (for charities registered in Scotland); and
- the trustees consider there to be appropriate controls in place to ensure overseas payments are applied for charitable purposes.

Timely communication by the auditor with the trustees on significant issues is particularly important in this sector, which relies primarily on voluntary trustees who may not be involved in the day-to-day running of the affairs of the charity.

ISA (UK) 600: Special Considerations – Audits of Group Financial Statements (including the Work of Component Auditors)

The audit of subsidiary undertakings of charitable parent companies is standard. However, for charities this extends to cover the audit work on branches and joint ventures and, under the *Charities (Accounts and Reports) Regulations* 2008, to UK subsidiary undertakings of non-company parent charities. Under the *Charities Act* 2011, charity auditors have a right of access to books, documents and records which relate to a charity, whether or not the charity owns them. However, this right does not extend to overseas entities with a separate legal constitution.

Charities may operate through branches to raise funds and/or deliver charitable services.

The auditor must understand the nature of such operations as to whether they are separate accounting entities requiring their own accounts and perhaps separate engagement letters and audits, or purely part of the charity itself just delivered from another location. The Charities SORP explains the principles of consolidation and irrespective of the accounting treatment of these branches, the auditor's application of ISA (UK) 600 will be determined by whether the branch financial information is included in the charity's financial statements.

Under the current ISA (UK) 600, parent auditors are likely to need to have considerably more involvement in the work of component auditors. This is particularly true where the charity has components overseas, as added complications can arise such as the need to adjust the figures where different accounting practices and policies have been applied or where additional specified audit procedures are required by the group auditor. The group auditor:

- obtains an understanding of the component business;
- obtains an understanding of the accounting framework and policies under which the component accounts will be prepared;
- considers the need to review the charity's conversion of the component financial statements into UK GAAP format;
- considers the need for the component auditors to perform work on UK GAAP specific areas. Depending on the local accounting framework, this may require details of the accounting requirements under the Charities SORP to be explained to the component auditors.

ISA (UK) 700: Forming an Opinion and Reporting on Financial Statements

In the case of a charity, the auditor's opinion is expressed in the context of the particular legislation and accounting requirements applicable to the charity concerned. The auditor is also aware that the governing documents and trust deed may establish additional requirements about the contents of the financial statements, but these cannot take away from the statutory requirements. If the auditor becomes aware of any information suggesting transactions undertaken by the charity have breached the terms of its trust deed, the auditor considers the implications for his reporting responsibilities under ISA (UK) 250 Section A.

The form and content of auditor's reports on the financial statements of charities follow the requirements established by ISA (UK) 700. However, because of the complexity of the legal framework, the auditor needs to ensure descriptions of the legislative basis and responsibilities of the auditor and trustees are specific to the circumstances of the charity audited.

Care must be taken when wording the auditor's report due to the complex legal framework for charities and the interaction between the *Companies Act* 2006 and *Charities Act* 2011. For example, charitable companies claiming audit exemption under the Companies Act would refer to Charities Act; and if that exemption is not claimed then audited under the Companies Act.

For charitable companies which do claim audit exemption under the Companies Act, a statement is required on face of the balance sheet confirming that entitlement as follows:

'For the year ended [date] the company was entitled to exemption from audit under Section 477 of the Companies Act 2006 relating to small companies but as this company is a charity, it is subject to audit under the Charities Act 2011.

(a) The members have not required the company to obtain an audit of its accounts for the year in question in accordance with Section 476 of the Companies Act 2006.

(b) The directors acknowledge their responsibilities for complying with the requirements of the Companies Act 2006 with respect to accounting records and the preparation of accounts.

These accounts have been prepared in accordance with the provisions applicable to companies subject to the small companies' regime.'

In March 2020, the FRC issued Bulletin *: Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements*, which is based on the new reporting requirements in revised ISAs (UK) effective for periods beginning on or after 15 December 2019. This Bulletin replaces the guidance and examples previously contained in Bulletin 2016: *Compendium of Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements for periods commencing on or after 17 June 2016*.

However, the 2020 bulletin does not specifically provide examples of suitable audit reports specifically tailored in respect of charity audits. As a result, the auditor will need to take care in combining the charitable law requirements with the ISA (UK) 700 (Revised November 2019) (Updated May 2022) *Forming an Opinion and Reporting on Financial Statements* and other reporting requirements set out in the bulletin.

~~Template audit reports for charities are available in the Template and Letters section of Navigate Audit.~~

Other particular areas to note are:

- the 2008 Regulations determine that audit reports should be addressed to the trustees unless the auditor has been appointed by the Charity Commission;
- Companies and Friendly Societies statutes require audit reports to be addressed to the members and Scottish law requires company audit reports to be addressed to trustees and members;
- ISA (UK) 700 requires the auditor to include a section describing the trustees' responsibilities, which will vary according to the constitution of the particular charity;
- the auditor may have other reporting responsibilities under legislation or regulation, depending on whether the charity is a company or not, and Appendix 2 to PN 11 includes a summary of these;
- the Charities SORP has been developed and issued under the code of practice established by the Financial Reporting Council for the production and issue of SORPs. They are authoritative guidance on the application of accounting standards to charities;
- as the 2011 Act requires trustees to state whether financial statements have been prepared in accordance with SORP, this provision, taken with the general status of the SORPs, implies a strong presumption that the

financial statements will need to follow the relevant SORP in order to give a true and fair view;

- for charitable companies audited under the *Companies Act* 2006, the auditor's report is signed by the Senior Statutory Auditor in his own name, for and on behalf of the firm;
- for charitable companies audited under the Charities Acts, or non-corporate charities, the auditor's report is signed in the name of the firm only;
- the relevant Charities Acts require the auditor to state in his report that the firm is eligible to act as an auditor in terms of the *Companies Act* 2006, s. 1212, even where the charity is not audited under the Companies Act. This statement is not required where a charitable company is audited solely in accordance with CA 2006.

There are also added complications for charities registered in more than one jurisdiction, e.g. with the Charity Commission in England and Wales, and with OSCR in Scotland.

ISA (UK) 720: The Auditor's Responsibilities Relating to Other Information

Charities annual reports often include a lot of information in addition to the financial statements, such as the trustees' annual report, statements by the chair and chief executive, grant making policy, risk management statement, financial review, impact assessment, etc. The auditors need to read all such material to identify whether there are any material inconsistencies between that other information and both the financial statements and the auditor's knowledge obtained in the audit, and if so to seek to resolve them.

The trustees' annual report meets the definition of 'statutory other information' and for all charities, the auditor is required to report on whether the information given in the trustees' annual report is inconsistent with the financial statements.

The auditor is not required by the ISA to perform additional procedures to verify other information that either does not relate to amounts or other items in the financial statements or about which the auditor has no knowledge.

Whilst auditors are not expected to verify any risk management statement made by the trustees they are likely to become aware of the steps taken by the trustees to identify and manage identified financial risks through performing their risk assessment procedures under ISA (UK) 315.

In concluding on whether there is a material misstatement of the other information, the auditor applies professional judgement, taking into account such matters, where relevant, as:

- whether the misstatement of the other information is material by size or by nature;
- the information needs of the primary users of the annual report;
- whether the element in the Charities SORP is a mandatory requirement (a 'must') or indicative of best practice ('should'); and

- any views expressed by the charity regulators (or other appropriate authority outside the charity).

The auditor then reports in the auditor's report as follows:

- on the trustees' annual report (and any other statutory other information):

– for charitable companies, in accordance with paragraph 22-1 of ISA (UK) 720;

– for all other charities, in accordance with the relevant law or regulation;

- on all other information, in accordance with paragraph 22 of ISA (UK) 720.

In March 2020, the FRC issued Bulletin *: Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements*, which is based on the new reporting requirements in revised ISAs (UK) effective for periods beginning on or after 15 December 2019. This compendium addresses companies only and therefore does not include any example reports for charities or any other specialist entities.

~~Template audit reports for charities are available in the Template and Letters section of Navigate Audit.~~

Summarised financial statements

The Practice Note makes reference to summarised financial statements but does not specifically cover such engagements.

Where a charity produces summarised financial statements, there is no requirement for a report by the auditor. However, should the charity wish such a report to be produced, the auditor may do so. In this case, the auditor will need to decide whether to continue to refer to the (now withdrawn) Bulletin 2008/3 or to refer to other guidance such as the IAASB's ISA 810 (Revised) *Engagements to Report on Summary Financial Statements* the latest version of which was issued in 2016.

Auditing accounting estimates

An accounting estimate is defined in ISA (UK) 540 (Revised December 2018) (Updated May 2022) *Auditing accounting estimates and related disclosures* as 'a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty' and estimation uncertainty is defined as 'susceptibility to an inherent lack of precision in measurement'. Examples of accounting estimates the auditor of a charity may come across include:

(a) valuation of investment assets such as property investments or financial investments with no market price;

(b) valuation of other assets such as gifts in kind, heritage assets and donated goods, facilities and services;

(c) recognition and measurement of grant commitments;

(d) recognition and valuation of legacy income receivable;

(e) the allocation of support costs between charitable activities and costs of raising funds;

(f) discounting and the quantification of future charitable commitments and constructive liabilities, e.g. legacies receivable or multi-year grants awarded; and

(g) recoverability of loans made to beneficiaries.

ISA (UK) 540 requires the auditor to gain an understanding of the entity's accounting estimates when obtaining an understanding of the entity and its environment, including internal control. The procedures are performed to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

In identifying the risks of material misstatement and assessing inherent risk, the auditor needs to take into account:

(a) the degree to which the accounting estimate is subject to estimation uncertainty; and

(b) the degree to which the following are affected by complexity, subjectivity or other inherent risk factors:

(i) the selection and application of the method, assumptions and data in making the accounting estimate; or

(ii) the selection of management's point estimate and related disclosures for inclusion in the financial statements.

The auditor also needs to determine whether any of the risks of material misstatement identified and assessed are a significant risk. If the auditor has determined that a significant risk exists, he is required to obtain an understanding of the entity's controls, including control activities, relevant to that risk.

Guidance on estimation uncertainty, subjectivity and complexity is available in the Risk assessment and accounting estimates section of Navigate Audit. The examples below demonstrate such considerations in the context of a charity.

Example – estimation uncertainty

A charity has recognised a receivable for a material amount of legacy income. The amount and the entitlement to the receivable may rely heavily on the professional opinions of those employed by the executors and the receivable may be sensitive to increased volatility and uncertainty in the property and investment markets caused by Covid-19. The prospect of any legal challenges to the wills may also affect entitlement and increase the level of estimation uncertainty.

Example – subjectivity

A charity owns two paintings which are accounted for as heritage assets. They were originally gifted to the charity and are held at fair value. A professional valuer assesses the value based on similar paintings by the same artist that have recently been sold in auction. Such paintings do not come to sale often and there is a high level of subjectivity due to the few relevant information sources that can be relied upon. The valuation is not inherently complex in nature.

Example – complexity

A charity sponsors a defined benefit pension scheme and engages an actuary to calculate the net pension liability. The calculations are complex and highly subjective with actuarial assumptions used to estimate the timing and level of benefits to be paid out in the future. A number of internal and external sources are used and specialised knowledge is required to interpret the valuation report.

When obtaining an understanding of how management makes the accounting estimates, auditors should also consider the Charities SORP, which provides detailed guidance on appropriate accounting policies and measurement bases. The SORP also provides some guidance on discount rates that may be used. This is covered in more detail at ISA (UK) 540: Auditing Accounting Estimates and Related Disclosures in Practice Note 11.

Reporting matters of material significance to charity regulators

In addition to the primary objective of reporting on financial statements, the auditor of a charity may, under the *Charities Act* 2011, s. 156–159:

- have an additional statutory duty to report in certain circumstances; or
- exercise the auditor's statutory right to report to the relevant charity regulator.

Section 160 covers 'exempt' charities and reporting to a principal regulator other than the Charity Commission.

To assist the auditor to comply with this reporting duty, the charity regulators jointly issued, in November 2017, guidance for auditors and independent examiners called *Matters of Material Significance reportable to UK charity regulators*. Auditors are expected to have an understanding of this guidance in order to ensure that the auditor complies with their additional responsibilities arising from legislation.

The Charity Commission reissued its guidance on matters of material significance during 2020 to consider the application of reporting duty in times of national emergency. However, the list of reportable matters has not changed since 2017. Shortly after issuing the guidance, the Charity Commission reviewed whether audit firms were meeting their obligation to report to the regulators in these circumstances. This found a low level of compliance with the requirements and resulted in them contacting the audit firms concerned to remind them of their obligations. The Commission have stated that in the future they will refer audit firms that fail to make the required reports to their professional bodies with a view to disciplinary action. Therefore, auditors and independent examiners need to ensure that, whenever they are considering modifications to a report, they are aware of their duties to make reports to the regulators.

ISA (UK) 250 Section B does not apply generally to charities, unless the charity also meets the definition of 'regulated entity', i.e. it carries on business in the financial sector or is a public interest entity.

The Charities Acts do not require the auditor to perform any additional audit work as a result of the statutory duty, nor are they required specifically to seek out breaches of the requirements applicable to a particular charity. However, where they identify that a reportable matter may exist, the auditor carries out such extra work, as considered necessary, to determine whether the facts and circumstances give it 'reasonable cause to believe' that the matter does in fact exist. The auditor's work does not need to prove that the reportable matter exists.

However, the auditor includes procedures within the planning process to ensure that members of the engagement team have sufficient understanding to enable them to identify situations which may give reasonable cause to believe that a matter should be reported to the regulator. Any situations identified by the engagement team which may give rise to a duty to report are brought to the attention of the engagement partner without delay in order to determine whether a report to the regulator is required.

Where a matter comes to light relating to a previous financial year which would give rise to a duty to report, then the auditor still makes a report, unless he is certain that the matter has already been reported by the auditor or a previous auditor.

Criteria for determining the existence of a duty to report to the charity regulators

In determining whether a matter is reportable to a charity regulator, the auditor considers both whether the auditor has a 'reasonable cause to believe' and that the matter in question 'is, or is likely to be of material significance' to the charity regulators.

'Material significance' is not defined in legislation; however, the *Matters of Material Significance reportable to UK charity regulators* guidance explains that it relates to matters which are of material significance to a regulator in carrying out their functions. Matters that the Charity Commission will always consider to be of material significance and hence reportable are:

(1) Matters suggesting dishonesty or fraud involving a significant loss of, or a material risk to, charitable funds or assets.

(2) Failure(s) of internal controls, including failure(s) in charity governance, that resulted in, or could give rise to, a material loss or misappropriation of charitable funds, or which leads to significant charitable funds being put at major risk.

(3) Knowledge or suspicion that the charity or charitable funds including the charity's bank account(s) have been used for money laundering or such funds are the proceeds of serious organised crime or that the charity is a conduit for criminal activity.

(4) Matters leading to the knowledge or suspicion that the charity, its trustees, employees or assets, have been involved in or used to support terrorism or proscribed organisations in the UK or outside of the UK, with the exception of matters related to a qualifying offence as defined by the *Northern Ireland (Sentences) Act* 1998, s. 3(7).

(5) Evidence suggesting that in the way the charity carries out its work relating to the care and welfare of beneficiaries, the charity's beneficiaries have been or were put at significant risk of abuse or of mistreatment.

(6) Single or recurring breach(es) of either a legislative requirement or of the charity's trusts leading to material charitable funds being misapplied.

(7) Evidence suggesting a deliberate or significant breach of an order or direction made by a charity regulator under statutory powers including suspending a charity trustee, prohibiting a particular transaction or activity or granting consent on particular terms involving significant charitable assets or liabilities.

(8) On making a modified audit opinion, emphasis of matter, material uncertainty related to going concern, or issuing of a qualified independent examiner's report identifying matters of concern to which attention is drawn, notification of the nature of the modification/qualification/emphasis of matter or concern with supporting reasons including notification of the action taken, if any, by the trustees subsequent to that audit opinion, emphasis of matter or material uncertainty identified / independent examiner's report.

(9) Evidence that significant conflicts of interest have not been managed appropriately by the trustees and/or related party transactions have not been fully disclosed in all the respects required by the applicable SORP, or applicable Regulations.

Further explanations of each of the nine matters can be found in *Matters of Material Significance reportable to UK charity regulators*.

'Material significance' also does not have the same meaning as materiality in the context of the audit of financial statements. Whilst an event may be trivial in terms of its possible effect on the financial statements of a charity, it may be of a nature or type that is likely to change the perception of the charity regulator. For example, dishonesty by a trustee may not be significant in financial terms in comparison with the income of the charity but would have a significant effect on the relevant charity regulator's consideration of whether the person concerned should be allowed to continue to act as a charity trustee.

To determine whether a matter is, or is likely to be, of material significance to the charity regulators, the auditor needs to exercise professional judgement. They need to consider not simply the facts of the matter but also their implications. In addition, it is possible that a matter, which is not materially significant in isolation, may become so when other possible breaches are considered, together with other reported and unreported breaches of which the auditor is aware.

The guidance states that the charity regulators' default preferences for auditors is 'when in doubt, report it'.

Minor breaches of trustees' obligations, or isolated administrative errors that are unlikely to jeopardise the charity's assets or amount to misconduct or mismanagement would not normally be of 'material significance'. However, based on the auditor's knowledge obtained in the audit, he assesses whether the cumulative effect is of 'material significance' such as to give rise to a duty to report to the charity regulator.

It should also be noted that in addition, an auditor who ceases to hold office, for any reason, is required by the relevant Charities Acts or Regulations to make a statement as to whether there are any circumstances connected with the auditor ceasing to hold office which should be brought to the attention of the trustees and to send a copy of the auditor's statement, where there are such circumstances, to the charity regulator.

Both the *Matters of Material Significance reportable to UK charity regulators* guidance and PN 11 give further detailed guidance on reporting matters to the regulator.

Contents of a report to the charity regulators

The reporting of any matters of material significance is a separate report from the auditor's report on the financial statements.

The *Matters of Material Significance reportable to UK charity regulators* guidance sets out the required information when making a report to the regulators, which includes that the report must be in writing, although e-mail is sufficient. The report must be made immediately once the matter comes to the auditor's attention.

In addition to his duty to report, the auditor has a separate right to report to a charity regulator where there is no statutory duty.

The auditor may determine that other matters that are not specified as reportable in the *Matters of Material Significance reportable to UK charity regulators* are, in his professional judgement, of such a nature that he considers them reportable as a matter of material significance. For example, where the trustees have failed repeatedly to take corrective action, without reasonable cause, to address deficiencies in internal control; or where the auditor has concerns about the level of reserves held by the charity.

In such situations, the auditor may find it helpful to refer to the guidance issued by the charity regulators on the auditor's right to report relevant matters.

Covid-19 considerations

On 23 March 2020, the SORP-making body of the various charities' commissions in the UK issued advice in the form of Implications of Covid-19 control measures and charity financial reporting. This advice concerns the financial reporting aspects of Covid-19 which should be considered by trustees when they are preparing the charity's accounts.

At the outset, it is worth emphasising that the guidance does not make any amendments to the Charities SORP (FRS 102) nor is the advice mandatory. However, trustees, independent examiners and auditors are advised to consider the advice in light of the significant impact that Covid-19 is having on charities across the country.

In respect of charities' financial statements, there are likely to be implications for the charity's income, expenditure and commitments as well as an impact on the charity's assets and liabilities. In more serious cases, the disruption caused by the pandemic may affect the charity's ability to continue as a going concern.

~~Further information on Covid-19 considerations can be found in our Charities Sector Guide, authored and updated by BDO. A section on Covid-19 is also available in the Independent examination guidance.~~

Materiality and charities

Basis of determining materiality

Any basis of determining materiality is necessarily judgemental. No basis should be applied blindly. In general, the level of materiality is relative to the size of the business. However, some items might be material by their nature, regardless of magnitude (e.g. statutory disclosures such as trustees' expenses). ISA (UK) 320 gives the auditor the option of setting lower levels of materiality for such items.

Gross income is normally used as the principal yardstick in determining the level of materiality because it is indicative of the level of business and transactions undertaken in the year, although gross expenditure may be more appropriate in some circumstances. Total assets are also indicative of size and therefore should be taken into account.

The following notes are a guide only to determining materiality in particular circumstances. Wherever the figure of materiality appears to be more appropriately calculated by other means, use an alternative basis, but the reasons for doing so must be documented.

The materiality ranges are calculated by the system when you access the Materiality dialog. A suggested level of materiality on Gross Income will be offered, however, you are free to enter whatever level is appropriate. Whether you enter a different figure, or accept the suggested figure, you will be required to enter an explanation as to why the level is appropriate.

The smaller charity

When the materiality ranges based on the guidelines have been established, the overall materiality must be determined. This is not a mathematical average but a matter of professional judgement. In most small charities it may be close to the income parameter, although due to the income recognition criteria in the SORP which can give rise to 'lumpy' income, expenses may be a better measure of the underlying activity level of a charity than income. However, in an asset-based charity, such as one holding a considerable amount of property and/or investments, it may be closer to the gross asset parameter. Materiality will not usually be set at the net incoming resources parameter. This figure should be used to help decide what level is most appropriate, somewhere between the income and gross asset parameters. Once materiality has been set, performance materiality also needs to be set as described earlier. However, performance materiality cannot exceed materiality.

Where total liabilities are significant, it may be necessary to calculate a parameter for total liabilities, introducing this into the overall equation. This may be particularly relevant where the charity is making a loss.

Where the charity is close to break even, such that a relatively small error could turn a surplus into a deficit (or vice versa), greater emphasis should be placed on trends over a period of years. Remember that materiality should remain broadly constant from year to year (subject to inflation and significant changes in the level of activity carried on). However, many choose to revise materiality downwards where a charity is near break even, either in terms of its results for the period or in terms of the net assets.

Determining materiality

A guide for determining the level of materiality is set out below. It must be emphasised that the table is guidance only. The level of materiality is a matter for professional judgement. Under no circumstances should materiality be 'calculated' as an average of the parameters.

Net incoming resources for year	Gross income/expenditure/asset parameter
5% – 10%	0.5% – 3%

Conclusion

The parameters set out above may be considered high in relation to the smaller charity. In practice, however, the use of a lower limit of 3% should not prove a problem for the smallest voluntary audits.

The table is not, however, mandatory. Firms are free to set their own levels, but, in doing so, should take care not to set levels of materiality which are either too high or too low. In the very small charity audit, experience indicates that there may be a tendency to set materiality at too low a figure, probably as a result of confusion of audit and accounting materiality.

Setting materiality too low will affect sample sizes; they will increase. This may cause time problems without necessarily increasing audit efficiency. Too low a materiality figure could also pose problems if an audit firm's work is called into question. By defining materiality at too low a level, the firm is defining 'truth and fairness' in too precise terms. Its work could be found wanting when judged in terms of too precise a definition of 'truth and fairness'. By opining that accounts are 'not materially misstated', auditors do themselves no favours by setting materiality at too low a level. In general, therefore, it is suggested that the table may be accepted for use in all but exceptional circumstances.

The Preliminary Analytical Review routine may be used to record any section specific levels of materiality or there is a template for Materiality Summary (C6), and a separate template is provided for recording materiality for group components (Materiality Summary – Group Components (C6.2)).

The materiality ranges are calculated by the system when you access the Materiality dialog. A suggested level of materiality on Turnover will be offered, however, you are free to enter whateverlevel is appropriate. Whether you enter a different figure, or accept the suggested figure, you will be required to enter an explanation as to why the level is appropriate.

Audit Automation calculates a level below which errors are considered clearly trivial, being 5% ofoverall materiality. However, this level can be overridden by users to comply with, say, firm policy, providing a reason is given for the override.

7.2 Programmes

Disclosure checklist

Introduction

In line with the guidance in Accounting requirements, the following schedules are available in the checklist ~~in *Navigate Accounting*~~ :

Ch-A7.0 Annual review of changes checklist to confirm the need for a new disclosure checklist to be completed. *Activated via a Tailoring question. Where the conclusion to this checklist is that the full disclosure checklist is required, this will then be activated.*

Ch-A7.1 to A7.1A17 Disclosure checklist based on FRS 102, Charities SORP (FRS 102), the Charity Regulations (both English & Welsh and Scottish), *Companies Act* 2006 and applicable regulations. *Activated via Tailoring question or through the conclusion of the Annual review of changes, a Tailoring checklist appears first to give the options to exclude irrelevant sections of the Disclosure checklist. After the Tailoring checklist is completed the Disclosure checklist will be activated.*

Ch-A7.8 Disclosure checklist for receipts and payments accounts.

Checklist A8 is designed to assist in reviewing compliance with reporting requirements. *This is incorporated within the main disclosure checklist for FRS 102* ~~There are three versions within the workbook, one each for audit, independent examinations and totally exempt (accountant's) reports.~~

Ch-A8 Checklist to assist in ensuring compliance with reporting requirements.

~~ChIE-A8 Independent examination report checklist.~~

~~ChTE-A8 Accountant's report checklist.~~

Requirements

With the increasing sophistication of accounts preparation packages, it is not essential that a checklist be completed each year. However, an annual review for proper preparation of the accounts in accordance with the Charities SORP (FRS 102) and other applicable requirements should take place and will form part of the critical review of the accounts. An annual review of changes checklist is included to help the user to confirm whether or not a new checklist is required for the current year.

The Charities SORP (FRS 102) contains no specific recommendations concerning receipts and payments accounts although the *Charities (Accounts and Reports) Regulations* 2008 do require the trustees' annual report to follow the same requirements as for any other small charity. These requirements are covered in the checklist A7.8 along with other requirements based on the Charity Commission 'Receipts and payments accounts pack' (CC16).

Using the programmes

Introduction to small charities

The Charities ~~Excel-based~~ tools are similar in functionality and content to the Private Company audit tool (previously known as PCAS). The files can be tailored to the requirements of a particular assignment, using the tailoring questionnaire ~~in the web browser~~, thus removing any audit~~/independent examination~~ areas which are not applicable.

The specific guidance in Audit and Reporting Requirements contains checklists and flowcharts to help determine a small charity's status for accounts preparation and audit exemption purposes.

~~Details on using the Charities Excel-based audit tools are available on the Charity audit tool and Independent examination tool pages and the latest charity audit programme and checklist PDFs can be found here.~~

7.3 Example letters and reports

This area ~~of Navigate Audit~~ contains example letters and reports which are specific to charities. ~~Templates which are applicable to all types of entity, including charities, are in Templates and Letters.~~

Audit letters

Letter of engagement

The letter of engagement forms the basis of the contract between the firm and the client. In the event of any dispute or uncertainty, this will play a vital part in reaching any agreement. It is essential that the letter is both complete and up to date.

In most charities, the trustees will be the appointing body and the letter should be addressed to them. The auditor should check the governing document to make sure that this is the case. If the trustees are not engaged in the day-to-day operations, you should send a copy of the letter to the chief executive or other persons responsible for the day-to-day management.

Example engagement letters for charity audits are available *as template ENGCHAR* ~~by following the links included here~~.

Letters of representation

Letters of representation should be obtained from the trustees of the charity on an annual basis to support any representations made during the course of the audit. The trustees should then be asked to sign the letter and return it as confirmation that they agree the contents.

Where the letter has been signed on behalf of the trustees by only one or two then there should be a minute of a meeting of the trustees agreeing its contents. An example minute has also been included. This ensures that all trustees are aware of those representations.

If there is a non-trustee chief executive, you may need to obtain representations from that person. If this is the case, you should ensure that the contents of any such letter are reviewed by the trustees. Again, this highlights relevant representations to the trustees.

The tendency in recent years is away from the full letter where the trustees make representations about all the assets, liabilities and other items affecting the accounts. Instead, the letter should be restricted to those areas where the auditor is unable to obtain independent evidence and could not reasonably expect it to be available. Provided no other evidence exists which conflicts with the representations by trustees, the auditor should obtain written confirmation of the representations.

The standard letter of representation included in PCAS should be used, and a specimen letter for a charity is included ~~below~~.

You may wish to obtain specific representations confirming that:

- all income has been recorded;
- the restricted funds have been properly applied;
- constructive obligations for grants have been recognised;
- all correspondence with regulators has been made available to the auditor, including, in England and Wales, any serious incident reports; and
- the trustees consider there to be appropriate controls in place to ensure overseas payments are applied for charitable purposes.

Example letter of representation

		Last reviewed
REPCHAR	Specimen letter of representation	Nov 2022

Other template letters included in the pack

As well as those above, the following templates have been included in the charities pack:

- *Request for bank report (BANKSTD, BANKFAST, BANKINC, BANKACK)*
- *Authority for the bank to disclose information (BANKDISC)*
- *Letter of resignation (RESIGN)*
- *Component Auditor's Confirmation (COMPCONF)*
- *Circularisation letters (CREDITORSW, DEBTORSW)*

Audit reports for charities

~~Introduction~~

~~The Audit reports section includes example audit reports which can be used for charities registered in England and Wales.~~

~~The example reports are set out in accordance with the relevant FRC illustrative reports for periods commencing on or after 15 December 2019.~~

~~It should be noted that the FRC examples do not address reports for audits undertaken under the *Charities Act* 2011. The reports provided are therefore the interpretation of the reporting requirements combined with guidance issued by the ICAEW in their helpsheet 'Preparing an audit report for a Charity', last updated in November 2018.~~

~~Templates are available for:~~

~~• charitable company audited under the Companies Act 2006;~~

~~• charitable company audited under charity legislation;~~

~~• unincorporated charity audited under charity legislation; and~~

~~• trustee’s statement of responsibilities.~~

~~Examples and guidance for periods before 15 December 2019 are here.~~

~~The reports will need to be amended slightly for charities or alternatively registered in Scotland or Northern Ireland.~~

~~Incorporated charities which fall below the company audit threshold and elect for audit exemption under the Companies Act, but are above the charity audit threshold, must have an audit under the Charities Act instead. In these circumstances, a statement of audit exemption under the Companies Act is needed on the charity's balance sheet.~~

~~Adding such a statement to the balance sheet will look very confusing given that the accounts will nevertheless be audited and contain an audit report.~~

~~This may cause confusion for many charities and users of charity accounts. The easiest solution is to have an audit under the Companies Act. This can be achieved very simply by not including the audit exemption statement on the balance sheet. This avoids the problem by removing the necessity for the balance sheet audit exemption statement.~~

Senior Statutory Auditor and signing audit reports

The audit report of any incorporated charity audit under the *Companies Act* 2006 should be signed in the personal name of the Senior Statutory Auditor.

Audit reports under the Charities Act (i.e. for all unincorporated charities, charitable incorporated organisations (CIOs) and small incorporated charities that elect for audit exemption under the *Companies Act* 2006) should be signed in the name of the firm.

Note

Audit reports of charities that do not publish their financial statements on a website or publish them using PDF files may continue to refer to the financial statements by reference to page numbers.

Filing accounts and audit reports

The availability of annual reports and accounts on the Charity Commission's website contributes to the sector's accountability, but the Commission is aware that issues can arise when an individual's signature appears on a public document. The risk of identity theft is real, and some people now even adopt an alternative signature when signing public documents to limit the risk.

However, not everyone is aware that the Commission no longer requires signatures on the copy annual reports and accounts that are filed with them. The requirement now is for trustees to file a copy of their charity's annual report and accounts and not a signed set of original documents, as happened in the past. Trustees should, however, retain the original signed documents at their registered address as evidence of their approval.

Additionally, some uncertainty remains about the signature of audit reports that are filed with the Commission. Where audit reports are signed in a firm's name, as in the case of Charities Act audits, then the risk of identity theft does not arise. However, *Companies Act* 2006 audit reports do identify the name of the senior statutory auditor and are signed in that individual's name. In this instance, the Charity Commission requires only a copy of the audit report to be filed, not the signed originals of the report.

If the trustees choose to file a signed copy of a Companies Act audit report with the Commission, then it is acceptable for the report to be signed in the firm's name provided that the name of the senior statutory auditor is also stated.

7.4 What’s changed

What’s changed

This table lists, in chronological order with the most recent at the top, the changes made to the Charities area. ~~Changes made over 12 months ago are in the archive.~~

~~Tracked changes are indicated as follows:~~

~~•Yellow – amended~~

~~•Green – new~~

~~•Red – deleted~~

Date	~~Link to~~ latest document	What has changed?
November 2023	Programmes	Version 5.0 of the Charities audit tool has been released. ~~A detailed mapping schedule of changes between v4.1 and v5.0 is available here.~~ This update incorporates amendments to audit programs required as a result of the revision to ISA (UK) 220. A number of other amendments have been made to respond to customer feedback and to clarify the requirements of ISA (UK) 240 and ISA (UK) 315. ~~A spotlight article that gives an overview of the revisions to ISA (UK) 220 (Revised July 2021) and the resulting changes to the Navigate Audit tools and guidance is available here.~~ Briefly, sections A (Final completion), B (File completion) and C (Planning) have been amended to: • reflect increased focus on the importance of professional scepticism throughout; • clarify leadership responsibilities, particularly in relation to quality management and evidence of RI involvement; • further increase focus on fraud; and • focus on team meetings and communication to enhance audit quality. The audit programmes have been amended to provide further prompts to the auditor to consider the reliability of audit evidence and also to consider the unpredictability of audit testing as part of a robust testing strategy.
November 2023	Permanent Audit File	The Permanent Audit File schedules have been removed

		from the Charities audit tool. The New Client Checklist is ~~now available in Templates and Letters in *Navigate Audit*.~~ *still available as a checklist within the Audit Automation Permanent file area.* The other schedules are available ~~in a new Permanent Audit File workbook in *Navigate Audit* Tools.~~ *as Background Information documents.*
~~November 2023~~	~~Audit file PDFs~~	~~Audit file PDFs have been updated for those schedules which have changed.~~
November 2023	Guidance and Methodology	A number of sections of the Audit Guidance and Methodology area ~~of *Navigate Audit*~~ have been updated to provide supporting guidance on these changes and the requirements of the latest ISAs. ~~Details of these are in Audit methodology > What's changed.~~
~~November 2023~~	~~User guide~~	~~An updated user guide is also available.~~
~~November 2023~~	~~Audit tool archive~~ ~~Audit file PDF archive~~	~~Version 4.1 of the Club audit tool has been moved to the Archive.~~
~~July 2023~~	~~Audit tool~~	~~Version 4.1 of the Charity Audit tool has been released.~~ ~~In this version, links to the Croner-i platform have been updated following some internal development work to enable updates to the platform to be processed more efficiently and quickly.~~
~~July 2023~~	~~Independent Examination tool~~	~~Version 3.1 of the Charity Independent Examination tool has been released.~~ ~~In this version, links to the Croner-i platform have been updated following some internal development work to enable updates to the platform to be processed more efficiently and quickly.~~ ~~Other minor editorial amendments have also been made.~~
~~July 2023~~	~~Independent Examination PDFs~~	~~Schedule D2 has been updated to correct the wording in question 1.~~

~~December 2022~~	~~Disclosure checklist~~	~~An updated disclosure checklist is available through Navigate Accounting.~~ ~~The archived disclosure checklists have been removed from the platform.~~
~~December 2022~~	~~Independent Examination Tool~~	~~V3.0 of the Charity Independent Examination Tool has been released with minor updates including:~~ ~~• updated guidance links and editorial amendments to improve formatting, documentation and relevance;~~ ~~• additional questions relating to Groups have been incorporated where applicable, to address guidance and recommendations provided by the Charity Commission (CC32); and~~ ~~• *Related parties covering letter* (PAF06.3) has been removed from the IE tool in line with the charity audit tool v4.0.~~
December 2022	Specimen letter of representation	The specimen letter of representation for charities has been reviewed and updated to reflect the requirements and wording of ISA (UK) 240 (Revised May 2021) (Updated May 2022)
~~December 2022~~	~~Reports for total exemption assignments~~	~~The reports for total exemption assignments have been reviewed and updated with minor editorial amendments.~~
~~December 2022~~	~~Pre-year end letter~~	~~The pre-year end letter for independent examinations has been reviewed and updated with minor editorial amendments.~~

8. Non Audit – Accounts Preparation

This area ~~of *Navigate UK GAAP Accounting*~~ is designed to provide a structured approach to fulfilling technical and professional obligations when preparing a set of statutory financial statements on behalf of the directors or others charged with governance.

Tools provided include an accounts preparation work programme, ~~model accounts~~ and disclosure checklists relevant to small, abridged and filleted accounts. *All optional, activated via tailoring questions.*

Guidance is available on determining small entity, group and audit exemption status with useful interactive decision trees *within the templates*. Guidance and tools for preparing management accounts and iXBRL tagging are also included. Assurance review content is provided *below* ~~in Navigate Audit~~.

8.1 Guidance

Scope and purpose

Scope and purpose

The aim of this Accounts Preparation area ~~of *Navigate UK GAAP Accounting*~~ is to provide the resources needed to prepare financial statements for an entity that is exempt from audit. The system is aimed primarily at companies and LLPs; however, the guidance and tools can be adapted for use with any entity that is not required to have an audit.

The system includes the following:

- practical guidance on preparation of financial statements;

- ~~guidance and interactive~~ flowcharts to help determine audit exemption status under the Companies *Act* 2006 for companies and LLPs *(template AUDEX)*;

- guidance on small entity and group status with ~~interactive~~ flowcharts *(templates FCSML and FCGROUP)*;

~~• Excel work programmes setting out the procedures required, generated and tailored using a web-based questionnaire;~~

- disclosure checklists ~~and model accounts~~ to assist with the content of financial statements (including filleted accounts) for small audit exempt companies and LLPs; and

- example engagement letters ~~and accountant's reports~~.

Further guidance and tools for other services which may be provided alongside accounts preparation are available as follows:

- Management accounts;

- iXBRL tagging; and

- Assurance reviews.

Purpose of an accounts preparation engagement

The aim of an accounts preparation engagement is to ensure that the financial statements are prepared to give a true and fair view of the company or LLP, based on appropriate, applicable accounting standards and in accordance with the *Companies Act* 2006 , as modified for LLPs where appropriate.

It is important to realise that, whilst the accountant does not need to express any opinion of any sort on the financial statements, the directors carry obligations which have been devolved by way of the client/agent relationship to the accountant. The accountant therefore needs to ensure that procedures exist to ensure that the financial statements are so prepared.

The intention when carrying out an accounts production assignment for a client is to produce a set of meaningful financial statements which are likely to be used:

- by the client as a means of reviewing the state of the business and its progress;
- by investors and/or lenders to satisfy themselves that their security is being properly safeguarded;
- by HMRC, directly or in summary form, in order to determine a tax liability; and
- by HMRC as a cross-check against the returns in the case of a control visit.

In most cases the financial statements should comply with UK Generally Accepted Accounting Practice (GAAP).

It is far less likely that the financial statements will be used by the management to report to the owners, since these two functions are less likely to be separated. In the case of HMRC, the financial statements are only routinely required by HMRC in the case of the largest partnerships and will otherwise only be used in the event of a tax enquiry. However, the owners of the business will use the financial statements to compute their tax liability whilst making their own self-assessment.

The financial statements are the first stage in a wider taxation process; indeed, under self-assessment, the tax return can no longer proceed to completion without the prior completion of these financial statements. The financial statements will also need to go through an XBRL tagging process which is mentioned in further detail here.

Unlike management accounts, the intention is to set out the definitive results of the business for the period concerned from an historical viewpoint. Apart from the taxation aspect, the main users of the financial statements are likely to be the investors and/or lenders. Even here, if the business is under close scrutiny, it is likely that more frequent management accounts will be prepared upon which decisions are made. Even so, the risk implications to the firm of the possibility of the bank relying on these accounts cannot be ignored.

Occasionally, year-end financial statements will be used in the course of negotiations for the sale or acquisition of a business. Here, the actual decision on whether to progress or not is unlikely to be made solely on the basis of the financial statements but it is quite likely that the financial statements will form a key part in the price setting process. The firm will need to review the risk implications to the practice in this instance and would be advised to consider a disclaimer or liability cap to prevent or limit the effect of any claim by the potential purchaser.

These notes refer to ‘company’ throughout. However, any reference to ‘company’ should be interpreted as applying equally to an LLP, except where stated otherwise.

Acceptance and engagement

Accepting compilation engagements

Compilation engagements are subject to the ethical and other guidance laid down by the ICAEW, including the Fundamental Principles of the Code of Ethics in section 3 of the Members' Handbook. Members should, therefore, not permit their names to be associated with financial information that they consider may be misleading.

The relevant sections of the Code of Ethics apply to the ICAEW member. The Code of Ethics indicates that independence, in the sense in which it is sometimes applied to audit assignments, is not essential to engagements to prepare financial statements, provided that objectivity is not impaired. However, the Code of Ethics highlights certain factors, which by their nature are a threat to objectivity in any professional role. These areas of risk include:

- family and other relationships;
- loans;
- goods and services: hospitality or other benefits;
- beneficial interests in shares and other investments; and
- acting as a business adviser and investing in or sponsoring or promoting shares.

It should be noted, however, that the audit sections of the Code do not apply during solely accounts preparation engagements.

The current version of the FRC's Ethical Standard applies to all audits of accounting periods commencing on or after 15 March 2020. Where the firm has produced accounts that they are also to audit, careful consideration needs to be given to the standard to ensure that the firm is in a position to perform the audit and, where applicable, ensure that appropriate safeguards have been put in place in respect of any threats to audit independence.

The audit engagement partner must be made aware of all potential non-audit services to be provided to the client before the engagement terms for those services are entered into, so that auditor independence can be reviewed and protected. In some cases, firms will have to decide between providing the non-audit services or carrying out the audit. Section B5 of the standard should be reviewed in full. In the event of an existing audit client requesting accounts preparation services for the first time, again this must be cleared through the audit engagement principal before the work is agreed to. Conversely, careful consideration and planning will be needed where a previously non-audit client will be coming into audit.

Under the Institute's Code of Ethics, it is acknowledged that 'independence' as associated with audit is not a requirement for engagements to prepare financial statements provided that objectivity is not impaired. Certain factors such as family relationships, loans, hospitality and beneficial interests can be threats to objectivity and, if present, should be considered and appropriate safeguards put in place. Consideration should also be given to conflicts of interest and, again, safeguards put in place where appropriate or, if necessary, the firm should withdraw from the assignment.

Engagement terms

There needs to be a clear understanding between the client and the accountant regarding the terms of the engagement. The client needs to understand, from the outset, the responsibility which the accountant accepts in relation to the financial statements. This is best dealt with by a discussion followed by an engagement letter, which will then act as the contract for the engagement. Technical release TECH 07/16 AAF suggests that the engagement letter includes matters such as:

- the Board of Directors as addressees;

- the directors will be responsible for the reliability, accuracy and completeness of the accounting records and for the truth and fairness of the financial statements themselves, as specified in the *Companies Act* 2006 ;

- the information to be supplied by the client to the accountant and a confirmation that any other information that they consider necessary for the performance of the engagement will be supplied;

- the nature of the engagement;

- the accountant will make enquiries of management and undertake any procedures that they judge appropriate, but are under no obligation to perform procedures that may be required for assurance engagements such as audits or reviews;

- the engagement cannot be relied on to disclose errors, fraud, weaknesses in internal controls or other irregularities;

- an audit, or any other type of assurance engagement, will not be carried out and so, no opinion will be given and no assurance, either implied or expressed;

- the financial reporting framework bases on which the financial statements will be prepared and the fact that any known departures will be disclosed;

- professional accountants' ethical and other professional obligations;

- written management representations may be required prior to the completion of the engagement and the issuing of the compilation report; and

- the form of report to be issued.

In addition, after discussions with the client, it may be appropriate to include a section on the limitation of the accountant's liability.

Audit exemption status and planning

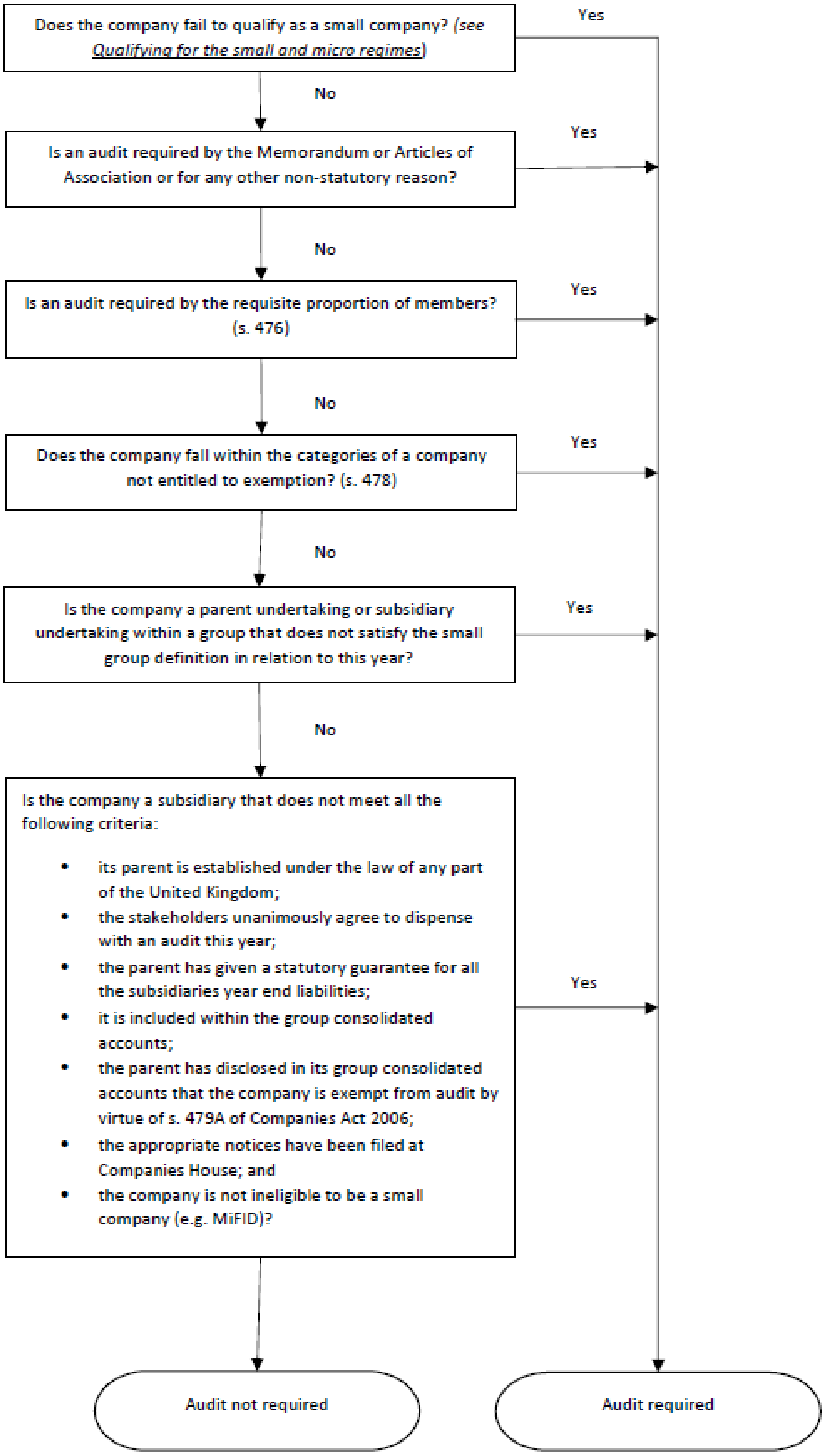
Risk assessment – audit exemption

Before the end of the year, it is appropriate to fill in a risk assessment form to determine whether it is likely that the company will become ineligible and lose the audit exemption.

A~~n interactive~~ decision tree to help determine whether a small company requires an audit can be found here ~~along with a PDF version of the decision tree~~:

Determining whether an audit for a small company is required

Flowchart to determine whether an audit is required



Does the company fail to qualify as a small company? *(see Qualifying for the small and micro regimes)*

Is an audit required by the Memorandum or Articles of Association or for any other non-statutory reason?

Is an audit required by the requisite proportion of members? (s. 476)

Does the company fall within the categories of a company not entitled to exemption? (s. 478)

Is the company a parent undertaking or subsidiary undertaking within a group that does not satisfy the small group definition in relation to this year?

Is the company a subsidiary that does not meet all the following criteria:

- its parent is established under the law of any part of the United Kingdom;
- the stakeholders unanimously agree to dispense with an audit this year;
- the parent has given a statutory guarantee for all the subsidiaries year end liabilities;
- it is included within the group consolidated accounts;
- the parent has disclosed in its group consolidated accounts that the company is exempt from audit by virtue of s. 479A of Companies Act 2006;
- the appropriate notices have been filed at Companies House; and
- the company is not ineligible to be a small company (e.g. MiFID)?

Audit not required

Audit required

Last reviewed: April 2021

Compilation procedures

ICAEW TECH 07/16 AAF suggests that the accountant should:

- plan the work required: the level varying according to the complexity of the company's accounting records and the accountant's experience of the business;

- obtain a general understanding of the business and operations of the company. This includes familiarity with the accounting principles and practices of the sector in which the company operates and with the form and content of the accounting information that is appropriate in the circumstances. The accountant's understanding of the business is usually obtained through experience of the company or enquiry of the company's management and staff;

- consider whether the financial statements are consistent with their understanding of the business and whether the financial statements are misleading. In so doing, the accountant makes such enquiries of management and undertakes such procedures as are judged appropriate. However, the technical release emphasises that the accountant is under no obligation to perform procedures that may be required for assurance engagements such as audits or reviews; and

- consider methods available, such as disclosure checklists or software packages, to check that relevant disclosures have been made on the basis of information available.

Process and completion

Performing work and management representation

The accounts preparation process for a limited company exempt from audit should be very similar to the process for a similarly exempt partnership. The main difference is the treatment of directors'/members' remuneration/appropriation.

It should be stressed that, as a part of the work performed, the accountant must consider whether the financial statements are consistent with their knowledge of the industry sector and their experience of that particular client. In compiling the financial statements, the accountant will normally rely on management representations and consideration should be given to obtaining a letter of representation on matters such as completeness, reliability and accuracy of information provided. Examples of the letter of representation can be found *in the templates* (REPACCS) ~~here~~.

Documentation

There is no mandatory requirement to document the work that has been carried out. However, where the quality of the accountant's work is subsequently challenged, documentation may help the accountant demonstrate the adequacy of the work performed and that the engagement was carried out in accordance with the terms of engagement.

The level of documentation may vary according to the complexity of the company's accounting records and accounting procedures, according to the accountant's experience with the business, and whether any matters have arisen during the course of the engagement.

Disclosure checklists

Limited companies and LLPs have strict disclosure requirements with which they must comply. Whilst it is the ultimate responsibility of the directors, there is also a responsibility on the accountant to ensure that the disclosures are appropriate. The accountant, however, is not required to give an opinion on the financial statements, since they are not performing an audit.

The best way to do this is to use a disclosure checklist. Disclosure checklists for a small company financial statements and abridged financial statements are available in the *disclosure checklists* ~~Tools~~ area.

~~A downloadable software tool providing checklists for a variety of entities and reporting frameworks, including FRS 102 1A and FRS 105 can be found in *Croner-i Interactive Disclosure Checklist* .~~

A checklist has also been included to facilitate the compilation of financial statements for filing at Companies House for entities which have opted to take advantage of some or all of the filing exemptions as permitted by CA 2006, s. 444 , sometimes referred to as 'filleted accounts'. Starting with a set of financial statements prepared for the members (whether micro-entity, abridged or Section 1A), this compilation checklist identifies the available filing exemptions.

Completion questionnaires and other procedures

Special completion questionnaires are provided for audit exempt companies. A critical review of financial statements questionnaire is also provided.

Accounts preparers may wish to use the analytical review summary and the calling over sheet and typing instructions which are also included. These sheets are not essential but may still be of use to an audit-exempt entity.

Misleading financial statements

During the course of an engagement, matters may come to light which appear to indicate that the financial statements may be misleading. In such cases, the accountant should discuss the matter with the directors, with a view to agreeing appropriate adjustments and/or disclosures. Where there are departures from accounting standards and appropriate disclosures are made in the financial statements, the accountant may wish to highlight these disclosures in their report by way of an explanatory paragraph. An appendix to the ICAEW Technical Release TECH 07/16 AAF gives an example wording for such a report.

Where the adjustments and/or disclosures that the accountant considers appropriate are not made in the financial statements, or appropriate information has not been provided to the satisfaction of the accountant, then more drastic action is recommended by the technical release. If the accountant considers that the financial statements are misleading, then he should withdraw from the engagement and should not permit their name to be associated with the financial statements.

TECH 07/16 AAF gives further details on misleading financial statements, which the professional accountant should be familiar with.

Deadlines and filing

In addition to those risks for any small company assignment, the financial statements need to be filed within strict deadlines, namely nine months of the accounting period end, with automatic penalties applying in the event of late filing. Excessively late filing may result in prosecution of the directors, or the company being struck off with resulting risk of the accountant receiving a claim.

The accountant has to prepare financial statements on the directors' behalf in accordance with disclosure requirements in the *Companies Act* 2006 . Companies House may reject filings if they are not prepared appropriately, with potentially severe implications, which may include the following:

- the rejection may be accompanied by a referral to the BEIS (Department of Business, Energy & Industrial Strategy) and/or ICAEW or ACCA, with disciplinary action being a possibility as a result; and
- there may not be sufficient time to correct the financial statements before the filing deadline.

The requirement for the financial statements to show a true and fair view also increases the risk. It should also be noted that the professional bodies will regularly ask to review a set of non-audit company financial statements as part of a visit.

Insight - Companies House Reform

The Economic Crime and Corporate Transparency Bill received royal assent on 26 October 2023 and became the *Economic Crime and Corporate Transparency Act* 2023 (ECCTA). Through this, the UK government is reforming how companies report to Companies House and what information they report upon.

The legislation aims to broaden the powers of the Registrar of Companies House and to improve the quality of data. In summary, the ECCTA will include the following measures for Companies House:

- introducing identity verification for all new and existing registered company directors, people with significant control and those who file on behalf of companies;
- broadening of powers to become a more active gatekeeper over company creation and a custodian of more reliable data;
- improving the financial information on the register so that the register is more reliable and accurate, reflects the latest advancements in digital technology and enables better business decisions;
- having more effective investigation and enforcement powers along with increasing the ability to share relevant information with partners; and
- enhancing the protection of personal information to protect individuals from fraud and other harms.

Filing obligations

The reforms aim to make the filing requirements easier to understand, reduce fraud and error, and improve transparency. It is expected that what is filed at Companies House will be closer to what companies have already prepared and benefit small companies and micro-entities by simplifying and streamlining the filing options.

Making filing obligations clearer

Rather than having the filing obligations for small companies and micro-entities within the same section of the *Companies Act* 2006, the ECCTA splits the requirements into two sections, which aims to make the filing requirements clearer for companies to understand.

Small company requirements

The amendments to the small companies filing requirements require the preparation of annual accounts in accordance with CA 2006 s. 396. This means small companies will now be required to file a profit and loss account and directors' report at Companies House under the new ECCTA. Therefore, the option of filing 'filleted' accounts for small companies will be removed. The purpose of this is to improve transparency and ensure key information such as turnover is available on the public register.

Small companies will also no longer have the option to prepare and file abridged accounts, streamlining the types of accounts filed at Companies House.

However, in a change to the original Bill, the ECCTA includes provisions allowing the Companies House registrar to make the profit and loss accounts of small companies (or parts of them) unavailable for public inspection. This will provide comfort to those concerned about trading information becoming publicly available on the grounds of commercial sensitivity, while ensuring Companies House receives the necessary information.

Micro-entity requirements

Under the new rules, micro-entities will be required to prepare annual accounts in accordance with the requirements of CA 2006 s. 396. This means micro-entities will now be required to prepare a profit and loss account but will still have the option not to prepare or file a directors' report.

The ECCTA also includes provisions allowing the Registrar to make the micro entity profit and loss accounts (or parts of them) unavailable for public inspection, a deviation from the original Bill.

Audit exempt and dormant companies

The ECCTA will require an additional statement to be provided by the directors when a company seeks to rely on an audit exemption (this includes dormant companies). The statement will require the directors to identify the exemption being relied on and to confirm that the company qualifies for the exemption. This additional statement is intended to act as a deterrent to criminal activity and to provide additional enforcement evidence.

Impact on tackling economic crime

It is believed that the reforms to the filing options for small companies and micro-entities will help to tackle economic crime. There are concerns that, under the existing regime, companies use filing options that require minimal disclosure when they are not eligible to do so. Simplifying the filing framework will prevent confusion and improve the accuracy of the information. Requiring more information to be filed will reduce the risk of deliberate misuse of minimal disclosure options to hide money laundering and other fraudulent activity. Ensuring all companies report sufficient information to determine a company's size and eligibility to file under size specific regimes will improve the value and reliability of the information.

The requirement for companies to file an eligibility statement will provide Companies House with additional evidence to take stronger enforcement action for false audit exemption filings in the future. For example, companies may have claimed the dormant audit exemption when their bank accounts clearly show they do not meet the definition of a dormant company.

Timetable for changes

As of yet, no implementation timetable has been set for these measures to commence. Indeed, it will take Companies House time to get policies and procedures in place as well as system development in order to manage the process.

Therefore, some of the measures in the ECCTA will not be introduced for a while. Many changes need system development and secondary legislation before they are introduced.

However, other measures will come into force sooner. The measures expected to be in force from early 2024 include:

- greater powers for Companies House to query information;
- stronger checks on company names;
- new rules for registered office addresses which will mean all companies must have an appropriate address at all times. Companies will not be able to use a PO Box as their registered office address;
- a requirement for all companies to supply a registered email address;
- a requirement for all companies to confirm the company is being formed for a lawful purpose on incorporation. Every year, each company will need to confirm that its future activities will be lawful on their confirmation statement;
- annotations on the register to let users know about potential issues with the information that has been supplied;
- taking steps to clean up the register, using data matching to identify and remove inaccurate information; and
- sharing data with other government departments and law enforcement agencies.

Future changes

Additional changes are intended to be made to the ECCTA at a later date, including:

- mandating digital filing and full tagging of financial information in iXBRL format; and
- reducing the number of times a company can shorten its Accounting Reference Period.

Approval by the client

Approval by the client

The directors are statutorily responsible for the financial statements and the *Companies Act* 2006 requires that directors approve the financial statements and that the balance sheet states the name of the director signing the financial statements on behalf of the Board.

The ICAEW recommends that as best practice, if the company or LLP is exempt from audit, an accountant's compilation report should be included in the financial statements. ~~This requirement has therefore been included in the model accounts on this basis, with example proforma accountant's reports provided in Example letters and reports. These reports are based on ICAEW Technical Release TECH 07/16 AAF and, for ACCA reports, Technical Factsheet 163.~~

The question of whether these reports should be submitted is down to the professional accountant's judgement. Both the ICAEW in TECH 07/16 AAF and ACCA in Technical Factsheet 163 recommend that these are included to demonstrate credibility of the company and its financial statements, especially as company accounts are freely available from Companies House. However, some accountants have raised concerns that some clients may not be happy to see that they also prepare the financial statements of competitors. There have also been instances of Companies House confusing accountant's reports with audit reports, which has then delayed filing.

The client's approval statement, used for sole traders and partnerships, is not considered appropriate for a corporate situation, but it is still important to ensure that the accountant has evidence for any statements on which the accountant may depend in assisting the client to meet their statutory duties. This is addressed by the letter of representation included *in the templates* ~~here within *Navigate Audit*~~.

It is important to note that the accountant's report should not be signed until the financial statements are approved by the directors and the approval statement has been signed and returned.

The aim of the accountant's report is for readers to draw comfort from the fact that the accounts have been compiled by a chartered accountant who is subject to the ethical and other guidance issued by the ICAEW. The report will normally be addressed to the directors of the company and should not be signed as 'registered auditor' or 'statutory auditor'. The financial statements should also contain a reference to the fact that they are unaudited, either on the front cover or on each page of the financial statements.

Accountants' reports

TECH 07/16 AAF recommends that the professional accountants' report on the financial statements of a company includes:

• a title identifying the persons to whom the report is addressed (usually the Board of Directors) and including the words 'Chartered Accountant's / Accountants' Report to ...';

• a statement that, in accordance with the engagement letter, the professional accountant has compiled the financial statements which comprise [state the primary financial statements] and the related notes from the accounting records and information and explanations supplied by the client;

- a statement that the report is made to the Company's Board of Directors, as a body, in accordance with the terms of engagement;
- an explanation as to the work involved and the purpose of the work and that, to the fullest extent permitted by law, no responsibility will be accepted for the work or the report to anyone other than the Company and the Company’s Board of Directors, as a body;
- a statement that the accountant has carried out the engagement in accordance with technical guidance issued by the Institute and that they have complied with the ethical guidance laid down by the Institute relating to members undertaking the compilation of financial statements;
- a statement that the directors have acknowledged their responsibility to prepare financial statements that give a true and fair view under the *Companies Act* 2006 ;
- a statement that the accountant has not carried out an audit of the financial statements, verified the accuracy or completeness of the accounting records or information and explanations supplied, and that the accountant does not express any opinion on the financial statements;
- the name and signature of the accountant and any appropriate designation (but not ‘Registered Auditor’); and
- the date of the report.

Quality control

As a part of the firm’s quality control procedures, consideration should be given to the performance of cold file reviews. These can be completed by a second partner or by an external reviewer. Particular consideration should be paid to assignments identified as high risk to the practice, where it may be more appropriate to perform hot file reviews. Where reviews are performed, it is essential that remedial action be taken to rectify any findings and that the implementation of this remedial action is followed up.

Responsibilities of the directors

The directors are responsible for ensuring that the company maintains adequate accounting records and for preparing financial statements which give a true and fair view and have been prepared in accordance with Companies Act 2006 .

The directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable UK accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare financial statements on a going-concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are also responsible for safeguarding the assets of the company and for taking steps for the prevention and detection of fraud and other irregularities.

They are also responsible for promoting the success of the company. This means that directors should be giving careful consideration to environmental, social and governance issues (ESG) which might impact the company.

External claims made by shareholders and investors against companies are increasing and so directors will need to ensure that appropriate ESG disclosures are reported in the accounts and that these statements can be substantiated.

Accountant's responsibilities

Under an account's preparation engagement, the accountant becomes an agent for the directors to prepare the accounts but the directors are ultimately responsible as set out above.

Engagement and representation letters will set out the responsibilities of the parties. An example engagement letter clause for an accountant's responsibilities is: "We will compile the financial statements for your approval based on the accounting records that you maintain and the information and explanations that you give us."

Any letter of representation must be signed by the directors before the financial statements are signed off. An example of such a letter can be found *in the templates* ~~here~~.

Whilst the accountant does not need to express an opinion on the financial statements, as agent for the company directors they need to perform sufficient procedures to satisfy themselves that the financial statements prepared give a true and fair view of the company, based on appropriate, applicable accounting standards and in accordance with the Companies Act 2006.

Qualifying for small and micro regimes

The small and micro regimes

CA 2006 contains different provisions which apply in certain respects to different kinds of company. As far as the smaller (and unquoted) company is concerned, the main distinction is between:

- companies subject to the 'small companies regime' (s. 381); and
- all other companies (companies that are not subject to that regime) (s. 380(3)).

The small companies' regime applies to a company for a financial year in relation to which the company:

- qualifies as small (s. 382–383); and
- is not excluded from the regime (s. 384).

The micro-entities regime was introduced in 2013 by the *Small Companies (Micro-Entities' Accounts) Regulations* 2013 (SI 2013/3008) and updated in 2015 by SI 2015/980. In order for a company to qualify as a micro-entity, it must first qualify as a small company. It must then meet certain further criteria, and again, not be excluded from the micro-entity regime (s. 384A).

~~Interactive~~ decision trees

~~Interactive~~ decision trees are available in *the templates* ~~*Navigate UK GAAP* Qualifying for the small and micro regimes along with PDF versions of the decision trees~~ to help determine whether a company or group qualifies as small in any particular year. The decision trees apply equally to LLPs and references to 'company' should be interpreted accordingly. It should be noted that these decision trees relate to the preparation of financial statements, not to eligibility for audit exemption.

Eligibility criteria

Eligibility criteria and exclusions for the various regime levels are available as follows:

- Micro-entities;
- Small companies; and
- Small groups.

Entity size decision trees

Eligibility criteria

Size criteria

Under CA 2006 , a company is treated as micro, small or medium-sized if it does not exceed more than one of the following criteria for two consecutive years:

Size criteria for the small and micro regimes

	Micro	**Small**	**Medium**
	s. 384A	*s. 382(3)*	*s. 465(3)*
Turnover	£632,000	£10.2m	£36m
Balance sheet total (gross assets)	£316,000	£5.1m	£18m
Average number of employees (on a monthly basis)	10	50	250

Small companies regime

Even if they qualify as small, the following companies cannot use the small companies regime (CA 2006 s. 381, s. 384):

- public companies (i.e. any UK incorporated public limited company, whether its securities are traded on a market or privately held);

- authorised insurance companies, banking companies, e-money issuers, MiFID investment firms or UCITS management companies;

- companies carrying on insurance market activity (as defined by the *Financial Services and Markets Act* 2000, s. 316(3), 'insurance market activity' means a regulated activity relating to contracts of insurance written at Lloyd's); or

- members of an ineligible group (see details below).

A group is ineligible if any one or more of its members is:

- a traded company;

- a body corporate (other than a company) whose shares are admitted to trading on a UK regulated market;

- a person (other than a small company) who has permission under the *Financial Services and Markets Act* 2000, Pt. 4 to carry on a regulated activity;

- an e-money issuer;

- a small company that is an authorised insurance company, a banking company, a MiFID investment firm or a UCITS management company; or

- a person who carries on insurance market activity.

A group is defined in CA 2006, s. 474 as 'a parent undertaking and its subsidiary undertakings', as defined in CA 2006, s. 1162. A company is generally a subsidiary if more than 50% of its voting shares are held by another (parent) company.

A traded company is defined in CA 2006, s. 474 as a company any of whose transferable securities are admitted to trading on a UK regulated market.

Insight – Brexit change

The definition of a traded company previously referred only to a 'regulated market' which was defined in the EU's Markets in Financial Instruments Directive (CA 2006, s. 1173). The change to 'UK regulated market' came into force following the end of the Brexit implementation period on 31 December 2020. The change means that small groups that do not have securities traded on a UK regulated market, for example have debt or equity listed in a mainland European exchange only, will be eligible to prepare and file financial statements under the UK small-company rules, as long as they meet the other criteria.

Insight – Brexit change

For a body corporate, the wording 'trading on a UK market' was previously 'trading on a regulated market in an EEA state'. The change came into force following the end of the Brexit implementation period on 31 December 2020.

In determining whether a company is part of an ineligible group, it is necessary to look at all companies within the largest group of which the company is part. This means that not only the subsidiaries of the company in question are assessed, but also any companies that sit above – or either side – of it. All companies in the group, including overseas companies, are taken into consideration.

Micro entities

For a company to qualify as a micro-entity, the company must first qualify as small (and not be excluded from the small companies regime).

After the 'small' test, a company is excluded from the micro-entities regime if it:

- would be an investment undertaking (as defined in art. 2(14) of Directive 2013/34/EU of 26 June 2013 on the annual financial statements, etc. of certain types of undertakings) if the UK was part of the EU;
- would be a financial holding undertaking (as defined in art. 2(15) of that directive) if the UK was part of the EU;
- is a credit institution within the meaning given by art. 4(1)(1) of Regulation (EU) No. 575/2013 of the European Parliament and of the Council, which is a CRR firm within the meaning of art. 4(1)(2A) of that Regulation);
- would be an insurance undertaking (as defined in art. 2(1) of Council Directive 91/674/EEC of 19 December 1991 on the annual accounts of insurance undertakings) if the UK was part of the EU; or
- is a charity.

Insight – Brexit changes

Changes were made to the wording of the micro-entity eligibility criteria so that from the end of the Brexit implementation period (31 December 2020) those referring to EU Directive definitions should apply as if the UK was still a member state of the EU. This means the ineligibility criteria apply in the same way as they did before the implementation period.

Applying the size criteria

Turnover represents the amounts derived from the provision of goods and services falling within the company's ordinary activities, after deduction of:

(a) trade discounts;

(b) value added tax; and

(c) any other taxes based on the amounts so derived.

For a normal trading company, this would mean that any 'other income' (such as rental income and other gains) would not be included in turnover for this purpose. Turnover figures should be taken from the statutory financial statements and proportionately adjusted where the financial 'year' is not 12 months (s. 382(4), 384A(5) and 465(4)).

'Balance sheet total' means the aggregate of the amounts shown as assets in the company's balance sheet (i.e. gross assets before deduction of liabilities, accruals and provisions; that is, the aggregate of headings A to D in Format 1 or the 'Assets' headings in Format 2) (s. 382(5), 384A(6) and 465(5)).

The average number of employees is determined by establishing the number of persons employed under contracts of employment by the company each month and calculating an average. This is therefore *not* a measurement of 'full time equivalent' employees. However, CA 2006 refers to 'persons employed under contracts of service'. Sub-contractors would potentially therefore be excluded, as would directors who do not have a 'contract of service', such as a non-executive director.

If the company is in its first year and if the criteria are met for that first year, the company will qualify as micro, small or medium-sized for that year (s. 382(1)).

Otherwise, as a general rule, for a company to qualify as micro, small or medium-sized, the criteria must be met for the current (Y1) and previous year (Y0) (s. 384(3), s. 382). If the criteria are not met for the following year (Y2), a company may still continue to be treated as micro, small or medium-sized, as appropriate, for that following year (Y2) if it met the criteria and qualified as micro, small or medium-sized in the previous year (Y1). However, if the criteria are not met in the year after that (Y3), then the company must file accounts according to its size for Y3. Growing companies can therefore continue to be treated as micro, small or medium-sized in the first year that they fail to meet the qualifying criteria.

To demonstrate the 'drop in-drop out' rules, where a company must fail to meet the size criteria for two years in a row before moving up to being a medium-sized company, it is helpful to set out an example to illustrate the way this works.

Example – Applying the size criteria

A company incorporated on 1 January 20X2. This company is not in a group and is not ineligible in any other way.

For each period, the ''size' this period' line in the table applies the size criteria just to the period in question, and applies the test to establish if the company meets two out of the three limits in that period alone.

The last line in the table, 'Qualify as small?', applies the 'drop in-drop out' rule, where criteria are not met for the following year (Y2), a company may still continue to be treated as small for that following year. The years are notional, solely to illustrate how the drop-in, drop-out works:

Small company size criteria

	Limits	**31 December 20X2**	**31 December 20X3**	**31 December 20X4**	**31 December 20X5**	**30 June 20X6 (6 months)**
Turnover	£10.2m	£7m	£11m	£10m	£15m	£6m
Balance sheet total	£5.1m	£5m	£6m	£6m	£6m	£5m
Employees	50	40	45	49	55	55
'Size' this period		Small	Medium	Small	Medium	Medium
Qualify as small?		Yes	Yes	Yes	Yes	No

For the year ended 31 December 20X4, the company qualified as small in the previous year (bottom row of 20X3). In 20X4, it is 'small-sized' as only one of the three criteria (penultimate row) has been breached. It did not breach the medium criteria for two years in a row. Therefore, it continues to qualify as small.

For the period ended 30 June 20X6, the company fails the turnover limit as this has been pro-rated for the shorter period to £5.1m for six months. It is only the turnover limit that is pro-rated, as the other limits are at a point in time or are an average.

Parent companies and small groups

Small group criteria

A parent company qualifies as a small company in relation to a financial year only if the group headed by it qualifies as a small group (CA 2006 s. 383(1)).

The size classification of a parent company is determined firstly by considering whether the parent itself qualifies as small per CA 2006 s. 382.

Having established that the parent company itself qualifies as small (or would do were it not a public company), CA 2006 s. 383 requires that, if the company is a parent company, the size of the group headed by the company in question must also be assessed. This has the effect that a parent only qualifies as small if the group (parent company and subsidiary undertakings) headed by it also qualifies as small.

A group qualifies as small in relation to the parent company's first financial year if the qualifying conditions are met in that year. In subsequent years, the same method of looking at current and previous years applies as with individual small companies (see Applying the size criteria).

A group meets the qualifying conditions if it does not exceed more than one of the following criteria on one or other of the following two bases.

	(The bases may be mixed)	
Criteria	*Net basis*	*Gross basis*
Small group (CA 2006, s. 383(4))		
Turnover	£10.2m	£12.2m
Balance sheet total	£5.1m	£6.1m
Average number of employees (on a monthly basis)	50	50

Net and gross thresholds

A company may satisfy any relevant requirement on the basis of either the net or the gross figure. In other words, the 'net' and 'gross' bases may be mixed in determining whether the criteria have been met.

Example – Determining a small group based on gross and net criteria

A group has a turnover of £12m (gross) and £11m (net), a balance sheet total of £6.3m (gross) and £4.8m (net) and 60 employees. On the size criteria the group would qualify as a small group.

The gross figure of £11m for the turnover is less than the gross limit of £12.2m and the net figure of £4.8m for the balance sheet, is less than the net limit of £5.1m. Therefore, although it exceeds the employee number threshold, it meets each of the other two criteria.

The aggregate figures are ascertained by aggregating the relevant figures from individual statutory accounts (determined in accordance with CA 2006, s. 382) for each member of the group.

The alternative bases for turnover and balance sheet totals (as qualifying conditions for exemption) as defined in CA 2006, s. 383(6) are:

(1) **'net'** means after any set-offs and other adjustments made to eliminate group transactions:

(a) in the case of Companies Act accounts, in accordance with regulations under s. 404 ;

(b) in the case of IAS accounts, in accordance with international accounting standards; and

(2) **'gross'** means without those set-offs and other adjustments.

Care should be taken when making the adjustments to reach the 'net' figure, that *all* consolidation adjustments are made. So for example, the cost of investment is taken out, but goodwill is added in.

Under SI 2008/409, Sch. 6, consolidation adjustments include:

- elimination of intra-group transactions and assets and liabilities;
- elimination of intra-group unrealised profits or losses; and
- adjustments to effect uniform accounting policies within the group.

Applying the requirements in practice

Because the gross thresholds are higher than the individual thresholds, it is possible for a group containing a medium-sized company to be a small group.

Example – Small group containing non-small company

Holding Company Ltd owns 100% of its subsidiary, Subsidiary Ltd (assume circumstances do not change year on year):

	Holding Company Ltd	Subsidiary Ltd
Turnover	£0	£10.8m
Balance sheet total	£250,000	£5.5m
Average number of employees	0	40

Ineligible?	No	No

On its own, Subsidiary Ltd is a medium-sized company as it breaches two out of three of the size criteria for two years in a row. However, the group headed by Holding Company Ltd is small, as Holding Company Ltd is itself small and the group headed by it is small as the total turnover when added together without consolidation adjustments are both below the gross thresholds (as are the employee numbers).

This means that the parent qualifies for the small companies regime and is exempt from the requirement to prepare consolidated financial statements and can apply FRS 102 with Section 1A. As a member of a small group, it also does not need an audit. However, its subsidiary, as a medium-sized company, will need to apply full FRS 102 and will also require an audit.

It is important to note that if the example above were the other way around and Holding Company Ltd was medium sized, the group could not be small, as both the parent and the group must meet the criteria for it to be considered a small group. This is because the requirements in CA 2006, s. 382 to determine if a company is small must first be applied. The company is then subject to the additional rules in CA 2006, s. 383 if it is a parent.

In determining whether a small company qualifies for the small companies regime, consideration needs to be given as to whether it is a member of an ineligible group. Ineligible groups are covered in Eligibility criteria.

Qualifying as a micro-entity in a group

A company within a group cannot qualify as a micro-entity if any of the following apply:

• the company is a parent company and the group headed by the company does not qualify as a small group (s. 384A(8));

• the company is a parent company which prepares group financial statements for that year (s. 384B(2)); or

• the company is not a parent company but its financial statements are included in consolidated group financial statements for that year (s. 384B).

~~More information concerning the qualification as micro or small, and the financial statements preparation requirements for such companies, is set out in the Small company area of *Navigate UK GAAP Accounting*. Information in relation to micro companies can be found in the Micro entity area of *Navigate UK GAAP Accounting*.~~

Audit exemption

Requirements and conditions for audit exemption

The full financial statements of a company require an audit unless an exemption is available. A company’s financial statements for a financial period must be audited unless the company can claim exemption under:

- s. 477 (small companies);
- s. 479A (certain subsidiary companies subject to certain qualifying conditions);

- s. 480 (dormant companies); or
- s. 482 (non-profit-making companies subject to public sector audit)

Even if a company is eligible for one of the exemptions from audit, any member of the company holding at least 10% of the nominal value of the company's issued share capital (or 10% of the votes if there is no share capital) can still require that the company has an audit.

In considering if the company is to take advantage of these exemptions, the members and directors should also consider if an audit is beneficial or required for other reasons, such as providing peace of mind, to assist in obtaining financing, to meet banking terms or as a requirement of the Articles of Association or a shareholders' agreement.

~~Details on the requirements for audit exemption are available in *Navigate UK GAAP Accounting* as follows:~~

~~• Small companies;~~

~~• Groups;~~

~~• Subsidiary companies;~~

~~• Dormant companies;~~

~~• Charities; and~~

~~• Right to require an audit (not applicable to LLPs) .~~

Insight - Companies House Reform

The Economic Crime and Corporate Transparency Bill received royal assent on 26 October 2023 and became the *Economic Crime and Corporate Transparency Act* 2023 (ECCTA). Through this, the UK government is reforming how companies report to Companies House and what information they report upon.

For audit exempt and dormant companies, the ECCTA will require an additional statement to be provided by the directors when a company seeks to rely on an audit exemption (this includes dormant companies). The statement will require the directors to identify the exemption being relied on and to confirm that the company qualifies for the exemption. This additional statement is intended to act as a deterrent to criminal activity and to provide additional enforcement evidence.

Further guidance on Companies House Reforms can be found in the Insight box within Deadlines and Filing.

Management accounts

Management accounts overview

The accounts preparation work set out in Scope and purpose refers specifically to the statutory financial statements at the end of an accounting period, which show the actual results of the business since the previous financial statements and its state of affairs as at that date. Such statements are usually prepared for HMRC, for the partners or proprietor and anyone else required to have an understanding of the business's performance during the period.

‘Management accounts’ is a term used to describe other accounts prepared during the financial period on a monthly, quarterly or other basis intended primarily to monitor the performance of the business with a view to exercising control. For such control to be exercised, the accounts need to be prepared quickly so management accounts are usually less accurate than the end of period financial statements, being reliant on estimates and standard costs in many cases.

Broadly, management accounts are used as follows:

(1) Internal use (within the business):

- (a) to exercise control over business activities;
- (b) to provide some comfort as to the present financial position; and
- (c) for decision making.

(2) External use (outside the business):

- (a) for a third party (such as a bank) who has an ongoing interest in the business's performance/financial position.

Many commentators treat management accounts, cash flow forecasts and business plans as being one single reporting subject but there is a very important difference between management accounts on the one hand and cash flow forecasts and business plans on the other. Management accounts are a historical document, although more recent than those financial statements referred to above, whereas business plans and cash flow forecasts are looking forwards and so are wholly reliant upon estimates. This distinction is very important; however, there is a great deal in common between the control systems for each.

Main risk areas

The main risk to the firm from the preparation of management accounts is that they are normally prepared with the express intention that someone will use them to make a decision. If that decision proves to be incorrect and the user can show that incorrect management accounts were a major influence in that decision and that the preparer owed the user a duty of care, then that user may sue the accountant for negligence.

It is best practice for all accounts to carry an accountants' report and this includes management accounts. This adds extra credibility to the figures when they are seen by a third party, so a review procedure for reasonableness must take place and the accounts must be backed up with an adequate workings file. When issuing such a report, consideration should also be given to the inclusion of a disclaimer or limitation of liability notice to third party users. More detailed guidance can be found later in this section. ~~A proforma accountant’s report is available within Example letters and reports.~~

Where management accounts are prepared for a limited company, it is very important that there are no misunderstandings as to the extent to which the figures have been audited. An external user seeing the management accounts may mistake them for audited accounts. On the other hand, there is a danger that figures extracted during the preparation of the management accounts by the auditor's staff may be used without further testing during the audit process, so weakening the audit. As with all unaudited accounts, the accountants' report should clearly state that the figures have not been audited.

Terms of engagement

As with any other assignment, there should be evidence in writing of the agreement of the terms of reference. Letters of engagement should be reviewed and updated at regular intervals.

Many accountants do not incorporate management accounting assignments within the engagement letter. However, management accounts are a higher risk, so their incorporation into the engagement letter process is essential.

The majority of management accounting assignments are regular recurring work for a client for whom the firm already prepares the final accounts, so it would seem appropriate for this to be treated as recurring work in the engagement letter, enabling any fees paid by standing orders to be used against the charges for that work without further reference to the client.

Engagement letter templates are available in the ~~Engagement Letter Tool and Engagement letter~~ templates~~ in *Navigate Practice Management*.~~ The *template* ~~Toolkit~~ includes a schedule for the provision of services related to the preparation of management accounts, a covering letter to the client, and the standard terms of business. ~~Guidance notes within the Toolkit provide further information about the terms and technical content within the schedules to assist with the tailoring process.~~

In other cases, management accounts are periodic non-recurring work. In these cases, a supplementary engagement letter may be more appropriate, along with appropriate standard terms of business. Reference should also be made to TECH 10/12 AAF *Reporting to third parties* when drafting the terms of engagement, particularly if third parties are involved.

Objectivity, independence and interaction with audit services

The FRC Ethical Standard applies to all audits. Where the firm produces VAT returns for an audit client, consideration needs to be given to this standard to ensure that the firm is in a position to perform the audit and, where applicable, appropriate safeguards have been put in place. Irrespective of whether an audit is to be performed or not, the firm still needs to comply with the ICAEW's ethical guidance on objectivity and independence. An assignment acceptance form should be completed for all assignments to evidence the firm's consideration of the issues of independence and objectivity and to confirm the firm's eligibility to perform the work.

Planning and control

As with any assignment, the work needs to be properly controlled.

Management accounts work will generally be carried out at the client's premises more often than will the year-end financial statements accounts production.

Overlap with accounts production

It is not uncommon for the accountant producing the management accounts to produce the year-end financial statements as well. There is a great deal of scope for a reduction in the cost of those year-end financial statements by relying on the work done at various intermediate stages. This fact should be carefully borne in mind at the planning stage of the management accounts' production; in particular, any overlap between the management accounts work and work on the annual financial statements should be taken into consideration. In preparing the monthly/quarterly analysis and posting, it may not take much extra effort to extract the information that will be required at the year-end, and, in so doing, dispense with the necessity to return to those client books and records at the year-end, in turn greatly improving the overall efficiency.

The layout of the accounts should also be considered. Management accounts do not have to adhere to the layout that would be usual for year-end financial statements and generally go into far greater depth in certain circumstances and miss out other areas altogether, depending upon the use to which the information is going to be put. However, in the case of computerised accounts production, if the same coding list can be used with different formats for the production of the management accounts and the annual financial statements, then a great deal of work can be saved.

Given the separate functions for which the different accounts are going to be used, careful planning can save a great deal of time turning two separate assignments into one larger hybrid assignment.

Detailed work

Working papers

The standard of preparation of working papers for management accounts should be no less than that for the final statutory accounts. All such schedules should clearly indicate what client and what period is involved, who prepared and reviewed the schedule, and when. The latter point is particularly important and surprisingly often overlooked.

Where a number of sets of management accounts are drawn up during the year, it may be beneficial for the lead schedules to be cumulative, with a column for each quarter or month. This enables trends to be clearly seen and saves time with the schedules being brought forward month by month. To ensure evidence of review doesn’t become clouded, each review occasion, i.e. each period, needs to be separately initialled and dated.

It is important that a trail exists from the final accounts to the lead schedules and then to supporting computer-produced schedules. One must always consider that this is a higher risk area, so it is more likely at some stage that someone will want to recreate what was done.

Assumptions

By their very nature, management accounts are less accurate than annual financial statements due to the necessity for certain items to be estimated. This is either due to the speed at which the accounts are prepared, preventing the use of hindsight (such as with accruals schedules), or cost consideration (such as not being able to carry out a detailed stock take for every accounting period). These problems are dealt with by the use of estimates and assumptions.

It is imperative that all such estimates be clearly identified so that they may be properly reported to the user of the accounts. The user can then temper their judgement in the light of those assumptions, so reducing the risk to the firm.

Many practices are reluctant to do this on the grounds that they are charging the client for the work and then appear to be avoiding responsibility for it. However, it is unreasonable for an accountant to be expected to accept any responsibility for such assumptions in an unaudited situation.

Completion

Casting

Calling and casting of management accounts is very rarely carried out. The necessity for such procedures depends upon the way in which the accounts are prepared.

Management accounts that are to be used internally are ephemeral in nature, will not be on record for any particular length of time and are frequently not subject to the calling process. However, all documents should be cast.

If any part of the management accounts process is on a spreadsheet rather than a bespoke or commercially produced accounting package, then casting is crucial. Spreadsheet accuracy of the total is wholly dependent upon the accuracy of the various formulae within the spreadsheet, all of which are user written and are particularly susceptible to accidental damage or hidden logical flaws.

Review

Review is imperative for management accounts. Staff need to be particularly alert, looking for variances and flaws in explanations given, added to the need for multiple review boxes in composite schedules. In fact, the whole review process outlined for the financial statements accounts preparation needs to be considered for management accounts, with the exception of the statutory disclosure consideration.

A matter of considerable concern is where junior or middle-ranking staff are sent out to a client to produce management accounts, complete them on site and leave them with the client without those accounts being reviewed by a manager, let alone a principal. These documents are still a product of the practice and full review procedures are essential. If necessary, the principal or senior manager should visit the client at the end of the particular assignment and be responsible for signing off the file and handing over the management accounts, having given them a reasonable review.

Quality control

As with other areas of the practice, consideration should be given to the performance of hot or cold file reviews to ensure the firm's standards and procedures are being adhered to. Particular consideration should be given to those assignments identified as high risk. This may be a part of a cyclical review programme. As mentioned previously, it is essential that, where reviews are performed, action is taken to remedy findings and there is a follow-up review to ensure this has been done.

Disclaimers and restrictions on use

The risk inherent in management accounts is greater than that for year-end financial statements, so the accountant’s report should be worded accordingly.

Management accounts should always contain an approval statement from the client, approving the figures, confirming that all information requested has been supplied and that the assumptions are reasonable. Once this has been obtained, the accountant’s report can be signed. This report should have a similar wording to a normal accountant’s report for year-end accounts, together with a disclaimer in respect of any assumptions and a clear restriction on the use of the accounts. ~~A proforma accountant’s report is available within Example letters and reports.~~

The majority of management accounts are prepared for the internal use of the business, so the restriction should clearly state that the accounts have been prepared with the express purpose of their use by the management internally and they are not to be shown to any third parties without the permission of the accountant.

If the accounts have been prepared for internal use and for submission to the bank, with the accountant aware of that from the outset, then the restriction can be rephrased, naming the bank. In this situation it is likely that the firm will also owe a duty of care to that third party, i.e. the bank. It is vital therefore that the firm consider the potential risks involved and act accordingly.

This is not to say that management accounts cannot be used by the management for other purposes but, if they do wish to show the accounts to another party, the accountant should be notified and a new accountant’s report printed, changing the restriction to permit that new purpose. If the accountant is not happy for this other party to see them, or feels that the work done was insufficient bearing in mind the new use to which the accounts are to be put, then at least they have an opportunity to refuse permission or require further work to be done before granting such permission.

Reference should again be made to TECH 10/12 AAF *Reporting to third parties* and TECH 1/03 AAF *The audit report and the auditor's duty of care to third parties* when considering and drafting an appropriate disclaimer. Restrictions on distribution should have been agreed when determining the terms of engagement.

The accountant’s report should be one of the first pages in the management accounts, with all pages clearly numbered and preferably with the report referring to the precise pages in those accounts. A user of the accounts could then spot the missing page if the report were to be removed.

On occasion, the accountant’s involvement in the management accounts production consists of a review of the nominal ledger, the processing of some journals and the printing of accounts from the client's own computer system. In such circumstances, it may not be practicable for an accountant’s report to be appended. This is acceptable, although not ideal, provided that there is no indication of the accountant’s involvement, i.e. the accounts are not printed on the practice's letterhead, and it is made clear to the client that they must not represent to third parties that the accounts have been prepared by the accountant.

Completion questionnaires

As for the year-end accounts production process, completion questionnaires can ensure that important procedures and controls are not omitted, particularly when there is pressure to complete the accounts for the client ~~(see Management accounts tools)~~.

The questionnaires can be simpler since the majority of the tax-related questions will not be an issue. However, it is important not to ignore taxation altogether since problems should always be addressed earlier rather than later, particularly when the tax authorities are involved. The questionnaires also retain the cross-selling and staff development questions.

If the client will not sign the accounts

When accounts are being prepared monthly, particularly when they are to be sent to the client's bank, there may not be time to get the accounts formally approved, or the client may be resistant, not seeing the need for the inconvenience and delay. In those circumstances, an alternative approach may be to notify the client that approval will be assumed unless they indicate otherwise.

It is imperative that an accountant’s report still be attached, and that the client is made aware that passing the accounts on will be considered to be evidence of their approval of the accounts. The accountant should also have some proof of delivery to the client.

This alternative approach is most definitely the second choice approach as far as the accountant is concerned. Every effort should be made to obtain written approval wherever possible.

iXBRL tagging

Interaction with taxation

Accountants are very commonly involved in providing both taxation and accounts preparation services, and iXBRL tagging is a service which interlinks the two.

Submission of the corporation tax return

The corporation tax return must include any supplementary pages and be accompanied by a corporation tax computation and a copy of the financial statements. Any additional information required to be disclosed to HMRC is usually incorporated into the tax computation schedules.

All companies must file their corporation tax self-assessment return and attachments online using XBRL (eXtensible Business Reporting Language) technology. This involves ‘tagging’ (like a bar code) a range of numbers and other data using a specified HMRC taxonomy (like a dictionary). These XBRL tags are machine readable codes that allow business data, in this case the accounts, to be communicated electronically.

Most of the work/effort will be in ‘tagging’ the financial statements using iXBRL (Inline eXtensible Business Reporting Language). iXBRL accounts are documents that have a human-readable rendering of the source accounts which can be displayed on a screen, but also have XBRL tags that are embedded within the document and that can be read by a computer.

There are no penalties for filing in an incorrect format, but the practical issue is that if the electronic data is not in the correct format it will not get through the Government Gateway at all and late filing penalties may apply. It should be noted at this stage that getting a corporation tax return through the Government Gateway is not necessarily an indicator of successful filing. As described above, for a submission to be truly successful, the following must be included in the pack submitted to HMRC:

- CT600 in XML format;
- corporation tax computation (even if there are no adjustments to profits before taxation in the accounts) in iXBRL format (*Note: dormant companies are not required to file a corporation tax computation.);*
- statutory financial statements (the 'full' accounts) in iXBRL format (*Note: there is no statutory obligation to prepare a detailed Profit and Loss Account, but it is considered best practice to include it with the accounts filed with HMRC. If a detailed Profit and Loss Account is not prepared or submitted, HMRC may ask for an alternative breakdown of the figures shown in the statutory Profit and Loss Account and this could lead to a greater administrative burden.);*
- any other appropriate information or supporting documentation.

Cases have been reported of submissions being accepted through the Gateway with the computation missing. Even if this isn't identified at the time of filing, HMRC may reject the whole return at a later stage; potentially leading to late filing penalties and client distress.

Most firms will use their corporation tax and accounts production commercial software to 'tag' the documents, but free software is provided by HMRC for the more basic (and fairly infrequent) cases.

Procedures

Of course, as is already the case for other returns filed online, the firm will need to ensure its procedures sufficiently demonstrate that the client approved an identical return prior to the firm filing it online. This must confirm that the return is complete and correct to the best of the knowledge of the proper officer or other person authorised to act for the company in this regard. The CT600 form does this as standard.

The firm will also need to ensure that the client is aware that the return will be filed online. In most cases, this will be done in the engagement letter or the letter sending the return for approval.

The approval letter

Technically the accuracy of the tagging is the client's responsibility but ultimately it is the data contained within the accounts and corporation tax return that is important. Therefore, unless anything particularly judgemental needs to be tagged, the client is not likely to need to get involved with the detailed process.

If a firm uses commercial software that is able to produce a tagging report that might be suitable for client review, the firm may wish to send this for approval along with the financial statements. However, this is not recommended as standard procedure.

Engagement letters

It should be made clear who will do what and by when. The example engagement letter *in the templates* includes suitable paragraphs for iXBRL responsibilities within the schedules of services.

XBRL tagged data reviews

In some cases a company may wish to employ the firm to check the accuracy and completeness of the XBRL tagging of iXBRL financial statements it has prepared itself.

As noted above, iXBRL financial statements are documents that contain a human-readable rendering of the source accounts that can be displayed on a screen, as well as having the XBRL tags embedded within the document that can be read by a computer.

In this type of engagement, the firm would have no control over the make-up of the source accounts or the submission of the financial statements to HMRC. The firm will also not be in a position to make a judgement on whether the procedures it is carrying out will be sufficient for the client. A specific engagement letter is therefore vital.

The letter should set out that the firm is not assuming responsibility for the source financial statements or the submission to HMRC as well as the procedures that will be carried out by the firm. Suggested wording is included in the example engagement letter *in the templates*. Since procedures may vary according to the client it is important that this is reviewed carefully and discussed with the client prior to starting any work.

~~An example work programme is included here for use in carrying out the work. This can be amended or tailored in accordance with the procedures that have been agreed with the client.~~

~~An example accountant's report is included here. The report refers to 'Attachment A' which is the client-specific document that sets out the procedures that have been carried out together with any findings. An example Attachment is included here.~~

The firm may report inaccuracies to the client and later discover that the client did not make corrections prior to submitting the iXBRL documents to HMRC. In such a case the firm would need to consider the ethical implications of acting for the client as well as the issued guidance, referred to above, on professional conduct in relation to taxation.

8.2 Example letters

Engagement letters

~~All engagement letter templates for statutory accounts preparation can be found here.~~

The Engagement letter *template ENGNA* ~~templates for the following services are available in the *Engagement Letter Tool* and Engagement letter templates in *Navigate Practice Management*. The Toolkit~~ includes:

A covering letter to the client

The standard terms of business

~~Preparation of management accounts~~

~~Preparation of iXBRL tagged financial statements~~

Letter of representation for audit exempt company

A proforma letter of representation is included ~~in *Navigate Audit*~~ entitled ‘ Letter of representation for an accounts preparation assignment’ *(template REPACCS)*.

8.3 What's changed

Date	**~~Link to~~ latest document**	**What has changed**
January 2024	Guidance	The Guidance section has been updated with insight boxes explaining the impact of the new Economic Crime and Corporate Transparency Act 2023 (ECCTA).
~~May 2023~~	~~Accounts preparation tool~~	~~Version 1.2.2 of the tool has been issued which includes some minor editorial amendments to update links to *Navigate Audit and Navigate UK GAAP Accounting.*~~
~~October 2022~~	~~Navigate UK GAAP Accounting – Accounts Preparation~~	~~A video has been added to the Accounts preparation homepage providing an overview of the tools and guidance available to assist in Accounts preparation assignments.~~
May 2022	Navigate UK GAAP Accounting – Accounts Preparation	All ~~links to FRS standards within the guidance have been updated to link to the latest 2022 versions issued by the FRC in January 2022 and available in~~ Latest FRS and amendments, and the associated guidance has been updated where relevant.
November 2021	Accounts preparation tool	The accounts preparation tool (previously *Small and Micro Accounts Preparation System*) has been significantly updated. ~~• removal of macros and the use of an online questionnaire for tailoring the work programme;~~ ~~• removal of the 3-option filing system and all referencing consistent with PCAS;~~ • addition of ~~guidance boxes and~~ guidance notes throughout; ~~• links to useful material available in *Navigate Audit* and *Navigate Accounting*;~~ • new work programmes added for going concern, VAT and P11D and checklists for PAYE and NI; • ~~removal of~~ assurance review work programme ~~which has moved to *Navigate Audit*~~ as a checklist. Detailed content changes have been made to the individual work programmes as follows: • completion section: addition of references to Accountant's Report, management representation

		letters, filleted accounts, subsequent events, going concern~~ and links to Croner-i *Disclose*~~; • planning section: ~~links created to~~ flowcharts for audit exemption and small company status, addition of planning analytical review and materiality considerations; • amortisation review added to intangible assets work programme; • depreciation review added to tangible fixed assets work programme; • accounting for forex transactions added to investments in group and associated undertakings work programme; ~~• links to disclosure requirements of financial instruments added to classification of financial instruments work programme~~; • assessment of stock provisioning added to stock and work in progress work programme; • VAT considerations moved from creditors and accruals work programme to a new VAT work programme; • deferred income procedures added into creditors and accruals work programme; • review of loan agreements and short/long term classifications added to long-term loans work programme; • corporation tax computation checklist updated for latest tax guidance; • VAT checklist updated for Brexit impact and Making Tax Digital; and • new PAYE and NI checklist added.
~~November 2021~~	~~Accounts Preparation~~	~~Changed name to *Accounts Preparation* (previously *Small and Micro Accounts Preparation*) and product moved into *Navigate UK GAAP Accounting*.~~ ~~Content changes include:~~ ~~• Links to the authors contributing to Accounts Preparation are now referenced in the Accounts Preparation homepage~~
November2021	Guidance	This section incorporates information from sections previously known as “Using the Small and Micro

		Accounts preparation System” and “Guidance on Small and Micro Accounts Preparation System”. The following scope changes have been made: • guidance for the preparation of management accounts has been added from Practice Management; and • guidance for iXBRL tagging services has been added from Practice Management. ~~Content changes include:~~ ~~• updated for links to *Navigate Accounting* and *Navigate Audit* as well as links to interactive decision trees; and~~ ~~• links to engagement letters, work plans and accountant’s reports added.~~
~~November 2021~~	~~Tools~~	~~This section has been renamed from “Programmes” to “Tools”~~ ~~Scope changes include:~~ ~~• a user guide is now available from the Tools section;~~ ~~• a video is provided to demonstrate how to navigate through Accounts Preparation on the platform and use the new Tool; and~~ ~~• work programmes for management accounts and iXBRL tagging services have been added from Practice Management.~~ ~~Content changes include:~~ ~~• a link to the new accounts preparation tool;~~ ~~• updates to the accounts preparation PDFs; and~~ ~~• moving disclosure checklists and model accounts from section 4 Model Accounts and Disclosure Checklists.~~
November 2021	Example letters ~~and reports~~	This section has been renamed “Example letters ~~and reports~~” from “Letters and Reports” ~~Content changes include links now going to all the relevant letters and reports within *Navigate Audit* and *Navigate Accounting.*~~
November 2021	Reference material	This is a newly named section. Content changes:

		• The what’s changed tables have been moved to within Reference material and have been split into what’s changed and what’s changed archive.
November 2021	Assurance review engagements	The section, previously entitled “Assurance review engagements (ICAEW Members)”~~, has moved to *Navigate Audit*~~

9. Non Audit – Assurance Reviews

This area ~~of *Navigate Audit*~~ is relevant to those entities requiring a level of assurance on their financial statements but not requiring a statutory audit under ISAs (UK).

The area contains ~~tools,~~ guidance ~~and template letters~~ for non-audit assurance engagements under International Standard on Review Engagements (ISRE) 2400 (Revised) Engagements to review historical financial statements and refers to TECH 09/13 AAF (Revised) Assurance review engagements on historical financial statements.

For entities requiring an audit under ISAs (UK), audit methodology is available here ~~in Navigate Audit.~~

~~An Accounts preparation tool is available here in Navigate UK GAAP Accounting~~.

9.1 Guidance and methodology

This area ~~of *Navigate Audit*~~ contains guidance specific to assurance reviews. It supplements other guidance available in the main Audit Guidance and Methodology.

Types of assurance engagement

Contents:

- Audit exemption
- What is an assurance engagement?
- Assurance on financial statements

Audit exemption

Higher statutory audit exemption limits introduced in 2016 have led to an increasing number of companies being entitled to take advantage of audit exemption. The thresholds for audit exemption are set out in the Accounts Preparation area of ~~*Navigate UK GAAP Accounting*~~. Whilst many such companies still choose, or are required for other reasons, to have their financial statements audited, this has created an expanding market for services that add credibility to financial statements, without being a full audit.

What is an assurance engagement?

The International Auditing and Assurance Standards Board (IAASB) developed the Amended International Framework for Assurance Engagements. This identifies five elements of an assurance engagement:

- a three-party relationship;
- an agreed and appropriate subject matter;
- suitable criteria;
- sufficient and appropriate evidence; and
- a conclusion or opinion, expressed in a written report.

Assurance on non-financial information

Assurance may be requested over non-financial information reported by entities, such as:

- statements and information contained in the annual report, including the enhanced business review, corporate governance statements and information on risk management policies, internal controls or wider operating data;
- corporate responsibility reporting on environmental, economic and social performance;
- reports to regulators on matters such as risk exposures, pricing policies or compliance with regulatory requirements; and
- reporting on public interest concerns, for example, quality of service provision, carbon emissions or the conduct of public competitions.

Engagements to provide assurance on non-financial information should follow guidance in ISAE (UK) 3000 (Revised) *Assurance engagements other than audits or reviews of historical financial information.*

Assurance on special purpose financial statements

For entities not required to prepare general purpose financial statements, accountants may also be asked to provide assurance on financial statements, or elements of financial statements prepared for a specific purpose or on non-financial information. ISAs (UK) 800 and 805 were issued in October 2016, based on the IAASB's ISAs 800 and 805 (Revised) and set out standards and guidance for use in such situations.

Engagements to report on special purpose financial statements are covered by ISA (UK) 800 (Revised), *Special considerations – audits of financial statements prepared in accordance with special purpose frameworks* and ISA (UK) 805 (Revised), *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*.

Assurance on unaudited financial statements

Since the thresholds increased in 2016, many UK companies and LLPs became eligible for the small company audit exemption and continue to take advantage of it. If required, various levels of assurance can be given by accountants on a company's financial statements, including:

- voluntary audit under ISAs (UK);
- assurance review;

- agreed-upon procedures; and
- compilation engagements.

Certain sectors have additional requirements. For example, the charity sector provides for an independent examination on certain charities which are below the audit threshold for charities. These engagements are covered in the Charity area~~ of *Navigate Audit*~~.

Depending on the circumstances, companies may identify there is no need for additional assurance. The company may be confident that their financial statements are put together accurately, and disclosure requirements are met and they not need to provide anybody else, inside or outside the business, with greater confidence in the financial statements.

Assurance on financial statements

The options available to directors of companies, the type of conclusion given, relevant guidance and potential reasons to have the work done are summarised below.

Type of engagement	**Type of conclusion**	**Guidance**	**Reasons to choose the format**
Voluntary audit under ISAs (UK)	Reasonable assurance. A positive opinion, e.g. 'true and fair'.	Audit in accordance with ISAs (UK) See *Audit guidance and methodology*	An independent, regulated and expert review of the financial statements and underlying data systems, performed by a registered auditor. Provides users and stakeholders (e.g. lenders, investors, co-owners and potential purchaser) with the highest level of confidence in the financial statements.
Assurance review	Limited assurance. Negative opinion, e.g. 'nothing has come to our attention'.	Review in accordance with ISRE 2400 (Revised)/ TECH 09/13 (Revised) AAF See *Review engagements*	An independent, professional review of the accounts, where the need does not justify spending resources on a full audit. Provides users and stakeholders (e.g. lenders, investors, co-owners and potential purchaser) with some confidence in the financial statements.
Agreed-upon procedures	Factual report of results of procedures, no conclusion given. The user draws their own conclusions, but	Engagement in accordance with ISRS 4400	Focuses on only some areas of the financial statements, where the need does not justify spending resources on a full audit or assurance review. Demonstrates that

	with increased confidence because they will be based on facts checked by the accountant.		the financial statements are an accurate reflection of the data in the entity's systems and that the financial statements meet all the relevant disclosure requirements.
Compilation engagements	Confirm facts of compilation only, no conclusion given. The accountant is engaged to prepare the financial statements from the company's accounting records but without carrying out any verification of those records.	Guidance from professional bodies including ICAEW TECH 07/16 AAF and TECH 08/16 AAF See *Accounts preparation*.	Directors are confident in the quality and integrity of the information in the underlying accounting systems and require an accountant to prepare financial statements from them. Demonstrates that the financial statements are an accurate reflection of the data in the entity's systems and that the financial statements meet all the relevant disclosure requirements.

Review engagements

Contents:

- Quick overview
- Standards and technical guidance
- Features of a review engagement
- Ethical and quality requirements
- Acceptance and continuance of the engagement
- Reliance by third parties
- Performing the engagement
- Evaluating evidence and forming conclusions
- Written representations
- Reporting
- Documentation

Quick overview

This area ~~of *Navigate Audit*~~ contains guidance on the performance of assurance review engagements.

~~This mind map provides a visual summary of this area, with links to further resources and guidance (click on the button to open in a new tab and download or print):~~

~~Mind map~~

Standards and technical guidance

Guidance on the performance of review engagements is given in TECH 09/13 AAF (Revised) *Assurance review engagements on historical financial statements* which was last updated in March 2019, with minor editorial amendments made in January 2020. The guidance is based on the IAASB's International Standard on Review Engagements (ISRE) 2400 (Revised) *Engagements to review historical financial statements*, issued in September 2012. The 2019 version of TECH 09/13 AAF (Revised) added appendix 7 containing guidance on the application of the technical release to the micro-entities regime.

In an assurance engagement, the accountant expresses a conclusion on the financial statements. In those review engagements covered by TECH 09/13 AAF (Revised), the accountant gives a negative form of conclusion on the unaudited financial statements. This is known as a limited assurance engagement, as opposed to a reasonable assurance engagement where positive assurance is given, usually in terms of a true and fair view.

ISRE 2400 (Revised) applies when a practitioner who is not the auditor of an entity undertakes an engagement to review financial statements. The principles contained therein may also be applied to reviews of other historical information. ISRE 2400 (Revised) helps practitioners performing review engagements to follow a globally accepted benchmark for undertaking such engagements and aims to promote clarity for users about the nature of a review.

An assurance review engagement is a flexible and proportionate service which can be adapted to suit different clients. Typically, to perform an assurance review engagement, the accountant will:

- review all material items in the financial statements;

- consider and make enquiries of management about factors which might lead to increased risk that the financial statements may contain material misstatements or be non-compliant such as:

    - the nature of the client's business and its organisational structures;
    - the incidence of fraud;
    - non-compliance with laws and regulations;
    - undisclosed related party transactions;
    - going concern problems;
    - post balance sheet events;
    - accounting estimates;

- suitability of accounting policies; and
- significant, unusual, or complex transactions or events.

TECH 09/13 AAF (Revised) issued by the ICAEW aims to provide guidance to assist with compliance with ISRE 2400 (Revised) and includes example letters and reports to support these engagements.

TECH 09/13 AAF (Revised) points out that review engagements, like audit engagements, may help the accountant to report weaknesses and other issues that come to their attention to the directors. As such, these engagements can generate more value for the directors than just the assurance report itself. A substantial degree of understanding of the client's circumstances is necessary but further substantive testing is not required unless the chartered accountant has reason to be concerned about a particular aspect of the business.

Features of a review engagement

An engagement performed under ISRE 2400 (Revised) should:

- enhance users' degree of confidence in the entity's financial statements, by reporting on them in a manner commensurate with the limited assurance obtained by the practitioner;
- be able to be performed on a cost-effective basis; and
- be clearly distinguishable from an audit of financial statements.

ISRE 2400 sets out guidance in the following areas:

- conduct of a review engagement in accordance with the ISRE;
- ethical requirements;
- professional scepticism and judgement;
- engagement level quality control;
- acceptance and continuance of review engagements;
- communication with management and those charged with governance;
- performing the engagement;
- subsequent events;
- written representations;
- evaluating evidence;
- forming a conclusion on the financial statements;
- reporting; and
- documentation.

Ethical and quality requirements

ISRE 2400:21 requires the accountant to comply with relevant ethical requirements, which in the UK means the ICAEW Code of Ethics.

In particular the independence requirements need to be applied. These are in Section 400 of the Code – *Applying the conceptual framework to independence for audit and review engagements*. As an alternative, however, the accountant can, if more convenient, apply the independence requirements of the FRC's Ethical Standard (ES), and therefore make use of the Provisions Available for Audits of Small Entities (PAASE), as applicable.

Scepticism

As with an audit, the accountant is required to plan and perform the engagement with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated as well as exercising professional judgement.

Quality management

The engagement level quality management requirements of the ISRE assume that the firm complies with the IAASB standard *International Standard on Quality Management (ISQM) 1 Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements.*

In the UK the applicable standard is ISQM (UK) 1, which should be read in the context of the FRC's Scope and Authority of Audit and Assurance Pronouncements. The ICAEW also emphasises that ICAEW's Practice Assurance Standard 4 on quality control applies to review engagements. ~~Further guidance and tools relating to quality management are available in the Audit Quality and Compliance area of *Navigate Audit*.~~

Acceptance and continuance of the engagement

Prior to commencing a review engagement, the accountant needs to consider the following requirements.

(1) ISRE 2400:30(a) requires that, prior to accepting a review engagement, the accountant must determine whether the financial reporting framework applied in the preparation of the financial statements is acceptable. AAF 09/13 (Revised) indicates that the following frameworks will be acceptable:

- FRS 101 *Reduced Disclosure Framework*;
- FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (this includes reduced disclosures for the individual accounts of qualifying entities and for entities qualifying as small entities); and
- FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime.*
- AAF 09/13 (Revised) also includes guidance in Appendix 7 on how this can be applied under the micro-entities regime.

(2) ISRE 2400:30(b) requires the accountant to obtain acknowledgement that management understands its responsibilities. AAF 09/13 (Revised) indicates that for a UK company, some of these responsibilities overlap with the directors' statutory duties and it may be helpful to make reference to these responsibilities in the engagement letter. The guidance also covers the responsibilities and requirements when taking audit exemption.

(3) AAF 09/13 (Revised) points out that it is possible to apply the principles of ISRE 2400 to financial statements for entities which do not have to comply with a recognised GAAP but which do follow accepted accounting principles (e.g. trust accounts) and the guidance explains the procedures required in this situation.

(4) AAF 09/13 (Revised) explains that the accountant needs to understand the use of the financial statements and the proposed review report and that, in order to manage their risk, they need to be aware that third parties may seek to rely on the financial statements. The guidance comments on seeking to limit the liability to third parties by means of a contract or a disclaimer. However, whether the accountant seeks to limit liability by means of a contract or a disclaimer, they can manage their risk by good practice throughout the engagement, including:

- ensuring all members of the engagement team are familiar with the requirements of ISRE 2400 (Revised) and AAF 09/13 (Revised);
- ensuring the required procedures are executed, documented and reviewed regularly;
- setting out the scope of the engagement and the various responsibilities of management and the reviewing firm in the engagement letter; and
- wording the assurance review report correctly.

Engagement letters

The letter of engagement forms the basis of the contract between the firm and the client. In the event of any dispute or uncertainty, this will play a vital part in reaching any agreement. It is essential that the letter is both complete and up to date.

The terms of the engagement should be agreed in writing. Example engagement letter ~~wording~~ is available *in the templates* ~~by following the links included here~~. The assurance report may be received by people not party to the engagement and the accountant should assess the risks of litigation arising from third parties prior to accepting the engagement. The engagement letter should be suitably worded to ensure that no liability is assumed to any third party.

As part of their risk management process, accountants should consider whether there are third parties who may seek to rely on their report. Depending on circumstances~~, and similar to the general guidance for managing professional liability set out in Navigate Practice Management,~~ accountants may:

• accept that they owe a duty of care to the third parties and enter into a tri-partite or multi-partite engagement contract with the client and the third parties. Provisions to limit liability may be appropriate;

• proceed with an engagement with the client alone, but allowing access to the report for third parties as long as they:

- acknowledge in writing that the reporting accountant owes them no duty of care; and
- agree in writing that no claims will be brought against the reporting accountant in relation to the assurance report;

• engage with the client alone, disclaiming any liability or duty to others by notice in the assurance report. This may be in conjunction with the client indemnifying the reporting accountant if a third party makes a claim against the reporting accountant; or

• decline to accept the engagement.

Reliance by third parties

During the performance of the engagement, or after the report has been issued, the accountant may become aware of third parties, such as banks or lenders, who may request sight of the report. In such cases, the accountant may decline the request, or access may be agreed if the third party acknowledges in writing that they owe the accountant no duty of care.

When the accountant becomes aware that a third party has obtained a copy of their report, they should consider writing to the third party informing them that they did not undertake the work for the use of third parties and that they do not accept any responsibility to them and that all liability is denied.

It is likely that most assurance review reports will relate to general purpose financial statements, including statutory financial statements for audit exempt companies. These may become widely available; for example, they may be filed at Companies House although there is no obligation on the company to do so. This will make it impossible to restrict who has access to them, and it may therefore not be possible for the accountant to limit liability purely by means of a contract. An assurance review report appended to general financial statements may, however, include a paragraph disclaiming liability to third parties.

~~The illustrative report in Example letters and reports includes a paragraph to this effect, which is equivalent to the ‘Bannerman’ paragraph used in audit reports and relies on the same legal precedent.~~

Performing the engagement

Further guidance on performing the engagement is given in ISRE 2400 and in AAF 09/13 (Revised) covering:

• materiality;

• obtaining an understanding of the entity;

- designing and performing procedures;

- specific procedures in relation to related parties, fraud and non-compliance with laws; and regulations, going concern, use of work performed by others, subsequent events and written representations.

The review always involves discussions with management and thorough analytical review procedures to identify any relevant areas of concern. If areas of concern are identified, the accountant will design additional substantive procedures to investigate further and obtain appropriate evidence to form their conclusion.

ISRE 2400:52 covers fraud and non-compliance with laws and regulations. In particular, the accountant should be aware that they are still subject to the *Money Laundering and Terrorist Financing (Amendment) Regulations* 2019 (SI 2019/1511) and the requirements of the *Proceeds of Crime Act* 2002. ~~The Anti-money laundering area of *Navigate Practice Management* has further details on these regulations.~~

ISRE 2400:53–54 considers the work required on going concern. Although the depth of work carried out on going concern will be less than that for an audit, the accountant will still need to consider the disclosures in this area in accordance with the applicable accounting framework and the FRC guidance for directors.

ISRE 2400:87 requires an emphasis of matter paragraph when the accountant considers a matter to be of such importance that it is fundamental to users' understanding of the financial statements. This includes situations where there is material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Example wording for this situation is given in Appendix 5 to TECH 09/13 (Revised).

Evaluating evidence and forming conclusions

ISRE 2400:66 requires the accountant to evaluate whether sufficient appropriate evidence has been obtained from the procedures performed and, if not, to perform further procedures considered necessary. If not able to obtain sufficient appropriate evidence the accountant should discuss with management the effects such limitations have on the scope of the review.

Evidence obtained should then be evaluated to determine the effect on the review report.

ISRE 2400:69 requires the accountant to consider the following in forming their conclusion on the financial statements:

- whether the financial statements adequately refer to or describe the applicable financial reporting framework;

- whether the financial statements adequately disclose significant accounting policies;

- whether the accounting policies selected and applied are appropriate;

- whether accounting estimates made by management appear reasonable;

• whether the information presented appears relevant, reliable, comparable, understandable and gives adequate disclosure to enable intended users to understand the effects of material transactions and events.

ISRE 2400:70 requires the accountant to consider the impact on the financial statements of uncorrected misstatements identified and of possible bias in management's judgements.

ISRE 2400:73 requires that an accountant should express an unmodified conclusion in their report on the financial statements as a whole when they have obtained limited assurance to be able to conclude that nothing has come to their attention that causes them to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework.

Guidance on modified conclusions is available in ISRE 2400:75–85.

Written representations

The ISRE requires the accountant to ask management to provide a written representation that:

- management has fulfilled its responsibility for the preparation of financial statements in accordance with the applicable financial reporting framework and has provided the accountant with all relevant information and access to information as agreed in the terms of the engagement; and
- all transactions have been recorded and are reflected in the financial statements.

The written representation should also include confirmation that management has disclosed the following to the accountant:

- the identity of the entity's related parties and all the related party relationships and transactions of which management is aware;
- significant facts relating to any frauds or suspected frauds known to management that may have affected the entity;
- known actual or possible non-compliance with laws and regulations for which the effects of non-compliance affect the entity's financial statements;
- all information relevant to use of the going concern assumption in the financial statements;
- that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure, have been adjusted or disclosed;
- material commitments, contractual obligations or contingencies that have affected or may affect the entity's financial statements, including disclosures; and
- material non-monetary transactions or transactions for no consideration undertaken by the entity in the financial reporting period under consideration.

If management does not provide one or more of the requested written representations, then the accountant will need to discuss the matter with management and those charged with governance; re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and evidence in general; and take appropriate actions, including determining the possible effect on the conclusion in the accountant's report.

If there is sufficient doubt about the integrity of management such that the written representations are not reliable, or the required representations are not provided by management, then the accountant will need to consider disclaiming an opinion or withdrawing from the engagement.

Date of representations

The date of the written representations should be as near as practicable to, but not after, the date of the accountant's report. The written representations should be for all financial statements and period(s) referred to in the report.

Example representation

Example wording for the representation is given in TECH 09/13 (Revised) and reproduced in a template~~ in Example letters and reports~~. The user should, however, consider whether any updates or tailoring are required to make the templates appropriate to their client circumstances.

Reporting

The accountant's report helps addressees derive comfort from the involvement of an independent accountant. It also assists in clarifying the scope of the engagement and ensuring that readers are aware that a full audit has not taken place.

Crucially, the report has a negatively worded conclusion. That is to say that the report effectively says that having completed certain specific procedures the professional accountant has not seen anything that suggests that the financial statements do not show a true and fair view.

~~An example report to directors is available in Example letters and reports.~~

Further detailed guidance on the contents of the accountant's report is in ISRE 2400:86–92 and in TECH 09/13 (Revised). ~~An example report is available in Example letters and reports.~~

Documentation

As with any other engagement, the accountant needs to ensure adequate documentation is made in a timely manner to ensure that an experienced practitioner, having no previous connection with the engagement, could understand:

(a) the nature, timing, and extent of the procedures performed to comply with the ISRE and applicable legal and regulatory requirements;

(b) results obtained from the procedures, and the accountant’s conclusions formed on the basis of those results; and

(c) significant matters arising during the engagement, the accountant’s conclusions reached thereon, and significant professional judgements made in reaching those conclusions.

The accountant should ensure that they record who performed the work and the date the work was completed; as well as who reviewed the work performed and the date and extent of the review.

Discussions with management, those charged with governance and others as relevant to the performance of the review of significant matters arising during the engagement, should be documented, including the nature of those matters. Where any information is identified that is inconsistent with the accountant’s findings regarding significant matters affecting the financial statements, then they should ensure they document how the inconsistency was addressed.

~~A checklist to assist the accountant is applying the requirements of the ISRE is available in the Tools section of *Navigate Audit*.~~

9.2 What's changed

This table lists, in chronological order with the most recent at the top, the changes made to the Assurance area.

Date	***~~Link to~~ latest document***	***What has changed***
September 2023	Guidance and methodology	The Review engagements section has been updated for references to ISQM (UK) 1.
August 2023	Assurance review checklist	The Assurance review checklist has been updated to include updated references for ISQM (UK) 1~~ and updated links to the Croner-i platform following some internal development work to enable updates to the platform to be processed more efficiently and quickly~~.
November 2021	Assurance reviews Accounts preparation tool	A new section ~~of *Navigate Audit*~~ has been created for Assurance reviews, based on content previously in 'Small and Micro Accounts Preparation – Assurance review engagements (ICAEW Members)'. The Accounts preparation ~~tool and~~ guidance is available *in ~~Navigate UK GAAP Accounting –~~ Accounts Preparation*.
November 2021	Guidance and methodology ~~Tools~~ Example letters~~ and reports~~ ~~Reference material~~	The section previously called 'Assurance review engagements (ICAEW Members)' has been split into: • Guidance and methodology ~~• Tools~~ ~~• Example letters and reports~~ ~~• Reference material~~ *What's changed*
November 2021	Guidance and methodology	This section has been updated to include additional guidance previously included in *Implementing GAAS* as well as additional guidance from ISRE 2400 relating to review engagements.
~~November 2021~~	~~Tools~~	~~A new checklist has been developed for accountants performing review engagements. The new checklist covers the main elements of ISRE 2400, along with links to relevant guidance.~~ ~~This was previously covered in the Assurance Review tab included in the Accounts Preparation tool.~~

~~November 2021~~	~~Example letters and reports~~	~~The example engagement letter has been removed and a link instead provided to the *Engagement Tetter Toolkit*.~~ ~~Other reports and letters have been reviewed and updated as necessary, including updating for references to UK adopted *International Accounting Standards*.~~
~~November 2021~~	~~Accounts preparation tool~~	~~Changes made to the Accounts preparation tool are detailed in the What's changed page in *Navigate UK GAAP Accounting*.~~