CCH Audit Automation

Mercia

Company & Group v.19
Pension v.11
LLP v.11
Charity v.17
Audit exempt v.18
Academy v.11

Guidance

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1 Introduction

These guidance notes will help you to use MERCIA's audit manual in conjunction with CCH Audit Automation.

The MERCIA manual is written to be used as a paper based system, customised using the Word based documents provided. A number of minor conceptual changes have therefore been made during implementation on CCH Audit Automation (AA) to make full use of the facilities provided bythis paperless on screen system. These guidance notes set out the changes in concepts and also acts as a guide to where the various paper based documents have been replicated in AA.

2 Navigating your way around AA

When you open a MERCIA based client in AA, you will see a navigation area on the left of the screenpopulated with a **Main index**. This provides access to the main areas of the permanent and current audit file in a logical order, representing the process that you will normally follow when planning the audit. There are a few preliminary steps that you will need to take before all of the documentsin the navigation area are available to you, e.g. initializing the checklists. The navigation area is made up of 3 folders:

- Planning (with sub folders for Appointment, Risk assessment and audit approach, Other planning areas.)
- Field work
- Review and completion

3 New client considerations

One of the options available in **Planning** is the **Appointment** folder, within that folder is the **Initialise pack** folder and within that folder there are **Tailoring questions**. This is also available from the Reference menu tab. One of the questions in the**Tailoring questions** is, **Is this a new audit client?** If the answer to this question is YES, the system will automatically include the **New client checklist** in the **Appointment folder** (also linked in the permanent file section of the current year audit file) and activate a number of other questions in other checklists as appropriate.

4 Tailoring Questions - General

As well as the new client question, there are several other questions which will affect different parts of the audit file:

- **Is a Quality review required?** – If answered Yes the system will automatically activate the B03 Quality review Checklist further down the appointment section.

- **Do you plan to undertake any tests of operating effectiveness (i.e. detailed tests) of controls?** – If answered YES the system will activate the B section control tests across all audit programme sections.

- **Is it appropriate to include the accounts preparations procedures (c) in the audit workprogrammes?** – If answered YES the systems will activate the C section non audit services tests across all audit programme sections.

- **Is a disclosure checklist required?** – A YES answer will activate the disclosure checklist options.

- **Does the company have an internal audit function?** – A YES answer will activate the PF2-4 using the work of and communication with internal auditors checklists.

- **Does the company have long term work in progress?** – A YES answer will activate appropriate questions in the disclosure checklist.

- **Has the company any Hire Purchase or Lease Agreements (including sale and lease back agreements)?** – Again a YES answer will activate appropriate disclosure checklist questions.

- **Do you want to generate the optional cashflow statement programme?** – A YES answer will activate the Review of the cash flow statement programme.

NOTE – The above questions may need to be revisited as the audit progresses. Other questions may be available depending on the master pack used, with similar results.

5 Tailoring Questions – Key accounting estimates

- **Are there any key accounting estimates?** – answering this question will activate the Key accounting estimates checklist within the Planning section as appropriate.

6 Tailoring Questions – Planning checklist options

The following questions will activate the appropriate supplementary checklists from the planning section:

- **Do you wish to assess the impact of COVID-19 on the risk assessment and planned audit approach?** – a YES answer will activate the COVID-19 risk analysis checklist.
- **Do you wish to assess the impact of Brexit on the risk assessment and planned audit approach?** – a YES answer will activate the Brexit risk analysis checklist.
- **Do you wish to assess the impact of a change in financial reporting framework (FRF) on the risk assessment and planned audit approach?** – a YES answer will activate the Change of financial reporting framework risk analysis checklist.

7 Appointment

The Appointment folder also contains:

- Acceptance of appointment or reappointment checklist (B11)
- Compliance with the Ethical Standard checklist (B12 (activated by the answers in B11)
- Opening balances and consistency of accounting policies checklist (B14)

All of the checklists in AA take the form of perennial checklists. This means that, once the system has been in use for more than a year, the system will display the answers to the previous 2 years for you to see when completing the checklist for the current year. In addition, you can see any comments that were made in respect of each question in the previous year and copy the commentto the current year where appropriate.

8 Background information

Background information is mainly held in the permanent file in the paper based version. AA has a number of functions which allow you to automate the process of recording information in respectof the following:

- **General background information.** This allows you to record such matters as Industryconsiderations, Regulatory environment, etc.
- **Key business processes.** AA provides the ability for you to either record details of theprocesses in summary or detail, or link in documents in which you already have the processes recorded.
- **Key control database.** This provides the facility for you to record the key controls that you have identified, your comments on their effectiveness and implementation, and to record any procedures that you have designed to test them.
- **Identified audit risk database.** Here you record any specific business risk that you haveidentified and the audit procedures that you have designed to cover them. Any risk canbe marked as a permanent risk so that it is carried forward from year to year.
- **Key accounting estimates.** Here you record any specific key accounting estimates that you have identified and the audit procedures that you have designed to cover them. Any estimate can be marked as permanent so that it is carried forward from year to year. Alternatively, the Q section can be user for recording key accounting estimates. A tailoring question is available to determine this

These facilities are used in conjunction with the standard checklists and other documentation which have been varied as required to refer to the AA routines.

The main changes are as follows:

PF1-1 The entity and its environment	This document is not present in the automated version. The information that you would have normally recorded here will be recorded in **Background Information**, accessible from the **Understanding the entity and its environment** folder in the **Main index**. Once the information has been recorded, the list of areas where data is present can be seen via the Planning | Reference data menu. From here you can also add other non-standard areas if required.

PF2-1 Systems notes	This document is not required as the information is recorded in the **Key controls database** and the **Key Business Processes** area.

9 Permanent file

The permanent file is divided into 2 areas in AA, there is a section in the current audit file **PF: Permanent file information** and the standard AA permanent file facility. The information recordedin each is as follows:

9.1 Current audit file

Two perennial checklists are included:

- PF.2-3 Internal control overview
- PF.2-4 Using the work of and communication with internal auditors

9.2 AA Permanent file

This is a standard facility contained in AA, the content of which is driven by the master pack. In thisyou will therefore see standard folders representing the following sections corresponding to the sections in the paper version:

- General business information
- Systems documentation
- Permanent risk documentation
- Accounts information
- Permanent audit planning documentation
- Statutory and legal information

These folders act as a filing system for electronic documents (Word, Excel, Scanned document) which would normally be stored in the paper permanent file. In addition, the general planning andpoints forward memo is also accessible as a link from Permanent audit planning documentation.

Links are also provided, via buttons on the left, to background information and key business processes.

9.3 Other permanent file documents

You are free to create additional folders in the permanent file and add any documentation that is appropriate. These can either be documents you create yourself, using a template or from scratch,imported or scanned documents.

10 Planning

The wordings of a number of checklists have been slightly modified to refer to AA routines and changes in operation as necessary to fit in with an automated system. Checklists have been implemented as perennial checklists which mean that once the system has been in use for over a year, you will see the answers provided for the previous audit.

The following documents are also provided as templates and can be created as required in the planning section:

- BFREE Planning Freeform memorandum approach
- B25 Materiality
- B32 Key accounting estimate
- B40-N2_ADA Audit plan – Trial balance (use of ADA)
- TRENDS Summary of Financial Ratios and Trends

The New client checklist (B13) will only appear if the question in **Tailoring questions**, **Appointment**:

Is this a new audit client?

is answered YES. As this checklist is included in the current audit file it is answered each year, where appropriate. If you wish to retain a permanent copy of the New client checklist, you can display the checklist via print preview and save it as a PDF file, then import it into the permanent file at PF3.

10.1 Materiality

The system automatically calculates materiality based on the contents of the trial balance.The system calculates 4 base figures as guidance, as follows:

- Turnover – based on 1% turnover
- Result before tax – based on 5% of the result
- Net assets/liabilities – based on 5% of the net assets
- Gross assets – based on 5% of the gross assets

In the MERCIA methodology, the planner determines the level of materiality and the above figuresare only calculated as guidelines. Hence, the system does not offer a figure for materiality and theplanner is required to enter the figure to use.

Performance materiality is calculated as 50% of materiality and is shown in the preliminary analytical review and risk dialogs.

The Clearly Trivial level is calculated at 5% of turnover and is shown on the materiality screen.

10.2 Review during completion

An option is provided on the completion menu to review materiality. This will recalculate the levelof the bases and the suggested materiality using the results after audit journals have beenprocessed. It is then up to the auditor if they need to revise the level of materiality and reconsiderthe work carried out.

10.3 Preliminary analytical review

A number of tools are provided in AA to assist you with this work:

- **Lead schedules**. The lead schedules in the planning section provide summary information in respect of main financial statement areas and key ratios. These areautomatically calculated from the contents of the trial balance.

- **Preliminary analytical review**. This routine displays total information and movement foreach audit area, and allows you to record your comments on you findings. There is alsoan area to allow the reviewer to record completion review comments at the end of the audit.
- **Trend analysis**. The system can record up to 9 years comparative data for each nominalaccount and calculate the trend on each. From this it can project the anticipated figurefor the current year and report on exceptional variances.
- **Equation editor**. Here you can enter any equations that form good AR indicators. Thesystem will calculate the results for the 10 years data stored and these can be shown graphically.

Although we have provided the Summary of Financial Ratios and Trends as a template, the internaltools will probably make this working paper redundant.

10.4 Budgets

Internal AA routines are provided to allow you to record details of the staff allocated to the auditand budgets.

10.5 Customisation

The system is interactive in that the answer to some checklist questions can automatically vary which other questions are shown and the contents of the audit file. Some checklist questions in the planning section are control questions which will vary the contents of the packs. For example, if in the planning checklist you answer the question on quality control indicating that a review is not required, checklist B03 will automatically be removed from the file.

11 Risk analysis and sample sizes

11.1 Assess risk at the assertion level

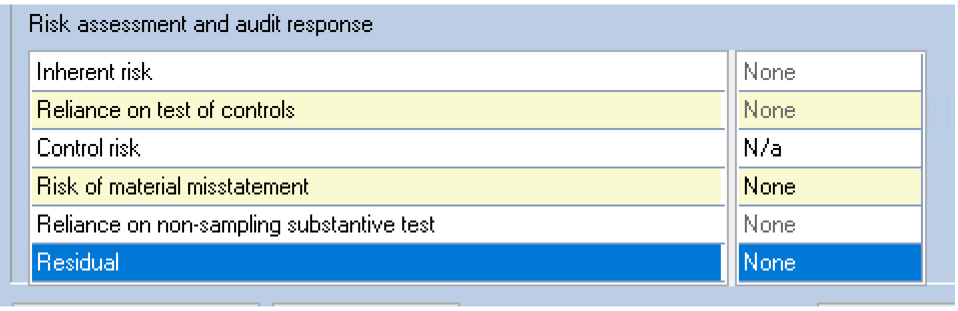
The identified risk screen has been updated to allow the assessment of risk at the assertion level. The financial impact, likelihood of misstatement and risk assessment and response options will now record these selections for each assertion instead of at the risk level.

11.2 Changing master pack from previous version

Due to the following changes in the identified risks and risk model, any risks that are balanced forward will be updated to work with the new updates. The risk description, financial statement areas and assertions will be carried forward. The risk profile, risk assessment and audit response will be cleared and ready to be assessed using the updated screens.

11.3 Risk assessment and audit response

The risk assessment and response area will now appear as the default risk assessment approach for identified risks when the ISA 315 option is selected at the master pack. For firms that have not used this system option as default before should not change this at the system level as this will result in unwanted changes to finalised audits on previous master packs.

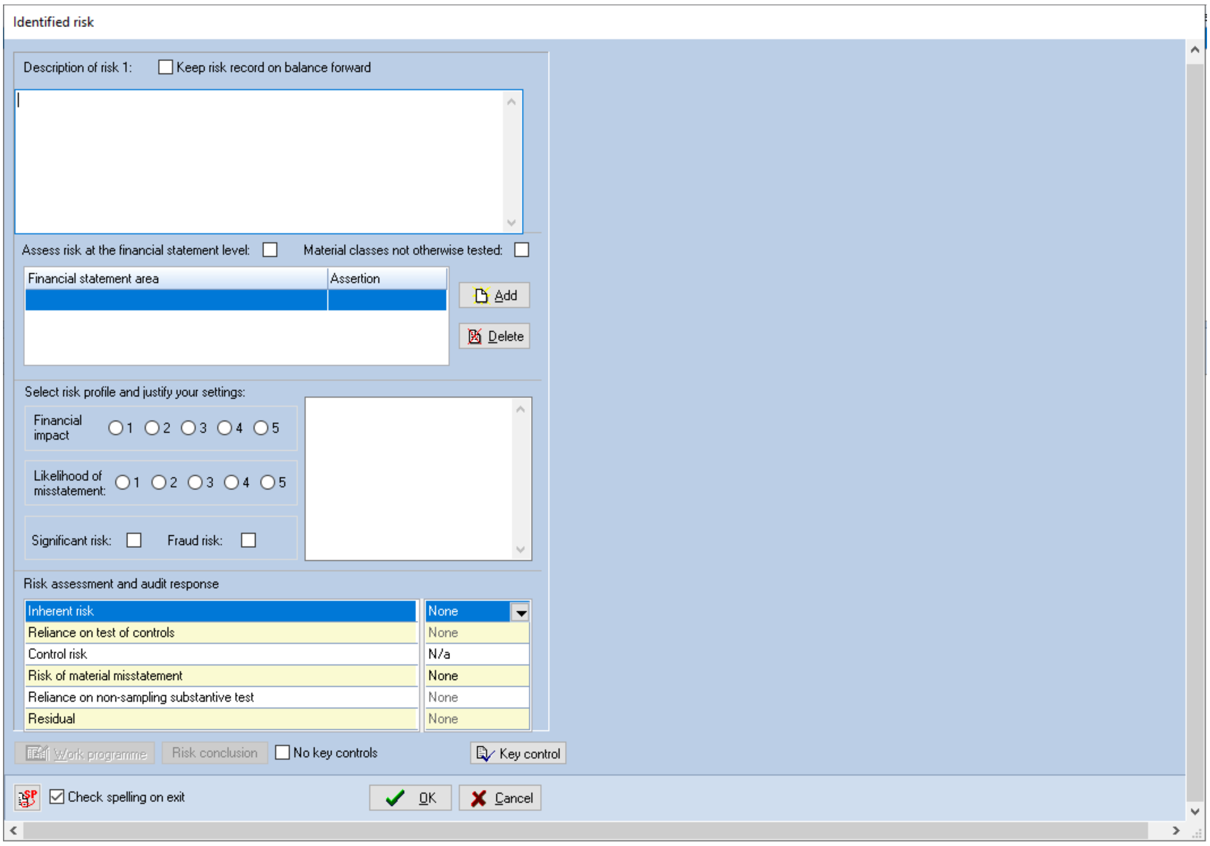


The new control risk and risk of material misstatement options added at the master pack level will flow through to audit assessment and response area. Control risk is not allowed to be assessed unless the user is placing reliance on the controls and therefore will only become active for selection if the reliance on tests of controls is changed from none. Risk of material misstatement will update to the same selection of inherent risk and will only become active for selection for the user to update if the control risk is assessed.

There is no change to the other options and residual risk will be calculated in the same way albeit the underlying risk calculations have been updated.

11.4 Assertion level risks

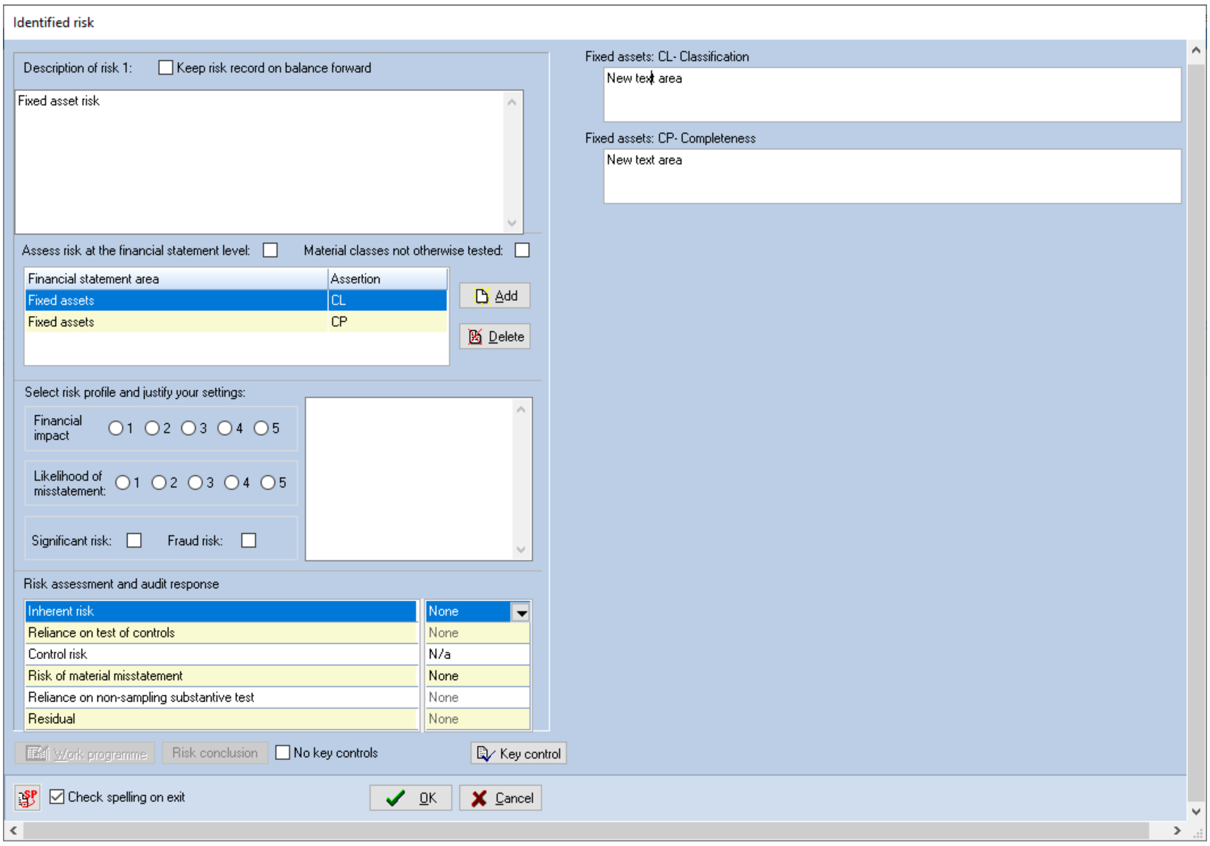
The identified risk screen has been updated and when open the software will assume the risk is to be assessed at the assertion level and the following updated screen will be shown:



The identified risk screen has been updated as follows:

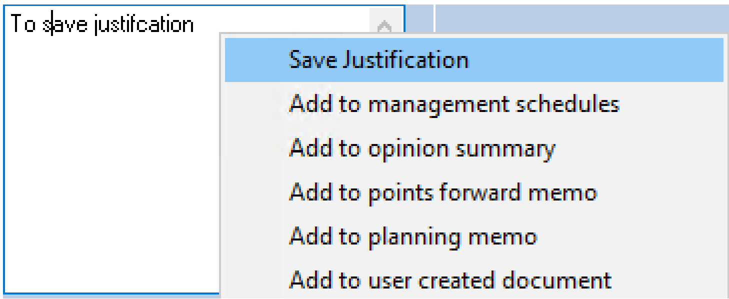
The profile and justification area for the risk screen has been updated to allow the assessment of financial impact and likelihood of misstatement using the new 1-5 spectrum. A fraud risk option has been added and the risk and audit response area will now become the default choice for identified risks. The identified risk screen will now allow for the assessment at the assertion level with the profile and risk assessment areas now recording the selection for each assertion. An option to assess the risk at the financial statement level has been added along with the option to assess material classes.

When selecting the assertions a new text dialog will appear on the right side of the screen allowing the user to record information for the assessment of the assertion:



If multiple assertions are linked to the risk when the justification and risk assessment has been made for the first assertion the next assertion can be selected, this will clear the results entered for the first assertion and the next assertion can be assessed.

Note: The identified risk screen will not save the justification entered for each assertion when closing the risk or switching between assertions. The trigger to save the justification narrative is when the user assesses the inherent risk for the assertion. If the justification is updated following the inherent risk assessment the justification must be manually saved. This can be achieved by right clicking on the justification box and selecting save justification.



11.5 Financial statement level risks

A new option has been added to allow assessment of the risk at the financial statement level. Upon selecting this option, the financial impact and likelihood options will be disabled. The risk assessment and audit response area will have the control risk and risk of material misstatement deactivated as the assertions can no longer be assessed individually.

The risk model has been changed to make it more appropriate to an automated environment. Theconstituent elements of the risk calculation remain as before, with slightly different names and areas follows:

Inherent risk	This is where you enter yourassessment of the assertion. If there is no inherent risk then there is no requirement to carry out any sampling as there is no audit risk. The risk level can be: ▪ 5 ▪ 4 ▪ 3 ▪ 2 ▪ 1 ▪ None If you select a risk level, the system will initially calculate the residual risk to be of the same level and if you derive no reliance for other sources you will need to

carry out sampling procedures to cover the risk.

Reliance on test of control	Where you are testing controls, enter here the level of reliance you feel it is appropriate to take on the work you plan to carry out, on the assumption that no errors are found. Where you enter a level of reliance, this will reduce the residual risk to be covered by sampling. The reliance can be: ■ Maximum ■ Medium ■ None
Reliance on non-sampling	Here you are entering the reliance that you can take on non-sampling substantive tests, such as detailed analytical review. Where you enter a level of reliance, this will reduce the residual risk to be covered by sampling. The reliance can be: ■ Maximum ■ Medium ■ Low ■ None
Control Risk	Here you are entering the control assessment for the assertion. Where you enter a level of reliance, this will allow for the assessment of the risk of material misstatement. The assessment can be: ■ High ■ Medium

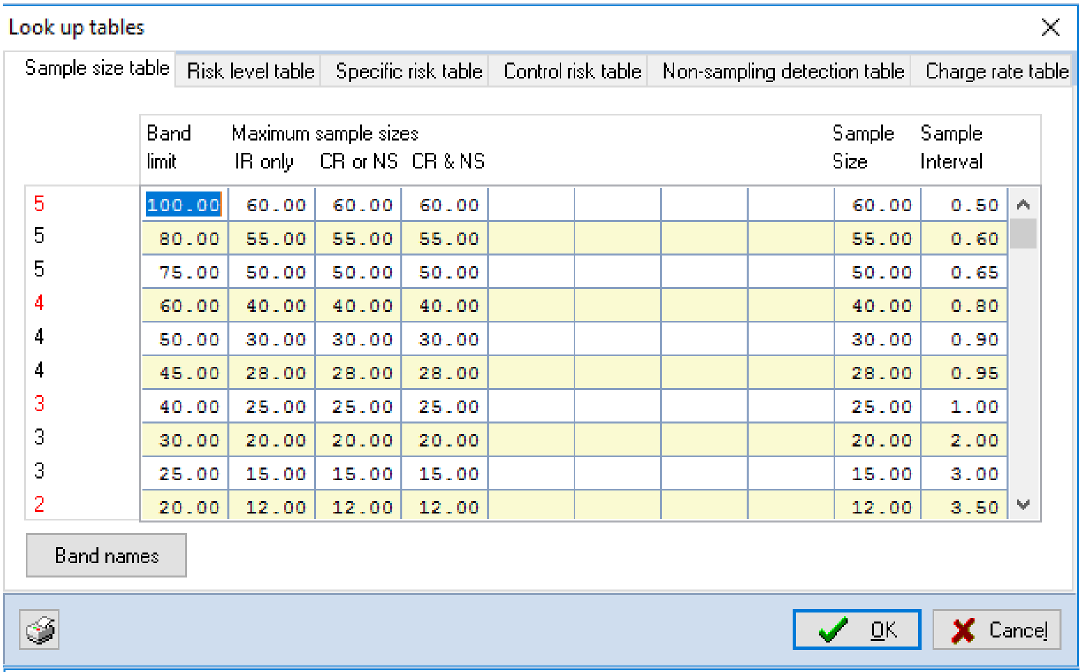
- Low
- N/A

Risk of material misstatement	If the control risk has been assessed, you will be able to change the risk of material misstatement assessment. If not this will default to same as the inherent risk assessment. The assessment can be: - 5 - 4 - 3 - 2 - 1 - None

By default, on the very first access, the system will set all of the risk and reliance levels to None.

You may change any of the setting to reflect the actual position and as you do the residual risk sample size will be updated. For any “cell” where you vary from the default you will need to designthe procedures to confirm that the setting is appropriate, e.g. Medium control reliance or Maximum non sampling. This is indicated by the cell turning red. To design the procedures to justifythe setting, double click on the cell. For controls and Non sampling, a blank program will appear and you can pick the tests from the standard program or the pool, edit these or enter your own. For the residual risk, the system will automatically include any tests from the standard program that relate to the assertion, and you can pick additional tests and modify those shown, or add further tests are required. See the reference manual for more information.

The residual sample size and risk factor is calculated by reference to the levels risk and reliance that you enter, using the following table:



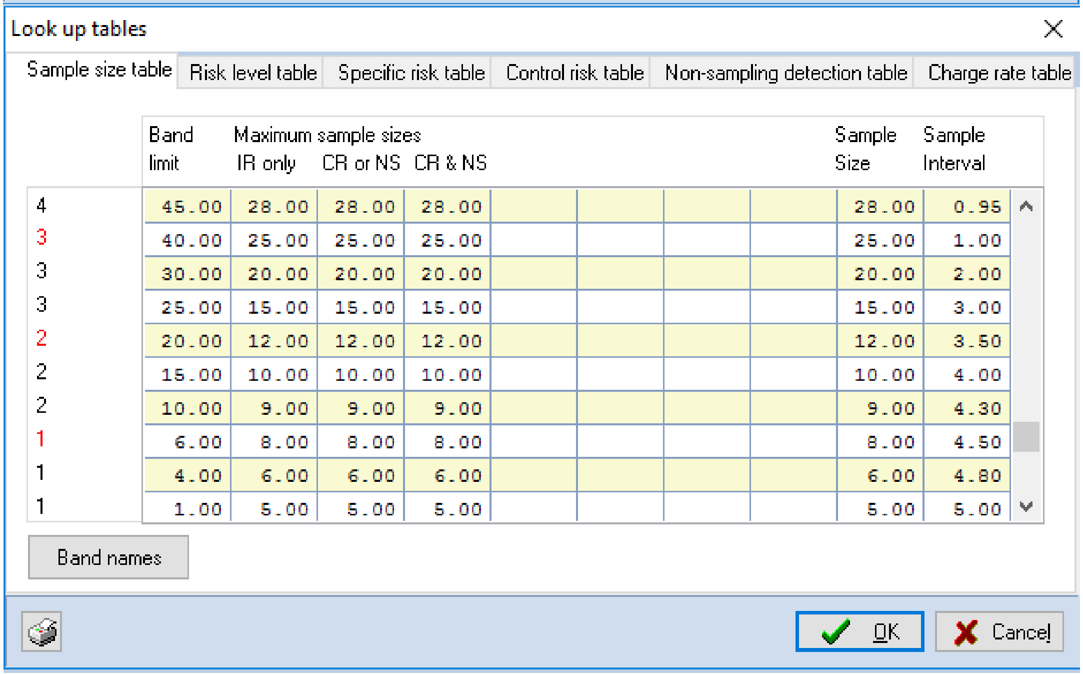
Look up tables

Sample size table | Risk level table | Specific risk table | Control risk table | Non-sampling detection table | Charge rate table

	Band limit	Maximum sample sizes IR only	CR or NS	CR & NS					Sample Size	Sample Interval
5	100.00	60.00	60.00	60.00					60.00	0.50
5	80.00	55.00	55.00	55.00					55.00	0.60
5	75.00	50.00	50.00	50.00					50.00	0.65
4	60.00	40.00	40.00	40.00					40.00	0.80
4	50.00	30.00	30.00	30.00					30.00	0.90
4	45.00	28.00	28.00	28.00					28.00	0.95
3	40.00	25.00	25.00	25.00					25.00	1.00
3	30.00	20.00	20.00	20.00					20.00	2.00
3	25.00	15.00	15.00	15.00					15.00	3.00
2	20.00	12.00	12.00	12.00					12.00	3.50

Band names

OK Cancel



Look up tables

Sample size table | Risk level table | Specific risk table | Control risk table | Non-sampling detection table | Charge rate table

	Band limit	Maximum sample sizes IR only	CR or NS	CR & NS					Sample Size	Sample Interval
4	45.00	28.00	28.00	28.00					28.00	0.95
3	40.00	25.00	25.00	25.00					25.00	1.00
3	30.00	20.00	20.00	20.00					20.00	2.00
3	25.00	15.00	15.00	15.00					15.00	3.00
2	20.00	12.00	12.00	12.00					12.00	3.50
2	15.00	10.00	10.00	10.00					10.00	4.00
2	10.00	9.00	9.00	9.00					9.00	4.30
1	6.00	8.00	8.00	8.00					8.00	4.50
1	4.00	6.00	6.00	6.00					6.00	4.80
1	1.00	5.00	5.00	5.00					5.00	5.00

Band names

OK Cancel

As you can see, the maximum sample size is 60 and this has a sample interval of 0.5.

Where a test requires an absolute sample size, it will be the size corresponding to the level of risk.Where the sample relates to value, the interval is used to calculate a value by reference to the residual population after excluding key items to be tested. The calculation used is as follows:

Residual population Materiality * Sample interval

However, the maximum sample size is restricted to sample size associated with the risk level.

Example calculations are as follows:

Residual population: £100,000

Materiality: £10,000

Residual risk: 5 – 0.5 Sample interval: 0.9

Value sample size: £100,000 / (0.5 * £10,000) = 20

Residual population: £250,000

Materiality: £10,000

Residual risk: 3 - 30Sample interval: 0.9

Value sample size: £250,000 / (0.9 * £10,000) = 27

Residual population: £100,000

Materiality: £10,000

Residual risk: 3 - 30

Sample interval: 0.9

Value sample size: £250,000 / (0.9 * £10,000) = 111 (restricted to30)

The residual population is after deducting any items that will be tested as key items as they areabove the level of the performance materiality / tolerable misstatement.

To access the sample size calculator, click on the calculator button to the right of the sample sizein the **Test completion** dialog. For more information please refer to the reference manual.

12 Audit programmes

In AA there are two types of audit programme, standard mandatory tests and the pool of tests. Thestandard tests are always included, where appropriate, in a client's audit file. These contain the following sections from the paper based system:

- A. General
- B. Systems

- C. Accounts preparation

The inclusion of sections B and C are determined by questions in **Tailoring questions**, Controloptions:

Section B

Do you plan to undertake any tests of operating effectiveness (ie. detailed tests) of controls?

Section C

Is it appropriate to include the accounts preparation procedures (c) in the audit work programmes?

If these are answered YES, the procedures will be included. The pool of tests is made up of 3 sections for each audit area:

- Control tests
- Substantive non sampling
- Substantive sampling

The analytical procedures from the main programmes in the paper version have been included in the **Substantive non sampling** section for each area and section E. Tests of details have been included in the **Substantive sampling** section. These are optional tests which can be selected whenreliance is taken on analytical procedures and if further testing is required to cover the residual riskto be covered by sampling.

The pool also contains a bank of possible tests of control. These can be selected where there are either key controls being tested or reliance is being placed on controls.

In all cases, the standard programmes or procedures related to reliance and risk can be customisedfor the client and the user can add their own tests where appropriate.

13 Lead schedules

Lead schedules are predefined in the master pack and will appear in each section where relevant. The lead schedules are automatically updated to show any audit journals that are agreed with theclient.

You may place annotations on lead schedules and create hyperlinks to other working papers in theaudit file.

14 Completion

14.1 Working paper indexes

The standard items listed in the manual's index have been included in AA. As with the paper version, this is a list of possible working papers, some of which will be present and some not. If youcreate a working paper with the same reference as an item in the standard index, the system will automatically link it to the index and show the associated icon by the entry. Any item in the index which does not have an associated user created working paper will be shown with no icon. If you wish, these items can be removed from the index after field work has been completed.

14.2 Schedule of unadjusted errors

The standard schedule A27 is only included as a template in AA as this is replaced by the internal journal facility. When journals are initially entered, they are entered as **Potential journals not reflected in the financial statements**. These are summarized on the automatic schedule of unadjusted errors shown when you display or print the journals. If you wish to have a permanent record of these stored in, say the permanent file, you can display the report, save it as a PDF file and then import it where required.

14.3 Other schedules

The majority of the working papers in section A are implemented as perennial checklists.

The following documents and letters have been implemented as templates so that you can createthe working paper as required based thereon.

A25-1	Audit summary memorandum (see also below)
A27	Summary of misstatements
A29T	Reporting on irregularities, including fraud in the auditor's report
REP	Letter of representation
DEBT	Debtors circularisation

DEBTCIRC	Debtors circularisation results Summary
CRED	Creditors circularisation
CREDCIRC	Creditors circularisation results Summary
TRENDS	Summary of Financial Ratios and Trends
BANK	Bank Letter
DISENG	Letter of disengagement
ENG	Letter of engagement
ENQUI	Professional enquiry letter
RESIG	Letter of resignation
BREACH	Breach of the Ethical Standard letter
EXTREP	External expert letter of representation
MAN	Report to management letter
PLAN	Planning communication letter
PRERES	Predecessor auditor response letter
SUCCREQ	Successor auditor requesting wp access

14.4 Audit summary memorandum

AA contains a feature called **Opinion summary**. This is the area where the various matters that affect the opinion are recorded and hence replaces schedule A25. The opinion summary is a wordprocessing document and will appear in the format of A25 in the paper based system.

15 Accounts Disclosure Checklists

The accounts disclosure checklist is fully interactive with the Accounts Disclosure Summary checklist forming a control over the contents of the checklists to be completed. As you will see, thesummary has been extensively extended to provide the following:

- The ability for you to enter the size of the company, or if you are not sure answer a seriesof question that will allow the system to determine the size.

- Enter details of the group status of the company.
- As you answer questions, the system will include or exclude subsequent questions in thechecklist as determined by the answers you have made so far. Hence you will only be asked to answer questions that are relevant to the company in question.
- After entering the questions determining the size and group criteria, the system willactivate the questions that will allow you to indicate the checklists required.
- A list of questions are also included detailing areas that appear to be inactive for the client as there are no related balances in the TB, e.g. Intangible fixed assets. This is to allow you to activate any area where it is relevant to the client but the information is notin the TB.
- Following this are a number of control questions regarding disclosure matters, such as “Has the company purchased any of its own shares, provided finance for the purchase of its own shares, acquired a charge or lien over its own shares or disposed of own sharesheld?”. Answering these will further customize the checklists so that you are only asked questions that are relevant to the client.

After answering all of the questions in the summary, closing it will result in the system reviewing the other checklists to activate and inactivate checklists and questions as appropriate. From this point you will therefore only see the checklists that are relevant and they will only contain questions appropriate to the client.

For Pensions, a disclosure checklist dealing with the 2018 SORP and pensions Regulations is included in this master pack.

16 Mercia manuals

Wilmington Professional

17 Company and group manual

17.1 Contents

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17.2 Guidance notes

1 Introduction

1.1 Scope

This manual provides you with all the programmes, documents and guidance needed to undertake the audit of a UK limited company subject to the Companies Act 2006 under the International Standards on Auditing (ISAs) (UK) and the FRC Ethical Standard.

The manual is suitable for audits of groups as well as standalone entities.

1.1.1 Specialist Assignment Manuals (SAMs)

Where an entity is a company of a specialist nature, or is not a company, a Specialist Assignment Manual (SAM) specifically designed for that type of entity should be used, or in some cases it may be appropriate to tailor this manual to meet the specialist requirements of the entity concerned.

Mercia provides a wide range of SAMs including:

- Academies;
- Charities;
- Clubs (GB);
- Clubs (NI);
- Limited Liability Partnerships (LLPs);
- Pension Schemes;
- Registered Social Housing Providers RSHPs; and
- Societies and Community Interest Companies (CICs)*.

** This is a supplementary manual designed to be used in conjunction with the Audit Manual (UK).*

1.1.2 Exclusions

Whilst it may provide a useful starting point, this manual is not intended to be used for the audit of Public Interest Entities (PIEs).

Additional requirements over and above those addressed in these guidance notes may also apply to quoted companies.

1.1.3 Quality management

Forms relevant to ensuring quality at the engagement level are included within this manual, with firm wide quality management aspects addressed in the Quality Management Manual (UK) which is available to purchase separately.

1.2 What's included in this manual?

This manual includes:

- Guidance notes - which provide detailed guidance on the sector;

And through separate downloads

- Example letters - including engagement letters;
- Example reports - including example auditor's reports;
- Example accounts - including accounts prepared under FRS 102 Section 1A, full FRS 102 and IFRS;
- Accounts disclosure checklists - including for accounts prepared under FRS 102 Section 1A, full FRS 102, FRS 101 and IFRS;
- Current file documents;
- Permanent file documents; and
- Supplementary forms - including a file review checklist and an audit programme for the cash flow statement.

1.3 What else is needed?

You should have access to the Audit Procedures Manual (UK), included as part of the Audit Manual Package (UK), which contains supporting audit methodology and guidance.

You will also need access to the applicable versions of the following:

- The Companies Act 2006;
- SI 2008/409 The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008; and
- SI 2008/410 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

2 Sector overview

2.1 Legal and Regulatory Framework

2.1.1 Companies Act 2006

UK companies are subject to the Companies Act 2006 (the Act). The Act is the primary source of UK company law and, supported by underlying regulations, addresses most aspects of how a company should be run, managed and financed.

In particular, the Act address the requirements for preparing and filing annual accounts and reports, as well as the need for an audit. These accounting and reporting requirements are addressed further in Section 3.

2.1.2 The Regulations

Commonly referred to as 'the Regulations' or the 'the Accounts Regulations', SI 2008/409 The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 and SI 2008/410 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 supplement the requirements of the Companies Act 2006. They include accounting requirements and requirements with regard to the content and format of accounts and reports for small and medium/large companies respectively and have been updated multiple times since they initially came into force.

Both are very similar with regard to the accounting requirements, but differ with regard to reporting and disclosure requirements as medium and large companies are generally required to disclose more than small companies.

Relevant requirements form the regulations are included within the disclosure checklists and example accounts. They are also discussed further in Section 3.

2.2 Governing documents

A company will also have its own governing documents. These include:

- A memorandum of association - a legal statement signed by all initial shareholders or guarantors agreeing to form the company; and
- Articles of association (articles) - written rules about running the company agreed by the shareholders or guarantors, directors and the company secretary (if there is one).

When a company formed, it may use a standard set of articles or draft its own.

Care should be taken to review the articles carefully as they may necessitate an audit (even where an exemption might otherwise be claimed), or could have other implications such as prohibiting certain transactions, or requiring certain processes or procedures to be followed.

2.3 Types of company

Under the Act, a company may be formed as a limited company or an unlimited company. The liability of a limited company's members is limited by its constitution and may be limited by shares or limited by guarantee. A company limited by guarantee will not have share capital. If the liability of members is not limited, the company is an unlimited company.

A company may be formed as (or may follow the process to change to/from) a private company (typically denoted ltd) or a public company (typically denoted plc). There are a number of sections of the Act which apply only to public companies, making their operation more onerous.

2.4 Company and group size

The size of a company or (if applicable) a group is important to determine as it affects accounting, reporting and audit requirements. A company may be:

- A micro-entity;
- Small;
- Medium-sized; or
- Large.

2.4.1 Micro

In a company's first financial year, it will quality as a micro-entity if the qualifying conditions (see below) are met in that year.

If it is not the first financial year of the company, a two-year rule applies. This means that in a subsequent financial year of the company, where on its balance sheet date it meets or ceases to meet the qualifying conditions, that affects its qualification as a micro-entity only if it occurs in two consecutive financial years. In other words, it takes two consecutive years to change size.

If the company is a parent company, it will only qualify as a micro-entity if the group it heads qualifies as a small group (see below).

2.4.1.1 Qualifying conditions

The qualifying conditions are met by a company in a year in which it satisfies two or more of the below requirements:

Criteria	Company
Turnover *Adjust proportionately if not a year.*	Not more than £632,000
Balance sheet total *The aggregate of the amounts shown as assets in the company's balance sheet.*	Not more than £316,000
Number of employees *This is not the full time equivalent.*	Not more than 10

2.4.1.2 Companies excluded from being treated as micro-entities

A company is excluded from being treated as a micro-entity if at any time within the year:

- It was a company excluded from the small companies regime (see below);
- It would have been an investment undertaking as defined in Article 2(14) of Directive 2013/34/ EU of 26 June 2013 on the annual financial statements etc. of certain types of undertakings were the United Kingdom a member State;
- It would have been a financial holding undertaking as defined in Article 2(15) of that Directive were the United Kingdom a member State;
- It was a credit institution within the meaning given by Article 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 Article 4(1)(2A) of that Regulation;
- It would have been an insurance undertaking as defined in Article 2(1) of Council Directive 91/674/EEC of 19 December 1991 on the annual accounts of insurance undertakings were the United Kingdom a member State; or
- It was a charity.

A company is also excluded if:

- It is a parent company which prepares group accounts for the year; or
- It is not a parent company but its accounts are included in group accounts for the year.

2.4.2 Small

In a company's first financial year, it will quality as small if the qualifying conditions (see below) are met in that year.

If it is not the first financial year of the company, a two-year rule applies. This means that in a subsequent financial year of the company, where on its balance sheet date it meets or ceases to meet the qualifying conditions, that affects its qualification as small only if it occurs in two consecutive financial years. In other words, it takes two consecutive years to change size.

If the company is a parent company, it will only qualify as small if the group it heads qualifies as a small group (see below).

2.4.2.1 Qualifying conditions

The qualifying conditions are met by a company in a year in which it satisfies two or more of the below requirements:

Criteria	Company	Group*
Turnover *Adjust proportionately if not a year.*	Not more than £10.2 million	Not more than £10.2 million net (or £12.2 million gross)
Balance sheet total *The aggregate of the amounts shown as assets in the company's balance sheet.*	Not more than £5.1 million	Not more than £5.1 million net (or £6.1 million gross)
Number of employees *This is not the full time equivalent.*	Not more than 50	Not more than 50

** Gross or net thresholds may be cherry picked.*

2.4.2.2 Companies excluded from the small companies regime

The small companies regime does not apply to a company that was at any time within the financial year to which the accounts relate:

- a public company;
- a company that:

- o is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company;
  - o carries on insurance market activity; or
  - o is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1);
- a member of an ineligible group.

A group is ineligible if any 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 Part 4A of the Financial Services and Markets Act 2000 (c. 8) 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;
- a person who carries on insurance market activity; or
- a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021] (interpretation of Part 1).

** A company is a small company for this purpose if it qualified as small in relation to its last financial year ending on or before the end of the financial year to which the accounts relate.*

2.4.3 Medium

In a company's first financial year, it will quality as medium-sized if the qualifying conditions (see below) are met in that year.

If it is not the first financial year of the company, a two-year rule applies. This means that in a subsequent financial year of the company, where on its balance sheet date it meets or ceases to meet the qualifying conditions, that affects its qualification as medium-sized only if it occurs in two consecutive financial years. In other words, it takes two consecutive years to change size.

If the company is a parent company, it will only qualify as medium-sized if the group it heads qualifies as a medium group (see below).

2.4.3.1 Qualifying conditions

The qualifying conditions are met by a company in a year in which it satisfies two or more of the below requirements:

Criteria	**Company**	**Group***
Turnover *Adjust proportionately if not a year.*	Not more than £36 million	Not more than £36 million net (or £43.2 million gross)
Balance sheet total *The aggregate of the amounts shown as assets in the company's balance sheet.*	Not more than £18 million	Not more than £18 million net (or £21.6 million gross)
Number of employees *This is not the full time equivalent.*	Not more than 250	Not more than 250

** Gross or net thresholds may be cherry picked.*

2.4.3.2 Companies excluded from being treated as medium-sized

A company may not be treated as medium-sized if it was at any time within the financial year in question:

- a public company;
- a company that:
  - o has permission under Part 4A of the Financial Services and Markets Act 2000 (c. 8) to carry on a regulated activity; or
  - o carries on insurance market activity; or
  - o is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1); or
- an e-money issuer; or
- a member of an ineligible group.

A group is ineligible if any 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 Part 4A of the Financial Services and Markets Act 2000 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;
- a person who carries on insurance market activity; or
- a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1).

** A company is a small company for this purpose if it qualified as small in relation to its last financial year ending on or before the end of the financial year to which the accounts relate.*

2.4.4 Large

A large company is any company that does not qualify as a micro-entity, for the small companies regime or as medium-sized.

3 Accounting and reporting

3.1 Preparation of accounts

The directors of every company must prepare accounts for the company for each of its financial years (unless the company is entitled to the dormant subsidiaries exemption*). The accounts must be true and fair and will be accruals based accounts.

The accounts must comply with the applicable accounting standard (see below) and the requirements of the regulations (see Section 2).

** The dormant subsidiaries exemption is set out in s394A of the Act and includes extensive requirements including the need for the parent to guarantee all outstanding liabilities of the subsidiary at the end of the financial year.*

3.1.1 Accounting standards

Under the Act, most companies have a choice of which accounting standard to apply as shown in the following table.

	FRS 105	**FRS 102 Section 1A**	**FRS 102**	**FRS 101 (for qualifying entities* only)**	**UK-adopted IFRS**
Micro	Yes	Yes	Yes	Yes	Yes
Small	No	Yes	Yes	Yes	Yes
Medium	No	No	Yes	Yes	Yes
Large	No	No	Yes	Yes	Yes

Most companies will tend to use the left most standard they are permitted to use in the above table as this will typically be the most straightforward to apply for the entity, however certain companies such as listed companies or those acting in certain sectors may however have that choice restricted. Additionally companies which are part of a group may be required to adhere to a particular standard for consistency with the group.

** A qualifying entity is a member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation. Charities and entities most insurance companies are excluded from being qualifying entities.*

3.1.2 Group accounts

If at the end of its financial year a company is a parent company, the directors must, as well as preparing individual accounts for the year, prepare group accounts, unless the company is exempt from that requirement.

Group accounts (also referred to as consolidated accounts or consolidated financial statements) are the financial statements of a parent and its subsidiaries presented as those of a single economic entity.

There are four possible exemptions:

- S399(2A) for small companies;
- S400 for companies included in UK accounts of a larger group;
- S401 for companies included in non-UK accounts of a larger group; or
- S402 for companies none of whose subsidiaries need to be included in the consolidation.

Each of these is set out in further detail in the following subsections. Note that entities operating in certain sectors may be required to prepare group accounts even if they would otherwise be exempt according to the above criteria.

3.1.2.1 S399(2A)

A company is exempt from the requirement to prepare group accounts if at the end of its financial year, the company is subject to the small companies regime, or would be subject to the small companies regime but for being a public company.

Requirements

There are no further requirements set out in the Act.

Exclusions

A company is excluded from this exemption if it is a member of a group which, at any time during the financial year, has an undertaking which is:

- established under the law of any part of the UK;
- has to prepare accounts in accordance with Part 15 of the Companies Act 2006; and
- either;
    - o is an undertaking whose transferable securities are admitted to trading on a UK regulated market;
    - o is a credit institution within the meaning given by Article 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 Article 4(1)(2A) of that Regulation; or
    - o would be an insurance undertaking within the meaning given by Article 2(1) of Council Directive 91/674/EEC of the European Parliament and of the Council on the annual accounts of insurance undertakings were the United Kingdom a member State.

3.1.2.2 S400

A company may be exempt from the requirement to prepare group accounts if it is included in UK group accounts of a larger group.

Requirements

The company must be a subsidiary and its immediate parent must be a parent undertaking established under the law of any part of the UK. In order to claim the exemption:

- the company must be a wholly-owned subsidiary of that parent undertaking; or
- the parent undertaking must hold 90% or more of the allotted shares in the company and the remaining shareholders must have approved the exemption; or
- the parent must hold more than 50% (but less than 90%) of the allotted shares in the company and notice requesting the preparation of group accounts has not been served on the company by shareholders holding in aggregate at least 5% of the allotted shares in the company.

Exemption is conditional upon compliance with the following conditions:

- the company must be included in consolidated accounts for a larger group drawn up to the same date, or to an earlier date in the same financial year, by a parent undertaking established under the law of any part of the United Kingdom;
- those accounts must be drawn up and audited, and that parent undertaking's annual report must be drawn up:
    - o if the undertaking is a company, in accordance with the requirements of this Part of the Act, or, if the undertaking is not a company, the legal requirements which apply to the drawing up of consolidated accounts for that undertaking; or
    - o in accordance with UK-adopted international accounting standards;
- the company must disclose in the notes to its individual accounts that it is exempt from the obligation to prepare and deliver group accounts;
- the company must state in its individual accounts the name of the parent undertaking that draws up the group accounts referred to above and:
    - o the address of the undertaking's registered office; or
    - o if it is unincorporated, the address of its principal place of business;
- the company must deliver to the registrar, within the period for filing its accounts and reports for the financial year in question, copies of:
    - o those group accounts; and
    - o the parent undertaking's annual report, together with the auditor's report on them;
- any requirement of Part 35 of the Act as to the delivery to the registrar of a certified translation into English must be met in relation to any document comprised in the accounts and reports delivered in accordance with the previous bullet point.

Exclusions

A company is excluded from this exemption if it is a traded company.

3.1.2.3 S401

A company may be exempt from the requirement to prepare group accounts if it is included in non-UK group accounts of a larger group.

Requirements

The company must be a subsidiary and its parent must not be established under the law of any part of the UK. In order to claim the exemption:

- the company must be a wholly-owned subsidiary of that parent undertaking; or
- the parent undertaking must hold 90% or more of the allotted shares in the company and the remaining shareholders must have approved the exemption; or
- the parent must hold more than 50% (but less than 90%) of the allotted shares in the company and notice requesting the preparation of group accounts has not been served on the company by the shareholders holding in aggregate at least 5% of the allotted shares in the company.

Exemption is conditional upon compliance with the following conditions:

- the company and all of its subsidiary undertakings must be included in consolidated accounts for a larger group drawn up to the same date, or to an earlier date in the same financial year, by a parent undertaking;
- those accounts and, where appropriate, the group's annual report, must be drawn up:
    - o in a manner equivalent to consolidated accounts and consolidated reports drawn up in accordance with the requirements of Part 15 of the Act;

  - in accordance with UK-adopted international accounting standards; or
  - in accordance with accounting standards which are equivalent* to such international accounting standards, as determined pursuant to Commission Regulation (EC) No. 1569/2007 of 21 December 2007 establishing a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities pursuant to Directives 2003/71/ EC and 2004/109/ EC of the European Parliament and of the Council;
- the group accounts must be audited by one or more persons authorised to audit accounts under the law under which the parent undertaking which draws them up is established;
- the company must disclose in its individual accounts that it is exempt from the obligation to prepare and deliver group accounts;
- the company must state in its individual accounts the name of the parent undertaking that draws up the group accounts referred to above and:
  - the address of the undertaking's registered office; or
  - if it is unincorporated, the address of its principal place of business;
- the company must deliver to the registrar, within the period for filing its accounts and reports for the financial year in question, copies of:
  - those group accounts; and
  - the parent undertaking's annual report, together with the auditor's report on them;
- any requirement of Part 35 of the Act as to the delivery to the registrar of a certified translation into English must be met in relation to any document comprised in the accounts and reports delivered in accordance with the previous bullet point.

Exclusions

A company is excluded from this exemption if it is a traded company.

** Guidance on equivalence is included in the application guidance to FRS 100.*

3.1.2.4 S402

A parent company is exempt from the requirement to prepare group accounts if under s405 of the Act all of its subsidiary undertakings could be excluded from consolidation.

A subsidiary may be excluded from consolidation under s405:

- if its inclusion is not material for the purpose of giving a true and fair view (but two or more undertakings may be excluded only if they are not material taken together);
- severe long-term restrictions substantially hinder the exercise of the rights of the parent company over the assets or management of that undertaking;
- extremely rare circumstances mean that the information necessary for the preparation of group accounts cannot be obtained without disproportionate expense or undue delay; or
- the interest of the parent company is held exclusively with a view to subsequent resale.

3.1.3 Statements of Recommended Practice (SORPs) and Directions

Statements of Recommended Practice (SORPs) are sector-driven recommendations on financial reporting for specialised industries, sectors or areas of work which supplement Financial Reporting Council (FRC) standards and other legal and regulatory requirements in light of special factors prevailing or transactions undertaken in that particular industry, sector or area of work that are not addressed in the FRC standards. SORPs also address matters that are addressed in FRC standards, but about which additional guidance is considered necessary.

There are a number of SORPs which companies may need to adhere to, depending on their sector. These include SORPs for:

- Charities;
- Further and higher education;
- Registered providers of social housing;
- Authorised funds; and
- Investment trust companies and venture capital trusts.

In addition to SORPs, companies operating in certain sectors are also required to adhere to accounting directions. These include:

- Academies needing to adhere to the Academy Accounts Direction;
- Further education and sixth-form colleges needing to adhere to the College accounts direction; and
- Private registered providers of social housing needing to adhere to the Accounting Direction for private registered providers of social housing.

These industry specific requirements are not directly addressed within this manual. Where one is available, it may be more appropriate to use a Specialist Assignment Manual (SAM) which addresses those industry specific requirements. For further information on SAMs, see Section 1.

3.2 Preparation of annual reports

Depending on the size and nature of the company, various reports are required in addition to the accounts. These typically include the directors' report and the strategic report, though listed entities will usually also require further reports. Depending on the sector in which the company operates, additional reports may also be required.

3.2.1 Directors' report

S415 of the Act requires all companies to prepare a directors' report for each financial year of the company with the exception of companies which qualify as micro-entities.

The directors' report will need to include:

- The names of the persons who, at any time during the financial year, were directors of the company;
- The amount (if any) that the directors recommend should be paid by way of a dividend*;
- A statement of the existence of any qualifying indemnity provisions;
- Information on political donations made or political expenditure incurred by the company or its subsidiaries if in excess of £2,000 in aggregate;
- A statement of directors' responsibilities (usually simply headed 'Directors' responsibilities) (unless included as a separate directors' responsibilities statement following the directors' report);
- Where the company is audited, a statement as to disclosure to auditors; and
- Approval by the board of directors and a signature on behalf of the board by a director or the secretary of the company.

** Companies entitled to prepare accounts for the year in accordance with the small companies regime, or would be so entitled but for being or having been a member of an ineligible group are exempt from this requirement.. If taking advantage of this exemption, the directors' report must contain a statement to the effect that advantage is taken of the small companies' exemption in preparing the directors' report in a prominent position above the signature.*

The directors' report of a medium or large company will also need to include:

- An indication of financial risk management objectives and policies, including the policy for hedging each major type of forecasted transaction for which hedge accounting is used (unless immaterial);
- An indication of exposure to price risk, credit risk, liquidity risk and cash flow risk (unless immaterial);
- Details of important events effecting the company (and any subsidiaries included in its consolidation, if applicable) since the end of the financial year;
- An indication of likely future developments in the business of the company (and any subsidiaries included in its consolidation);
- An indication of activities (if any) of the company (and any subsidiaries included in its consolidation) in the field of research and development;
- An indication of the existence of branches of the company outside the UK (not required for unlimited companies);
- Information on the acquisition of own shares (not required for medium-sized private companies);
- A statement describing the company's policy regarding the hiring, continuing employment and training, career development and promotion of disabled persons (where the weekly average number of employees exceeds 250);
- A statement on employee engagement (where the weekly average number of employees exceeds 250);
- A statement summarising how the directors have had regard to the need to foster the company's business relationships with suppliers, customers and others, and the effect of that regard, including on the principal decisions taken by the company during the financial year (large companies only); and
- Streamlined energy and carbon reporting (see subsection below).

Where a strategic report is also prepared, the company may elect to include information normally required to be included in the director's report within its strategic report instead. Where this is the case, such information must nevertheless be identified in the directors' report.

Example directors' reports are included within the Example Accounts contained within this manual.

The directors' report must be signed by a director or company secretary on behalf of the board.

3.2.1.1 Groups

Where the company is a parent company, and group accounts are prepared, the directors' report must be a consolidated report (a 'group directors' report) relating to the undertakings included in the consolidation.

A group directors' report may, where appropriate, give greater emphasis to the matters that are significant to the undertakings included in the consolidation, taken as a whole.

3.2.1.2 Streamlined energy and carbon reporting (SECR)

Requirements

Companies to which these requirements apply must disclose:

- Emissions (UK and offshore area only) from:
  - activities for which the entity is responsible involving the combustion of gas, or consumption of fuel for the purposes of transport; and
  - the purchase of electricity by the entity for its own use, including for the purpose of transport;
- Energy consumption in kWh (UK only) corresponding to the above;
- Comparatives (if not the first year);
- Methodologies used to calculate the emissions and energy consumption information disclosed;
- Principal measures taken to increase energy efficiency (if any measures have been taken); and
- At lease one ratio expressing emissions in relation to a quantifiable factor associated with the company's activities (e.g. emissions per £m of revenue).

Parent companies

If the directors' report is a group director's report (i.e. if group accounts are prepared), the above requirements apply as if references to entity were to the company and its subsidiary undertakings included in the consolidation that are companies or LLPs.

The report may however exclude information which relates to a subsidiary which that subsidiary would not be required to included in its own director's report.

Exemptions

A company is exempt from this requirement if:

- It is a small company;

- It is a subsidiary at the end of the financial year where it is included within a group report of a parent which is prepared for a financial year of the parent that ends at the same time as, or before the end of, the company's financial year **and** the report complies with the SECR requirements of the regulations (or the equivalent requirements for LLPs, where applicable);
- The company consumed 40,000 kWh of energy or less in the UK during the period in respect of which the directors' report is prepared **and** the report states that the information is not disclosed for that reason; or
- It meets the criteria below.

A company is exempt from these SECR requirements in relation to its first financial year if the qualifying conditions below are met. If it is not the first financial year of the company, a two-year rule applies. This means that in a subsequent financial year of the company, where on its balance sheet date it meets or ceases to meet the qualifying conditions, that affects the exemption only if it occurs in two consecutive financial years. The qualifying conditions are met by a company in a year in which it satisfies two or more of the following. A parent company must consider the size of the group it heads against the group thresholds.

Criteria	**Company**	**Group***
Turnover *Adjust proportionately if not a year.*	Not more than £36 million	Not more than £36 million net (or £43.2 million gross)
Balance sheet total *The aggregate of the amounts shown as assets in the company's balance sheet.*	Not more than £18 million	Not more than £18 million net (or £21.6 million gross)
Number of employees *This is not the full time equivalent.*	Not more than 250	Not more than 250

** Gross or net thresholds may be cherry picked.*

Whilst the thresholds currently mirror those for medium-sized companies, there is no consideration of ineligibility for the purpose of SECR. A company that is large because, despite meeting the qualifying criteria, it is excluded from being treated as medium-sized may nevertheless be able to claim exemption from SECR therefore.

3.2.2 Strategic report

S414A of the Act requires all companies, except those entitled to the small companies exemption* are required to prepare a strategic report for each financial year of the company.

All companies preparing a strategic report will need to include:

- A fair review of the business (which is a balanced and comprehensive analysis of the development and performance of the entity's business during the financial year, and the position of the entity's business at the end of that year, consistent with the size and complexity of the entity);
- A description of the principal risks and uncertainties facing the entity;
- Financial key performance indicators;
- A s172 statement (large companies only - see below); and
- Where appropriate, references to and explanations of amounts included in the annual accounts.

Additional requirements apply for various categories of companies - these requirements can be complex and directors should carefully consider which requirements apply to the company.

The FRC has produced extensive Guidance on the Strategic Report.

The strategic report must be signed by a director of company secretary on behalf of the board.

** The small companies exemption is available to a company for a financial year if it is entitled to prepare its accounts in accordance with the small companies regime, or it would be so entitled but for being or having been a member of an ineligible group.*

3.2.2.1 Section 172 statement

The requirement to prepare a s172 statement applies to all large companies - there is no exception for subsidiary companies, since the statement must be prepared at an individual company level.

The s172 duty (that is the duty of directors to promote the success of the company) is consistent with the principle of enlightened shareholder value; recognising that companies are run for the benefit of shareholders, but that the long-term success of a business is dependent on maintaining relationships with stakeholders and considering the external impact of the entity's activities. The s172 statement should therefore explain how the board has had regard to the broader matters in their actions, behaviours and decisions. It should focus on matters that are of strategic importance to the company with the level of information being consistent with the size and complexity of the business.

The s172 statement should address the matters outlined in s172 which include:

- the likely consequences of any decision in the long term (e.g. how the long term success of the company has been considered in making strategic decisions);
- the interests of the company's employees;

- 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.

3.2.2.2 Groups

Where the company is a parent company, and group accounts are prepared, the strategic report must be a consolidated report (a 'group strategic report) relating to the undertakings included in the consolidation.

A group strategic report may, where appropriate, give greater emphasis to the matters that are significant to the undertakings included in the consolidation, taken as a whole.

3.3 Circulating and filing accounts and reports

The directors of a company are responsible for circulating copies of accounts and reports and for filing them with the registrar (Companies House).

Note that additional requirements and different deadlines may apply to quoted companies and companies operating in certain sectors by virtue of sector specific requirements.

3.3.1 Circulating accounts and reports

Every company must send a copy of its annual accounts and reports for each financial year to:

- every member of the company;
- every holder of the company's debentures; and
- every person who is entitled to receive notice of general meetings.

A private company must circulate its accounts within nine months* of the end of the relevant accounting reference period, or, if earlier, the date on which it files its accounts with Companies House.

A public company must circulate its accounts at least 21 days before the date of the relevant accounts meeting.

** If the relevant accounting reference period has been shortened by virtue of altering its accounting reference date, the period is the later of the above of three months from the date of the notice given to the registrar to alter its accounting reference date.*

3.3.2 Filing accounts and reports

The directors of all companies (with the exception of unlimited companies and dormant companies which meet the requirements of each exemption respectively) must deliver to the registrar (i.e. file at Companies House) a copy of the accounts and reports each financial year.

A private company must do so within nine months* after the end of the relevant accounting reference period. A public company must do so within six months* of the relevant accounting reference period.

At present, small and micro-entities are able to 'fillet' their accounts before filing. Broadly, this means the directors may elect not to file either the directors' report or the profit and loss account. Where it chooses one or both of these options, the balance sheet must contain a statement that the accounts have been delivered in accordance with the provisions applicable companies subject to the small companies regime. Where the profit and loss account is not filed, the balance sheet filed must disclose that fact. If the entity was audited, and the profit and loss account is not filed, the auditor's report would also not be filed - instead a note would need to be included regarding the outcome of the audit. The government is currently consulting on changes to the Companies Act 2006 which would remove the option to file filleted accounts.

** If the relevant accounting reference period has been shortened by virtue of altering its accounting reference date, the period is the later of the above of three months from the date of the notice given to the registrar to alter its accounting reference date.*

4 External scrutiny

4.1 Audit

4.1.1 Requirement for an audit

Under the Act, a company must be audited in accordance with Part 16 of the Act unless:

- it is exempt from audit under:
    - s477 (small companies);
    - s479A (subsidiary companies); or
    - s480 (dormant companies); or
- it is exempt from the requirements of Part 16 of the act under s482 (non-profit making companies subject to public sector audit).

In all of the above cases, a company is not entitled to exemption unless its balance sheet contains a statement to that effect. Additionally where an exemption is claimed under s477, s479A or s480, the balance sheet must contain a statement by the directors to the effect that:

- the members have not required the company to obtain an audit of its accounts for the year in question in accordance with s476; and

- the directors acknowledge their responsibilities for complying with the requirements of the Act with respect to accounting records and the preparation of accounts.

Such a statement must appear on the balance sheet above the signature.

4.1.1.1 Exemption from audit: Small companies

A company that qualifies as a small company* in relation to a financial year is exempt from the requirements of the Act relating fo audit of accounts for that year.

** Whether a company qualifies as a small company shall be determined in accordance with section 382(1) to (6) of the Act.*

Exclusions

A company is not entitled to this audit exemption if it was at any time within the financial year in question:

- a public company;
- a company that;
    - is an authorised insurance company, a banking company, an e-money issuer, MiFID investment firm or a UCITS management company; or
    - carries on insurance market activity; or
    - is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1); or
- a special register body as defined in section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 (c. 52) or an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992 (S.I. 1992/807 (N.I. 5)).

A company is also not entitled to this audit exemption in respect of a financial year during any part of which it was a group company unless:

- the group qualifies as a small group* in relation to that financial year and was not at any time in that year an ineligible group*; or
- if, throughout the whole of the period or periods during the financial year when it was a group company, it was both a subsidiary undertaking and dormant.

** Whether a group qualifies as small shall be determined in accordance with s383 of the Act and ineligible group has the meaning given by s384(2) and (3).*

This audit exemption is also not available if members of the company representing not less than 10% in nominal value of the company's issued share capital or any class of it (or not less than 10% of the number of members of the company if the company does not have share capital) have given notice under s476 to require it to have an audit. Such notice may not be given before the financial year to which it relates and must be given not later than one month before the end of that year.

4.1.1.2 Exemption from audit: Subsidiary companies

A company is exempt from the requirements of the Act relating to the audit of individual accounts for a financial year if:

- it is itself a subsidiary undertaking; and
- its parent undertaking is established under the law of any part of the UK.

Requirements

The main requirements are that a parent guarantees the outstanding liabilities of the company and also prepares consolidated accounts which include that company.

Specifically, exemption is conditional on compliance with the following conditions:

- all members of the company must agree to the exemption in respect of the financial year in question;
- the parent undertaking must give a guarantee under section 479C in respect of that year;
- the company must be included in the consolidated accounts drawn up for that year or to an earlier date in that year by the parent undertaking in accordance with:
    - if the undertaking is a company, the requirements of Part 15 of the Act or, if the undertaking is not a company, the legal requirements which apply to the drawing up of consolidated accounts for that undertaking; or
    - UK-adopted international accounting standards (within the meaning given by section 474(1));
- the parent undertaking must disclose in the notes to the consolidated accounts that the company is exempt from the requirements of this Act relating to the audit of individual accounts by virtue of this section; and
- the directors of the company must deliver to the registrar on or before the date that they file the accounts for that year:
    - a written notice of the agreement referred to above;
    - the statement referred to in section 479C(1);
    - a copy of the consolidated accounts referred to in above;
    - a copy of the auditor's report on those accounts; and
    - a copy of the consolidated annual report drawn up by the parent undertaking.

Exclusions

A company is not entitled to this audit exemption if it was at any time within the financial year in question:

- a traded company;
- a company that:
    - is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company;
    - carries on insurance market activity; or
    - is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1), or

- a special register body as defined in section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 (c 52) or an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992 (S.I. 1992/807) (NI 5).

This audit exemption is also not available if members of the company representing not less than 10% in nominal value of the company's issued share capital or any class of it (or not less than 10% of the number of members of the company if the company does not have share capital) have given notice under s476 to require it to have an audit. Such notice may not be given before the financial year to which it relates and must be given not later than one month before the end of that year.

4.1.1.3 Exemption from audit: Dormant companies

A company is exempt from the requirements of the Act relating to the audit of individual accounts for a financial year if:

- it has been dormant* since its formation; or
- it has been dormant* since the end of the previous financial year and:
    - o it is entitled to prepare accounts in accordance with the small companies regime or would be so entitled but for having been a public company or member of an ineligible group; and
    - o it is not required to prepare group accounts for that year.

** A company is dormant during any period in which it has no significant accounting transactions. Significant accounting transactions are those that are required by s386 of the Act to be entered into the company's accounting records. In determining whether a company is dormant the following shall be disregarded:*

- *any transaction arising from the taking of shares in the company by a subscriber to the memorandum as a result of an undertaking of his in connection with the formation of the company;*
- *any transaction consisting of the payment of:*
    - o *a fee to the registrar on a change of the company's name;*
    - o *a fee to the registrar on the re-registration of the company;*
    - o *a penalty under section 453 (penalty for failure to file accounts); or*
    - o *a fee to the registrar for the registration of a confirmation statement.*

Exclusions

A company is not entitled to this audit exemption if it was at any time within the financial year in question:

- a traded company;
- an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company; or
- a company which carried out insurance market activity.

This audit exemption is also not available if members of the company representing not less than 10% in nominal value of the company's issued share capital or any class of it (or not less than 10% of the number of members of the company if the company does not have share capital) have given notice under s476 to require it to have an audit. Such notice may not be given before the financial year to which it relates and must be given not later than one month before the end of that year.

4.1.2 Appointment as auditor

4.1.2.1 Private companies

An auditor (or more than one, if appropriate) of a private company must be appointed for each financial year of the company, unless the directors reasonably resolve otherwise on the ground that audited accounts are unlikely to be required. Powers for appointment are broadly set out below (note that additional requirements apply with respect to public interest entities (PIEs)).

The period for appointing auditors

For each financial year where an auditor is to be appointed (other than the company's first financial year), the appointment must be made before the end of the period of 28 days beginning with the end of the time allowed for sending out copies of the company's annual accounts and reports for the previous financial year; or if earlier, the day on which copies of the company's annual accounts and reports for the previous financial year are sent out under s423 of the Act. This is the 'period for appointing auditors'.

Appointment by directors

The directors may appoint an auditor:

- at any time before the company's first period for appointing auditors;
- following a period during which the company (being exempt from audit) did not have any auditor, at any time before the company's next period for appointing auditors; or
- to fill a casual vacancy in the office of auditor.

Appointment by members

The members may appoint an auditor by ordinary resolution:

- during the period for appointing auditors;
- if the company should have appointed an auditor during a period for appointing auditors but failed to do so; or
- where the directors had power to appoint (see appointment by directors, above), but failed to make an appointment.

Appointment by the Secretary of State

If the company fails to appoint an auditor, the Secretary of State may appoint an auditor to fill the vacancy.

4.1.2.2 Public companies

An auditor (or more than one, if appropriate) of a public company must be appointed for each financial year of the company, unless the directors reasonably resolve otherwise on the ground that audited accounts are unlikely to be required. Powers for appointment are broadly set out below (note that additional requirements apply with respect to public interest entities (PIEs)).

The period for appointing auditors

For each financial year where an auditor is to be appointed (other than the company's first financial year), the appointment must be made before the end of the accounts meeting of the company at which the company's annual accounts and reports for the previous financial year are laid.

Appointment by directors

The directors may appoint an auditor:

- at any time before the company's first accounts meeting;
- following a period during which the company (being exempt from audit) did not have any auditor, at any time before the company's next accounts meeting; or
- to fill a casual vacancy in the office of auditor.

Appointment by members

The members may appoint an auditor by ordinary resolution:

- at an accounts meeting;
- if the company should have appointed an auditor at an accounts meeting but failed to do so; or
- where the directors had power to appoint (see appointment by directors, above), but failed to make an appointment.

Appointment by the Secretary of State

If the company fails to appoint an auditor, the Secretary of State may appoint an auditor to fill the vacancy.

4.1.2.3 Ethical considerations

Before accepting appointment or reappointment the auditor must consider whether they would be permitted to do so under the FRC Ethical Standard* and the firm's own policies and procedures (including those related to quality management).

** Guidance on the FRC Ethical Standard is included within Section D of the Audit Procedures Manual.*

4.1.2.4 Auditor liability limitation agreements

Sections 532 to 538 of the Companies Act 2006 permit auditors to negotiate with their clients to limit their liability on an engagement to an amount that is fair and reasonable in all the circumstances. This term of the engagement is not mandatory and as such reference within the engagement letter should only be made where applicable.

Guidance on the issues to be considered in this respect, including what is and is not allowed under the Companies Act 2006, the procedures and timetable to follow and specimen wording can be found in the FRC Guidance on Auditor Liability Limitation Agreements at www.frc.org.uk.

4.1.3 Conducting the audit

General procedures for conducting an audit of an entity are outlined in the Audit Procedures Manual.

This section outlines a number of considerations when conducting an audit which are specifically relevant for audits of companies.

4.1.3.1 Requesting information from a predecessor auditor

In addition to usual professional enquiry and handover procedures, for entities audited under the Companies Act 2006, the auditor may, once formally appointed as auditor of a client, request in writing access to all relevant information the predecessor auditor holds in respect of their audit work, including access to their audit working papers, and permanent or systems files. The right to request this and the procedures to follow in both seeking and providing information are set out in Audit Regulation 3.09.

Working papers in this context include papers prepared to:

- assist in the planning and performance of the audit;
- assist in the supervision and review of the audit work; and
- record the audit evidence resulting from the audit work performed to support the auditor's opinion.

Normally this information will be in respect of any audit report relating to the period falling between the beginning of the last financial statements on which our predecessor reported and the date of cessation of their audit appointment. The obligation to provide access to working papers does not extend to all papers held by the auditor, eg. tax working papers must be subject to a separate request for access. Further guidance on this area can be found in Technical Release 01/08 issued jointly by the Audit & Assurance Faculty of the ICAEW, ICAS and CAI.

4.1.3.2 Materiality

When considering an appropriate benchmark the following should be considered:

- the nature of the company;

- the industry in which it operates;
- whether users focus on particular items in the financial statements; and
- the relative volatility of the benchmark.

The appropriate benchmark should link to what users are most concerned about in the financial statements.

In a commercial owner-managed company, profit before tax is usually the starting point. However, gross assets may be more appropriate for a company with significantly higher values in the balance sheet compared with its income statement (e.g. an investment property company) .

4.1.3.3 Share capital and reserves, and distributions

As shareholders of a limited liability company have no liability for the losses of the company beyond the amount in which they have invested, there are strict rules on capital maintenance within the Act. These rules aim to protect creditors by preventing the directors from being able to pay dividends or return capital to members of the company other than in limited circumstances - the directors or members cannot simply help themselves to the company's assets as they have separate legal personalities.

Types of capital

Capital in a company includes:

- Share capital - the nominal value of a company's shares.
- Share premium - the premiums received on the allotment of shares.
- Capital redemption reserve - relates to amounts which are transferred following the redemption or purchase of a company's own shares out of distributable profits.

Types of reserve

There is considerable flexibility in the reserves of a company. Companies usually have:

- Profit and loss account / Profit and loss reserve / Retained earnings - care should be taken as not all of such a reserve may be distributable (see below);
- Revaluation reserve (if a revaluation model is applied); and
- Other reserves (analysed into more detail as appropriate).

Distributions

The most common form of distribution is a dividend, although it is possible for other distributions to arise. A distribution can only be made out of 'profits available for distribution'. It can be difficult to determine the level of a company's 'profits available for distribution' as not all amounts within a company's P&L reserve / retained earnings will be considered distributable. TECH 02/17 BL Guidance on Realised and Distributable Profits Under the Companies Act 2006 is the authoritative guidance on the matter and should be consulted.

It's perhaps worth noting that a revaluation reserve is not a distributable reserve.

Audit procedures

When auditing a company, it is therefore necessary to ensure that share capital is properly disclosed in accordance with the company's articles and applicable legislation. Minutes should be reviewed and examined for any changes in share capital which may result from alterations to:

- the classes of share capital;
- the rights associated with each class of share;
- authorised share capital;
- allotted share capital; and/or
- issued share capital.

Movements in share capital may arise as a result of:

- issue of new shares (including a rights issue or bonus issue);
- additional calls on partly paid up shares; or
- issues other than by way of rights (eg. re acquisition of subsidiaries; the exercise of options; conversion rights taken up; purchase or redemption of own shares; a reduction in share capital).

It is also necessary to:

- ensure the proper notice of changes have been forwarded to the registrar (Companies House);
- ensure changes in share capital are in accordance with the entity's Articles of Association;
- check the share capital agrees with the register of members;
- reconcile any movements in the share capital with the previous year's closing balance;
- check that where changes in share capital have occurred, the relevant company law procedures have been followed; and
- check that where rights attaching to share capital have properties of non-equity instruments, the basis of calculation and classification of the respective components (as well as any dividends paid thereon) is appropriate and in line with the applicable financial reporting framework;
- record all movements in reserves and check that they are in order; and
- check reserves are properly analysed and disclosed.

With respect to distributions we should:

- check distributions from reserves are properly authorised;
- check distributions from reserves are only paid out of funds available for that purpose (in accordance with company law and any provisions within the company's articles);
- check reserves are appropriately described within the financial statements (in accordance with company law, the applicable financial reporting framework and the company's articles);

- ensure that the appropriation of profits for the purpose of a dividend has been properly minuted;
- check calculation of payment;
- where relevant and appropriate vouch selection of dividends paid to the register of members and the cash book; and
- confirm validity of waivers (if any) and ensure that they are properly noted in the financial statements.

4.1.3.4 Statutory and other records

As part of the audit of a company, it is necessary to check that statutory and other records required to be maintained by the company have been properly kept.

The main statutory records which may be required to be kept include:

- register of members;
- register of debenture / loan stock holders;
- register of mortgages and charges;
- register of directors and secretaries; and
- minute books (both entity and directors').

At each audit these records should be examined to ensure that they are up to date. It must be ensured that all important events noted in the minutes of the entity and directors / trustees have been entered into on an arm's length basis and that appropriate approvals have been obtained. Any failure may not affect the view given by the financial records but should be reported to management to ensure that penalties are avoided.

Company law requires that the entity's auditors, in preparing their report, carry out investigations to enable them to form an opinion as to whether the entity has kept adequate accounting records. These records must be sufficient to show and explain the entity's transactions. The main records that must be kept will therefore probably include the following:

- cash book, containing daily entries;
- where goods are sold other than in the course of ordinary retail trade, purchases and sales records supported by invoices;
- year end stock summaries and supporting stock sheets;
- nominal / general ledger.

It is prudent for the entity to maintain some form of fixed asset record and it should be recommended that a fixed asset register is kept.

4.1.4 Auditor's reports

Example auditor's reports are included within the Example Reports section of the manual.

In preparing an auditor's report the latest applicable bulletin, published by the FRC should be followed. The subsections below address a number of company specific considerations.

4.1.4.1 Content of an auditor's report

The content of an auditor's report on a company is driven not only by the requirements of the ISAs (guidance is provided in the Audit Procedures Manual), but also by the specific requirements in this regard set out in the Act. This includes:

Other information

The auditor's responsibility is to read the other information* and, in doing so, consider whether this other information is materially inconsistent with the financial statements or the knowledge obtained in the course of the audit. The opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in the auditor's report, no assurance conclusion is formed thereon.

Opinions on other matters prescribed by the Companies Act 2006

The auditor is required to express an opinion on:

- whether the information in the directors' report and (if applicable) the strategic report is consistent with the financial statements; and
- whether those reports have been prepared in accordance with the applicable legal requirements.

Matters on which the auditor is required to report by exception

The auditor is also required to state whether, in the light of the knowledge and understanding of the entity and its environment obtained in the course of the audit, the auditor has identified any material misstatements in those reports. Additionally, the auditor is required to report by exception in respect of the following matters in relation to which the Companies Act 2006 requires them to report by exception if, in their opinion:

- adequate accounting records have not been kept, or returns adequate for the audit have not been received from branches not visited by the auditor; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- the auditor has not received all the information and explanations required for the audit; or
- the directors were not entitled to prepare the financial statements in accordance with the small companies regime and take advantage of the small companies' exemptions in preparing the directors' report and from the requirement to prepare a strategic report.

** Other information comprises the information included in the annual report, other than the financial statements and the auditor's report thereon. It would therefore include the contents of a directors' report, strategic report (where applicable) and any other reports included within the annual reports.*

4.1.4.2 Signing off an auditor's report

The auditor's report must be dated and must be signed:

- in the case of the auditor being a firm, by the senior statutory auditor in their own name, for and on behalf of the firm; and
- in the case of the auditor being an individual, by them, in their own name.

Names (including post nominal initials) must mirror those contained in the Audit Register.

Signatures may be the individual's usual signature, even if this differs from the name on the audit register (e.g. Bill Smith rather than William Smith).

4.1.4.3 Modifications to the auditor's report

Where the auditor's report is modified, in addition to the ISA considerations, consideration must be given to the impact on the other aspects of the report required by the Companies Act 2006. Whilst the exact amendments to these elements will depend on the reason for the modification to the rest of the report,

Other information

Where the auditor disclaims an opinion on the financial statements, this section is deleted.

Where the auditor qualifies an opinion on the financial statements or issues an adverse opinion on the financial statements, consideration needs to be given as to whether the other information is also impacted by the same matter, or a related matter to that which gives rise to the qualified opinion or adverse opinion on the financial statements. In certain circumstances, it may therefore be necessary to replace the reference to *"We have nothing to report"* with details of the modification and the a conclusion that the other information is materially misstated.

Opinions on other matters prescribed by the Companies Act 2006

Where the auditor disclaims an opinion on the financial statements:

- If both a directors' report and strategic report are prepared, given the auditor will be unlikely to conclude, for example, whether the strategic report provides a fair review of the financial position and performance, the wording would ordinarily be updated to state, *"Because of the significance of the matter described in the basis for disclaimer of opinion section of our report, we have been unable to form an opinion, whether based on the work undertaken in the course of the audit:..."*.
- If only a director's report is prepared (i.e. in the case of a small company), as the contents of a directors' report are more limited, it may be appropriate to simply amend the wording to read, *"Notwithstanding our disclaimer of opinion on the financial statements, in our opinion, based on the work undertaken in the course of the audit:..."*.

Where the auditor qualifies an opinion on the financial statements, they must consider whether it impacts the opinions on other matters prescribed by the Companies Act 2006. If it does, it is usually possible to add a reference to the directors' report and/or strategic report at the end of the basis for qualified opinion section, and to then amend the first sentence in the opinions on other matters prescribed by the Companies Act 2006 section to instead refer to, *"Except for the possible effects of the matter described in the basis for qualified opinion section of the report, in our opinion, based on the work undertaken in the course of the audit:..."*.

Where the auditor issues an adverse opinion on the financial statements, it is unlikely that they will be able to report on whether the strategic report in particular has been prepared in accordance with the requirements of the Act. The wording must be amended to reflect the circumstances.

Matters on which the auditor is required to report by exception

Where the auditor disclaims an opinion on the financial statements, it is expected that they are unable to obtain all of the information and explanations required for the audit and unable to determine whether adequate accounting records have been kept (although further matters may also need to be reported). This would usually result in amending the wording to read,

"Notwithstanding our disclaimer of an opinion on the financial statements, in the light of the knowledge and understanding of the company and its environment obtained in the course of the audit performed subject to the pervasive limitation described above, we have not identified material misstatements in the [strategic report or the] directors' report. Arising from the limitation of our work referred to above:

- *we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and*
- *we were unable to determine whether adequate accounting records have been kept.*

We have nothing to report in respect of the following matters in relation to which the Companies Act 2006 requires us to report to you if, in our opinion:

- *returns adequate for our audit have not been received from branches not visited by us; or*
- *the financial statements are not in agreement with the accounting records and returns; or*
- *certain disclosures of directors' remuneration specified by law are not made; [or*
- *the directors were not entitled to prepare the financial statements in accordance with the small companies regime and take advantage of the small companies' exemptions in preparing the directors' report and from the requirement to prepare a strategic report.]"*

Where the auditor qualifies their opinion on the financial statements or issues an adverse opinion, the wording of this section must be updated to reflect the circumstances. It's likely that there will still be nothing to report on certain matters, but there will be matters to report in respect of others.

4.1.5 Ceasing as auditor

The Act includes detailed requirements with respect to ceasing to hold office as auditor.

The requirements differ depending on whether the auditor:

- resigns; or
- simply ceases to hold office at the end of a period for appointing auditors (in the case of a private company) or at the end of an accounts meeting (in the case of of a public company).

The requirements also differ depending on whether or not the company is classified as a public interest company*.

** For this purpose, a public interest company is defined by s519A of the Act as:*

- *an issuer whose transferable securities are admitted to trading on a UK regulated market;*
- *a credit institution within the meaning given by Article 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 Article 4(1)(2A) of that Regulation; or*
- *a person who would be an insurance undertaking as defined in Article 2(1) of Council Directive 91/674/EEC of 19 December 1991 of the European Parliament and of the Council on the annual accounts and consolidated accounts of insurance undertakings as that Article had effect immediately before IP completion day, were the United Kingdom a member State.*

4.1.5.1 Notice of resignation to the company

Where an auditor resigns, they must send notice to that effect to the company.

Such a notice of resignation operates to bring the auditor's term of office to an end as of the date on which the notice is received or on such later date as may be specified in it, as long as, in the case of a public interest company, the notice is accompanied by a s519 statement (see below).

4.1.5.2 S519 statement to the company

When a s519 statement is required

A s519 statement is required where:

- the auditor of a public interest company who is ceasing to hold office (at any time and for any reason); or
- the auditor of a non-public interest company ceases to hold office except where:
  - they cease to hold office at the end of a period for appointing auditors (for a private company) or the end of an accounts meeting (for a public company); or
  - the reasons for ceasing to hold office are all exempt reasons* and there are no matters connected with ceasing to hold office that need to be brought to the attention of members or creditors of the company.

** Exempt reasons are:*

- *the auditor is no longer to carry out statutory auditor work within the meaning of Part 42;*
- *the company is, or is to become, exempt from audit under s477, s479A or s480 and intends to include such an audit exemption statement on its balance sheet;*
- *the company is a subsidiary undertaking of a parent undertaking that is incorporated in the UK, that parent prepares group accounts, and the auditor is being replaced as auditor of the company by the auditor who is conducting, or is to conduct, an audit of the group accounts and each subsidiary included therein; or*
- *the company is being wound up.*

Contents of a s519 statement

Where required, a s519 statement must include:

- the auditor's name and address;
- the auditor's registration number on the register of auditors;
- the company's name and registered number; and
- details of any matters connected with the auditor ceasing to hold office that the auditor considers need to be brought to the attention of members or creditors* or a statement that there are no such matters.

An example s519 statement is included within the Example Letters section of this manual.

** The Act does not provide any guidance on the sorts of matters that should be brought to the attention of members or creditors – it is instead left to professional judgement. Where a decision has been taken not to participate in a tender for an entity previously audited, the firm should consider whether to provide further detail on the specific matters that impacted its decision (e.g. a conflict of interest, the audit fee no longer reflecting the extent of the work required etc.). ICAEW has published a guidance paper that discusses auditor resignation statements.*

Timescales

Where a s519 statement is required to be sent to the company:

- in the case of a resignation, it must be sent along with the notice of resignation;
- in the case of failure to seek reappointment, not less than 14 days before the end of the time allowed for next appointing an auditor; and
- in any other case, not later than the end of the period of 14 days beginning with the date on which the auditor ceases to hold office.

4.1.5.3 Notifying the registering Institute / Association or the Competent Authority

Where an auditor sends a statement under section 519, they must at the same time send a copy of the statement to the competent authority (the Financial Reporting Council (FRC) for a public interest company or our Institute or Association for a non-public interest company).

4.1.5.4 Notifying the registrar

A copy of the s519 statement is only required to be sent to Companies House by the auditor where:

- the company is a public interest company; or
- the company is a non-public interest company and the s519 statement includes matters that need to be brought to the attention of members or creditors of the company.

In such cases, the auditor must send the s519 statement to the company first, and if the auditor does not receive notice of an application to the court under s520 of the Act (which gives the company the right to apply to the court in the rare cases where they consider the contents of the s519 matters include needless publicity for a defamatory matter) within 21 days, they must then send the s519 statement to Companies House within a further seven days.

4.1.5.5 Company responsibilities

Notifying members or creditors

Where a company receives a s519 statement from an auditor who is ceasing to hold office where:

- the company is a public interest company; or
- the company is a non-public interest company and the s519 statement includes matters that need to be brought to the attention of members or creditors of the company;

they must, within 14 days of receipt either:

- send a copy of it to every person who under s423 of the Act is entitled to be sent copies of the accounts; or
- apply to the court (and notify the auditor of that application)*.

** The situation where a company applies to the court is not addressed further in this guidance.*

Notifying the registering Institute / Association or the Competent Authority

When an auditor ceases to hold office at any time other than at the end of their term of office, and the reasons for auditor ceasing to hold office are not exempt reasons, the company is required to provide a statement to the appropriate audit authority within 28 days. The statement should include either:

- an endorsed copy of the auditor's s519 statement; or
- what the company considers the reasons to be for the cessation.

4.1.5.6 Other responsibilities on ceasing to act

As a matter of professional courtesy, clients should be advised of their responsibilities where an auditor ceases to act as auditor, such advice is usually included within a disengagement letter. Where an auditor ceases to hold an audit appointment they must, if asked in writing, allow their successor access to all relevant information held by them in relation to their audit work. This includes audit working papers in relation to the last accounting period for which they acted. They should also be prepared to assist their successor by providing oral or written explanations to assist their understanding of working papers.

4.2 Other forms of external scrutiny

Where a company claims audit exemption, it may nevertheless wish to subject its annual reports and accounts to some form of external scrutiny.

4.2.1 Assurance Review Engagement

One form of scrutiny that may be selected is that of an assurance review engagement in accordance with ISRE 2400 International Standard for Review Engagements.

ISRE 2400 (Revised) requires the chartered accountant to make enquiries of management, and others, and to carry out analytical procedures to gain a degree of assurance that:

- The financial statements comply with the chosen financial reporting framework and give a true and fair view; and
- Management is aware of its responsibilities for producing the financial statements.

To be able 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;
    - Significant, unusual or complex transactions or events.

Assurance review engagements, like audits, may help the accountant report weaknesses and other issues that come to their attention to the directors. In other words, such engagements can generate much more value for the directors than just the assurance report itself. This represents a substantial degree of understanding of the client's circumstances.

Further substantive testing is not required unless the accountant has reason to be concerned about some aspect of the business.

It is important to note though that a review of finanical statements in accordance with ISARE 2400 is a limited assurance engagement, and the procedures performed are substantially less than those performed in an audit conducted in accordance with the ISAs - an audit opinion is not provided.

Where an assurance review engagement is to be undertaken, it is recommended that a specialist manual such as Mercia's Assurance Review Engagement Manual is used.

4.2.2 Independent examination

Certain types of company may be subject to independent examination where they claim audit exemption. For example, depending on their level of income and assets, charities may be subject to independent examination should they claim audit exemption.

An independent examination is usually carried out in line with a particular set of sector requirements (e.g. the directions of the charity regulators in the case of charities).

Independent examinations are limited assurance engagements and the procedures performed are substantially less than those performed in an audit conducted in accordance with the ISAs.

Appendix 1a: Notes for completion of planning form B25 - Materiality

Materiality – Notes for completion
The objective of the materiality form is to determine materiality and performance materiality.

Materiality B25

Objective: To determine materiality and performance materiality

For guidance on materiality, refer to Section B.4.9 and Appendix 2 to Section B.4 of the Audit Procedures Manual. NB. Shaded areas to be completed at the completion stage of the audit.

		Expected Current Year £'000	Actual Current Year £'000
Benchmarks			
Profit before tax			
Adjustments for unusual transactions or items			
Adjusted profit before tax			
Turnover			
Assets (state "net" or "gross")			
Other			
Basis for determining materiality			
Adjusted profit before tax	%		
Turnover	%		
Assets (state "net" or "gross")	%		
Other (specify ______________________)	%		
Justification for materiality level:			
Materiality for the financial statements as a whole			
Justification for performance materiality level:			
Performance materiality			
Amount below which misstatements are clearly trivial			
Audit areas requiring other levels of materiality and performance materiality (e.g. directors' transactions):			

Conclusions

Planning materiality
The planned levels of materiality are appropriate for this audit.

Prepared by		Dated:	
Reviewed by		Dated:	

Final materiality
The final level of materiality is appropriate for this audit

Prepared by		Dated:	
Reviewed by		Dated:	

Other could include total expenditure or total funds.

State which benchmark from above and the percentage or level to be adopted. ISA (UK) 320 suggests 5% of unadjusted profit may be used for a profit-orientated entity in a manufacturing industry or 1% of income for a non-for-profit entity but other benchmarks and higher or lower percentages may be appropriate.

Materiality on the financial statements as a whole relates to the level at which misstatements (including omissions) individually or in the aggregate would affect the decisions of users of the financial statements. Materiality is not affected directly by audit risk but some of the factors in determining materiality may also lead to increased audit risk.

Performance materiality is the working level of materiality used throughout the fieldwork as a guide as to which balances and transactions need to be tested.

It is the amount set at less than materiality (ie. for the financial statements as a whole) to reduce to an acceptably low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

Performance materiality may be set at an amount or a percentage of materiality on the financial statements as a whole. This percentage is a matter of judgement but is affected by the auditor's understanding of the entity, updated during the risk assessment procedures, and the expectation of misstatements. For example, where the overall risks are low the auditor may set performance materiality at 90% of materiality. Where the risk of misstatement is higher, the auditor should use a lower percentage of materiality.

Clearly trivial refers to matters which are clearly inconsequential and is of a wholly different (smaller) magnitude than performance materiality (for example the auditor may use up to 5% of materiality). Where there is uncertainty as to whether something is clearly trivial, it should be assumed that it is not.

State the area and the level of materiality and performance materiality.

Revisit the levels of materiality and performance materiality at the closing stages of the audit, and consider if / how this impacts the audit.

Appendix 1b: Notes for completion of planning form B41 - Materiality

Materiality – Notes for completion
The objective of the materiality form is to determine materiality and performance materiality.

Materiality B41

Objective: To determine materiality and performance materiality

For guidance on materiality, refer to Section B.4.8 and Appendix 2 to Section B.4 of the Audit Procedures Manual. NB. Shaded areas to be completed at the completion stage of the audit.

		Expected Current Year £'000	Actual Current Year £'000
Benchmarks			
Profit before tax			
Adjustments for unusual transactions or items			
Adjusted profit before tax			
Turnover			
Assets (state "net" or "gross")			
Other			
Basis for determining materiality			
Adjusted profit before tax	%		
Turnover	%		
Assets (state "net" or "gross")	%		
Other (specify ______________________)	%		
Justification for materiality level:			
Materiality for the financial statements as a whole			
Justification for performance materiality level:			
Performance materiality			
Amount below which misstatements are clearly trivial			
Audit areas requiring other levels of materiality and performance materiality (e.g. directors' transactions):			

Conclusions

Planning materiality
The planned levels of materiality are appropriate for this audit.

Prepared by		Dated:	
Reviewed by		Dated:	

Final materiality
The final level of materiality is appropriate for this audit

Prepared by		Dated:	
Reviewed by		Dated:	

Other could include total expenditure or total funds.

State which benchmark from above and the percentage or level to be adopted. ISA (UK) 320 suggests 5% of unadjusted profit may be used for a profit-orientated entity in a manufacturing industry or 1% of income for a non-for-profit entity but other benchmarks and higher or lower percentages may be appropriate.

Materiality on the financial statements as a whole relates to the level at which misstatements (including omissions) individually or in the aggregate would affect the decisions of users of the financial statements. Materiality is not affected directly by audit risk but some of the factors in determining materiality may also lead to increased audit risk.

Performance materiality is the working level of materiality used throughout the fieldwork as a guide as to which balances and transactions need to be tested.

It is the amount set at less than materiality (ie. for the financial statements as a whole) to reduce to an acceptably low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

Performance materiality may be set at an amount or a percentage of materiality on the financial statements as a whole. This percentage is a matter of judgement but is affected by the auditor's understanding of the entity, updated during the risk assessment procedures, and the expectation of misstatements. For example, where the overall risks are low the auditor may set performance materiality at 90% of materiality. Where the risk of misstatement is higher, the auditor should use a lower percentage of materiality.

Clearly trivial refers to matters which are clearly inconsequential and is of a wholly different (smaller) magnitude than performance materiality (for example the auditor may use up to 5% of materiality). Where there is uncertainty as to whether something is clearly trivial, it should be assumed that it is not.

State the area and the level of materiality and performance materiality.

Revisit the levels of materiality and performance materiality at the closing stages of the audit, and consider if / how this impacts the audit.

Appendix 2a: Notes for completion of planning form B40 - Audit plan

Audit plan – Notes for completion
The objective of the Audit plan is to record the risk and approach for the individual areas of the audit. This can be achieved by completing the individual area audit plans on **B40/X2**. Alternatively, you may prepare a free-form audit plan setting out the risks (including the risks in relation to internal control) and the planned approach.

Choice of filing at **B40** or **X2** (eg. for taxation, this example is C2, and for bank and cash, this would be **I2**.

Audit plan - Taxation B40/C2

Objective: To record the risk and the planned audit approach for this individual area of the audit.

For guidance on completing the audit plan, refer to Appendix 2 to Section B.5 of the Audit Procedures Manual.

Risks identified

Note factors which affect risk (including fraud risk). Refer to specific audit assertions.

Note any factors which affect risk (including fraud risk) and state whether there are any significant risks identified in each area. The risk factors and risks identified should be considered at the specific audit assertion level.

Audit approach

Current tax

Occurrence, Completeness, Accuracy, Cut-off, Classification

Audit programme(s):	Tests of control ☐	Non-audit procedures ☐	Analytical procedures ☐	Other substantive procedures ☐

Deferred tax

Occurrence, Completeness, Accuracy, Cut-off, Classification

Audit programme(s):	Tests of control ☐	Non-audit procedures ☐	Analytical procedures ☐	Other substantive procedures ☐

Sampling

Cross refer to sampling plan(s) or if judgemental, document justification of planned sample sizes.

Where tests of control or other substantive procedures require sampling then documentation regarding the sample sizes is required. If a sampling plan is used, a cross reference to the relevant plan is required. Where judgement is used then justification of the determined sample size would be stated. Justifications may relate to size of population, risk, performance materiality, other work performed etc. Further guidance on sampling is provided in Appendix 3.

Prepared by		Dated:	
Reviewed by		Dated:	

The audit approach is split into relevant areas (ie. for taxation, split between current and deferred tax) and the key assertions for those areas identified. The team should document the justification for audit tests to be performed in order to address the identified key assertions.

The audit tests documented will help to decide which audit programmes are to be used (eg. non-audit procedures and other substantive procedures). The relevant boxes are then ticked.

When tailoring the detailed programmes form the audit plan, section A should always be required as it contains general and mandatory procedures such as confirming the design and implementation of systems, agreeing the financial statements to the underlying accounting records and other mandatory ISA testing.

The audit programmes generally include test of controls in section B, non-audit procedures in section C, analytical procedures in section D and other substantive procedures in section E. Either E (blank programme) is used to record any additional tests for objectives not achieved by other testing or the full F test bank is used. Tests should be tailored / deleted as appropriate.

Accounting estimates (Q), going concern (R), and subsequent events (S) only include section A (general and mandatory tests) and do not include the audit programme(s) tick boxes.

A plan for each key accounting estimate (as included on the **B32Xs**) is required on **B40/Q2**.

Appendix 2b: Notes for completion of planning form B33 - Audit plan

Audit plan – Notes for completion
The objective of the Audit plan is to record the risk and approach for the individual areas of the audit. This can be achieved by completing the individual area audit plans on **B33/X2**. Alternatively, you may prepare a free-form audit plan setting out the risks (including the risks in relation to internal control) and the planned approach.

Choice of filing at **B33** or **X2** (eg. for taxation, this example is C2, and for bank and cash, this would be **I2**.

Audit plan - Taxation **B33/C2**

Objective: To record the risk and the planned audit approach for this individual area of the audit.

For guidance on completing the audit plan, refer to Appendix 2 to Section B.5 of the Audit Procedures Manual.

Risks identified

Note factors which affect risk (including fraud risk). Refer to specific audit assertions.

Note any factors which affect risk (including fraud risk) and state whether there are any significant risks identified in each area. The risk factors and risks identified should be considered at the specific audit assertion level.

Audit approach

Current tax Occurrence, Completeness, Accuracy, Cut-off, Classification				
Audit programme(s):	Tests of control ☐	Non-audit procedures ☐	Analytical procedures ☐	Other substantive procedures ☐

Deferred tax Occurrence, Completeness, Accuracy, Cut-off, Classification				
Audit programme(s):	Tests of control ☐	Non-audit procedures ☐	Analytical procedures ☐	Other substantive procedures ☐

Where tests of control or other substantive procedures require sampling then documentation regarding the sample sizes is required. If a sampling plan is used, a cross reference to the relevant plan is required. Where judgement is used then justification of the determined sample size would be stated. Justifications may relate to size of population, risk, performance materiality, other work performed etc. Further guidance on sampling is provided in Appendix 1.

Sampling

Cross refer to sampling plan(s) or if judgemental, document justification of planned sample sizes.

Prepared by		Dated:	
Reviewed by		Dated:	

The audit approach is split into relevant areas (ie. for taxation, split between current and deferred tax) and the key assertions for those areas identified. The team should document the justification for audit tests to be performed in order to address the identified key assertions.

The audit tests documented will help to decide which audit programmes are to be used (eg. non-audit procedures and other substantive procedures). The relevant boxes are then ticked.

When tailoring the detailed programmes form the audit plan, section A should always be required as it contains general and mandatory procedures such as confirming the design and implementation of systems, agreeing the financial statements to the underlying accounting records and other mandatory ISA testing.

The audit programmes generally include test of controls in section B, non-audit procedures in section C, analytical procedures in section D and other substantive procedures in section E. Either E (blank programme) is used to record any additional tests for objectives not achieved by other testing or the full F test bank is used. Tests should be tailored / deleted as appropriate.

Accounting estimates (Q), going concern (R), and subsequent events (S) only include section A (general and mandatory tests) and do not include the audit programme(s) tick boxes.

A plan for each key accounting estimate (as included on the **B30Xs**) is required on **B33/Q2**.

Appendix 2.1a: Notes for completion of planning form B40 Audit plan - Trial balance (use of ADA)

Audit plan - Trial balance (use of ADA) – Notes for completion
The objective of Audit plan - Trail balance (use of audit data analytics) is to tailor the use of ADA when being used to identify journals/significant unusual transactions for testing. This form is only necessary where audit data analytics (ADA) is planned to identify high risk transactions for testing.

To confirm if an automated or manual ADA application is being used to risk score transactions, including an indication of where the parameters used for the risk assessment are set out and have been assessed. For automated, it may be easiest to reference to a printed schedule from the application alongside clear justifications on the parameters.

For manual scoring, indicate if a particular criterion is considered relevant or not (Y/N). NB. the list of risk conditions is not exhaustive and customised risk conditions should be added where relevant.

The specific criteria to be applied to should be defined (eg. what is considered to be a 'large value').

A risk score to be applied should be noted (1 being for the lowest risk and 5 being for the highest risk).

Any risk enhancers should be defined (eg. what particular risk criteria exist which means the risk score for certain transactions should be enhanced by a multiple).

The risk multiple should be recorded.

Audit plan - Trial balance (use of ADA) B40/N2(ADA)

Objective: To record the use of audit data analytics (ADA) when being used to identify journals / significant unusual transactions for testing.

For guidance on completing this audit plan, refer to Appendix 3 to Section B.5 of the Audit Procedures Manual.

B21 must be completed to appraise the use of ADA.

Risk criteria to identify high risk journals / transactions

Transactions have been risk scored using an automated ADA application. The parameters used by the system (including details of any tailoring specific to this client), with justification for why these are considered appropriate are set out on sch______.[1]	☐
Transaction risk criteria is being applied manually[2]. Tailoring of the risk criteria for this client is detailed below or on sch ____.	☐

Risk criteria to be applied manually:[3]

Risk condition	Relevant for this engagement (Y/N)	Specific definition	Risk score applied	Justification
Large value				
Round sum amounts or transactions ending '999'				
Unusual description / key word search				
Transactions posted at an unusual time				
Back dated transactions				
Transactions posted and reviewed by the same person				
Transactions posted by an unexpected person				
Unexpected account combination(s)				
Other (describe):				

Risk enhancers

If applicable, risk enhancer multiply to be applied[4]:

Risk enhancer	Multiple to be applied	Justification

Items to be selected for testing

Criteria to select or exclude transactions for testing[5]:

	Criteria	Justification
Transactions with a risk score[6] equal or greater than:		
De minimis threshold below which journal values can be excluded from testing:		
Other criteria specifically triggering a journal to be tested:		
Other criteria specifically triggering a journal to be excluded from testing:		

Prepared by		Dated:	
Reviewed by		Dated:	

[1] The assessment of automated risk scoring is likely to require a freeform assessment. See Section B.5.10 of the Audit Procedures Manual for further guidance.

[2] Manual risk scoring is likely to be done in a spreadsheet or similar. See Section B.5.10 of the Audit Procedures Manual for further guidance.

[3] Example risk criteria is given in Section B.5.10 of the Audit Procedures Manual.

[4] For guidance on the use risk enhancers to emphasise risk factors for a transaction by applying a multiple to the risk score, see Section B.5.10 of the Audit Procedures Manual.

[5] Judgement is required when determining the criteria to select transactions for testing, see Section B.5.10 of the Audit Procedures Manual for further guidance.

[6] An example risk score calculation is given in Section B.5.10 of the Audit Procedures Manual.

The criteria to trigger a transaction to be considered high risk and which should be tested should be recorded (eg. high risk score). Any criteria which would mean a transaction could be excluded from testing should also be recorded here (eg. below a trivial value).

Appendix 2.1b: Notes for completion of planning form B33 Audit plan - Trial balance (use of ADA)

Audit plan - Trial balance (use of ADA) – Notes for completion
The objective of Audit plan - Trail balance (use of audit data analytics) is to tailor the use of ADA when being used to identify journals/significant unusual transactions for testing. This form is only necessary where audit data analytics (ADA) is planned to identify high risk transactions for testing.

To confirm if an automated or manual ADA application is being used to risk score transactions, including an indication of where the parameters used for the risk assessment are set out and have been assessed. For automated, it may be easiest to reference to a printed schedule from the application alongside clear justifications on the parameters.

For manual scoring, indicate if a particular criterion is considered relevant or not (Y/N). NB. the list of risk conditions is not exhaustive and customised risk conditions should be added where relevant.

The specific criteria to be applied to should be defined (eg. what is considered to be a 'large value').

A risk score to be applied should be noted (1 being for the lowest risk and 5 being for the highest risk).

Any risk enhancers should be defined (eg. what particular risk criteria exist which means the risk score for certain transactions should be enhanced by a multiple).

The risk multiple should be recorded.

Audit plan - Trial balance (use of ADA) B33/N2(ADA)

Objective: To record the use of audit data analytics (ADA) when being used to identify journals / significant unusual transactions for testing.

For guidance on completing this audit plan, refer to Appendix 3 to Section B.5 of the Audit Procedures Manual.

B20 must be completed to appraise the use of ADA.

Risk criteria to identify high risk journals / transactions

Transactions have been risk scored using an automated ADA application. The parameters used by the system (including details of any tailoring specific to this client), with justification for why these are considered appropriate are set out on sch______.[1]	☐
Transaction risk criteria is being applied manually[2]. Tailoring of the risk criteria for this client is detailed below or on sch ____.	☐

Risk criteria to be applied manually:[3]

Risk condition	Relevant for this engagement (Y/N)	Specific definition	Risk score applied	Justification
Large value				
Round sum amounts or transactions ending '999'				
Unusual description / key word search				
Transactions posted at an unusual time				
Back dated transactions				
Transactions posted and reviewed by the same person				
Transactions posted by an unexpected person				
Unexpected account combination(s)				
Other (describe):				

Risk enhancers

If applicable, risk enhancer multiply to be applied[4]:

Risk enhancer	Multiple to be applied	Justification

Items to be selected for testing

Criteria to select or exclude transactions for testing[5]:

	Criteria	Justification
Transactions with a risk score[6] equal or greater than:		
De minimis threshold below which journal values can be excluded from testing:		
Other criteria specifically triggering a journal to be tested:		
Other criteria specifically triggering a journal to be excluded from testing:		

Prepared by		Dated:	
Reviewed by		Dated:	

1. The assessment of automated risk scoring is likely to require a freeform assessment. See Chapter 5.10 of Part B of the Audit Procedures Manual for further guidance.
2. Manual risk scoring is likely to be done in a spreadsheet or similar. See Chapter 5.10 of Part B of the Audit Procedures Manual for further guidance.
3. Example risk criteria is given in chapter 5.10 of Part B of the Audit Procedures Manual.
4. For guidance on the use risk enhancers to emphasise risk factors for a transaction by applying a multiple to the risk score, see chapter 5.10 of Part B of the Audit Procedures Manual.
5. Judgement is required when determining the criteria to select transactions for testing., see Chapter 5.10 of Part B of the Audit Procedures Manual for further guidance.
6. An example risk score calculation is given in chapter 5.10 of Part B of the Audit Procedures Manual.

The criteria to trigger a transaction to be considered high risk and which should be tested should be recorded (eg. high risk score). Any criteria which would mean a transaction could be excluded from testing should also be recorded here (eg. below a trivial value).

Appendix 3a: Notes for completion of substantive sampling forms (p/c on or after 15 Dec 21)

Substantive sampling approach | ISA or ES para

General information

Introduction

This methodology includes two different sampling approaches. One is for judgemental sampling (and incorporates a sample cap), the other is a statistical sampling approach (which does not incorporate a sample cap). Whilst a different approach may be used on different audits, it would be difficult to justify mixing and matching the different approaches on the same audit. For many audits, particularly where populations are smaller, the judgemental sampling approach will be appropriate, however it is not suitable for use on the audits of PIEs or other audits where the populations are very large. The firm's policy should also be consulted, as some firms may mandate the use of the statistical sampling approach in all cases.

A sample size calculated using either of the substantive sampling approaches is derived on the basis that little error is expected in the population being tested. If this is not be the case and a number of errors are likely, then the form is not appropriate and the level of testing should be set judgementally at a level considered to be sufficient to provide adequate audit assurance. In these cases testing levels are likely to be considerably in excess of the numbers calculated using either of the approaches.

The substantive sampling forms require the documentation of a number of qualities of the test being performed and population being tested in order to evidence due consideration of those factors. The forms encourage the extraction of significant and other key items which would be tested in addition to the calculated sample size for the residual population. This sample size for the residual population is determined by reference to the assessed risk in the population, the planned reliance on other procedures and the size of the residual population. Key factors to consider when completing the substantive sampling forms are highlighted below.

Definition and expectation of error

Errors should be defined when designing the sample. The definition of an error is important because the errors found in a sample will be projected (extrapolated) across the population being sampled.

As noted above, where the expectation of an error occurring is more than low, we should set the sample size judgementally at a level considered to be sufficient to provide adequate audit assurance.

Stratification

Where appropriate, we should divide a population into discrete sub-populations which have an identifying characteristic, this process is termed stratification.

The objective of stratification is to reduce the variability of items within each sub-population (stratum) and therefore allow a reduced sample size to be taken without increasing sampling risk. If revenue is generated in a number of different ways by the entity, it is likely to be appropriate to split each type of revenue into a different stratum, for example. *530.5, 530 App. 1*

Where there is little variation in the population stratification may not be required. For example, if testing debtors for membership fees, stratification may not be necessary as there is little or no variability in the population.

Consideration should be given to increasing the sample size if the population contains sufficient variability to warrant stratification, but a decision is taken not to stratify.

When performing substantive tests of details, the population may be stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement.

Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

If values are not known (eg. unpriced stock), then the population may be stratified in some other way, for example by quantity or by type.

If a class of transactions or an account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

Substantive sampling approach | ISA or ES para

The value of residual population to sample

There may be certain items in the population that we wish to test specifically. This may be due to either their value or some qualitative characteristic (eg intra-group items, transactions or balances with related parties, etc.). We will remove these items from the population and test them separately.

When designing a sample, we determine a level of tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality to a particular sampling procedure and may be the same amount or an amount lower than performance materiality. *530.5*

All items greater than tolerable misstatement should normally be treated as individually significant items. These, along with other key items, are extracted from the population and examined separately. The residual population is then sampled.

Method of selection to use

Once the sample size has been determined we will use one of the following methods to select the sample: *530 App 4*

- random selection;
- systematic selection (ie. every “nth” item);
- monetary unit sampling (items with greater monetary value have a proportionally greater chance of being sampled); or
- haphazard selection (not generally recommended but may be necessary where documents are filed alphabetically).

Whichever method is chosen, the following criteria need to be observed:

- items chosen must be selected in such a way that we can reasonably expect them to represent the whole population;
- each item in the population must have a chance of being selected; and
- conscious bias must be avoided.

Some form of systematic selection is frequently used to arrive at the items to be sampled, although random selection can also be used.

Example: Systematic selection of a sample

a. A sample of 30 items is required from a population of 4,000 items. The sampling interval would be 4,000 / 30 = 133. A random start should be taken from within the first 133 items with every 133rd item chosen thereafter.

b. A sample of 20 items is required from a day book of 50 pages. A random start point somewhere between pages 1 - 10 would be chosen then an item would be sampled from every 2nd page. Depending on the number of entries per page a random number calculator could be used to select a line on each of the pages to be sampled.

Accounting estimates

Sampling techniques are unlikely to be utilised when testing accounting estimates, however certain accounting estimates such as depreciation / amortisation calculations may utilise a sampling approach. Care is needed here regarding clarity over the assertion(s) being tested.

Sample size calculation - Judgemental sampling

When determining the sample size for the residual population in a substantive test of detail the initial sample size will be 60 items. Note that where there are different income or expense streams, that have different systems, each of these should be treated as a separate population – i.e. the each stream will need to be sampled separately, with each stream having an initial sample size of 60. This number can be reduced based on various deduction factors that are dependent upon the following:

- the risk of material misstatement associated with the population being tested;
- the planned level of reliance placed on the operating effectiveness of controls;
- the strength of analytical and other related substantive procedures; and
- the size of the residual population (adjusted via a ‘materiality factor’).

The following table highlights the level of deduction available in each instance. This is followed by guidance on the application of judgement in taking deductions available.

ISA or ES para

Substantive sampling approach

Assessed inherent risk in population		Planned reliance on internal controls		Analytical and other related substantive procedures		Materiality factor	
Level	No.	Level	No.	Strength of evidence	No.	Value	No.
1	20	High	20	Strong	20	Under 15	20
2	15	Medium	10	Moderate	10	15-27	10
3	10	None	0	Weak	0	Over 27	0
4	5						
5	0						

Assessed inherent risk in the population

The assessed inherent risk in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

This assessed inherent risk in the population will depend on the audit area and the particular assertion being tested. For example, it may be deemed within a population of stock that the existence assertion is at a lower risk of material misstatement than the valuation assertion. This could be due to the stock existence being easily verifiable whereas the valuation within the population could be subject to complex accounting estimates. Therefore we may deem it appropriate to calculate separate samples for the existence and valuation testing.

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, eg, valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

Planned reliance on internal controls

Where we only evaluate whether relevant controls are designed effectively and determine whether they have been implemented, we cannot reduce the substantive test sample size for any reliance on controls - this can only be done where we have tested their operating effectiveness.

Tests of operating effectiveness of internal controls are often designed to provide either a high or moderate level of reliance and therefore risk reduction.

- A high level of reliance (low level of risk remaining) applies where the primary evidence is coming from tests of controls.
- A medium level of reliance (medium level of risk remaining) applies where the tests of controls will be combined with other substantive procedures to address a particular assertion.

The type of controls being tested may influence the level of reliance to be placed on them. For example, a control applied to all items in the population is likely to provide a sounder basis for reliance than one only applied to certain types or sizes of transactions.

The extent to which we test controls for the planned level of reliance is a matter of professional judgement; however, in ascertaining an appropriate sample size for tests of controls we may use the tests of controls sampling form.

Analytical and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

ISA or ES para

Substantive sampling approach

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg. sales or debtors, or the population could be disaggregated into its component parts, eg. different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may "take credit" for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

Materiality factor

The materiality factor is calculated as follows:

total value of population / materiality = materiality factor

The lower the resulting figure for the materiality factor the greater the reduction in sample size. Thus, not surprisingly, the larger the value of the residual population relative to materiality the greater the value of the materiality factor and the larger the final sample size will be.

Where a different specific audit area materiality is set on the **B25** then this materiality rather than the overall materiality should be used to calculate any sample sizes for that particular area.

Minimum sample size

Small samples have an increased risk of being unrepresentative and unreliable. If the total population comprises a relatively small number of items, say fewer than 50 items, then alternative procedures should be considered in place of sampling. For example, this might include analytical procedures or a review for unusual items.

When the calculated sample results in a sample size of 15 items or fewer, then alternative audit procedures should be considered as outlined above. If these are not appropriate, then the minimum sample size should be 15 items.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

Justification

Since this is a judgemental sampling approach, it is necessary to justify the sample size used. The substantive sampling form includes appropriate space to document this justification. It is not acceptable to simply state that that it is appropriate because that is what was calculated by the approach – this is simply an indicative guide to be used as a starting point.

ISA or ES para

Substantive sampling approach

Example: Transaction tests on income

We have established the following:

Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Assessed inherent risk in population	= 1
Planned reliance on internal controls	= High
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor	= 30

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(20)
Planned reliance on internal controls	(20)
Analytical and other related substantive procedures	(10)
Materiality factor	(0)
Total sample size	**10**

However, the sample size will still be 15 (ie. the minimum sample size) which would therefore require 15 items to be tested substantively.

Alternatively, we may choose not to place any reliance on internal controls and therefore not test the operating effectiveness of controls. The resulting substantive sample size would be 30 items, with no tests of control being necessary. This, in practice, may be a more cost effective approach.

Example: Testing existence of debtor balances

We have established the following:

Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Assessed inherent risk in population	= 3
Planned reliance on internal controls	= None
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor (Residual population value / materiality)	= 250,000 / 10,000 = 25

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(10)
Planned reliance on internal controls	(0)
Analytical and other related substantive procedures	(10)
Materiality factor	(10)
Total sample size	**30**

ISA or ES para

Substantive sampling approach

Example: Testing valuation of stock lines

We have established the following:

Total population value	= £200,000
Monetary value of items over tolerable misstatement	= £130,000
Number of items over tolerable misstatement	= 7
Number of other key items	= 0
Residual population to be sampled	= £70,000
Assessed inherent risk in population	= 5
Planned reliance on internal controls	= Moderate
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor (Residual population value / materiality)	= 70,000 / 7,000 = 10

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(0)
Planned reliance on internal controls	(10)
Analytical and other related substantive procedures	(10)
Materiality factor	(20)
Total sample size	**20**

Therefore, the total number of items to examine will be 27 items (20 sample items + 7 individually significant items).

- **Sample size calculation - Statistical sampling**

When determining the sample size for the residual population in a substantive test of detail the sample size will be based on:

- the risk of material misstatement associated with the population being tested;
- the strength of analytical and other related substantive procedures;
- the tolerable misstatement; and
- the size of the residual population.

Tolerable misstatement is defined in ISA 530 as 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. The tolerable misstatement cannot exceed performance materiality.

Risk of material misstatement

The assessed risk of material misstatement inherent in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements. It should have been assessed as part of the risk assessment process.

This assessed risk in the population will depend on the audit area and the particular assertion being tested. For example, it may be deemed within a population of stock that the existence assertion is at a lower risk of material misstatement than the valuation assertion. This could be due to the stock existence being easily verifiable whereas the valuation within the population could be subject to complex accounting estimates. Therefore we may deem it appropriate to calculate separate samples for the existence and valuation testing.

ISA or ES para

Substantive sampling approach

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, e.g. valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

The risk of material misstatement will also be affected by the control risk. Where a controls based approach is taken to the audit, and it is possible to place reliance on relevant controls (the operating effectiveness of which will be tested as part of controls testing), this may serve to reduce the risk of material misstatement – see **B30**.

Analytical and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg. sales or debtors, or the population could be disaggregated into its component parts, eg. different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may “take credit” for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

The strength of analytical and other related substantive procedures is ultimately a matter of professional judgement, however the following should be considered:

- Weak analytical and other related substantive procedures would generally be where no such procedures were undertaken, or would include simple variance analysis, or other limited procedures which do not confirm to the requirements of ISA 520 Analytical Procedures.
- Moderate analytical and other related substantive procedures would generally include analytical procedures in conformity with the requirements of ISA 520 Analytical Procedures in addition to at least some other substantive work.
- Strong analytical and other related substantive procedures would generally include detailed analytical procedures in conformity with the requirements of ISA 520 Analytical Procedures and extensive further substantive procedures over the population in addition to the testing to be performed on the sample.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

ISA or ES para

Substantive sampling approach

Note that in some cases it's not possible to calculate a sample size using the statistical approach. This occurs where the analytical and other related substantial procedures are strong and the risk of material misstatement is very low, low or medium; or where the analytical and other related substantial procedures are moderate and the risk of material misstatement is very low. In such cases, statistically, the planned test of details may not be necessary unless specified by regulation or other standards.

Example: Transaction tests on income

We have established the following:

Total population value	= £6,100,000
Tolerable misstatement	= £75,000
Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Risk of material misstatement	= High (4)
Analytical and other related substantive procedures	= Weak

The high risk of material misstatement, coupled with the weak analytical and other substantive procedures would result in a confidence factor of 2.30. The substantive sample size would therefore be (£6,100,000 x 2.30) / £75,000 = 188. This would also be the number of items to be tested in this case.

If stronger work was undertaken on analytical and other related substantive procedures, this can significantly reduce the sample size. For example, if instead the analytical and other related substantive procedures were Strong, the confidence factor would instead be 0.41 and the sample size would only be 34 items.

Of course, in order to change the strength of analytical and other related substantive procedures, additional such procedures would need to be undertaken.

Example: Testing valuation of stock lines

We have established the following:

Total population value	= £200,000
Tolerable misstatement	= £7,000
Number of items over tolerable misstatement	= 7
Monetary value of items over tolerable misstatement	= £130,000
Number of other key items	= 0
Risk of material misstatement	= Very High (5)
Analytical and other related substantive procedures	=Moderate

The very high risk of material misstatement, coupled with the moderate analytical and other related substantive procedures would result in a confidence factor of 2.08. The substantive sample size would therefore be (£70,000 x 2.08) / £7,000 = 21. The total number of items to be tested would therefore be 28 (21 + 7).

Appendix 3b: Notes for completion of substantive sampling form (p/c before 15 Dec 21)

The substantive sampling form requires the documentation of a number of qualities of the test being performed and population being tested in order to evidence due consideration of those factors. The form encourages the extraction of significant and other key items which would be tested in addition to the calculated sample size for the residual population. This sample size for the residual population is determined by reference to the assessed risk in the population, the planned reliance on other procedures and the size of the residual population.

Sample size calculation

When determining the sample size for the residual population in a substantive test of detail the initial sample size will be 60 items. This number can be reduced based on various deduction factors that are dependent upon the following:

- the risk of material misstatement associated with the population being tested;
- the planned level of reliance placed on the operating effectiveness of controls;
- the strength of analytical and other related substantive procedures; and
- the size of the residual population (adjusted via a 'materiality factor').

The following table highlights the level of deduction available in each instance. This is followed by guidance on the application of judgement in taking deductions available.

Assessed risk in population		Planned reliance on internal controls		Analytical and other related substantive procedures		Materiality factor	
Level	No.	Level	No.	Strength of evidence	No.	Value	No.
Low	20	High	20	Strong	20	Under 15	20
Medium	10	Medium	10	Moderate	10	15-27	10
High	0	None	0	Weak	0	Over 27	0

Assessed risk in the population

The assessed risk of material misstatement inherent in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

This assessed risk in the population will depend on the audit area and the particular assertion being tested.

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, eg, valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

Accounting estimates

Sampling techniques are unlikely to be utilised when testing accounting estimates, however certain accounting estimates such as depreciation / amortisation calculations may utilise a sampling approach. Care is needed here regarding clarity over the assertion(s) being tested The process for determining the risk assessment of accounting estimates differs from other aspects of the financial statements as it requires inherent risk and control risk to be considered separately.

The inherent risk assessment of an accounting estimate is assessed on a 'spectrum of risk' resulting in an assessment ranging between very low and very high. In order to be able to reflect how this method of assessing the risk inherent in an accounting estimate when determining a sample size for testing the approach should be as follows:

Inherent risk as assessed for an accounting estimate	Assessed risk in the population as used for determining a sample size
1 or 2	Low
3	Medium
4 or 5	High

Control risk is assessed using low / moderate / high and if there is no plan to test the operating effectiveness of controls then control risk is assessed as high.

Planned reliance on internal controls

Where we only confirm the design and implementation of control procedures, we cannot reduce the substantive test sample size for any reliance on controls.

Tests of operating effectiveness of internal controls are often designed to provide either a high or moderate level of reliance and therefore risk reduction.

- A high level of reliance (low level of risk remaining) applies where the primary evidence is coming from tests of controls.
- A medium level of reliance (medium level of risk remaining) applies where the tests of controls will be combined with other substantive procedures to address a particular assertion.

The type of controls being tested may influence the level of reliance to be placed on them. For example, a control applied to all items in the population is likely to provide a sounder basis for reliance than one only applied to certain types or sizes of transactions.

The extent to which we test controls for the planned level of reliance is a matter of professional judgement; however, in ascertaining an appropriate sample size for tests of controls we may use the tests of controls sampling form.

Analytical procedures and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg sales or debtors, or the population could be disaggregated into its component parts, eg different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may “take credit” for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

Materiality factor

The materiality factor is calculated as follows:

total value of population / materiality = materiality factor

The lower the resulting figure for the materiality factor the greater the reduction in sample size. Thus, not surprisingly, the larger the value of the residual population relative to materiality the greater the value of the materiality factor and the larger the final sample size will be.

Where a different specific audit area materiality is set on the B41 then this materiality rather than the overall materiality should be used to calculate any sample sizes for that particular area.

Minimum sample size

Small samples have an increased risk of being unrepresentative and unreliable. If the total population comprises a relatively small number of items, say fewer than 50 items, then alternative procedures should be considered in place of sampling. For example, this might include analytical procedures or a review for unusual items.

When the calculated sample results in a sample size of 15 items or fewer, then alternative audit procedures should be considered as outlined above. If these are not appropriate then the minimum sample size should be 15 items.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

17.3 Getting started for new manual users

Introduction

This 'Getting started' guidance will help you to use the Mercia Audit Manual. You may be a regular user of our products, or this may be the first time that you have used such a manual. Either way, these notes will help you understand the Mercia approach and how to maximise the benefits of the package.

Your subscription also includes the Audit Procedures Manual. Your Audit Procedures Manual contains guidance on general audit procedures such as the planning, controlling, recording and completion of audit work. It also includes specific procedures by audit area (for example, for fixed assets and for income and debtors) that set out the Mercia approach used within the programmes contained within your audit manual. There are also sections on the FRC Ethical Standard and on audit regulation and quality control.

Guidance

You will find the following documents in this section of the Audit Manual:

- a contents page;
- guidance notes;
- this getting started guidance for new manual users; and
- 'What’s changed', which provides a summary of the changes made to the manual in the most recent updates.

Audit approach

The Mercia approach encourages you to adopt a thinking, rather than a form filling, approach. This is achieved in two main ways:

- Through the use of permanent information. If something that you record is unlikely to change significantly from one year to the next, we believe it is better that this is recorded properly once and then rolled forward, updating where necessary each year.
- By encouraging those completing audit work not to file surplus copy documentation, thus generating the need to sign off, date and evidence, as reviewed, the excess paperwork. Where additional paperwork is considered necessary, the system encourages you to file these on a non-audit section of the file.

The planning approach (the permanent file documents and section B within the current file documents)

The key to an effective audit is effective planning. The various steps to be undertaken at the planning stage (such as updating your knowledge of the client, calculating materiality, etc.) are driven by the planning checklist which is filed within the current file documents planning section.

There are different approaches to completing the planning documentation. For more straightforward assignments, as an alternative to completing many of the standard current planning forms, you may choose to adopt a ‘free-form’ planning memorandum.

In such cases, you may opt for the Mercia proforma free-form memorandum which must also be completed alongside the free-form memorandum planning checklist, and the other documents provided within this section, where required, to ensure you have covered all necessary matters.

Whilst completing the memorandum, you should read guidance provided on what is required in certain areas.

It is for the firm to decide the criteria as to when the free-form planning memorandum should be used to replace other standard forms. We recommend that such criteria include:

- the client has been audited by the firm for at least the immediate preceding period;
- there has been no history of controversial issues arising from the previous audits;
- the client qualifies as small, as per company law, or contains characteristics indicative of a simple business as set out below.

The following characteristics may be indicative of a simple business:

- ownership is concentrated in a small number of individuals (sometimes a single individual) who are actively involved in managing the business; and
- the operations are uncomplicated with few sources of income and activities; and
- business processes and accounting systems are simple; and
- internal controls are relatively few and may be informal.

Such entities are likely to include companies which are exempt from audit, but which choose nonetheless to have a voluntary audit, small subsidiary companies, as well as larger entities that are also relatively simple.

The fieldwork approach (sections C onwards within the current file documents)

Once the audit plan has been formed and tailored audit programmes have been produced (see the section named 'The structure of each audit section' within these notes), the audit evidence should be obtained in accordance with these programmes.

To assist in the recording of the detailed procedures at the fieldwork stage, you may find it useful to use some or all of the proforma working papers included in the manual.

The completion approach (section A within the current file documents)

At the completion stage, the planning must be reviewed, alongside the evidence obtained, and all matters need to be drawn together and concluded upon. Completion of the appropriate forms on this section (including a full record of review points, notes of discussions with the client and evidence of clearance of all of these points) will help to achieve the required objectives.

Audit of group accounts

Where you are responsible for the audit opinion of group accounts, the manual contains alternative versions of the planning and completion documentation, as well as additional permanent file documents. This documentation should be used for the audit of the group accounts as it covers both the parent company and the group audit opinions.

Where you are also responsible for the audit opinion of one or more subsidiary companies, you should create standalone documentation, and not use the 'Audit of group accounts' documentation, for these companies and their individual audit files.

The current file

The current audit file provides the documentary record of the audit and constitutes the evidence of what was done and why. In conjunction with the permanent file, it supports the report on the financial statements.

The report not only consists of the opinion but also contains a statement that the audit has been carried out in accordance with auditing standards, thus the two files must demonstrate compliance with the International Standards on Auditing (ISA) (UK), the Ethical Standard and any other regulatory requirements.

The principal objectives of the current audit file are to provide:

- evidence of the planning process, including the risk assessment procedures, and any changes from the original plan;
- a record of the nature, timing and extent of auditing procedures undertaken, the results of such procedures and conclusions drawn;
- a record of the figures included in the financial statements and evidence supporting these figures;
- evidence of control and review;
- a record of problems encountered, weaknesses discovered, and any contentious issues raised and how they were resolved;
- a record of communications with the client relevant to the audit; and
- evidence of the opinion formed.

Because of the significance of the amendments resulting from the changes to ISAs 240 and 315 two versions of the documentation have been included: one for periods commencing before 15 December 2021 reflecting the previous ISA requirements and another for periods commencing on or after 15 December 2021 reflecting the new versions.

The permanent file

The principal purpose of the permanent file is to improve the efficiency of the assignment by providing a good understanding of the organisation. It is an intrinsic part of the audit assignment. Therefore, the permanent file must be comprehensive and up to date. Each year, the permanent file should be reviewed, updated and signed to evidence that this has been done.

The permanent file contains information of a permanent and semi-permanent nature, being information which will be of continuing importance to assignments over a number of years.

Although there is a standard index to the file, as with all aspects of an audit, the file should only contain mandatory information required to comply with auditing standards, and other legislation and regulation, along with information which will aid the efficiency of the audit. The content and form of the file is therefore likely to be different for each client and must be decided upon by the Responsible Individual and manager.

However, a permanent file will normally include the following information:

- information concerning the legal and organisational structure of the organisation, including information regarding related parties and any group structure;
- extracts of important legal documents and agreements;
- any sector specific data;

- details of the accounting systems and internal control environment;
- an appraisal of those systems;
- a summary of key ratios and figures over a period of years; and
- accounts information of ongoing value.

The Mercia approach also encourages users to develop tailored audit programmes which can be held on the permanent file. If held on the permanent file, in future years these must be reviewed and, if necessary, updated as appropriate.

Because of the significance of the amendments resulting from the changes to ISAs 240 and 315 two versions of the documentation have been included: one for periods commencing before 15 December 2021 reflecting the previous ISA requirements and another for periods commencing on or after 15 December 2021 reflecting the new versions.

The structure of each audit section

Divider cards (see current file indexes within the current file documents)

The divider cards include recommended standard references for working papers, as well as the conclusions, for each section of the audit file.

The audit conclusions should be signed by the person completing the work and should then be signed by the reviewer.

Audit plan

Where individual audit sections have been planned separately using the standard individual area audit plans, a copy of the working paper can be placed on the planning section, the permanent file and / or the front of each section of the audit file (where it is filed behind the relevant lead schedule, as this helps to ensure that the section is audited in accordance with the plan).

The use of the individual area audit plan schedules also helps to focus the selection of appropriate audit programmes.

Audit programmes

The audit programme is very flexible and must be carefully tailored for each audit area at the planning stage.

We generally have a choice of sections as follows:

- A General and mandatory tests
- B Tests of controls
- C Non-audit services
- D Analytical procedures
- E Tests of detail (blank programme), or
- F Tests of detail (tailorable programme)

The only sections where this choice is not available are the Accounting Estimates (Q), Going Concern (R) and Subsequent Events (S) audit programmes. In programmes R and S, only the A section is available. For programme Q, this is a supplementary form which must be used where there are key accounting estimates. A separate Q programme is used for each individual key accounting estimate. For example, if there are three key accounting estimates documented in planning, then there would be three Q programmes. The Q programmes can either be filed in the Q section or with the relevant fieldwork for that key accounting estimates (eg. for a stock provision, it could be filed either at Q or in the G Stocks section).

Section A (General and mandatory tests)

This section is nearly always applicable, as this deals with general file completion issues in addition to mandatory ISA testing. Selecting section A will ensure that each programme generated has the correct heading and objectives at the top.

Also included in this section, where applicable, are:

- a prompt to record the risk assessment procedure confirming the design and implementation of key controls; and
- certain procedures mandated by the ISAs.

Section B (Tests of controls)

This section is a prompt to the tests required when assurance is to be placed on the effective operation, throughout the period, of one or more control procedures, as established on the individual area audit plans.

Section C (Non-audit services)

This section is useful when non-audit procedures (such as involvement in the compiling of numbers for the financial statements) are to be carried out and used as part of the audit evidence.

Section D (Analytical procedures)

This section is a menu of possible procedures that could be utilised to achieve the objectives.

Section E (Tests of detail (blank programme))

This section is a page highlighting the key audit assertions for the individual audit area. It should be used either:

- to record any additional tests for objectives not achieved by sections A to D above; or

- on a very low risk area, to record all the tests required for the section.

Section F (Tests of detail (tailorable programme))

This section can be used:

- to record the additional procedures for objectives not achieved by sections A to D above; or

- as the main audit programme for the individual audit area.

NB. If this section is selected, it is very likely that it will need to be tailored, with a number of the procedures crossed through or deleted.

Each individual section of the audit file has its own audit programme. The tailoring process takes place in two stages. Firstly, you should select which of the standard pages are appropriate. Once this decision has been made, further tailoring on a line by line basis is required to select / design the appropriate tests.

The four main areas are referenced consistently for each individual section. Using the sales / income and debtors section as an illustrative example:

- **H3 General and mandatory tests and tests of controls**
  This must be selected for nearly all audits as it ensures general and mandatory ISA tests are performed. The controls – operating effectiveness programme should be selected when some or all of the evidence is to be obtained from testing some or all of the operating effectiveness of controls.

- **H3 Non-audit services programme**
  This is the programme to select when some or all of the evidence is to be obtained from non-audit services, such as financial statements compilation.

- **H3 Analytical procedures**
  This is the programme to select when some or all of the evidence is to be obtained from analytical procedures.

- **H4 Blank additional programme**
  The programme to select either:

  - o to record any further tests on objectives not met by work planned on the above tests at H3; or

  - o to record all the tests required in a low risk area, when H3 are not selected.

These pages could be used in every section of a very low risk assignment.

- **H5 Bank of 'tests of detail'**
  This programme can be used in a variety of ways, for example:

  - as the main programme; or
  - as a reference document to select tests for recording on H4; or
  - as an additional programme to H3.

Selecting appropriate audit programmes for each section is the answer to eliminating over auditing and improving efficiency.

Regardless of which audit programmes are selected as the starting point, individual tests must be added or deleted depending on the specific knowledge of the client.

All combinations and permutations of programmes are acceptable. It is extremely unlikely that all of the tests on any of the programmes will be necessary. This is particularly true of the 'bank of tests of detail' programme (H5).

17.4 What's changed

Update - June 2023

What's changed

We are pleased to issue updates to your Mercia Audit Manual (dated 06/23).

The principal technical changes in this update include:

- Changes in relation to ISA (UK) 600 *Special considerations - Audits of group financial statements (Including the work of component auditors)*;
- The introduction of a new (optional) statistical sampling approach; and
- The introduction of a set of guidance notes specifically tailored for companies.

In addition a number of other minor improvements and amendments have been made to the manual.

See below for a full list of changes.

ISA (UK) 600 Special considerations - Audits of group financial statements (Including the work of component auditors)

In September 2022, the FRC issued a revised ISA (UK) 600. The proposed revisions enhance the risk-based approach to undertaking a group audit and reinforce the need for robust communication and interactions between the group engagement team, group engagement partner and component auditors.

The revised ISA is effective for periods commencing on or after 15 December 2023, although the changes have been early adopted given certain requirements in relation to component auditors are already effectively in place due to the requirements of ISQM 1, and many of the other changes are considered good practice, with some firms already doing a lot of what the new requirements necessitate.

New (optional) statistical sampling approach

A new (optional) statistical sampling approach has been added to sit alongside the extant judgemental sampling approach. For many audits the extant judgemental approach, particularly where populations are smaller, will remain appropriate, however it is not suitable for use on the audits of PIEs or other audits where populations are very large. As such a new statistical sampling approach which does not include a sample size cap has been added to the methodology for use on audits where the judgemental approach is not considered appropriate.

Guidance notes

A new set of guidance notes has been included to reflect the specific requirements of companies. These guidance notes supplement the contents of the Audit Procedures Manual (UK) which support the underlying methodology.

Contact us

We are always pleased to receive feedback on our manuals, including any improvements that you would like to see incorporated. Please contact me if you have any comments to make.

Andy Holton

June 2023

June 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
Guidance	
Contents	• Updated for the Group audit instruction letter and Group audit questionnaire being moved into the Example letters section.
Guidance notes	• A new set of guidance notes including company specific requirements has been added. • Appendix 3a to the guidance notes includes guidance on the new statistical sampling approach.
Getting started for new manual users	• The Accessing the manual section has been removed - guidance on accessing manuals is available on the website.

What's changed	• A copy of this What's changed notice has been added to the manual.

Example letters

3.2 Schedule of professional services - Audit (group)	• Minor update to more clearly reference the group and parent company. • Additional paragraph added in Section 2 to highlight the group auditor is responsible for the direction, supervision and review of the group audit, and to secure agreement to communicate with component auditors without further consent being required.
17 Group audit instruction letter	• Moved from Example reports section. • Significant update to reflect revisions to ISA 600 and best practice updates.
18 Group audit questionnaire	• Moved from Example reports section. • Minor updates to reflect revisions to ISA 600 and best practice updates.

Example reports

2 Unqualified IAS (IFRS) audit report	• References to transitional period wording removed as no longer applicable.
5 Unqualified group audit report	• Minor update to wording of last bullet point in the Auditor responsibilities for the audit of the financial statements section where the full responsibilities are included rather than a link to the FRC website.
6 Unqualified IAS (IFRS) group audit report	• References to transitional period wording removed as no longer applicable. • Minor update to wording of last bullet point in the Auditor responsibilities for the audit of the financial statements section where the full responsibilities are included rather than a link to the FRC website.
Group audit instruction letter	• Moved to Example letters section.
Group audit questionnaire	• Moved to Example letters section.

Example accounts

1 Small Full (FRS 102 1A) accounts	• Updated to state the accounts are based on standards and amendments in issue at 1 April 2023 (no technical changes to the content of the accounts).
1a Small Abridged (FRS 102 1A) accounts	• Updated to state the accounts are based on standards and amendments in issue at 1 April 2023 (no technical changes to the content of the accounts).
2 Not Small (FRS 102) accounts	• Updated to state the accounts are based on standards and amendments in issue at 1 April 2023 (no technical changes to the content of the accounts).
3 UK-adopted IAS accounts	• Updated to state that the accounts reflects standards and amendments in issue as at 1 April 2023 and are applicable for periods commencing on or after 1 January 2021 but before 1 January 2024. • Updated to refer to UK-adopted international accounting standards. • References to p/c before 1 January 2021 removed. • Updated for Disclosure of Accounting Policies: Amendments to IAS 1 Presentation of Financial Statements and consequential amendments.

Accounts disclosure checklists

A32 SUMMARY Disclosure checklist summary	• Updated to refer to UK-adopted international accounting standards.
A32 SMALL FRS 102 1A	• Updated to state that the checklist reflects standards and amendments in issue as at 1 April 2023 (no technical changes to the content of the checklist).
A32 NOT SMALL FRS 102	• Updated to state that the checklist reflects standards and amendments in issue as at 1 April 2023 (no technical changes to the content of the checklist).
A32 IFRS UK-adopted international accounting standards	• Updated to state that the checklist reflects standards and amendments in issue as at 1 April 2023 and is applicable for periods commencing on or after 1 January 2021 but before 1 January 2024. • Updated to refer to UK-adopted international accounting standards. • Updated for Disclosure of Accounting Policies: Amendments to IAS 1 Presentation of Financial Statements and consequential amendments.

A32 FRS 101	• Updated to state that the checklist reflects standards and amendments in issue as at 1 April 2023 and is applicable for periods commencing on or after 1 January 2021 but before 1 January 2024. • Updated to refer to UK-adopted international accounting standards. • Updated for Disclosure of Accounting Policies: Amendments to IAS 1 Presentation of Financial Statements and consequential amendments.

Current file documents

A29 Reporting on irregularities, including fraud in the auditor's report (individual and group)	• An additional column has been added to enable comments to be cross referenced back to where the underlying work has been performed.
A31 Group audit completion checklist (group)	• Four new bullet points added to Evidence section to reflect ISA 600 revisions. • Minor amendments to wording of component auditor questions to reflect revisions to ISA 600. • References to ISA 600 updated.
A41 Group subsequent events update and evaluation (group)	• Minor change to wording of component auditor question to reflect ISA 600 revisions.
A52-1 Communication with group management checklist (group)	• Additional point added to reflect ISA 600 revisions.
A53 Component auditors (group)	• Major update to reflect ISA 600 revisions.
B01 Group planning checklist (group)	• Additional point added in pre planning to reflect ISA 600 revisions.
B02 Group audit strategy (group)	• Minor update to wording of guidance to characteristics of the engagement and nature, timing and extent of resources sections to reflect ISA 600 revisions.
B05 Freeform planning memo (freeform)	• An additional row for Profit before tax has been added into the basis for determining materiality section.
B25 Materiality (individual)	• An additional row for Profit before tax has been added into the basis for determining materiality section.
B25 Materiality (group)	• An additional row for Profit before tax has been added into the basis for determining materiality section. • Update to component materiality section to reflect ISA 600 revisions.
B26 Component auditors (group)	• Major update to reflect ISA 600 revisions.
B30 Group inherent and control risk assessment (group)	• Minor update to Group audit approach section to reflect ISA 600 revisions.
B35 Group audit team discussion (group)	• Update to component auditor point under fraud risk to reflect ISA 600 revisions.
B40 Audit plans (individual and group)	• Guidance in sampling section updated to refer to sampling plan(s) / sampling form(s) as appropriate.
B40/P2 Group audit plan - Intra group balances, transactions and consolidations	• Reference to financially significant, risk significant and not significant under components section removed due to ISA 600 revisions.
CSF Controls sampling form (individual, freeform and group)	• Updated to new format (no substantive technical changes).

SSF Substantive sampling form - Judgemental (individual, freeform and group)	• Updated to new format including more space to justify sample sizes.
SSF Substantive sampling form - Statistical (individual, freeform and group)	• New form for use with the new statistical sampling approach.
P Audit programme - Intra group balances, transactions and consolidations	• A - Update to wording of undertaking work on components test to reflect revisions to ISA 600. • F - Updates to two tests under consolidation section to reflect revisions to ISA 600.
Proforma working papers	• Updated to reflect the update to the SSF Substantive sampling form - Judgemental.

Permanent file documents

PF1-5 Groups	• Additional point added to component entity risks section to reflect ISA 600 revisions.
PF1-7 Using the work of an expert	• Auditor's expert section expanded.
PF1-9 Component auditors	• Understanding the component auditor section expanded.

Supplementary forms

File review checklist (p/c on or after 15 Dec 21)	• Groups section updated to reflect ISA 600 revisions.

Update - February 2023

What's changed

We are pleased to issue updates to your Mercia Audit Manual (dated 02/23).

The principal technical changes in this update include the removal of content relating to the now superseded ISQCs and consequential amendments arising as a result of this. The Audit Manual, together with the Audit Procedures Manual, address engagement level quality management, with the Quality Management Manual addressing firm wide requirements.

In addition a number of minor amendments / improvements have been made to other sections of the Audit Manual, including updating engagement letters to reflect latest guidance.

See below for a full list of changes.

Contact us

We are always pleased to receive feedback on our manuals, including any improvements that you would like to see incorporated. Please contact me if you have any comments to make.

Andy Holton

February 2023

February 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
Guidance	
Contents	• Updated for addition of file review checklists to supplementary forms section.
What's changed	• A copy of this What's changed notice has been added to the manual.
Example letters	
1 Engagement - Covering letter	• Updated the 'professional services provided' section to include a new paragraph which confirms whether disbursements are expected to be incurred. • A new section detailing how communication will be maintained throughout the engagement has been added. • Updated the 'agreement of terms' section to include reference to the firm's privacy notice on their website and reference to the standard terms of business in relation to instances of variation or termination of the engagement.
2 Engagement - Covering letter (group)	• Updated the 'professional services provided' section to include a new paragraph which confirms whether disbursements are expected to be incurred. • A new section detailing how communication will be maintained throughout the engagement has been added. • Updated the 'agreement of terms' section to include reference to the firm's privacy notice on their website and reference to the standard terms of business in relation to instances of variation or termination of the engagement.
3.1 Engagement - Schedule of professional services - audit	• Moved the paragraph highlighted the client's responsibility towards publishing electronic information from the 'Scope of audit' section to the 'Your responsibilities' section. • Added an optional paragraph in the 'Our responsibilities' section highlighting that the auditors have a statutory requirement to communicate with the group auditor. • Included a paragraph in 'Our responsibilities' confirming that the client is to be informed should matters or significant facts arise that may raise ethical concerns.

	• A paragraph was added to the ‘Scope of audit’ section explaining that the auditors may also use analytical tools in their work.
3.2 Engagement - Schedule of professional services - audit (group)	• Moved the paragraph highlighted the client’s responsibility towards publishing electronic information from the ‘Scope of audit’ section to the ‘Your responsibilities’ section. • Included a paragraph in ‘Our responsibilities’ confirming that the client is to be informed should matters or significant facts arise that may raise ethical concerns. • A paragraph was added to the ‘Scope of audit’ section explaining that the auditors may also use analytical tools in their work.
3.3 Engagement - Schedule of professional services - accounting	• Updated the ‘Our responsibilities’ section to clarify that the firm will advise the client on whether their accounting records are appropriate for the preparation of financial statements. • Added a paragraph confirming that the firm has a professional duty to not allow its name to be associated with financial statements that could be misleading. • Included an optional paragraph highlighting the responsibility to provide information in iXBRL format lies with the client, should they ask the firm to convert the financial statements into the iXBRL.
3.4 Engagement - Schedule of professional services - taxation	• Included is a paragraph confirming there may be occasions where the firm will need to seek specialist advice. • Added a paragraph confirming that the responsibility for monitoring turnover in respect of VAT registration thresholds lies with the client. • Clarification that the responsibility for employment taxes, pensions and the assessment of employment status for workers, lies with the client has also been included.
4 Engagement - Terms of business	• Updated paragraphs in the ‘Fees and payment terms’ section clarifying the use of insurance policies to cover fees, circumstances where clients are unable to pay fees and the rights of the firm to exercise a lien over all funds have also been added. • Added a new section detailing standard business terms in relation to confidentiality. • Clarification of potentials actions of the firm, should a dispute arise between parties within the engagement.
Example reports	
3 Statement of directors' responsibilities	• Clarified that the reference to material departures is only required where there are any such departures.
5 Group audit instruction letter	• References to ISQC and quality control updated to ISQM and quality management respectively.
6 Group audit questionnaire	• References to ISQC and quality control updated to ISQM and quality management respectively.
Accounts disclosure checklists	
A32 FRS 101 (FRS 101)	• A small number of disclosure items for which there is an available exemption were missing the omega symbol which has now been added to affected disclosures.
A34 FRS 102 1AG Small Group (FRS 102 1A)	• A number of disclosure points in relation to parent/subsidiary relations have been moved from Section 3 to Section 1 for clarity on when they apply.
Current file documents	
Current file indices (both p/c before and on or after 15 Dec 21)	• Updated to more accurately reflect naming of A21-1, A21-2, A21-3 and B03/B14.
A21-2 Engagement quality review checklist (individual and group) (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.

A21-2 Engagement quality review checklist (individual and group) (p/c before 15 Dec 21)	• Updated to ISQM version of form.
A21-3 Consultation review (individual and group) (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
A21-3 Consultation review (individual and group) (p/c before 15 Dec 21)	• Updated to ISQM version of form.
A22 Overall review of the financial statements (individual and group) (p/c on or after 15 Dec 21)	• Additional bullet 'requirements for and of a statement of cash flows' added to Q21.
A31 Audit completion checklist (individual and group) (p/c on or after 15 Dec 21)	• References to ISA (UK) 240 updated to reflect the FRC's reissued ISA which includes corrected numbering aligned to the international version.
A46 Fraud update and evaluation (individual and group) (p/c on or after 15 Dec 21)	• References to ISA (UK) 240 updated to reflect the FRC's reissued ISA which includes corrected numbering aligned to the international version.
B03 Preliminary engagement quality review (individual and group) (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
B10 Engagement review (individual and group) (p/c on or after 15 Dec 21)	• Under the 'New client checklist' heading, the wording has been updated from "We have completed B13..." to "We have completed / reviewed B13..." to reflect the fact that relevant matters should also be identified in future years when the client is not new.
B14 Preliminary engagement quality review (individual and group) (p/c before 15 Dec 21)	• Updated to ISQM version of form.
B32A-E Key accounting estimate (individual, freeform and group) (p/c on or after 15 Dec 21)	• Updated wording of the key assertions relevant to the accounting estimate which may be selected for clarity.
Permanent file documents	
PF1-2 The applicable financial reporting framework	• Additional bullet 'Requirements for a statement of cash flows' added.
PF5 Permanent audit planning documentation (both p/c before and on or after 15 Dec 21)	• Additional table added to list engagement team members each year if desired.
Supplementary forms	
File review checklist (p/c before 15 Dec 21)	• File review checklist added (moved from Audit Procedures Manual).
File review checklist (p/c on or after 15 Dec 21)	• File review checklist added (moved from Audit Procedures Manual).

18 Pension manual

18.1 Contents

	Guidance
	Guidance notes
1	Introduction
2	Sector overview
3	Accounting and reporting
4	External scrutiny
5	Other reporting requirements
	Appendices
	Appendix 1: Summary of contents of the Annual Report
	Appendix 2: Pension Scheme: is an audit required?
	Appendix 3.1: Notes for completion of planning form B40 Audit plan - Other audit areas - Trial balance (use of ADA)
	Appendix 4: Notes for completion of planning form B25 - Materiality
	Appendix 5: Notes for completion of substantive sampling forms
	Getting started for new manual users
	What's changed

18.2 Guidance notes

1 Introduction

1.1 Scope

This manual provides you with all the programmes, documents and guidance needed to undertake the audit of a UK pension scheme under the International Standards on Auditing (ISAs) (UK) and the FRC Ethical Standard.

The manual is only suitable for audits of standalone entities as, for most pension schemes, components are classed as investments held at fair value. Programmes, documents and guidance in respect of group audits can be found in the Audit Manual (UK).

1.1.1 Specialist Assignment Manuals (SAMs)

Where an entity is not a pension scheme, a Specialist Assignment Manual (SAM) specifically designed for that type of entity should be used, or in some cases it may be appropriate to tailor this manual to meet the specialist requirements of the entity concerned.

In addition to the Audit Manual (UK) dealing with the audit of companies Mercia provides a wide range of SAMs including:

- Academies;
- Charities;
- ~~Clubs (GB);~~
- ~~Clubs (NI);~~
- Limited Liability Partnerships (LLPs);
- ~~Registered Social Housing Providers (RSHPs); and~~
- ~~Societies and Community Interest Companies (CICs)*.~~

~~** This is a supplementary manual designed to be used in conjunction with the Audit Manual (UK).*~~

1.1.2 Quality management

Forms relevant to ensuring quality at the engagement level are included within this manual, with firm wide quality management aspects addressed in the Quality Management Manual (UK) which is available to purchase separately.

1.2 What's included in this manual?

This manual includes:

- Guidance notes - which provide detailed guidance on the sector;
- ~~Example letters - including engagement letters;~~
- ~~Example reports - including example auditor's reports;~~
- ~~Example accounts - prepared in accordance with the Pensions SORP;~~
- ~~Accounts disclosure checklists - for accounts prepared in accordance with the Pensions SORP;~~
- ~~Current file documents;~~
- ~~Permanent file documents; and~~
- ~~Supplementary forms - including a file review checklist.~~

1.3 What else is needed?

You should have access to the Audit Procedures Manual (UK), included as part of the Audit Manual Package (UK) or available to purchase separately, which contains supporting audit methodology and guidance.

You will also need access to the applicable versions of the following:

- the Occupational Pension Schemes (Disclosure of Information) Regulations 2013 (as amended);
- the Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 (as amended);
- the Occupational Pension Schemes (Scheme Administration) Regulations 1996 and other Statutory Instruments (as amended);
- Practice Note 15 - The Audit of Occupational Pension Schemes in the United Kingdom (revised November 2017); and
- Statement of Recommended Practice - Financial Reports of Pension Schemes (SORP), which was last revised in July 2018 and is effective for accounting periods beginning on or after 1 January 2019.

2 Sector overview

2.1 Legal and Regulatory Framework

2.1.1 Introduction

In order to understand the requirements for the audit and accounts of pension schemes, auditors must consider a number of factors:

- the legislation of Pension Schemes, notably the Pensions Act 1995 (PA 95), the Pensions Act 2004 (PA 04) and related regulations;
- Codes of Practice (CoP), issued by The Pensions Regulator;
- the trust deed and scheme rules;
- accounting standards, including the Statement of Recommended Practice (SORP): Financial Reports of Pension Schemes; and
- Practice Note 15: The Audit of Occupational Pension Schemes in the UK (Revised).

2.1.2 The Regulations

2.1.2.1 Pensions Act 1995 (PA 95) and Pensions Act 2004 (PA 04)

The PA 04 is a non-consolidating framework Act. Therefore, previous legislation (ie. PA 95 and a series of regulations to this Act) is still extant and a large number of regulations were issued in 2005 and 2006 making amendments to the previous legislation and regulations.

The regulations that are particularly relevant to accountants and auditors are:

- the Occupational Pension Schemes (Disclosure of Information) Regulations 1996. This has been superseded by the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 with effect from 1 April 2014. This in turn has been amended by The Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021 (SI 2021/1070) which came into force on 1 October 2021 (details in respect of this are outlined below);
- the Occupational Pension Schemes (Scheme Administration) Regulations 1996;
- the Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996; and
- the Occupational Pension Schemes (Scheme Funding) Regulations 2005.

2.1.2.2 Pensions Act 2008

The Pensions Act 2008 introduced fundamental reform with regard to the provision of occupational pension schemes in the UK. The reforms have come about as a result of lengthy consultation around the level of individuals' savings for retirement.

For the first time, the Act requires all UK employers to enrol their employees in an occupational pension scheme and to pay contributions on their behalf. Employers may use their own existing occupational schemes or set up a new one, so long as the scheme meets certain qualifying criteria around automatic enrolment and minimum contribution levels. Alternatively, the contributions may be paid in to a national scheme set up specifically for this purpose, the National Employment Savings Trust (NEST).

Compliance with the Act has taken effect for the largest employers first, starting back in 2012, with all employers on board by 2017.

2.1.2.3 Pensions Act 2011

The Pensions Act 2011 amended some of the legislative framework set out in Pensions Act 2008 relating to the auto enrolment of employees in to qualifying pension schemes. The legislation also introduced provisions for amending the state pension framework, including bringing forward the state pension age equalisation.

The provisions of the Act are unlikely to have a significant practical impact on the accounting for or auditing of pension schemes.

2.1.2.4 Pension Schemes Act 2017

This Act received is primarily concerned with providing greater regulation of master trusts. These are trusts that provide defined contribution benefits (either alone or in conjunction with other benefits) pension solutions to employers who want the advantages of a trust-based scheme without the cost and time of setting up and running their own arrangement.

The provisions of the Act are unlikely to have a significant practical impact on the accounting for or auditing of pension schemes unless the firm is the auditor of a master trust.

2.1.2.5 Pension Schemes Act 2021

The Pension Schemes Act 2021 received royal assent on 11 February 2021.

The Act strengthened the regulatory regime for defined benefit schemes. This will have no direct impact on accounting and reporting by occupational schemes. However, two new criminal offences created by the act of avoidance of an employer debt or acting in a way that detrimentally affects in a material way the likelihood of accrued scheme benefits being received may be relevant from an audit perspective when considering compliance with laws and regulations.

There is also an expansion of the notifiable events regime for employers which are likely to include the sale of a controlling interest in a sponsoring employer, the sale of the business or assets of a sponsoring employer, and the granting of security in priority to scheme debt. This would be relevant from an audit perspective where an employer failed to notify an event when required to do so as the auditor has an obligation to report any failure of employers or trustees to report notifiable events.

Updated guidance from The Pensions Regulator can be found here.

In addition, the Act introduced Collective Defined Contribution (CDC) schemes that combine elements of defined benefit schemes with the principles of defined contribution schemes. See 2.4.2.2 below.

2.1.2.6 Other recent developments to be aware of

The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (SI 2021/839):

These Regulations amend the PA 95, which have also been included within the Pension Schemes Act 2021, and impose requirements on trustees of certain occupational pension schemes to ensure that there is effective governance of those schemes with respect to the effects of climate change. The Regulations also impose associated reporting and publication requirements on the trustees, in particular the requirement to produce a Task Force on Climate-related Financial Disclosures (TCFD) report which is to be published on a publicly available website, a link to which must be referred to in the Annual Report and Financial Statements. The regulations were made on the 13 July 2021 and came into force on 1 October 2021. The disclosure checklist has been updated to reflect the new reporting requirements within the Annual Report and Financial Statements. Currently, there is no requirement for the TCFD report itself to be audited, however, on the basis the TCFD report is referred to within the Annual Report and Financial Statements, auditors would need read this report to identify any material inconsistencies with the audited Financial Statements and knowledge of the scheme in order to fulfil their responsibilities under ISA (UK) 720.

The Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021 (SI 2021/1070):

These Regulations amend the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013. The regulations were made on the 20 September 2021 and came into force on 1 October 2021. This instrument places new administration and governance requirements on trustees of occupational defined contribution (DC) pension schemes, in particular to require trustees of certain DC pension schemes to disclose their investment returns and demonstrate that they are providing value for their members as part of the Annual Statement, which applies for scheme year ends that fall after 1 October 2021. It also increases flexibility for DC schemes to take account of performance fees payable to fund managers when calculating the cap on charges that applies to default investment arrangements in relation to the first charges year of that scheme which ends after 1 October 2021 and, in respect of default arrangements, the later of after the end of three months beginning with the last day of the first scheme year of that scheme which ends after 1 October 2021, or after the end of six months beginning with the day on which these Regulations come into force. Finally, it makes other minor technical changes, including to the ways in which specific types of pension schemes must comply with the requirements to produce a statement of investment principles in relation to the first scheme year of that scheme which ends after 31 December 2021.

2.1.3 The Pensions Regulator (TPR)

The Pensions Regulator (TPR) has been the UK regulator of work-based pension schemes since April 2005.

The Pensions Regulator's website (www.thepensionsregulator.gov.uk) is an essential reference site for all those involved in pension scheme audits.

2.1.4 Codes of Practice (CoP)

One of the requirements of the PA 04 was for TPR to issue Codes of Practice (CoP) which, although not law in themselves, provide important guidance on key issues. The following CoP currently are in force:

Code of Practice	Effective date
1 Reporting breaches of the law	April 2005
2 Notifiable events	June 2005
3 Funding defined benefits	February 2006 (Updated July 2014)
4 Early leavers - reasonable periods	May 2006
5 Reporting late payment of contributions to occupational money purchase schemes	May 2006 (Updated September 2013)
6 Reporting late payment of contributions to personal pension schemes	May 2006 (Updated September 2013)
7 Trustee knowledge and understanding (second issue)	November 2009
8 Member nominated trustees and directors - putting in place and implementing arrangements	November 2006

Code of Practice	Effective date
9 Internal controls	November 2006
10 Modification of subsisting rights	January 2007
11 Dispute resolution - reasonable periods	July 2008
12 Circumstances in relation to the material detriment test	June 2009 (Updated November 2021)
13 Governance and administration of occupational defined contribution trust-based schemes	November 2013 (Updated July 2016)
14 Governance and administration of public service pension schemes	April 2015
15. Authorisation and supervision of master trusts	October 2018
Collective defined contribution	August 2022

2.2 Governing documents

As noted above, a scheme will also have its own governing documents. These include:

- A trust deed - a legal document signed by all initial trustees agreeing to form the scheme that sets out the conditions of the trust under which the pension scheme is set up; and
- Scheme rules - written rules about running the scheme agreed by the trustees.

Care should be taken to review the trust deed carefully as it may necessitate an audit (even where an exemption might otherwise be claimed), or could have other implications such as prohibiting certain transactions, or requiring certain processes or procedures to be followed. Any audits that are required under the trust deed or scheme rules would be classified as non-statutory audits.

2.3 Governing bodies, regulators and sources of reference

The following regulate or advise on different aspects of pension schemes.

2.3.1 The Pensions Regulator (TPR)

TPR's role is to protect members' interests, ensuring that those running occupational schemes meet their legal obligations under pensions legislation.

Scheme auditors, trustees and actuaries have a duty to report to TPR if material breaches of the law have occurred. The PA 04 extended the duty to report breaches to essentially anyone advising trustees.

Legislation provides for both civil and criminal action where offences have been committed. Civil penalties can be imposed by TPR of up to £5,000 for an individual scheme trustee or manager and £50,000 for an organisation. Criminal offences can render those liable to a fine of up to £5,000 or to imprisonment and / or an unlimited fine, depending on the offence.

2.3.2 Registrar of Pension Schemes

TPR has been appointed as Registrar and will continue to provide a tracing service for anyone seeking information on pension rights. The PA 04 introduced the requirement to file a scheme return. These are used by TPR to ensure that their register of pension schemes is up to date, to calculate levies and to identify schemes where members' benefits are, or may be, at risk.

2.3.3 The Pensions Advisory Service (TPAS)

This is a voluntary organisation providing free advice to the public on pension matters generally (excluding advice on state benefits or financial advice).

2.3.4 The Pensions Ombudsman

This body deals with disputes and complaints relating to maladministration. Pensions legislation extends the Ombudsman's role to include looking at complaints or disputes between trustees and employers.

The Pensions Ombudsman is also the Pension Protection Fund Ombudsman.

2.3.5 Pension Protection Fund (PPF)

The PPF is a revision to the previous compensation scheme. It is funded by a levy on schemes. Its primary purpose is to pay compensation to members of defined benefit schemes where the sponsoring employer is insolvent.

2.3.6 Pensions Research Accountants Group (PRAG)

Another useful source of reference is PRAG which is an independent research and discussion group for the development and exchange of ideas in the pensions field. Their website (www.prag.org.uk) contains, inter alia, the latest consultation papers in the field. It is PRAG that has developed the Statement of Recommended Practice (SORP) for occupational pension schemes.

For further information see www.prag.org.uk.

2.3.7 National Association of Pension Funds (NAPF)

NAPF provides representation and other services for those involved in designing, operating, advising and investing in all aspects of pensions and other retirement provision. Their website (www.professionalpensions.com) includes regular updates on the latest developments in the political, research and media arenas as they affect pension schemes.

2.4 Types of scheme

2.4.1 Introduction

Pension schemes may be divided into two main types:

- occupational trust-based pension schemes; and
- contract based personal pension schemes.

Occupational schemes are those run by employers for the benefit of their employees and from an employee viewpoint, are linked with employment. On leaving the service of the employer, active membership ceases, though the employee may leave the benefits accrued to date in the scheme.

Personal pension schemes are individual arrangements made by individuals themselves. These arrangements are available to all individuals. Such schemes may accept contributions from an employer as well as the individual.

Some employers set up group personal pension plans, which are an arrangement for the employees of a particular employer to participate in a personal pension scheme on a grouped basis. These arrangements are subject to different legislation from occupational pension schemes and, with the exception of a stakeholder pension scheme registered as an occupational trust-based scheme, are not subject to the pension scheme audit regime.

Certain specific personal pension schemes such as group money purchase personal pension plans or self-invested pension plans (SIPPs) are exempt from audits under legislation.

This manual is for the use of occupational schemes only.

2.4.2 Scheme classifications

Schemes are classified in a number of different ways, all of which can affect the accounting disclosures and consequently the audit approach. The classifications are as follows:

2.4.2.1 Funded and unfunded schemes

A funded scheme is one in which a pool of assets is accumulated over time for the purpose of meeting liabilities, ie. pension benefits, as they fall due. These assets will be maintained and controlled separately from the assets of the employer company, usually by trustees.

An unfunded scheme is one in which pensions and other benefits will be paid directly out of the employer company's assets, rather than setting aside any provision.

This manual is concerned with funded schemes.

2.4.2.2 Defined benefit, defined contribution and hybrid schemes

Defined benefit schemes, often referred to as salary related schemes, traditionally offered a pension based on the salary of a person when they retired or left the scheme. A defined benefit scheme is built up over the years of employment to enable the trustees to administer the pension rights on retirement. It is the trustees' duty to arrange a level of contributions so that the fund can meet its obligations. This will be on the advice of an actuary. There has been a significant move away from defined benefit schemes because of the risk and related cost to the employer. Many have closed to new members, and others have moved from a final salary basis to a career average. Much of the regulatory role of TPR is concerned with under-funded defined benefit schemes.

Defined contribution schemes, more commonly known as money purchase schemes, are relatively straightforward. Funds are paid into the scheme and the pension benefits payable will be determined by the level of funds. The risk is therefore to the employee. Because the scheme's commitment to pay future pensions is determined by the extent of funds available, no actuarial valuation is normally required. Defined contribution schemes may also be referred to as relevant schemes.

Schemes will normally be a defined contribution or a defined benefit type scheme, although a number of hybrid schemes have developed over the years. In hybrid schemes, the benefit is usually calculated as the better of two alternatives, for example, on a defined contribution and a defined benefit basis. Such a term may also be applied to a multiple benefit or mixed benefit scheme - a pension scheme in which there is both a defined benefit and defined contribution section; membership of the different sections need not necessarily be compulsory or complementary.

As indicated above, many defined benefit schemes are now closed to new members and new employees may enrolled on a defined contribution basis. If they are enrolled into an existing scheme, this becomes a hybrid scheme. Given that a hybrid scheme contains both a defined benefit and defined contribution element, and these pose different risks, each section requires different management strategies by trustees. TPR have expressed concern that these are not always properly addressed.

As noted above, the Pension Schemes Act 2021 introduced Collective Defined Contribution (CDC) schemes. In a CDC scheme, both the employer and employee contribute to a collective fund which provides an income in retirement. Unlike in a defined benefit scheme the employer does not need to guarantee the benefits paid by the scheme. CDC schemes provide a target pension, if the scheme is under (or over) funded then the pensions it pays can be decreased (or increased accordingly).

2.4.3 Classification of a scheme by its investment category and size

It is also important to understand the classification of a scheme by its investment category.

2.4.3.1 Insured schemes

In an insured scheme, the trustees enter into a contract with a life assurance company under which premiums will be paid both to secure benefits and to cover the administration costs of the scheme. The insurance contract does not necessarily guarantee the benefits promised under the scheme rules. The benefits secured by the insurance contract will depend on the level of premiums paid (and the performance of the insurance company's investments). Two types of insured scheme (ear-marked and wholly insured schemes) are explained below.

2.4.3.2 Ear-marked schemes

A type of insured scheme is an ear-marked scheme. These are money purchase schemes which the Audited Accounts Regulations 1996 define as:

"*an occupational pension scheme under which all the benefits other than death benefits are money purchase benefits and all the benefits are secured by one or more policies of insurance or annuity contracts and such policies or contracts are specifically allocated to the provision of benefits for individual members or any other person who has a right to benefits under the scheme.*"

The significance of these types of schemes is that they are exempt from the requirement to obtain audited accounts (unless the trust deed and / or scheme rules specify), but they are still required to have contributions audited. See 2.5.7 below for a summary of the requirements of trustees in relation to ear-marked schemes.

2.4.3.3 Wholly insured schemes

The Scheme Administration Regulations 1996 define a wholly insured scheme as:

"*a trust scheme, other than a stakeholder pension scheme … which has no investments other than specified qualifying insurance policies.*"

Unless small schemes (see below), these schemes require audited accounts. They will invariably be salary related insured schemes.

The term 'fully insured scheme' is no longer referred to in the various regulations. However, when spoken of, it is one under which insurance policies provide benefits corresponding at all times to those promised under the scheme. On retirement, the trustees of insured schemes arrange for an annuity to be purchased to settle the liability for the pension and in most cases, the responsibility for paying the pension is passed to the insurer. Therefore, it used to be the case that the payment of pensions did not appear in the financial statements of many pension schemes. This changed under the 2015 SORP which requires certain annuities (buy-ins, where the annuity contract is in the name of the trustees and thus a scheme investment) to be reported.

2.4.3.4 Self-administered schemes

In a self-administered scheme, the trustees are free to invest in any form of investment permitted by the trust deed. Initially, the term was use where the trustees themselves made the decisions and not where decisions were delegated to investment managers, which were known as managed schemes. Latterly, self-administered in practice means not wholly insured.

Typically, the trustees will invest in fixed interest and index linked securities, cash deposits, UK equities, foreign equities, managed funds, unit trusts and property.

The management of the investment portfolio will be handled either in-house or more usually by an external investment manager and custodian. Similarly, the administration of the scheme will be handled either by in-house staff or by one of the many companies which provide such services to trustees.

A self-administered scheme is often a defined benefit scheme (and often a final salary scheme). However, self-administered money purchase schemes are growing in popularity.

2.4.3.5 Small schemes

A 'small Scheme' is referred to in the (amended) Scheme Administration Regulations 1996 as a scheme with:

- fewer than 12 members where all the members are trustees (or directors if a company) of the scheme; and
- either:
    - the provisions of the scheme provide that all decisions which fall to be made by the trustees (or directors) are made by unanimous agreement by the trustees (or directors) who are members of the scheme; or
    - the scheme has a trustee (or director) who is independent in relation to the scheme for the purposes of section 23 of the PA 95 (power to appoint independent trustees) and is registered on the approved register maintained by TPR.

This exemption therefore does not apply if, for example, there are deferred members who are not trustees. Even if the exemption applies, the scheme's trust deed and rules may still require an audit and HMRC and the scheme actuary may require scheme accounts. Schemes which are exempt from the requirement to appoint an auditor are also exempt from the requirement to prepare a payment schedule.

The definition of 'small' in the Occupational Pension Schemes (Administration and Audited Accounts) (Amendment) Regulations 2005, which came into force on 6 April 2006, applies to all types of schemes. This included schemes previously known as 'small self-administered schemes' (SSASs) and 'small relevant ear-marked schemes', which had a previous statutory exemption. Since these schemes are covered by the general 'small' schemes' exemption, the terms are hardly, if ever, now used.

2.4.4 Additional voluntary contributions

Since 6 April 2006 it is no longer compulsory for employers to offer members a facility to pay additional voluntary contributions (AVCs). Many continue to do so however, and therefore contributions received and benefits paid in relation to such contributions are usually dealt with in the pension scheme accounts. Under the new tax regime scheme, (see 2.4.5 below) members can instead contribute to however many pension schemes they wish. Where AVCs are available, these may be on a defined benefit or defined contribution basis.

AVCs providing defined benefits are generally paid into the scheme itself and can provide 'added years' at retirement. Defined contribution AVCs may be invested in the main fund or, more usually, invested with a third party such as an insurance company or building society. These investments remain under the control of, and are the responsibility of, the trustees of the scheme. Members may choose to pay 'free standing AVCs' (FSAVCs) to an independent third party provider. FSAVCs are outside the control of the trustees and do not form part of the assets of the occupational scheme.

It is important to understand the nature of any AVC scheme, as this determines how the contributions and benefits are reported.

2.4.5 Taxation

On 6 April 2006 (known as Authorisation Day or 'A' Day) pre-existing tax legislation relating to pension schemes was replaced by a new regime. Details of the new regime were set out in the Finance Act 2004 and Finance Act 2005.

Where pension schemes had obtained HMRC approval by 5 April 2006, they automatically became Registered Pension Schemes under the new tax rules. All new schemes need to register with HMRC to become Registered Pension Schemes. Registered Pension Schemes receive a number of valuable tax reliefs, so it is usual for pension schemes in the United Kingdom to seek such status.

The basic concept is that payments into an authorised pension scheme are on a tax beneficial basis and the income and gains within the scheme are tax free. There are a number of situations in which tax benefits can be lost, both for the scheme itself and for individuals within the scheme. One area currently troubling TPR is the rise of what is known as 'pensions liberation fraud' in which individual members are duped into extracting funds from pension schemes in the hope of getting better benefits (usually higher and earlier lump sum payments) but end up losing some or all of their pension entitlement and triggering a tax liability.

2.5 Trustees' duties

2.5.1 Trustees' duties

The PA 95 and the Scheme Administration Regulations 1996 impose a number of specific duties on trustees and the PA 04 further developed their functions and powers. Guidance on the trustees' responsibilities in relation to being sufficiently informed are contained in Code of Practice (CoP) 7: Trustees' Knowledge and Understanding. Also, TPR made available 'The Trustee Toolkit', a series of free on-line training modules to enable pension scheme trustees to meet the requirements in CoP 7 to obtain sufficient knowledge and understanding.

In response to the increased number of members within defined contribution schemes under PA 08 and automatic enrolment, Code of Practice 13 on the governance and administration of occupational defined contribution trust-based schemes was issued and is essential reading for all trustees of such schemes. Given that non-compliance by the trustees may give the auditor a whistle-blowing duty, it is also essential reading for auditors.

2.5.2 Duty to appoint auditors

Section 47(1)(a) of PA 95 requires the trustees or managers of a scheme to appoint auditors. The exemptions from this requirement, as set out in the Scheme Administration Regulations 1996 (as amended), are as follows:

- schemes provided for, or by, or under an enactment (including a local Act);
- schemes with Minister of the Crown or other public authority guarantees;
- unfunded schemes;
- schemes with fewer than two members;
- small schemes which meet the conditions set out in 2.4.3.5 above;
- schemes which provide relevant benefits and which are not registered schemes and which have fewer than 100 members; and
- schemes with a superannuation fund and which have fewer than 100 members.

It should be noted that for schemes to be totally audit exempt, there must be no audit requirement in the trust deed or schemes rules. Where the trust deed requires an audit, the audit will be non-statutory (see 4.2 below).

There is a standardised form of appointment and acceptance of appointment prescribed by the legislation and the appropriate letters are included within the Example Reports section of this manual (see also 4.1.2 below).

2.5.3 Duty to appoint an actuary

Section 47(1)(b) of PA 95 requires the trustees or managers of a scheme to appoint an actuary. The exemptions from this requirement, as set out in the Scheme Administration Regulations 1996 (as amended), are as follows:

- money purchase schemes;
- all of the exemptions in 2.5.2 above.

2.5.4 Duty to appoint a fund manager

Section 47(2) of PA 95 requires the trustees or managers of a scheme, that consists of, or includes investments, to appoint a fund manager. The exemptions from this requirement, as set out in the Scheme Administration Regulations 1996 (as amended), are as follows:

- relevant schemes (as defined by the Financial Services Act 1986 (Occupational Pension Schemes) (No.2) Order 1988);
- wholly insured schemes;
- schemes provided for or under an enactment (including a local Act);
- schemes with minister of the crown guarantees;
- unfunded schemes;
- schemes with fewer than two members;
- schemes which provide relevant benefits and which are not registered schemes; and
- schemes with a superannuation fund.

2.5.5 Receipts, payments and records

Section 49 of the PA 95 and the Scheme Administration Regulations 1996 (as amended) set out the detailed requirements relating to the books and records (including the records of trustees' meetings) that need to be kept. Many of these requirements do not apply to:

- schemes with fewer than two members;
- schemes which provide relevant benefits and which are not registered schemes and which have fewer than 100 members; and
- schemes with a superannuation fund and which have fewer than 100 members.

Further guidance on this is contained in CoP 7: Trustees' Knowledge and Understanding. Also, CoP 9: Internal Controls gives further guidance on what constitutes an adequate system of internal control.

2.5.6 Money purchase schemes - payments schedule

Trustees must ensure that money purchase schemes draw up a payments schedule as specified by the Regulations, ie. setting out the rates of employers' and employees' contributions and the dates that they are due. These schedules will fall as part of the audit requirement in respect of contributions.

Legislation requires that trustees must ensure that any employees' pension contributions deducted from pay are paid to the scheme within 22 days of the end of the month in which they were deducted, or 19 days if paid by cheque. Note that these dates do not override any earlier due date set out in the payment schedule, so if an earlier date is included in the payment schedule the breach is defined by reference to the schedule date and not the statutory 19 or 22 days.

If these payments are late, a breach occurs and may trigger a duty to report to TPR. Code of Practice 5 (CoP 5) 'Reporting late payments of contributions to occupational pension schemes' deals with the duty of trustees in defined contribution schemes to report breaches. The duty of trustees in defined benefit schemes to report is dealt with in Code of Practice 3, which deals with funding defined benefit schemes generally. Theoretically, late payment into a defined benefit scheme does not affect the amount of the member's pension entitlement as it is determined by the scheme rules, hence the fact that trustees of such schemes are not covered by CoP 5.

Note that auditors are not required to comply with CoP 5. However CoP 1 may require the auditor to notify TPR.

For money purchase schemes a concession is provided in regulation 21 of the Scheme Administration Regulations 1996 (as amended) to exclude the requirement to report a late contribution breach where contributions have not been paid in accordance with the payments schedule and are less than 10 days late and the breach is only the first or second default in the 12 months ending on the due date for contributions. For further details regarding reporting to TPR, see 5.1.

2.5.7 Ear-marked schemes

The Audited Accounts Regulations 1996 (as amended) require, for accounting periods starting on or after 22 September 2005, that the trustees and managers of an ear-marked scheme shall, upon receiving a written request from a member of the scheme, make available to them a copy of the most recent accounts published in relation to the insurance companies with which they hold ear-marked policies of insurance or annuity contracts in relation to that person within a reasonable time.

Trustees are also required to provide each scheme member, within 12 months of the end of the scheme year, with a statement detailing the amount of contributions credited to the member during that scheme year.

2.5.8 Defined benefit schemes: scheme funding requirements

The Scheme Funding Objectives (SFO) does not set out a statutory common funding measure. Instead trustees need to take account of the specific circumstances of the scheme.

Trustees or scheme managers of all schemes that are not wholly money purchase schemes (other than where the only element of defined benefit is death benefits that are wholly insured) need to prepare, review and (if necessary) revise a Statement of Funding Principles (SFP) following advice from their actuary. This may be combined with the Statement of Investment Principles (SIP) which is also required.

The actuary is required to prepare a triennial valuation (much as before) but the basis of this valuation is to ascertain what future funding is required so that benefits will be able to be paid when they fall due, taking into account the specific factors of the scheme rather than some statutory calculation. The actuarial valuation is a comparison by the actuary of the value placed on the scheme assets with the technical provisions and an assessment of any future contribution requirement. Calculations of the technical provisions will usually be based on full member-by-member data.

Following the actuarial valuation, trustees must prepare a SFP within 15 months. Where the SFO is not met, the trustees will need to initiate a recovery plan, again with the assistance of the actuary. Any decisions made about the period within which, and manner with which, a funding shortfall is to be eliminated must be set out in the SFP.

Also following on from the actuarial valuation, a schedule of contributions will be prepared setting out the respective rates of contributions payable and the dates by when those contributions should be paid by the employer and employees.

Trustees of defined benefit schemes with at least 100 members must issue an annual summary funding statement (SFS) to scheme members and beneficiaries. Although it will vary from scheme to scheme, TPR consider that the statement should normally be provided within three months from the dates by when valuations or reports must be obtained.

In between the full actuarial valuations, an actuarial report is needed on an annual basis (unless a further actuarial valuation has been undertaken). An actuarial report is the actuary's estimate of the changes to the funding position of the scheme since the last actuarial valuation. Unlike the actuarial valuation, it will not usually be based on such detailed member-by-member calculations.

CoP 3 provides detailed guidance on these arrangements.

2.5.9 Defined benefit schemes: the role of the employer and the employer covenant

It is important to understand the role of the employer in agreeing schedules of contributions. There is a tension between the need to fund any deficit as quickly as possible to protect the interests of the members, and the requirement to retain funds within the employer. This was exacerbated by the objective for TPR to take into account sustainable economic growth. In other words, the regulator needs to ensure that rigorously enforcing scheme funding objectives does not jeopardise the economic well-being or future of the employer.

To reflect this tension, TPR published a defined benefit regulatory strategy, funding policy and a revision to CoP 3. The result is a more flexible approach to recovering deficits so as to not impair the sustainable growth of the sponsoring employer.

Linked to this subject is what is known as the 'employer covenant', which is defined as the obligation and ability to support the scheme in the short and long term. The strength of the employer covenant will have a direct impact on the scheme's funding policy and investment strategy. For example, where the employer is profitable, solvent and liquid there is a strong covenant. Any deficit can be funded over a longer period than would be the case for a weaker covenant. The pension scheme can adopt a riskier investment policy than would be the case for a scheme with a weaker employer covenant as any shortfall caused by an adverse return could be filled by the employer. Trustees are therefore required to consider the employer covenant in setting the funding strategy.

The auditor of a defined benefit pension scheme may be asked to carry out an employer covenant review on behalf of the trustees and would need to consider whether the firm could carry one out within the constraints of Ethical Standards for Auditors.

2.5.10 Member nominated trustees

Sections 241 to 243 of the PA 04 require schemes to make arrangements that provide for at least one third of the trustees in an occupational pension scheme to be member nominated trustees (MNTs). If the trustee is a company, the arrangements must provide for at least one third of the directors to be member nominated directors (MNDs). These provisions came into force on 6 April 2006. CoP 8 provides further guidance on this.

2.5.11 Annual statement regarding governance

Following the publication of The Occupational Pension Schemes (Charges and Governance) Regulation 2015 (SI 2015/879), the majority of schemes providing money purchases benefits are now required to appoint a chair of trustees and produce an annual statement regarding governance which will be included within the annual report, completed within seven months following the end of the scheme year.

2.5.12 GDPR

GDPR will apply to almost all pension schemes in the same way as it does to other entities that process personal data.

The pension trustees are data controllers and are therefore responsible for compliance with data protection requirements. This will be the case regardless of who administers the scheme on their behalf. Guidance on the application of data protection requirements to a pension scheme can be found in the following publications:

- 'An overview of GDPR' and 'Preparing for GDPR' provide general guidance on the application of GDPR and can be found on the Information Commissioner's website (www.ico.org.uk).
- 'PRAG - GDPR Working party: An overview of how the new requirements apply to pension schemes' provides more specific guidance. This is available to PRAG members from the website (http://members.prag.org.uk).

3 Accounting and reporting

3.1 Preparation of accounts

Within seven months of the end of the scheme year, the Regulations require the trustees to make available to members, prospective members, spouses of members or prospective members, beneficiaries and recognised trade unions, a document containing the audited accounts (where the scheme is exempt from appointing an auditor as set out in 2.5.2 above, unaudited accounts), the latest actuarial statement (if applicable) and other specified information. This document is commonly referred to as the annual report.

The regulations referred to above apply to all tax approved occupational pension schemes other than:

- schemes with fewer than two members;
- death benefit only schemes;
- unapproved schemes; and
- unregistered public service schemes.

3.1.1 Accounting standards (SORP)

Compliance with the applicable Pension Scheme SORP is effectively mandatory as both regulations and FRS 102 require a statement in the accounts as to whether or not the SORP has been complied with, and if not, an indication of material departures. The latest SORP was published in June 2018 and is applicable for periods commencing on or after 1 January 2019, although early adoption is permitted. The 2018 SORP incorporates changes made as a result of the triennial review of FRS 102 and also some other legislative changes.

A summary of the main changes is as follows:

- Disclosure of the fair value hierarchy has been amended to require use of the 1, 2, 3 hierarchy. The transitional provision that allowed reference to the a, b, c categories has been removed.
- Disclosure of concentration of investment risk (5%) has been amended in the SORP to include holdings pooled investment vehicles. However, there is no requirement to look at the underlying investments in a pooled investment vehicle unless the scheme is the sole investor.
- Removal of the requirement for an auditor's statement on contributions for schemes with more than 20 participating employers.
- The new requirement a chair's statement on corporate governance for qualifying defined contribution arrangements, including hybrid schemes and master trusts.
- Disclosure of comparative information is always required unless FRS 102 or the SORP state otherwise. Exceptions in the revised SORP include the comparatives for the table of movements in investments and detailed comparatives for derivatives. Further disclosure is also required for hybrid scheme accounts when comparatives are required for both the defined benefit and defined contribution sections, whether on the face of the primary statements or prominently in the notes.
- Inclusion of an explicit reference to the going concern basis even if there is no material uncertainty in relation to going concern. Disclosure requirements for significant benefits pending members decisions at year end have been extended.
- Clarification of the disclosure requirements in pension scheme financial statements regarding the identification of those statements as stated in FRS 102.
- Confirmation that the SORP does not include any of the exemptions allowed for small schemes under FRS 102 Section 1A.

The general accounting rules are as follows:

- the accounts should be prepared on the basis of the accruals concept;
- investments should be shown at their fair value;
- full disclosure of all relevant accounting policies should be made;
- all assets and liabilities should be included on the net assets statement except for:
    - the liability to pay future pensions;
    - free standing AVCs, separately invested from the principal scheme;
- corresponding amounts should be shown;
- disclosure of material related party transactions is required;
- disclosure of any other information necessary to show a true and fair view is also required.

Example annual reports for defined benefit, defined contribution and hybrid schemes prepared under the 2018 SORP are included in the Example Accounts section of this manual. Disclosure requirements for pension scheme annual reports under the 2018 SORP are included in the accounts disclosure checklists in the accounts disclosure checklist section of this manual.

3.2 Preparation of the annual report

The annual report must contain the following:

- list of trustees and advisers;
- trustees' report (which contains details regarding scheme management, investment matters, compliance matters, governance and trustee responsibilities);
- accounts (usually consisting of a fund account and statement of net assets together with related notes as set out in the Disclosure Regulations 2013 and the applicable SORP);
- auditor's report on the accounts;
- auditor's statement about contributions;
- report on actuarial liabilities (if applicable);
- actuarial certification of the schedule of contributions (if applicable).

See Appendix 1 of these guidance notes for exceptions concerning the above.

The form and content of each statement within the annual report is prescribed by the Disclosure Regulations 2013 and the SORP, full details of which are contained in the disclosure checklist in this manual.

3.2.1 Schedule of contributions

The Disclosure Regulations require the trustees to prepare a statement of contributions, as well as providing information to members on their individual contributions. It is not a mandatory requirement to include the schedule of contributions within the annual report, but it is quite common for one to be included. It is, however, mandatory to include the auditor's statement about contributions. Care, therefore, needs to be taken in drafting the auditor's statement on contributions to include the appropriate cross reference to the relevant page in the annual accounts or the separate statement.

With effect from 1 April 2016, the requirement to obtain an auditor's statement about contributions does not apply in relation to a scheme for a scheme year in which, on the first day of the scheme year, the scheme had at least 20 participating employers.

3.2.2 Other accounts

In some circumstances, audited accounts are required in instances other than in accordance with the regular requirements. These circumstances include accounts:

- for the purposes of an actuarial valuation (where trustees decide to obtain such a valuation earlier than is normal because events have changed to such an extent that it would be unsafe to rely on the previous valuation as a basis for setting the level of contributions);
- required for Pension Protection Fund (PPF) section 143 valuations (in the event of a qualifying insolvency event when the scheme enters into an assessment period). The accounts required here mirrored the disclosure requirements previously included in the schedule to the Audited Accounts Regulations 1996. It should be noted that whilst the schedule has been removed from these regulations the PPF Regulations are yet to be amended and the historic disclosure requirements therefore remain when preparing accounts under the PPF Regulations;
- required for PPF section 179 valuations (the valuation used by the Pension Protection Fund (PPF) to calculate the levy to be charged to a scheme; although in practice the accounts prepared under the Audited Accounts Regulations 1996 are deemed to be 'relevant');
- for applications to the Fraud Compensation Fund.

This manual does not provide detailed guidance on these accounts.

3.2.3 Other disclosure requirements: New Task Force on Climate-related Financial Disclosures (TCFD)

There have been recent legislative changes which have placed more obligations on trustees of certain occupational pension schemes to consider environmental factors, including climate change, when setting their investment strategies. The new regulations also impose associated reporting and publication requirements on trustees, in particular the requirement to produce a Task Force on Climate-related Financial Disclosures (TCFD) report which is to be published on a publicly available website, a link to which must be referred to in the scheme's Annual Report and Financial Statements. These regulations came into force on 1 October 2021.

3.2.3.1 Which schemes are affected?

Schemes with net assets, excluding bulk and individual annuity policies, of £5bn or more (except in the case of earmarked schemes) on the first scheme year-end date which falls on or after 1 March 2020 are required to prepare a report in respect of the period from 1 October 2021 to the end of that scheme year (unless audited accounts have not been obtained in respect of that scheme year, in which case from the date they are obtained). Trustees must also publish a TCFD report within seven months of the end of the scheme year which is underway on 1 October 2021 (unless scheme relevant assets are zero on the scheme year-end date).

From 1 October 2021, schemes that are an authorised master trust or a collective money purchase scheme, are also required to prepare a report for the current scheme year which is underway to the end of that scheme year and produce a TCFD report within seven months of the end of that scheme year.

In addition, these new regulations will apply on or after 1 October 2022 for schemes with assets of £1bn or more.

All schemes are able to adopt the new requirements on a voluntary basis.

3.2.3.2 Audit implications

Currently, there is no requirement for the TCFD report itself to be audited, however, on the basis the TCFD report is referred to within the Annual Report and Financial Statements, auditors would need read this report to identify any material inconsistencies with the audited Financial Statements and knowledge of the scheme in order to fulfil their responsibilities under ISA (UK) 720.

3.2.3.3 Future plans

There are plans to expand the new requirements to cover smaller schemes (assets less than £1bn assets). A review of the requirements for smaller schemes is planned to take place in the second half of 2023.

3.2.3.4 Further guidance

The Gov.UK website contains a quick start guide for trustees which outlines the TCFD requirements and trustee's legal duties.

PRAG has also released Guidance for its members, prepared by the ESG Working Party. This covers the TCFD governance and reporting requirements.

3.3 Circulating and filing accounts and reports

The requirements for trustees to make available accounts and reports to certain stakeholders is outlined in 3.1 above.

There is no obligation to file accounts although copies must be provided on request by TPR or HMRC.

4 External scrutiny

4.1 Audit

4.1.1 Requirement for an audit

Trustees are required to obtain audited accounts for all schemes unless they meet one of the exemptions set out in 2.5.2 above. Appendix 2 provides a flow chart to help ascertain if an audit is required. These accounts are required to show a 'true and fair' view and accordingly the auditor is required to comply with International Standards on Auditing (UK) and the FRC Ethical Standard.

Practice Note 15 (revised November 2017): 'the Audit of Occupational Pension Schemes in the UK', provides guidance for the audit of pension schemes and how to deal with specific problems. Whilst this manual draws on guidance in this Practice Note (PN15) it is not reproduced in full.

4.1.1.1 Auditor's statement about contributions

In addition to reporting on the accounts the auditor is required to report whether the contributions have been made "*in all material respects, at least in accordance with the payment schedule for defined contribution schemes or the schedule of contributions for defined benefit schemes*". Where the scheme is an ear-marked scheme, an auditor is required to make the statement on contributions but not to report on accounts.

It is important to note that, since this is not a report on financial statements it is not an audit, and is not conducted under ISAs. Paragraphs 218 to 256 of PN15 deal with reporting on contributions.

PN15 requires two separate reports, one on the accounts and one on the statement. In practice, however, the work will be planned and conducted as a single assignment and the guidance throughout 4.1.3 includes consideration of the work necessary to issue both reports.

With effect from 1 April 2016, the requirement to obtain an auditor's statement about contributions does not apply in relation to a scheme for a scheme year in which, on the first day of the scheme year, the scheme had at least 20 participating employers.

4.1.2 Appointment as auditor

It is the trustees' responsibility to appoint an auditor, who must be qualified to act as a statutory auditor under the Companies Act 2006.

The Regulations include strict requirements for the appointment procedures to be properly recorded in writing. In addition to the usual engagement letter, there needs to first be in place a letter from the trustees formally appointing the auditors and a letter from the auditors as acknowledgement of this appointment. The audit appointment must be acknowledged by the auditor within one month of the appointment. If this procedure is not strictly applied then the appointment is invalid. Additional guidance and practical considerations are contained within PN15. Examples of these letters are available in this manual.

The rules relating to the appointment and removal of auditors are contained in the Scheme Administration Regulations 1996 (as amended). The main points are:

- Auditors are appointed normally for an indefinite period (there is no requirement for annual appointment in the regulations).
- The trustees or managers may remove the auditor at any time by serving notice in writing.
- Auditors may resign at any time.
- If the auditors resign or are removed, they must provide the trustees with:
    - a statement specifying any circumstances connected with their resignation / removal which, in their opinion, significantly affect the interest of the members or prospective members of, or beneficiaries under the scheme; or
    - a statement that the auditors know of no such circumstances.
- The auditor's resignation statement above has to be given to the next auditor appointed and any auditor who is still in office. It should be reproduced in full and included in the annual report. Guidance contained in PN15 explains that this statement will only be required in the annual report if there are circumstances to report.

4.1.2.1 Ethical considerations

Additionally, an auditor must be independent and therefore must not be:

- a member of the scheme;
- a trustee of the scheme, or connected to a trustee of a scheme;
- an employee of the scheme; or
- the employer of any member of the scheme.

Before accepting appointment or reappointment the auditor must consider whether they would be permitted to do so under the FRC Ethical Standard* and the firm's own policies and procedures (including those related to quality management).

** Guidance on the FRC Ethical Standard is included within Section D of the Audit Procedures Manual.*

4.1.2.2 Ethical threats

Whilst all ethical threats must be identified and described, particular attention may need to be paid to the management and self review threats in a pension scheme. Problems may specifically arise as a result of the provision of accounting services and the lack of 'informed management'.

The Ethical Standard states that unless there is 'informed management' and there are appropriate safeguards there is a risk of the auditor taking a management role. Auditors of pension schemes should therefore record clearly on file who they believe is 'informed management' within the scheme where such threats arise. Where problems exist the provisions available for smaller entities may be useful.

4.1.2.3 Provisions Available for Audits of Small Entities (PAASE)

To qualify for PAASE, a pension scheme must be a 'small entity'. The definition of a pension scheme that qualifies as small, and can therefore take advantage of PAASE, is any scheme with fewer than 100 members (including active, deferred and pensioner members). As a result, many audits of pension schemes will be able to utilise these provisions.

Alternative provision

For scheme that qualify to apply PAASE, auditors are not required to apply safeguards to address a self-review threat, provided:

- the client has 'informed management'; and
- the audit firm extends the cyclical inspection of completed engagements that is performed for quality control purposes, to include some PAASE clients.

It should be noted that if advantage is being taken of the alternative provision, no disclosure of this is needed in the audit report or notes to the accounts.

Exemption

Where advantage has been taken of the exemption in relation to the provision of non-audit services or partners / statutory auditors joining the audited entity, the Responsible Individual should ensure that:

- the audit report discloses this fact; and
- either the financial statements or the auditor's report discloses the type of non-audit services provided.

The sample wording offered to include in the basis of opinion section of the audit report is:

"*We are independent of the scheme in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and the provisions available for small entities, in the circumstances set out in note [X] to the financial statements, and we have fulfilled our other ethical responsibilities in accordance with these requirements.*"

Wording provided in the notes to the financial statements will then need to be tailored to the specific circumstances. Other PAASE exemptions are also available - see the Audit Procedures Manual or section 6 of the FRC Ethical Standard for details.

4.1.2.4 Rights of auditors

The Scheme Administration Regulations 1996 (as amended) also require:

c. any employer who employs members or prospective members of the scheme;
d. b. the auditors of any such employer;
e. the trustees of the scheme;

to furnish the auditors (and, in the case of a. and b., the trustees) with such information as the auditors may reasonably require for the performance of their duties. In addition, the trustees are required to allow the auditors access to the scheme's accounts, books and records at all reasonable times.

4.1.2.5 Ear-marked schemes

While trustees of ear-marked schemes are not required to have accounts prepared and audited, they still require the auditor to report on the payment of contributions. Examples of an engagement letter and relevant audit report can be found in the Example Letters and Example Reports sections of this manual, respectively.

4.1.2.6 Non-statutory audits

There may be situations where schemes such as small schemes would be exempt from audit under the regulations, but not by the trust deed. If the trust deed is not altered, then an audit will still be required. In this case the appointment under the Pensions Act would now be as 'professional adviser' or, as referred to in PN15, 'non-statutory auditor' and not as auditor. The audit then becomes a non-statutory audit (see 4.2 below).

If the non-statutory audit requires a report on the accounts in similar terms to that of the statutory audit, the guidance throughout 4.1.3 should be followed. Similarly, if a report on contributions is required regard should be had to the relevant paragraphs of those chapters.

4.1.3 Conducting the audit

This section outlines a number of considerations when conducting an audit which are specifically relevant for audits of pension schemes.

The audit of a pension scheme is in principle no different from any other true and fair audit. International Standards on Auditing (UK) apply as normal. However, the nature and activities of a pension scheme mean that auditors have to adapt their procedures to suit the circumstances. Testing will concentrate on key areas (investments, contributions, investment income and benefits); areas which may not normally be encountered in other audits.

As with any other audit, the important issue is to identify the objectives of the work and plan what is needed to achieve them. No two pension schemes will be exactly the same and the approach will need to be decided according to the circumstances.

The pension schemes more commonly dealt with will be of three principal types:

Ear-marked schemes

In this type of scheme, an insurance contract is effected in respect of each member which guarantees all benefits payable. For this type of scheme, the requirement for assurance only concerns contributions.

Wholly insured schemes

Here one or more insurance policies are the only long term investment medium, but they do not necessarily guarantee all benefits. To the extent that the policies do not provide for all benefits, they will need to be valued and included on the asset statement.

Other self-administered schemes

With these, the trustees decide where the assets of the scheme are invested. They may do this themselves, or it may be delegated to an in-house manager or an external fund manager.

It is likely that an auditor will sometimes encounter larger schemes with significantly more members. For these schemes, greater emphasis will need to be given to the controls established by the trustees.

4.1.3.1 Initial considerations

Prior to considering the approach in detail, auditors should ensure that the following are addressed:

Regulations

Staff should be made aware of their duties and responsibilities and obtain a general understanding of the various regulations and SORP.

Trust deed / rules

The type of scheme should be properly understood and a general review of the trust deed should be carried out. This is particularly relevant as there is a reporting requirement should the rules be breached.

Letters of engagement

In the first year of an assignment, there are formal appointment procedures that need to be carried out (see 4.1.2 above). In subsequent years, this letter should be reviewed and, if necessary, updated.

Other advisers

There could be a number of other agents and advisers involved with the scheme. These may include an actuary, investment manager, insurance company, administrator and sponsoring employer. If possible, auditors should agree the right of direct access to these parties and should consult with them as early as possible. During the audit, information will be received from these parties and the auditors will need to decide if it constitutes independent confirmation from third parties or more similar to management representations.

ISA (UK) 500 outlines more specifically the evidence provided by experts engaged by the client. ISA (UK) 402 provides additional guidance for situations where the trustees have outsourced the pension scheme administration to these other advisers. Practice Note 15 (revised November 2017) (PN15) also includes additional guidance in these areas.

Actuarial report / statement

If the scheme is one which requires the actuary's involvement the latest report and annual statement should be obtained. The report will be useful as part of the audit evidence to support matters such as contribution rates, etc. Its existence will also be evidence of the trustees' compliance with their responsibilities.

If such a report is included within the annual report the auditor will be required to perform procedures and report in accordance with requirements related to other information as set out in ISA (UK) 720. PN15 provides guidance on liaison with the scheme actuary.

Appointment

There is an ethical requirement to consider the appropriateness of the appointment each year regardless of the fact that the auditors may have been appointed for an indefinite term. Auditors should complete the appointment consideration in the planning section.

Money Laundering Regulations (MLR)

The implications of the MLR must be considered on all pension scheme assignments. Full details of the firm's anti-money laundering procedures can be found in firm's money laundering compliance manual.

Prompts are included in the planning and completion sections of the pension schemes documentation to remind staff of the need to consider the need to update customer due diligence (CDD) information as well as reminding them of the need to report any suspicious activities observed during the course of their work.

The permanent file documentation includes new client forms.

It is likely that the risk can be assessed as low which means verification need not extend beyond the above points, where the following applies:

- evidence is available confirming HMRC approval and / or registration with TPR; and
- the scheme provides retirement benefits for employees, where contributions are made by an employer or by way of deduction from an employee's wages and the scheme rules do not permit the assignment of a member's interest under the scheme.

4.1.3.2 Materiality and the financial statements

Guidance on materiality in planning and performing an audit for a pension scheme is included in PN15. The nature of pension schemes is such that there can be a very large difference between the size of numbers on the net asset statement and fund account which means it may be useful to calculate a separate materiality figure for each of these to avoid under or over auditing.

Appendix 3 to these guidance notes provides further guidance on completion of the Materiality planning form for pension scheme audits.

Errors identified during the course of the audit are recorded and the overall and net effects considered in determining whether the errors are material for reporting purposes.

4.1.3.3 Materiality and the statement on contributions

In addition, the auditor will in many cases give an opinion on contributions. It is important to remember that in dealing with work on contributions the key term is "*contributions have in all material respects been paid at least in accordance with …*".

'In all material respects' will involve a numerical assessment, which will usually involve a separate materiality figure being calculated (in line with the suggestion made in PN15) since the opinion is on contributions due under the schedule of contributions or payment schedule, rather than a 'true and fair' opinion. Therefore, it should be based upon contributions receivable and combined with a consideration of the timing of contributions and whether these are materially late. See also 'risk assessment procedures' in paragraph 4.1.3.4 below.

Regarding the auditor's statement on contributions, a lower level of materiality will be appropriate for the work carried out in this area (and should be noted as such in the box at the bottom of the Materiality planning form).

It is worth noting that The Pensions Regulator (TPR) expects whistle-blowing reports to be made for anything it considers materiality significant. These transactions may not be material to the accounts or opinion on contributions but need to be highlighted on the Summary of misstatements completion form and considered for reporting. An example might be a small amount of contributions taken by the trustees. More details are included in section 5.1 of these notes.

4.1.3.4 Understanding the entity and risk assessment procedures

In planning the approach, auditors should ensure that all the relevant background information including controls has been obtained and recorded (ISA (UK) 315). It is essential that an up to date copy of the scheme rules is obtained as these drive many of the numbers which appear in the accounts, eligibility for membership, contribution and benefit levels, etc.

Depending on the size of complexity of the scheme, either:

- record brief details about the background and systems and controls in operation which can then be filed on **PF1** and **PF2** and assess the risk in note form; or
- for larger, or more complicated schemes, it may be more appropriate to complete the detailed standard forms on **PF1** and **PF2**.

To assist with understanding the scheme it will be beneficial to obtain a copy of the scheme annual return (if one has been completed) which, again, can be filed in **PF1**.

Reliance on controls will be particularly relevant where trustees have delegated much of the administration to others, as they still are accountable to members and it is their responsibility to safeguard the assets of the scheme. Auditors should also consider the requirements of ISA (UK) 402 where these areas have been outsourced, including (where appropriate) the need to obtain and review a Type 1 or Type 2 report. Further details of requirements relating to service organisations are outlined on **PF1-6** and guidance is available in PN15.

Where used, the detailed standard forms on the entity and its environment facilitate documentation of the assessment of areas such as related parties on **PF1-4**, using the work of an expert (eg. actuaries and professional valuers) on **PF1-7** and accounting estimates (eg. valuation of investments and property held for disposal and 'buy-in' or 'buy-out' arrangements) on **PF1-8**.

As with any audit, an assessment of overall risk and risk due to fraud is an essential part of the planning process. The permanent risk factors should be recorded on the audit file. The risk assessment, together with risk areas and the audit approach, should be recorded on the Inherent and control risk assessment form within planning. PN15 gives detailed guidance on factors affecting risk and in particular on those risks at the financial statement level (paragraph 211) and at the assertion level (paragraph 212). In addition paragraphs 213 and 214 give guidance on the identification of significant risks.

The requirements of ISA (UK) 250A in relation to risk arising from non-compliance with laws and regulations is particularly important in pension scheme audits. It is not the auditor's responsibility to prevent non-compliance with laws and regulations and auditors are not expected to detect non-compliance with all laws and regulation. Auditors should be chiefly concerned with areas that:

a. directly affect amounts / disclosures in the financial statements;
b. may have a fundamental effect on operations of the pension schemes.

The auditor is required to obtain sufficient appropriate audit evidence regarding compliance with those in a. above. PN15 gives guidance on the identification and classification of such laws and in particular notes that the trust deed and scheme rules together with the legal framework plus the detailed framework concerning the preparation of the financial statements and other matters on which scheme auditors are required to report together comprise those in section a. Hence the requirement above to have a copy of the trust deed and scheme rules on file.

In addition to those laws and regulations which relate to reporting on the accounts, PN15 recognises a separate category of laws and regulation relating to the payment of contributions, which the auditor issuing a report needs to be aware of and to check compliance with.

These details are recorded on **PF1-3** and appending schedules.

Beyond the risk assessment procedures, auditors must maintain professional scepticism and remain alert for the possibility of non-compliance or suspected non-compliance during the fieldwork and completion stages of the audit (prompted on **A31**). Certain procedures on significant laws and regulations are included on K section audit programmes (in this context, 'significant' means those laws and regulations where non-compliance may have a material effect on the financial statements). Written representations from the client are obtained and confirm that they have disclosed all known or suspected instances of non-compliance with laws and regulations.

Beyond this however, in the absence of identified or suspected non-compliance, auditors are not required to perform any further procedures.

Risk response

Having understood the entity and identified the risks, the auditor determines the appropriate response. Again, PN15 has guidance on this area. It is important to appreciate that in the audit of the financial statements analytical review is a very powerful tool and in many small schemes may be used on its own to provide sufficient appropriate audit evidence. Where contribution levels are consistent and membership categories are simple, analytical review may be sufficient to ensure that contributions are neither overstated nor understated. It cannot however confirm that the contributions were paid at the right time. Some substantive testing is therefore required to enable the auditor's statement on contributions to be made.

Section 4.1.3.5, below, has further guidance on audit evidence.

4.1.3.5 Audit evidence

Auditors are required to obtain sufficient appropriate evidence in order to give their opinion on the accounts and on the payment of contributions. The following key areas will need to be considered.

4.1.3.5.1 Contributions receivable

Auditors have a specific responsibility to report that the contributions to the scheme are in accordance with the schedule of contributions or payments schedule (see 4.1.5 below for further details regarding the auditor's statement on contributions).

The evidence obtained will derive mainly from the membership records and the sponsoring employer's payroll records. The testing of the overall level of contributions should provide a great deal of assurance. However, consideration of the timing of contributions receivable will need to be considered and not just total amounts.

For ear-marked schemes, the payment of contributions is the only area on which the scheme auditor is required to report.

Auditors must view this area as potentially high risk. Indeed, ISA (UK) 240 includes revenue recognition as a presumed significant risk and contributions receivable is usually the biggest source of 'revenue' for the scheme. This presumption is, of course, rebuttable, and in small, simple schemes this may the case, otherwise contributions will be a significant risk. Tests should, generally, include joiners and where renewals have taken place. As part of this testing, auditors should ensure that the amounts deducted from employees' pay were correctly paid over to the scheme by the due date.

Testing can be carried out at two levels:

- in total;
- checking individual members.

It is common for the timing of all monthly contribution payments to be checked. It is also relatively easy to check all monthly payroll records to the amounts paid over. Analytical procedures provide powerful evidence by applying the applicable contributions percentages to total pensionable salaries to form a proof in total.

A relatively small sample of members can be selected for testing. This will usually be a judgmental sample but the sample, where applicable, should include at least one member:

- from each separate payroll;
- paying at each rate of contribution if there are different scales for different ages or positions within the sponsoring employer;
- making AVCs;
- making contributions in the period immediately after a change in the schedule of contributions.

For each member selected the following checks should be performed:

- Check that the current employee contribution has been deducted. This will involve checking the percentage used to the schedule of contributions or payment schedule, checking the correct definition of pensionable salary (as defined in schedule itself or scheme rules) is being used and checking the calculation itself.
- Check that the current employer's contribution is being paid. Again, check the correct percentages are being used along with the calculations and definition of pensionable salary.
- Check that any AVCs deducted are properly authorised by the member and paid over to the scheme by the due date.
- Check that all the deductions above are included in the monthly total paid over.
- For defined contribution schemes, the contributions made in respect of each member should be checked to the members' files or investment reports to ensure they have been correctly allocated to the member in question.

4.1.3.5.2 Benefits payable

If the scheme is responsible for the payment of benefits, auditors will need to verify these. With ear-marked schemes, the benefits are the responsibility of the insurance company and are therefore outside the scope of the accounts or audit. In other situations auditors will need to look at:

- pension payments (similar to a normal payroll audit);
- death benefits;
- transfers in or out of the scheme;
- early leavers; and
- whether they are properly paid in accordance with the trust deed, making reference to actuarial workings, where appropriate.

4.1.3.5.3 Investments and investment income

Investments will represent the majority of the scheme's assets and, other than the receipt of contributions and payment of benefits, the purchase and sale of investments may well represent the main items for audit testing.

Changes to the SORP as a result of FRS 102 now require annuity policies held in the name of the trustees to be reported at the value of the related obligation. They can no longer be reported at nil value.

All other insurance policies and investments should be valued at fair value and included in the statement of net assets.

The requirement to include investments at fair value, and the fact that many investments are held by custodians and valued by investment managers, means that the audit of investments will have a number of issues different from other entities. These include valuation of investments, use of service organisations and accounting estimates (all covered in more detail below).

VAT on fund management costs

Prior to Brexit, European court decisions confirmed the position regarding the VAT treatment of pension fund managements costs and also the recovery of that VAT by sponsoring employers. Guidance from PRAG, issued in January 2018, highlighted the options available and the need for correct documentation.

The guidance considered the different VAT treatments that apply depending on whether the scheme or the employer contract for the management services and also the new option of using a tri-partite agreement (Scheme, Manager and Employer) that could enable employers to recover 100% of the VAT.

Copies of the guidance are still available to PRAG members on the PRAG website (www.prag.org.uk).

4.1.3.5.4 Problem areas

Auditors may encounter a number of problem areas when attempting to obtain sufficient appropriate evidence.

These include:

- where the scheme auditor does not audit the sponsoring employer (see below);
- valuation of investments (see below);
- use of service organisations (see below);
- insured schemes (see below); and
- accounting estimates (see below).

In addition, going concern does not play the same fundamental role in the audit of pension schemes (see below).

4.1.3.5.5 Where the scheme auditor does not audit the sponsoring employer

The audit of contributions will rely upon information obtained from the records of the sponsoring employer. If the auditors also audit the employer, this information is available to them and they can undertake whatever work they need to. In other circumstances, auditors will need to agree with the trustees whether they or the employer's auditor are to undertake the work on the payroll records.

Where the work will be carried out by the employer's auditor, the scheme auditor may request the scheme trustees to ask the employer's auditor to carry out certain work on contributions paid by the employer. The scheme auditor would need to specify to the trustees those procedures to be undertaken. Usually, the trustees would make their request via the sponsoring employer; should the trustees wish to contract directly with the employer's auditor, the latter will need to be appointed as professional adviser to the scheme.

The scheme auditor would advise the employer's auditor of the use that is to be made of their work and make necessary arrangements for the co-ordination of their efforts at the initial planning stage of the audit.

4.1.3.5.6 Valuation of investments

The SORP requires all investments to be valued at fair value and provides guidance on how this should be achieved. With marketable securities, it is not too difficult to confirm the SORP has been complied with. However, with property and unlisted securities, the auditors may be more reliant upon the opinion of experts. If the expert is 'internal', they should consider the necessity of obtaining independent confirmation. Before accepting the evidence of an independent expert, auditors should ensure that the procedures adopted are in accordance with ISA (UK) 620.

Under the SORP, insurance policies are also included on the statement of net assets, therefore they must also be included at fair value. The SORP provides specific details in relation to the valuation of annuity policies and other insurance policies. Normally, the insurer or the scheme's actuary will provide the value. Auditors will be relying upon a specialist and should adopt the required procedures before accepting the value.

4.1.3.5.7 Use of service organisations

ISA (UK) 402 is concerned with audit evidence considerations in relation to service organisations. These principles apply to pension schemes and auditors need to consider whether sufficient evidence can be obtained from the pension scheme without recourse to the accounting records of the service provider. If they are unable to obtain such evidence from the scheme, they need to contact or visit the service provider, or obtain a Type 1 or Type 2 report (if available) to support their understanding of the service organisation. If they are still unable to obtain such evidence, they need to consider whether to qualify their audit report. Refer to ICAEW technical release TECH 01/20 AAF Assurance reports on internal controls of service organisations made available to third parties, which replaces TECH 01/06, effective for accounting periods beginning on or after 1 July 2020 for guidance on the preparation and use of such reports. Practice Note 15 (revised November 2017) (PN15) also gives guidance on the use of such reports.

Paragraph 142 of PN15 states that "*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 (see also ISA (UK) 500)*".

Therefore, with regard to confirming the valuation of investments, this can usually be done either by analytical review (comparing the closing value of each individual fund with the previous year and linking this to your knowledge of movements in the market) or by test checking a sample of the closing prices to external market information.

4.1.3.5.8 Insured schemes

Here, much of the administration and record keeping will be undertaken by the insurance company. Although, ideally, auditors should examine the records kept by the insurance company, they will normally be satisfied with the information made available by the company, supported by other certificates and valuations obtained by direct communication.

4.1.3.5.9 Accounting estimates

Whilst often unavoidable, the use of accounting estimates in the preparation of the accounts gives rise to increased risk of material misstatement. Accounting estimates are identified and assessed on the permanent file (form **PF1-8**). Examples of accounting estimates may include:

- valuation of investments;
- complex financial instruments;
- provisions for doubtful debts;
- costs arising from legal settlements/judgments;
- property held for disposal;
- outcomes of litigation; and / or
- 'buy-in' or 'buy-out' arrangements.

The focus should be on estimates with a high level of estimation uncertainty. Examples of situations where there is relatively low estimation uncertainty include non-complex 'business' operations, routine transactions, simple methods of estimation or well established models used to make the estimation.

PRAG Guidance: Accounting for Guaranteed Minimum Pension equalisation by pension schemes following the Lloyd's judgement (March 2019)

Following a legal judgement in 2018 defined benefit schemes have a legal obligation to equalise Guaranteed Minimum Pensions (GMPs) for members contracted out between May 1990 and April 1997, backdated to May 1990, through provision of other scheme benefits. Under FRS 102 and the Pension SORP the obligation in respect of backdated benefits and related interest should be recognised as a liability in pension scheme accounts where material and it can be measured reliably.

The guidance looks at the issues arising from this ruling and how they can be addressed.

Whether or not it is necessary to recognise a liability and incur the time and expense of obtaining a reliable estimate, will depend on whether or not it is material to a scheme's financial statements.

Current industry estimates of the total cost range from less than 1 to 4% of scheme liabilities for some schemes. There are no estimates publicly available for the backdated element which is likely to be only a proportion of the total liability.

It may be possible to carry out a high-level assessment of the likely liability. This assessment could be based on estimates determined by the Scheme Actuary or estimates prepared for the purposes of the employer's financial reporting. If it is clearly going to be immaterial it will not be necessary to include it in the financial statements. However, the trustees should explain their approach to dealing with the issue in the trustees' report pointing out that a provision is not required on the grounds of materiality.

Determination of the provision at a member level is likely to be complex and will involve detailed analysis of individual member records which may not be available for some time. There may also be complications in applying the methodologies approved by the court. Therefore, if a reliable estimate can be determined by other methods it will not be necessary to calculate the backdated benefits and related interest at a member level.

It is possible that measurement difficulties might exist which mean the trustees cannot reach a reliable estimate. Non-recognition of liabilities due to measurement difficulties is normally expected to be rare (SORP 3.6.3). If the trustees conclude that it is too early in the process to determine a reliable estimate and there are grounds to believe the amounts are likely to be material this should be disclosed in the notes to the financial statements (FRS102:2:32) as a contingent liability (FRS 102:21:12). The scheme auditor will obviously need to consider the implications for their report.

The question arises as from what date this obligation existed. This matters in determining whether the ruling as an adjusting or non-adjusting post balance sheet event. Either the effective date of the obligation is the date of the ruling meaning it is a non-adjusting event for periods ending before the ruling. Or it could be argued that trustees have always had this obligation making it an adjusting event. The balance of views emerging from accounting firms is that the effective date for recognising the obligation is the date of the ruling which provides clear guidance as to the measurement methods available.

Schemes with year ends after the judgement date will recognise the cost of backdated benefits and related interest in their financial statements where material and where a reliable estimate can be made.

Early communication between trustees, scheme auditors, scheme actuaries and the employer is vital to assess the implications and likely impact on pension scheme financial reporting.

Other cases to be aware of

In addition to the Lloyd's judgement, a number of other cases centred around discrimination should be noted and considered:

- McCloud - In the McCloud case, the Court of Appeal ruled that the Government's 2015 public sector pension reforms unlawfully treated existing public sectors differently based upon members' age on the 1 April 2012.
- Goodwin - The decision in Goodwin & I v UK Government held that the Government's failure to alter the birth certificates of transsexual people, or to allow them to marry in their new gender role, was a breach of the European Convention on Human Rights.
- Walker - The Walker case related to a defined benefit scheme where the survivor's pension payable to a surviving civil partner or same sex spouse was restricted so that it reflects only the member's pensionable service since 5 December 2005, the date on which the Civil Partnership Act 2004 came into force. The Supreme Court overturned the Court of Appeal decision and held that this restriction is unlawful.
- O'Brien - The O'Brien case relates to part-time workers gaining pension rights prior to the part-time workers legislation coming into force on 1 July 2000, the ruling in respect of this case means firefighters with service prior to this date would be eligible to retrospectively buy-back pension rights to when they originally joined the fire service.

4.1.3.5.10 Data protection, cybercrime and fraud

PRAG Guidance: An Overview of the Effects of Cybercrime on Pension Schemes (October 2020)

TPR issued guidance for trustees on the 'Cyber Security Principles for Pension Schemes' in April 2018. This guidance states that trustees and scheme managers need to take steps to protect members and assets, which includes protecting them against cyber risk, and that this is regardless of the size or structure of a scheme. The guidance issued by PRAG provides further guidance to those involved in the pension sector about controls and procedures needed to minimise the damage which can be caused by cybercrime.

This is relevant from an audit perspective as it concerns the risk of fraud, compliance with laws and regulations and also assessment of the systems and controls maintained by the scheme.

The guidance explains:

- What constitutes cybercrime:
    - data theft;
    - ransomware;
    - loss or theft of storage devices;
    - targeted security vulnerabilities in systems;
    - disclosure of confidential documents.

And also:

- Why pension schemes are potentially vulnerable and attractive to cyber criminals, namely:
    - schemes hold a lot of personal data about members and employees including sensitive information;
    - many functions are outsourced to third parties which also deal with other schemes and so would be particularly attractive targets.

The April 2018 guidance, issued by TPR, set out the following points:

- trustees and scheme managers are accountable for the security of scheme information and assets;
- roles and responsibilities should be clearly defined, assigned and understood;
- trustees and scheme managers should have access to the required skills and expertise to understand and manage the scheme cyber risk;
- trustees and scheme managers should ensure there is sufficient understanding of the cyber risk including: a scheme's key functions, systems and assets, its 'cyber footprint', vulnerabilities and impact;
- trustees should make sure cyber risk is on the risk register and regularly reviewed;
- trustees should ensure sufficient controls are in place to minimise the risk of cyber incident, around systems, processes and people;
- trustees should assure themselves that all third-party suppliers have put sufficient controls in place and certain standards and accreditations can help demonstrate cyber resilience;
- trustees and scheme managers should have systems and processes in place to ensure the safe and swift resumption of operations;
- there should be an incident response plan in place to deal with security incidents and enable the scheme to swiftly and safely resume operations - trustees should ensure they understand their third-party suppliers' incident response processes;
- trustees should be clear on how and when incidents would be reported to the trustees and others, including regulators (such as the ICO and TPR);
- cyber risk is complex and evolving and requires a dynamic response - controls, processes and the response plan should be regularly tested and reviewed and trustees and scheme managers need to be regularly updated on cyber risks, incidents and controls, and seek appropriate information and guidance on threats.

TPR also made it clear that it expects trustees to maintain robust internal controls and to be assessing and monitoring their administrators to ensure that processes and internal controls are meeting their requirements.

The guidance then addresses how a scheme should respond:

- IT based solutions such as firewalls, access controls, security settings, etc.;
- mapping data to identify targets;
- assessing and testing cyber defences;
- planning for resilience;
- dealing with identified vulnerabilities;
- prompt response and triage of any incidents;
- investigation of what happened, who was affected, the severity of the breach and remedial action required;
- what can be done to mitigate any legal or financial (fines and penalties) consequences.

PRAG Guidance: Counter fraud (June 2021)

This guidance has been developed by the PRAG's Cybercrime and Fraud Working Party and is intended as guidance for pension scheme trustees and those in senior management positions rather than being a technical document.

The guidance explains that trustees and senior management will need to have considered fraud risk when compiling their risk register and whether it should appear in the risk register, noting that ISA (UK) 700 (Revised) 'Forming an opinion and reporting on financial statements' now requires auditors to include a new explanation in the audit report as to what extent the audit was considered capable of detecting irregularities, including fraud.

Auditors are expected to discuss the trustee's view of the risk of material fraud and the controls on place to mitigate those risks as part of the audit process.

The guidance covers:

- what fraud is (including legal definitions);
- types of pension fraud;
- the nature and cost of pension fraud;
- what should be done, focusing on the following three main areas;
    - meeting legal and regulatory expectations;
    - understanding the scheme's vulnerability to fraud;
    - ensuring the scheme is resilient to fraud.

In addition, Appendix 1 of the guidance outlines the questions likely to be asked by auditors.

4.1.3.5.11 Going concern

Going concern does not play the same fundamental role in the measurement and classification of assets and liabilities of pension scheme accounts as it does for commercial entities. Where a scheme is underfunded in terms of meeting those future liabilities which are not shown on its net assets statement, it does not necessarily follow that there is doubt as to the scheme's ability to continue as a going concern.

The auditor's procedures with regard to going concern are therefore likely to focus on those circumstances which would lead to significant doubt about the scheme's ability to continue as a going concern, namely:

- where a decision has been made to wind up the scheme;
- where an event triggering wind up has occurred (eg. insolvency of the employer); or
- where the scheme has entered the PPF assessment period.

PN15 provides additional guidance in this area. Prompts are included at the planning and completion stage to consider and discuss relevant matters in this area, and the completion checklist prompts documentation of conclusions drawn.

PRAG Guidance: Pension Scheme Financial Statements and Going Concern (December 2020)

The revised ISA (UK) 570 Going Concern requires an explicit reference to the use of the going concern basis in audit reports. This revised guidance provides assistance to both trustees and accounts preparers and to auditors on the going concern assessment and applies to defined benefit, defined contribution, hybrid and master trust pension scheme financial statements.

For most pension schemes, the assessment of going concern will be straightforward and the additional disclosure in the scheme audit report will be uncontroversial. The guidance addresses the circumstances where this is not the case.

Some examples of situations which could give rise to material uncertainties as to whether or not a scheme enters wind up include but are not limited to:

- where the TPR is investigating the scheme and has issued a freezing order but has not yet indicated whether it will issue a winding up order;
- the employer is experiencing financial difficulties, but the directors regard the business as a going concern as they are seeking to resolve the difficulties (for example, re-negotiating banking covenants or re-financing debt obligations); or
- the scheme has entered the PPF assessment period and the scheme funding level against PPF compensation has yet to be determined.

To assess whether the going concern basis is appropriate, and to identify any material uncertainties over a scheme's ability to continue as a going concern, the trustees should consider events that can trigger a wind up of the scheme. The period covered by the assessment needs to be at least 12 months from the date of approval of the financial statements.

The guidance notes that this assessment:

- is based on information available at the time of approval of the accounts;
- should be formally documented and minuted at a trustees' meeting or included in the trustees' report; and

- is best addressed when planning preparation of the accounts.

Examples of circumstances that may lead to non-going concern or material uncertainty disclosures, and hence be considered in the formal trustee assessment, include:

- trustees decision to wind up a scheme;
- notice served by an employer to wind up a scheme;
- termination of contributions by the employer;
- if the employer has experienced an insolvency event;
- the employer has a history of late payment of contributions or there are overdue contributions;
- trustees are aware that the employer is experiencing financial difficulties;
- failure by an employer to comply with its duties under the scheme;
- TPR orders the scheme to be wound up.

The guidance does not provide much detail about the specific disclosures to be made as the principles are the same as for any other entity. However, the following points should be noted:

- the trustees have an overall responsibility to act in members' interests and will have regard to this in the context of disclosures and how and when they are made;
- the trustees should consider the status of member communications and whether there might be sensitivities about disclosure of going concern issues that have not already been communicated to employees and members - such concerns cannot override the requirement for disclosure but might affect the timing of approval of the accounts with the statutory limits; and
- where there are uncertainties over the going concern status of the employer, this could be sensitive or prejudicial to the financial position of the employer and any negotiations with the PPF or TPR - the guidance therefore recommends early engagement with all relevant parties by the trustees.

The guidance also addresses the work an auditor should undertake in order to evaluate the trustees' assessment of the scheme's ability to continue as a going concern. Possible sources of information to assist with that evaluation set out in the guidance include:

- the wind-up provisions of the scheme trust deed;
- trustee minutes;
- formal trustee and employer communications;
- results of trustee employer covenant review;
- employer contribution payment history;
- for defined benefit schemes, latest recovery plan and actuarial valuation;
- employer financial statements;
- trustee communications with TPR;
- notifiable events reported to TPR by the trustee and employer.

The guidance also highlights key provisions in ISAs 570 and 700 and Practice Note 15 on the audit of pension schemes.

4.1.3.5.12 PRAG comments on the impact of the LDI crisis and the annual report and financial statements

In March 2023, PRAG issued a document discussing their initial thoughts around the impact Autumn 2022's gilt yield crisis may have on the annual report and accounts of UK pension schemes. Although, not intended as guidance, it does outline key considerations for auditors undertaking scheme audits covering this period. This is available to PRAG members from the website (http://members.prag.org.uk).

4.1.3.6 Using audit data analytics (ADA) and other technology

4.1.3.6.1 Use of technology

The variety of technology and automated tools which are available for use on an audit engagement is incredibly diverse, ranging from relative routine analysis within a spreadsheet, to the use of sophisticated applications which apply algorithms and machine learning, to the use of drones or online applications. Throughout this manual, audit data analytics (ADA) is referred to as a specific category of technology and automated tools. For the purposes of this manual ADA is defined as data analysis techniques (eg. the filtering and sorting of data to identify outliers, anomalies, deviations and other inconsistencies or detection and evaluation of trends and patterns within a data set) which can be used by the engagement team to perform risk assessment procedures, both controls and substantive testing and completion activities. In most cases, audit teams performing such analysis will have the ability to directly control the parameters used within this analysis, although certain applications may draw on the use of algorithms, artificial intelligence and machine learning to aid users with this analysis. Guidance on the additional considerations needed when planning the use of algorithms, artificial intelligence and machine learning is set out below.

B21 should be used to record how ADA and other technology is intended to be utilised on an engagement and how its use has been considered appropriate. Whilst not an exhaustive list, areas where ADA and other technology could be considered are:

- As part of the risk assessment (for example for its use as part of the preliminary analytical review)
- Highlighting high risk transactions for testing (see section below)
- Stratification of populations for sampling (see Appendix 5 below)

The use other technology which does not meet the definition of ADA should be recorded on the respective **B40/X2** when setting out the audit plan for each area (for example use of a drone or video technology to physically verify a fixed asset would be recorded on **B40/E2**).

4.1.3.6.2 Appraising the use of technology on engagements

As noted above, the use of technology on engagements can take various forms and each engagement team will need to appraise the use of technology on each engagement. We shall record our considerations on **B21**.

Applicability and potential uses of ADA on an engagement

We will evaluate if the use of technology is appropriate on a client by client basis and it will not be deployed as a blanket approach to all engagements. While it is expected certain technologies and in particular ADA will be appropriate to use on the majority of engagements (with the section above setting out the expected benefits its use would bring, which should form part of our appraisal of the applicability for use), certain complexities for particular clients may mean its use is not appropriate (such as unusual general ledger posting processes or complex business model meaning common algorithms are less applicable to them, etc.). Balanced consideration of these factors will assist us to record whether ADA or technology is applicable for use or not.

For clients where the use of ADA is considered applicable, we should then consider how we intend to use it on an engagement. While not an exhaustive list, areas where its use could be considered are:

- As part of the risk assessment (for example for its use of part of the preliminary analytical review)
- Highlighting high risk transactions for testing (see section below)
- Stratification of populations for sampling (see Appendix 5 below)

Where we plan the use of ADA in other areas, (eg. to gather audit evidence), this should be recorded on **B21** and we should also consider if this needed to be recorded on **B40** to confirm the audit plan has been suitable tailored to reflect its use.

Evaluation of the application being used

Before using ADA or other data analysis applications, we need to understand and evaluate the system being used. Such applications may have been developed either internally or sourced from an external provider, but in either case individual engagement files need to record how it was deemed appropriate for use. As a minimum this needs to evaluate the integrity of the application being used and the knowledge, expertise, and competence of the developers (whether internal or external to the firm). While the extent of evaluation needed requires an element of judgement in each case, as a general rule the more complex / sophisticated the application being used is, the extent of evaluation required increases.

We will need to evaluate the independence and expertise of the application developer, much in the same way we would assess an expert. The application itself will also need to have its integrity evaluated, in the same way an internally developed application would. Where the application being used is hosted by a third party, this should be discussed with the client to confirm they understand the role of the third party and respective responsibilities for data handling have been acknowledged and agreed.

Where the use of ADA purely involves analysing data within a spreadsheet, using relatively routine functionality that can be understood and reviewed by most individuals with basic spreadsheet training, this would generally involve explaining which functionality / formula(s) is being used and why they are considered appropriate.

Where we utilise a more bespoke ADA application (for example one which automates the running of analytical tools based upon parameters within the application), this evaluation needs to be expanded to demonstrate an understanding of the automation within the application, how this has been assessed as reliable and as such is appropriate for use (for example via user acceptance testing).

Some efficiencies may be gained by a central team of experts within the firm undertaking the required testing and evaluation of the ADA application being used, which individual engagement teams then look to draw on when completing **B21**, rather than the underlying evaluation of the application being performed by each individual audit team. Where teams use a centrally approved ADA application/functionality, they need to ensure the appropriate version is used on their engagement (ie. not rolling forward an old version which is now out of date or accelerating the use of a new version prior to it being approved). Where individual engagement teams use a version of an ADA application that has not been tested and approved centrally, they should document why they are comfortable in using an unapproved version and how it is deemed appropriate for use.

Where we utilise and rely on an algorithm within an application (for example use of machine learning or artificial intelligence), it is essential that development of any algorithms used is tracked, along with an audit trail to show how that algorithm has been tested and confirmed as being appropriate for use. It is expected that such testing (and approval for use) will be undertaken by a central team within the firm and that once approved any applications which utilise algorithms will be deployed and used consistently for a fixed amount of time (for example 1 audit cycle) across all engagements, as this will help to ensure a consistent understanding of the application is in place across the firm. Individual teams looking to use such applications/algorithms will be responsible for confirming and documenting on each file that the version being used is appropriate, referencing where the testing of the version being used can be found and appraising why its use is considered appropriate for that specific engagement (eg. there are no specific factors for that particular client which means it would not be reliable).

Evaluating the data to be used for ADA and other technology

Where applicable, each file should record details of the data set being analysed by ADA or other technological applications. In most cases this will be general ledger data, but could vary from audit to audit, with some analysing multiple data sets, from various sources (eg. sales ledger, purchase ledger or inventory records from client systems).

We will need to perform procedures to confirm the application has a complete and accurate data set(s) to be analysed. For general ledger data, this will generally be done by using the data set for all general ledger transactions during a period to reconcile the opening trial balance to the closing trial balance. We evaluate the integrity of the data being used, in particular considering controls around data extraction and the prevention of the data set being manipulated post extraction and also considering if wider audit procedures indicate any issues with the data set being used (eg. the results the preliminary analytical review) or if audit procedures need to be planned to test the validity of a data set (eg. where sales ledger data is being used, have audit procedures been planned to confirm this is complete and accurate).

Where teams are unable to validate the integrity of the data, then use of ADA is unlikely to be appropriate.

Preparing data for use in an application

In most cases where the application is using general ledger data, the chart of accounts will need to be mapped to the financial statements (ie. which general ledger accounts make up sales, cost of sales, etc.). While the account mapping will generally be rolled forward from one year to the next (with this documentation also being rolled forward), any new accounts will need to be mapped in the first period they are used and an annual review should be performed to confirm if any accounts need to be remapped (for example as a result of an accounting policy change).

For some uses, the application may also require the different document / transaction types within the clients general ledger data to be defined (for example manual journals, automated subledger posting, reversing journal, etc.), as these will generally present different levels of risk. As the coding of the different document / transaction types will vary between client systems this will be done for each engagement (although retaining a central firm wide library of system codes may provide some efficiencies should multiple clients use the same accounting software), with particular attention being paid to any bespoke document/journal types used by the client.

Where non-general ledger data is being analysed, we will also need to define the key data fields used by the application for its analysis. For example where ADA is being used to analyse the aging of debtors, it is likely that the data fields which contain invoice number (as a document identifier), invoice date (to determine age) and invoice amount will be needed. Where necessary we should confirm the data fields which need to be defined with any internal experts or the application developer as applicable.

Where we are unable to obtain sufficient understanding of the parameters needed for the application to analyse the data appropriately, then use of ADA is unlikely to be appropriate.

4.1.3.6.3 Use of audit data analytics (ADA) for identifying high risk journals / transactions

As noted above, ADA can be applied to identify transactions for testing on the basis of risk criteria, including journal entries. This allows testing to be focused more efficiently than it would be using manual sample selection. This could involve using ADA to generate a risk score for each general ledger transaction, which can either be based upon artificial intelligence / machine learning, criteria set manually by the audit team (which is tailored for each client), or a combination of these methods depending on the ADA system being used.

Automated risk scoring

Where transactions have been risk scored using an automated ADA application, the application will usually have pre-set parameters set by the developer. In such cases we should ensure we have understood what these are and evaluate their use for each client, ensuring they are tailored as appropriate. Given the bespoke nature of such applications, a freeform working paper will be needed to record this assessment, and a prompt to reference this included on **B40/N2 (ADA)**. Some efficiencies may be gained by a central team of experts within the firm undertaking the required evaluation of the pre-set system parameters, which we draw on when completing our assessment. We may also want to consult with a central team of experts or the application developer to confirm the appropriateness of any tailoring made to these parameters, recording details of this in our assessment.

Manual risk scoring

Where we manually apply risk criteria to transactions (eg. when analysing data in a spreadsheet), each of the criteria selected should be allocated a risk score on a scale of 1 to 5 (1 being used for criteria which is considered to be the lowest risk and 5 for criteria which is considered the highest risk). The risk posed by certain factors will vary from client to client, so we will tailor this based upon our knowledge and experience of each client.

There are various criteria we can apply when manually evaluating the level of risk posed by a transaction. While not an exhaustive list, common criteria to apply are as follows:

Risk Condition	**Example of criteria that could be applied**
Large amounts	Greater than or equal to performance materiality
Round sum amounts	Amounts which end 000.00, 999.99, 999.00
Unusual description / key word search	Descriptions which include names / titles of key management, directors and other related parties or unusual words such as adjust, correct etc
Transactions posted at unusual times	Journals posted when the office is usually closed, such as weekends or between 7pm and 8am
Back dated transactions	Journals which post to a prior period (i.e. a journal raised in accounting period 3 which is shown in accounting period 2)
Transactions posted and reviewed by the same person	Where a system had a ‘park and post’ or ‘maker/checker’ function and these roles have been performed by the same person
Transactions posted by an unexpected person	Journal posted by a senior member of staff/non-finance staff who typically are not involved in day to day ledger posting
Unexpected account combinations	Journals which are posted to accounts which would not typically be linked, for example sales and fixed assets
Transactions which bypass the expected transaction flow	System entries which are usually automated/triggered from a sub-ledger but are posted manually

These risk conditions and examples are not exhaustive examples and teams should also use their judgement to consider additional criteria and tailoring which could be applied relevant to the client. The justification for the criteria selected should be documented on file, with a template within **B40/N2 (ADA**) being provided for this.

Risk enhancers

To further tailor the risk score, certain ADA applications (both automated and manual) may allow us to enhance the risk score of a transaction by applying a multiple. This may be linked to certain document / journal types or members of client staff considered to present a higher risk, the financial statement assertion risks (eg. a high risk area could receive a higher risk multiple) or certain accounts which are considered inherently riskier due to their susceptibility to fraud. Details of enhancers applied should be recorded on **B40/N2 (ADA)**.

Manually calculating a transactions risk score

A transaction risk score is calculated by taking the sum of any risk scores triggered by a specific risk condition, which is then multiplied by any applicable risk enhancers (where no enhancer is applicable to a particular transaction, this will be assumed to be a multiplier of 1).

Example risk score calculation

Extract example of a manually applied risk criteria:

Risk condition	**Specific definition for this client**	**Risk score applied**
Large Value	£100,000 (performance materiality)	3
Round sum amount or transaction ending in '999'	Amount ending '000.00'	2
Transaction posted at unusual time	Any posting between before 7.30am and after 8.00pm Monday to Friday and at any time on a weekend	5

Extract example of a risk enhancer:

Risk enhancer	**Multiple to be applied**
Any transactions posted to Contributions	3

Example extract transaction data and scores calculation:

Description	**Transaction ID**	**Account Dr**	**Account Cr**	**Value (£)**	**Time and Date**	**Risk score**
Correction to contributions due from employer	1234	Contributions due from employer (Current assets within Statement of Net Assets)	Employer contributions (within Fund Account)	200,000.00	11pm Friday dd/mm/yyyy	30 [(3+2+5)x3]
Monthly professional fees	1235	Professional fees (within Fund Account)	Accrued expenses (Current liabilities within Statement of Net Assets)	5,000.00	2pm Monday dd/mm/yyyy	5 [(3+2)x1]

Items to be selected for testing

The final element of tailoring is setting the criteria which highlight the transaction to be tested. We will set a risk score and any transactions which score equal or greater than this will be selected for testing. We will consider other specific risk factors which may trigger a transaction to be tested or why it can be excluded from testing (eg. the value of the transaction is trivial or a reversing journals where it can be confirmed the net impact in the period is nil). This criteria, along with our rationale will be recorded on **B40/N2(ADA)**.

Where teams are relying on an algorithm (eg. in which risk scoring is done via machine learning or artificial intelligence), their understanding and evaluation of the appropriateness of the algorithm being used should be recorded on **B21**.

4.1.3.6.4 Use of ADA for testing and responding to assessed risks

Evaluating the results of testing obtained from ADA

Where we undertake testing utilising ADA, this will generally involve us using the application to develop an expectation for the population being tested. This will draw on our understanding of the entity and ensure the application being used is appropriate for the specific circumstances of the entity.

Upon reviewing the results we may find these are generally in-line with our expectations, with some exceptions that require further testing. However in some circumstances we may find the results do not match our expectations, with a significant number of outliers within the population meaning further analysis is needed before we can begin to test exceptions.

Outliers which cause a deviation to our expectation can arise through one or a multiple of the following factors:

1. Our understanding of the entity was not sufficient to appropriately calibrate and set the parameters within the ADA application.
2. The data may not be of sufficient quality to facilitate the use of the ADA.
3. Our initial evaluation of the appropriateness of the use of ADA for this entity may be inappropriate.

Point two may be overcome through data cleansing activity or discussion with the client to evaluate if a more refined data set is available. Where this is the case we will need to ensure our evaluation on **B21** is updated accordingly. Where this is not possible we will need to modify our planned approach accordingly.

The third point will also mean we will need to modify our planned approach accordingly.

For the first point above we may be able to recalibrate the parameters upon revising our understanding of the entity. Should we look to do this, the following points are areas to consider:

- Undertaking careful analysis of the outliers in order to assess which of the parameters used within the ADA require refinement and how this needs to be done. This includes revisiting our understanding of the entity and its environment to determine if parameters can be refined in order to reduce the number of outliers or identify those which are truly exceptions and therefore warrant further investigation as exceptions.
- Discussion with management, in a similar fashion to how we would when refining an expectation when undertaking analytical procedures in line with ISA 520, to understand the underlying data and potential relationships better.

When redefining the parameters used when applying ADA we need to be mindful to not adjust these for inappropriate reasons which include:

- Artificially reducing the amount of work required which ultimately results in obtaining insufficient appropriate audit evidence.
- Attempting to generate the same number of outliers / exceptions as seen in previous periods.
- Adjusting the parameters to compensate for data quality issues.

Once we are comfortable that the ADA application has been configured appropriately such that there are no outliers and any deviations from our expectation are due to true exceptions, we begin substantively testing these.

When testing the exceptions we will first need to consider if the population is homogenous, in which case sampling these can be considered. Where we determine the population is not homogenous we will need to consider if there is scope to stratify the population of exceptions into homogenous sub-populations before beginning sampling and substantive testing of these discrete groups. Where we do stratify the population of exceptions we need to take care that when sampling based on sub-populations, the untested population in a single financial statement line item does not exceed materiality.

Guidance on considerations to make when stratifying populations is given in Appendix 5: Audit sampling (below).

For the remaining population (i.e. that which falls in-line with our expectation), we may be able to leverage testing undertaken elsewhere in the audit file in order to gain comfort over the non-exception population. Where this is not the case we will need to consider what additional procedures are needed.

4.1.3.6.5 The use of ADA and other technology and ethics

The use of certain ADA applications and / or other technology may allow us to communicate more detailed and meaningful insights to management. However we need to mindful that this does not extend beyond feedback that would be seen as being the normal by product of the audit, into wider commentary and analysis that could be seen as offering business advice that could be used in a managerial decision making process.

4.1.4 Auditor's reports

Example auditor's reports are included within the Example Reports section of the manual.

In preparing an auditor's report the latest applicable bulletin, published by the FRC should be followed. The subsections below address a number of company specific considerations.

Guidance on the requirements for audit reports can also be found in:

- International Standards on Auditing (UK) 570, 700, 701, 705, 706, 710 and 720;
- Practice Note 15 (revised November 2017): 'the Audit of Occupational Pension Schemes in the UK' (PN15); and
- the relevant legislation.

The Audit and Assurance Faculty of the ICAEW has also published helpsheets designed to assist firms prepare their revised ISA (UK) 700 audit reports for certain specified other types of entity, including pension schemes in addition to setting up a new guidance hub to outline good practice when auditing pension schemes. The ICAEW helpsheets can be found within the Audit & Assurance Faculty section of the ICAEW website and the new guidance hub is available at Auditing pension figures: guidance unravels complexities | ICAEW.

If the auditor has to qualify the opinion on any matters, the law requires the auditor to state the reasons. Other than this the normal principles regarding qualified audit reports apply.

4.1.5 Summary of contributions and the auditor's statement on contributions

One specific aspect of pensions legislation is, in addition to the requirement to report on the accounts, usually auditors also have to provide a statement on whether contributions have been paid at least in accordance with the payments schedule / contributions schedule.

For the contributions statement, Practice Note 15 (revised November 2017) (PN15) recommends that a summary of contributions is prepared for all schemes (not just ear-marked arrangements).

This summary schedule should be contained within the trustees' report as, under law, any qualification on an auditor's statement relating to contributions must also be disclosed in the trustees' report. A proforma summary of contributions can also be found in the Example Reports section of this manual.

The wording of the auditor's statement about contributions includes an opinion as to whether contributions have 'in all material respects' been paid 'at least' in accordance with the schedule of contributions or payments schedule, in order to avoid the reporting of all, sometimes very minor breaches, of the schedule. An example of the auditor's statement is available in the Example Reports section of this manual.

If there is no schedule in place, the auditor's opinion refers to the scheme rules and, where applicable, the recommendations of the actuary.

4.2 Non-statutory audits and audit exempt schemes

In order to be audit exempt, schemes must satisfy the criteria specified in 2.5.2 above. If it is a small scheme, but there are deferred members who are not trustees, then the scheme will not be audit exempt.

Other matters to consider include the trust deed or scheme rules and whether it requires an audit or refers to investment decisions being taken on a majority basis. Both of these issues require modifications to the trust deed before a scheme can be audit exempt.

4.2.1 Annual report

Whether a scheme is audit exempt or not, it is likely that accounts will still need to be prepared. It should be noted that the SORP applies to any accounts required to show a true and fair view and/or where the accounts are used by those such as an actuary.

Depending on whether the audit is statutory, non-statutory or in the form of an audit exemption report, changes will need to be made to the annual report for:

- the trustees' responsibility note;
- the reference in the trustees' report to audited accounts by reference to Section 41 of the PA 95;
- the audit report; the basis of opinion note; and
- the reference to statute contained within the accounting policies.

In all cases, unless it is a statutory audit, it is unlikely that auditors will need to refer anywhere to the Occupational Pension Schemes (Requirement to Obtain Audited Accounts and Statements from the Auditor) Regulations 1996.

4.2.2 Non-statutory audits

Assuming a scheme is audit exempt by statute, but the trustees still require an audit, there are two options available:

- the audit is conducted as normal by reference to auditing standards but classed as non-statutory; or
- the term audit is redefined.

Under the latter heading, most trust deeds do not define an audit. Accordingly, with the agreement of the trustees, it may be possible to carry out an 'audit' in the form of an 'audit exemption' report now only required by certain clubs and charities.

Whatever approach is adopted, it is important that a suitable engagement letter is issued.

An example engagement letter for a non-statutory audit is given in the Example Letters section of this manual and a suggested audit report is given in the Example Reports section.

4.2.3 Audit exemption

Where there are no requirements for an audit, it is suggested that a normal accountant's report is appended to the accounts. Guidance on such a report is given in the Example Reports section.

4.2.4 Reporting to the Pensions Regulator

Under the PA 04, the whistle-blowing regulations have been extended to include a wider range of advisers. In the past a 'professional adviser' had the option to report breaches, whereas under PA 04 there is now a duty to report.

5 Other reporting requirements

5.1 Reporting to the regulator

5.1.1 Introduction

The PA 95 brought in the requirement for scheme auditors to 'whistle-blow' in various circumstances to, what is now, the Pensions Regulator.

As indicated in Section 2 of these notes, TPR has issued various Codes of Practice (CoP) which are virtually mandatory. The most important one of these for a scheme auditor is CoP 1 on reporting breaches of the law, and this sets out TPRs requirements for reporting by those parties such as auditors, trustees and scheme actuaries.

The Code uses a traffic light system for ascertaining potential reports:

- green means no report is necessary;
- amber means that a lot of due consideration is required to decide if a report is necessary or not;
- red means an automatic report.

5.1.2 What must be reported

When deciding whether a report is necessary, ie. whether the breach is likely to be of material significance to TPR, due consideration should be given to the following:

- **The cause of the breach** - TPR is likely to find it materially significant if it is one of the following:
    - dishonesty;
    - poor governance, inadequate controls resulting in deficient administration (including poor record keeping), or slow or inappropriate decision-making practices;
    - incomplete or inaccurate advice; or
    - acting (or failing to act) in deliberate contravention of the law.
- **The effect of the breach** - TPR's key roles include protecting members interests and calls on the PPF so are likely to find any of the following materially significant:
    - substantially the right money is not paid into the scheme at the right time;
    - assets of the scheme are inappropriately safeguarded;
    - payments out of the scheme are not legitimate and timely;
    - defined benefit schemes are not complying with the legal requirements on scheme funding;
    - trustees of occupational pension schemes are not properly considering their investment policy and investing in accordance with it;
    - contributions for defined contribution members are being incorrectly allocated or invested;
    - TPR is not being informed of notifiable events.
- **The reaction to the breach** - TPR expects the trustees to deal with any discovered breach quickly and effectively and would find the following materially significant if the trustees and their advisors 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 the risk or reoccurrence;
    - 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.
- **The wider implications of the breach** - for example TPR is likely to consider the following materially significant:
    - the fact that the breach has occurred makes it appear more likely that other breaches will emerge in the future because the trustees (or manager) lack the appropriate knowledge and understanding to fulfil their responsibilities; or
    - other schemes may be affected, for example schemes administrated by the same organisation where a system failure is applicable.

5.1.3 Timing of report

A report should be made in writing as soon as is reasonable. Trustees and scheme advisors are permitted reasonable time to ascertain all the facts before making a report but TPR would not expect any undue delay. The report should be in writing but where time is of the essence, such as where pension scheme assets are being wrongly appropriated, TPR will accept a report over the phone as long as this is followed by a written report.

5.1.4 Contents of a report to the regulator

A form can be downloaded from TPR's website (in pdf or Microsoft Word so it can be typed on) for making the report and this can either be posted or emailed to TPR. A report to TPR can be preceded by a telephone call if appropriate.

Under the Pensions Act, duties to report exist for trustees and various scheme advisors such as administrators, the scheme actuary or auditor. When a breach is discovered it may well be that several parties all need to make a report. TPR has indicated they would prefer joint reports to be made to them as this is more efficient. Also, in many cases (either to ascertain all the relevant facts or just to maintain a good professional working relationship) it is advisable for the parties to all discuss a report and make a joint one wherever possible. In amber reporting situations, this may clarify the need to report or not for all the parties and will aid consistency. Although TPR would prefer joint reports, they have stated that there should not be undue delays in reporting waiting for the agreement of one party and that party will have to report separately.

All reports to TPR (or even potential reports) should be recorded in one place in the audit file and carried forward each year for future consideration. TPR has indicated that persistent breaches, such as late audited accounts, or lots of different problems that point to poor governance, may require a report and the best way properly to consider these is to have a history of the problems. It is suggested a schedule of potential TPR reports and reasons for not reporting is maintained and updated each year to aid with this. This can be kept in the permanent audit file or in the current audit file behind the Whistle blowing checklist in the completion section of the current file documents.

5.1.5 Reporting to the National Crime Agency (NCA) and to the Regulator

The scheme auditors should, of course, consider whether, in addition to a duty to report to TPR, there is a duty to report under the Anti-Money Laundering Regulations. For example, the identification of a fraud involving misappropriation of pension scheme funds by trustees would require such a report, as well as a report to TPR. In such circumstances, the auditors should ensure that they comply with legislation relating to 'tipping off'.

It should be noted that the submission of a report to NCA under the Anti-Money Laundering Regulations does not relieve an auditor of a duty to report that matter to pension regulators where the information is of material significance to the Regulator's function.

5.1.6 What may be reported?

A separate statutory right (as opposed to a duty) to report to the appropriate regulator also exists and may be used by auditors. Auditors may become aware of circumstances which in their opinion does not give rise to a duty to report to the Regulator but which should nonetheless be brought to their attention. Such matters should be considered in conjunction with ISA (UK) 250 'Consideration of law and regulations', and where any report is made auditors rely on the protection afforded by general law.

5.2 Reporting of late payments of contributions

CoP 1 does not provide detailed guidance on the reporting of late payments of contributions. TPR has issued separate codes for this issue. The relevant codes are as follows:

- for defined benefit schemes - Code of Practice 03: Funding defined benefits;
- for defined contribution schemes - Code of Practice 05: Reporting late payment of contributions to occupational pension schemes.

Within these codes, the primary responsibility for reporting late payment lies with the trustees. The issue for the auditor is generally limited to making the annual statement on contributions. However, where the auditor identifies that the trustees have not fulfilled their responsibility for making a report under CoP 3 or 5, it may give the auditor cause to make a report under CoP 1.

18.3 Appendices

Appendix 1: Summary of contents of the Annual Report

REQUIREMENT	Defined Benefit			Defined Contribution (Money Purchase)		
	[1]SMALL	WHOLLY INSURED	OTHER	[1]SMALL	EAR-MARKED	OTHER
Trustees' report	Yes	Yes	Yes	Yes	Yes	Yes
Investment report[2 4]	No	No	Yes	No	No	Yes
Statement of investment principles	No	No	Yes	No	No	Yes
Implementation Statement[6]	No	No	Yes	No	[3]Yes	Yes
Summary of contributions	Yes	Yes	Yes	Yes	Yes	Yes
Audit report on accounts	No	Yes	Yes	No	No	Yes
Auditor's statement about contributions[5] / payments	No	Yes	Yes	No	[3]Yes	Yes
Fund account	Yes	Yes	Yes	Yes	No	Yes
Statement of net assets	Yes	Yes	Yes	Yes	No	Yes
Notes to accounts	Yes	Yes	Yes	Yes	No	Yes
Compliance statement[4]	Yes	Yes	Yes	Yes	Yes	Yes
Actuarial statement	Yes	Yes	Yes	No	No	No
Report on actuarial liabilities	Yes	Yes	Yes	No	No	No
Annual statement regarding governance	No	No	No	No	No	Yes

[1] See the definition of a "small scheme" in 2.4.3.5 of these guidance notes. It should be noted that for small schemes, whilst technically the requirement for an annual report exists, Disclosure Regulations state that the regulations do not impose on the trustees any duty in relation to any member where all the members are trustees. So if the trustees decide not to produce an annual report there is no responsibility on the auditor to insist on one. However, accounts will be required to support tax returns.

[2] No investment report is required where schemes are exempt from preparing a statement of investment principles.

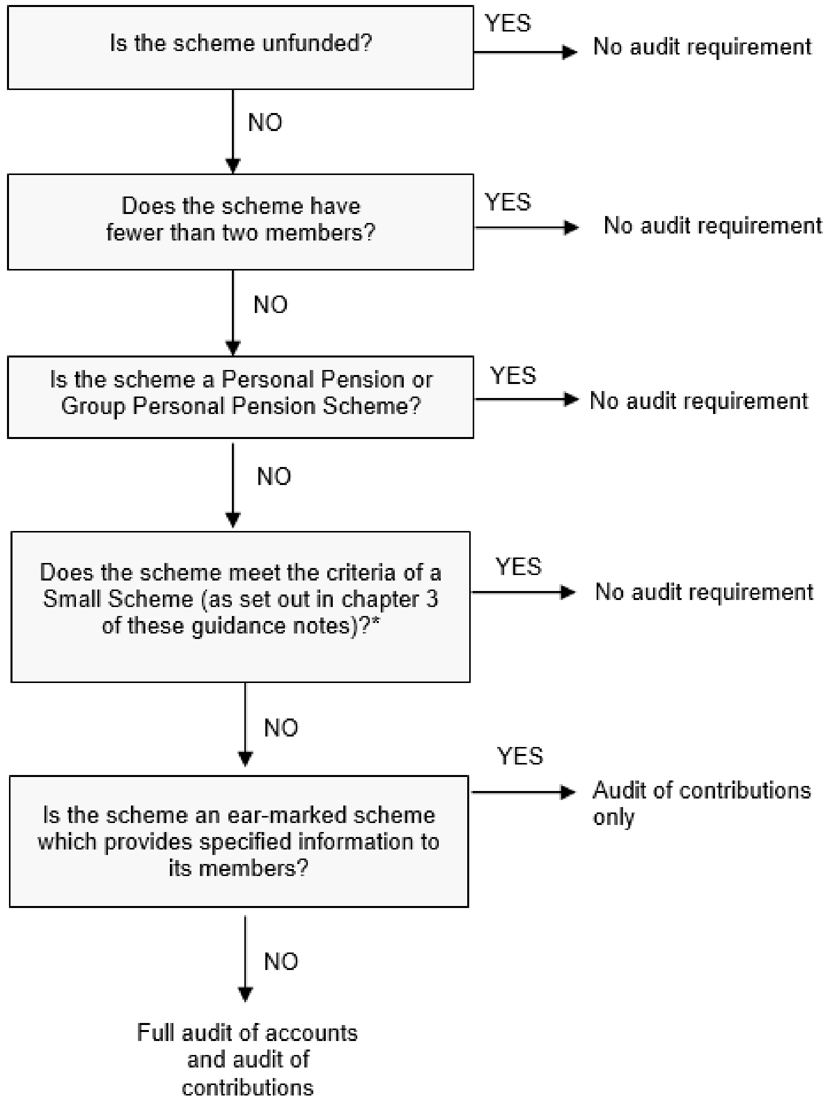
[3] Not if a small scheme.

[4] The SORP suggests these are presented as a single report within the Trustees' report.

[5] Not required for a scheme in which on the first day of the scheme year, the scheme had at least 20 participating employers.

[6] Implementation Statements must be published on line by 1 October 2021.

Appendix 2: Pension Schemes: is an audit required?



* **Note** if the conditions are met, but there is an audit requirement in the trust deed, the audit will be non-statutory.

Appendix 3.1: Notes for completion of planning form B40 Audit plan - Other audit areas - Trial balance (use of ADA)

Audit plan - Trial balance (use of ADA) – Notes for completion
The objective of Audit plan - Trail balance (use of audit data analytics) is to tailor the use of ADA when being used to identify journals/significant unusual transactions for testing. This form is only necessary where audit data analytics (ADA) is planned to identify high risk transactions for testing.

To confirm if an automated or manual ADA application is being used to risk score transactions, including an indication of where the parameters used for the risk assessment are set out and have been assessed. For automated, it may be easiest to reference to a printed schedule from the application alongside clear justifications on the parameters.

For manual scoring, indicate if a particular criterion is considered relevant or not (Y/N). NB. the list of risk conditions is not exhaustive and customised risk conditions should be added where relevant.

The specific criteria to be applied to should be defined (eg. what is considered to be a 'large value').

A risk score to be applied should be noted (1 being for the lowest risk and 5 being for the highest risk).

Any risk enhancers should be defined (eg. what particular risk criteria exist which means the risk score for certain transactions should be enhanced by a multiple).

The risk multiple should be recorded.

Audit plan - Other audit areas - Trial balance (use of ADA) B40/K2(ADA)

Objective: To record the use of audit data analytics (ADA) when being used to identify journals / significant unusual transactions for testing.

For guidance on completing this audit plan, refer to Appendix 3.1 of the guidance notes in this manual.

B21 must be completed to appraise the use of ADA.

Risk criteria to identify high risk journals / transactions

Transactions have been risk scored using an automated ADA application. The parameters used by the system (including details of any tailoring specific to this client), with justification for why these are considered appropriate are set out on sch______.[1]	☐
Transaction risk criteria is being applied manually[2]. Tailoring of the risk criteria for this client is detailed below or on sch ____.	☐

Risk criteria to be applied manually:[3]

Risk condition	Relevant for this engagement (Y/N)	Specific definition	Risk score applied	Justification
Large value				
Round sum amounts or transactions ending '999'				
Unusual description / key word search				
Transactions posted at an unusual time				
Back dated transactions				
Transactions posted and reviewed by the same person				
Transactions posted by an unexpected person				
Unexpected account combination(s)				
Other (describe):				

Risk enhancers

If applicable, risk enhancer multiply to be applied[4]:

Risk enhancer	Multiple to be applied	Justification

Items to be selected for testing

Criteria to select or exclude transactions for testing[5]:

	Criteria	Justification
Transactions with a risk score[6] equal or greater than:		
De minimis threshold below which journal values can be excluded from testing:		
Other criteria specifically triggering a journal to be tested:		
Other criteria specifically triggering a journal to be excluded from testing:		

Prepared by		Dated:	
Reviewed by		Dated:	

1. The assessment of automated risk scoring is likely to require a freeform assessment. See Section 7 of the guidance notes in this manual.
2. Manual risk scoring is likely to be done in a spreadsheet or similar. See Section 7 of the guidance notes in this manual.
3. Example risk criteria is given in chapter 7 of the guidance notes in this manual.
4. For guidance on the use of risk enhancers to emphasise risk factors for a transaction by applying a multiple to the risk score, see Section 7 of the guidance notes in this manual.
5. Judgement is required when determining the criteria to select transactions for testing, see Section 7 of the guidance notes in this manual.
6. An example risk score calculation is given in Section 7 of the guidance notes in this manual.

The criteria to trigger a transaction to be considered high risk and which should be tested should be recorded (eg. high risk score). Any criteria which would mean a transaction could be excluded from testing should also be recorded here (eg. below a trivial value).

Appendix 4: Notes for completion of planning form B25 - Materiality

Materiality – Notes for completion
The objective of the materiality form is to determine materiality and performance materiality.

Materiality B25

Objective: To determine materiality and performance materiality

Note: Where different levels of materiality are used (eg. for the statement of net assets and the fund account, or for the reporting on the financial statements and the auditor's statement on contributions) ensure this is documented appropriately.

For guidance on materiality, refer to Appendix 4 of the guidance notes in this manual. NB. Shaded areas to be completed at the completion stage of the audit.

		Expected Current Year £'000	Actual Current Year £'000
Benchmarks			
Gross assets			
Total inflows from dealing with members			
Total outflows from dealing with members			
Other (specify ______)			
Basis for determining materiality			
Gross assets	%		
Total inflows from dealing with members	%		
Total outflows from dealing with members	%		
Other (specify ______)	%		
Justification for materiality level:			
Materiality for the financial statements as a whole			
Justification for performance materiality level:			
Performance materiality			
Amount below which misstatements are clearly trivial			
Audit areas requiring other levels of materiality and performance materiality			
Materiality for statement about contributions (where applicable)			

Conclusions

Planning materiality

The planned levels of materiality are appropriate for this audit.

Prepared by		Dated:	
Reviewed by		Dated:	

Final materiality

The final level of materiality is appropriate for this audit

Prepared by		Dated:	
Reviewed by		Dated:	

Other could include total expenditure or total funds.

State which benchmark from above and the percentage or level to be adopted. Practice Note 15 (revised November 2017) notes that when considering materiality, the focus is directed at scheme assets (mainly investments), contributions, benefits and / or returns on investments.

Materiality on the financial statements as a whole relates to the level at which misstatements (including omissions) individually or in the aggregate would affect the decisions of users of the financial statements. Materiality is not affected directly by audit risk but some of the factors in determining materiality may also lead to increased audit risk.

Performance materiality is the working level of materiality used throughout the fieldwork as a guide as to which balances and transactions need to be tested.

It is the amount set at less than materiality (ie. for the financial statements as a whole) to reduce to an acceptably low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

Performance materiality may be set at an amount or a percentage of materiality on the financial statements as a whole. This percentage is a matter of judgement but is affected by the auditor's understanding of the entity, updated during the risk assessment procedures, and the expectation of misstatements. For example, where the overall risks are low, the auditor may set performance materiality at 90% of materiality. Where the risk of misstatement is higher, the auditor should use a lower percentage of materiality.

Clearly trivial refers to matters which are clearly inconsequential and is of a wholly different (smaller) magnitude than performance materiality (for example the auditor may use up to 5% of materiality). Where there is uncertainty as to whether something is clearly trivial, it should be assumed that it is not.

State the area and the level of materiality and performance materiality.

Revisit the levels of materiality and performance materiality at the closing stages of the audit, and consider if / how this impacts the audit.

Appendix 5: Notes for completion of substantive sampling forms

Substantive sampling approach

ISA or ES para

General information

Introduction

This methodology includes two different sampling approaches. One is for judgemental sampling (and incorporates a sample cap), the other is a statistical sampling approach (which does not incorporate a sample cap). Whilst a different approach may be used on different audits, it would be difficult to justify mixing and matching the different approaches on the same audit. For many audits, particularly where populations are smaller, the judgemental sampling approach will be appropriate, however it is not suitable for use on the audits of PIEs or other audits where the populations are very large. The firm's policy should also be consulted, as some firms may mandate the use of the statistical sampling approach in all cases.

A sample size calculated using either of the substantive sampling approaches is derived on the basis that little error is expected in the population being tested. If this is not be the case and a number of errors are likely, then the form is not appropriate and the level of testing should be set judgementally at a level considered to be sufficient to provide adequate audit assurance. In these cases testing levels are likely to be considerably in excess of the numbers calculated using either of the approaches.

The substantive sampling forms require the documentation of a number of qualities of the test being performed and population being tested in order to evidence due consideration of those factors. The forms encourage the extraction of significant and other key items which would be tested in addition to the calculated sample size for the residual population. This sample size for the residual population is determined by reference to the assessed risk in the population, the planned reliance on other procedures and the size of the residual population. Key factors to consider when completing the substantive sampling forms are highlighted below.

Definition and expectation of error

Errors should be defined when designing the sample. The definition of an error is important because the errors found in a sample will be projected (extrapolated) across the population being sampled.

As noted above, where the expectation of an error occurring is more than low, we should set the sample size judgementally at a level considered to be sufficient to provide adequate audit assurance.

Stratification

Where appropriate, we should divide a population into discrete sub-populations which have an identifying characteristic, this process is termed stratification.

The objective of stratification is to reduce the variability of items within each sub-population (stratum) and therefore allow a reduced sample size to be taken without increasing sampling risk. If income is received from different sources by the entity, it is likely to be appropriate to split each type of income into a different stratum, for example. *530.5, 530 App. 1*

Where there is little variation in the population stratification may not be required. For example, if testing current assets for contributions, stratification may not be necessary as there is little or no variability in the population.

Consideration should be given to increasing the sample size if the population contains sufficient variability to warrant stratification, but a decision is taken not to stratify.

When performing substantive tests of details, the population may be stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement.

Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

If values are not known (eg. unlisted investments), then the population may be stratified in some other way, for example by quantity or by type.

If a class of transactions or an account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

 ISA or ES para

The value of residual population to sample

There may be certain items in the population that we wish to test specifically. This may be due to either their value or some qualitative characteristic (eg intra-group items, transactions or balances with related parties, etc.). We will remove these items from the population and test them separately.

When designing a sample, we determine a level of tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality to a particular sampling procedure and may be the same amount or an amount lower than performance materiality. *530.5*

All items greater than tolerable misstatement should normally be treated as individually significant items. These, along with other key items, are extracted from the population and examined separately. The residual population is then sampled.

Method of selection to use

Once the sample size has been determined we will use one of the following methods to select the sample: *530 App 4*

- random selection;
- systematic selection (ie. every "nth" item);
- monetary unit sampling (items with greater monetary value have a proportionally greater chance of being sampled); or
- judgemental selection (not generally recommended but may be necessary where documents are filed alphabetically).

Whichever method is chosen, the following criteria need to be observed:

- items chosen must be selected in such a way that we can reasonably expect them to represent the whole population;
- each item in the population must have a chance of being selected; and
- conscious bias must be avoided.

Some form of systematic selection is frequently used to arrive at the items to be sampled, although random selection can also be used.

Example: Systematic selection of a sample

a. A sample of 30 items is required from a population of 4,000 items. The sampling interval would be 4,000 / 30 = 133. A random start should be taken from within the first 133 items with every 133rd item chosen thereafter.

b. A sample of 20 items is required from a day book of 50 pages. A random start point somewhere between pages 1 - 10 would be chosen then an item would be sampled from every 2nd page. Depending on the number of entries per page a random number calculator could be used to select a line on each of the pages to be sampled.

Accounting estimates

Sampling techniques are unlikely to be utilised when testing accounting estimates, however certain accounting estimates such as accruals calculations may utilise a sampling approach. Care is needed here regarding clarity over the assertion(s) being tested.

Sample size calculation - Judgemental sampling

When determining the sample size for the residual population in a substantive test of detail the initial sample size will be 60 items. Note that where there are different income or expense streams, that have different systems, each of these should be treated as a separate population – i.e. each stream will need to be sampled separately, with each stream having an initial sample size of 60. This number can be reduced based on various deduction factors that are dependent upon the following:

- the risk of material misstatement associated with the population being tested;
- the planned level of reliance placed on the operating effectiveness of controls;
- the strength of analytical and other related substantive procedures; and
- the size of the residual population (adjusted via a 'materiality factor').

The following table highlights the level of deduction available in each instance. This is followed by guidance on the application of judgement in taking deductions available.

Substantive sampling approach

Assessed inherent risk in population		Planned reliance on internal controls		Analytical and other related substantive procedures		Materiality factor	
Level	No.	Level	No.	Strength of evidence	No.	Value	No.
1	20	High	20	Strong	20	Under 15	20
2	15	Medium	10	Moderate	10	15-27	10
3	10	None	0	Weak	0	Over 27	0
4	5						
5	0						

Assessed inherent risk in the population

The assessed inherent risk in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

This assessed inherent risk in the population will depend on the audit area and the particular assertion being tested. For example, it may be deemed within a population of investments that the existence assertion is at a lower risk of material misstatement than the valuation assertion. This could be due to the investment existence being easily verifiable whereas the valuation within the population could be subject to complex accounting estimates. Therefore we may deem it appropriate to calculate separate samples for the existence and valuation testing.

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, eg, valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

Planned reliance on internal controls

Where we only evaluate whether relevant controls are designed effectively and determine whether they have been implemented, we cannot reduce the substantive test sample size for any reliance on controls - this can only be done where we have tested their operating effectiveness.

Tests of operating effectiveness of internal controls are often designed to provide either a high or moderate level of reliance and therefore risk reduction.

- A high level of reliance (low level of risk remaining) applies where the primary evidence is coming from tests of controls.
- A medium level of reliance (medium level of risk remaining) applies where the tests of controls will be combined with other substantive procedures to address a particular assertion.

The type of controls being tested may influence the level of reliance to be placed on them. For example, a control applied to all items in the population is likely to provide a sounder basis for reliance than one only applied to certain types or sizes of transactions.

The extent to which we test controls for the planned level of reliance is a matter of professional judgement; however, in ascertaining an appropriate sample size for tests of controls we may use the tests of controls sampling form.

Analytical and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

ISA or ES para

Substantive sampling approach

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg. investment income, or the population could be disaggregated into its component parts, eg. different types of contributions or classes of investments.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may “take credit” for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

Materiality factor

The materiality factor is calculated as follows:

total value of population / materiality = materiality factor

The lower the resulting figure for the materiality factor the greater the reduction in sample size. Thus, not surprisingly, the larger the value of the residual population relative to materiality the greater the value of the materiality factor and the larger the final sample size will be.

Where a different specific audit area materiality is set on the **B25** then this materiality rather than the overall materiality should be used to calculate any sample sizes for that particular area.

Minimum sample size

Small samples have an increased risk of being unrepresentative and unreliable. If the total population comprises a relatively small number of items, say fewer than 50 items, then alternative procedures should be considered in place of sampling. For example, this might include analytical procedures or a review for unusual items.

When the calculated sample results in a sample size of 15 items or fewer, then alternative audit procedures should be considered as outlined above. If these are not appropriate, then the minimum sample size should be 15 items.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

Justification

Since this is a judgemental sampling approach, it is necessary to justify the sample size used. The substantive sampling form includes appropriate space to document this justification. It is not acceptable to simply state that that it is appropriate because that is what was calculated by the approach – this is simply an indicative guide to be used as a starting point.

ISA or ES para

Substantive sampling approach

Example: Transaction tests on income

We have established the following:

Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Assessed inherent risk in population	= 1
Planned reliance on internal controls	= High
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor	= 30

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(20)
Planned reliance on internal controls	(20)
Analytical and other related substantive procedures	(10)
Materiality factor	(0)
Total sample size	**10**

However, the sample size will still be 15 (ie. the minimum sample size) which would therefore require 15 items to be tested substantively.

Alternatively, we may choose not to place any reliance on internal controls and therefore not test the operating effectiveness of controls. The resulting substantive sample size would be 30 items, with no tests of control being necessary. This, in practice, may be a more cost effective approach.

Example: Testing existence of debtor balances

We have established the following:

Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Assessed inherent risk in population	= 3
Planned reliance on internal controls	= None
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor (Residual population value / materiality)	= 250,000 / 10,000 = 25

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(10)
Planned reliance on internal controls	(0)
Analytical and other related substantive procedures	(10)
Materiality factor	(10)
Total sample size	**30**

ISA or ES para

Substantive sampling approach

Example: Testing valuation of investments

We have established the following:

Total population value	= £200,000
Monetary value of items over tolerable misstatement	= £130,000
Number of items over tolerable misstatement	= 7
Number of other key items	= 0
Residual population to be sampled	= £70,000
Assessed inherent risk in population	= 5
Planned reliance on internal controls	= Moderate
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor (Residual population value / materiality)	= 70,000 / 7,000 = 10

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(0)
Planned reliance on internal controls	(10)
Analytical and other related substantive procedures	(10)
Materiality factor	(20)
Total sample size	**20**

Therefore, the total number of items to examine will be 27 items (20 sample items + 7 individually significant items).

Sample size calculation - Statistical sampling

When determining the sample size for the residual population in a substantive test of detail the sample size will be based on:

- the risk of material misstatement associated with the population being tested;
- the strength of analytical and other related substantive procedures;
- the tolerable misstatement; and
- the size of the residual population.

Tolerable misstatement is defined in ISA 530 as 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. The tolerable misstatement cannot exceed performance materiality.

Risk of material misstatement

The assessed risk of material misstatement inherent in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements. It should have been assessed as part of the risk assessment process.

This assessed risk in the population will depend on the audit area and the particular assertion being tested. For example, it may be deemed within a population of investments that the existence assertion is at a lower risk of material misstatement than the valuation assertion. This could be due to the investment existence being easily verifiable whereas the valuation within the population could be subject to complex accounting estimates. Therefore we may deem it appropriate to calculate separate samples for the existence and valuation testing.

ISA or ES para

Substantive sampling approach

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, eg. valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

The risk of material misstatement will also be affected by the control risk. Where a controls based approach is taken to the audit, and it is possible to place reliance on relevant controls (the operating effectiveness of which will be tested as part of controls testing), this may serve to reduce the risk of material misstatement – see **B30**.

Analytical and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg. investment income, or the population could be disaggregated into its component parts, eg. different types of contributions or classes of investments.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may “take credit” for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

The strength of analytical and other related substantive procedures is ultimately a matter of professional judgement; however the following should be considered:

- Weak analytical and other related substantive procedures would generally be where no such procedures were undertaken, or would include simple variance analysis, or other limited procedures which do not confirm to the requirements of ISA 520 Analytical Procedures.
- Moderate analytical and other related substantive procedures would generally include analytical procedures in conformity with the requirements of ISA 520 Analytical Procedures in addition to at least some other substantive work.
- Strong analytical and other related substantive procedures would generally include detailed analytical procedures in conformity with the requirements of ISA 520 Analytical Procedures and extensive further substantive procedures over the population in addition to the testing to be performed on the sample.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

ISA or ES para

Substantive sampling approach

Note that in some cases it's not possible to calculate a sample size using the statistical approach. This occurs where the analytical and other related substantial procedures are strong and the risk of material misstatement is very low, low or medium; or where the analytical and other related substantial procedures are moderate and the risk of material misstatement is very low. In such cases, statistically, the planned test of details may not be necessary unless specified by regulation or other standards.

Example: Transaction tests on income

We have established the following:

Total population value	= £6,100,000
Tolerable misstatement	= £75,000
Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Risk of material misstatement	= High (4)
Analytical and other related substantive procedures	= Weak

The high risk of material misstatement, coupled with the weak analytical and other substantive procedures would result in a confidence factor of 2.30. The substantive sample size would therefore be (£6,100,000 x 2.30) / £75,000 = 188. This would also be the number of items to be tested in this case.

If stronger work was undertaken on analytical and other related substantive procedures, this can significantly reduce the sample size. For example, if instead the analytical and other related substantive procedures were Strong, the confidence factor would instead be 0.41 and the sample size would only be 34 items.

Of course, in order to change the strength of analytical and other related substantive procedures, additional such procedures would need to be undertaken.

Example: Testing valuation of investments

We have established the following:

Total population value	= £200,000
Tolerable misstatement	= £7,000
Number of items over tolerable misstatement	= 7
Monetary value of items over tolerable misstatement	= £130,000
Number of other key items	= 0
Risk of material misstatement	= Very High (5)
Analytical and other related substantive procedures	=Moderate

The very high risk of material misstatement, coupled with the moderate analytical and other related substantive procedures would result in a confidence factor of 2.08. The substantive sample size would therefore be (£70,000 x 2.08) / £7,000 = 21. The total number of items to be tested would therefore be 28 (21 + 7).

18.4 Getting started for new manual users

Introduction

This 'Getting started' guidance will help you to use the Mercia Pension Schemes Manual. You may be a regular user of our products, or this may be the first time that you have used such a manual. Either way, these notes will help you understand the Mercia approach and how to maximise the benefits of the manual.

The manual covers two types of pension scheme assignments:

- True and fair audit; and
- Audit of contributions schedule only - ear-marked schemes.

Through the website, the ~~The~~ manual includes example letters, proforma accounts and disclosure checklists, in addition to all the other essential current and permanent file documentation necessary for an audit assignment.

Moreover, because the manual includes proforma accounts, engagement letters and comprehensive disclosure checklists, it can be used by preparers of accounts, even if they will not be subject to any external scrutiny.

The Pension Schemes Manual itself consists of the following sections:

- Guidance
- ~~Example letters~~
- ~~Example reports~~
- ~~Example accounts~~
- ~~Accounts disclosure checklists~~
- ~~Current file documents~~
- ~~Permanent file documents~~
- ~~Supplementary forms~~

Guidance

You will find the following documents in this section of the Pension Schemes Manual:

- a contents page;
- guidance notes on the pensions sector;
- this getting started guidance for new manual users; and
- 'What's changed', which provides a summary of the changes made to the manual in the most recent updates.

Example letters

This section provides examples of the following:

- letters of engagement - the engagement letters are structured in the following way:
    - a covering letter to identify the services to be provided, which cross-reference to detailed schedules of professional services;
    - standard terms of business;
    - detailed schedules of professional services - example terms have been provided for:
        - a full audit;
        - an ear-marked scheme;
        - a non-statutory audit; and
        - an audit exempt scheme.

    Alternative, or further, schedules of professional services can be added.
- letter of representation;
- resignation letter; and
- appointment letters (for both statutory and non-statutory audits).

Example reports

Example reports (eg. audit reports and reports to management) can be found in this section, along with an example statement of trustees' responsibilities, an example summary of contributions and an example report on actuarial liabilities. There is also guidance on accountants' reports.

Example accounts

Example proforma accounts are available for SORP 2018 for defined benefit schemes, defined contribution schemes and hybrid schemes.

~~Accounts disclosure checklists~~

~~An accounts disclosure checklist is included in this section covering the SORP 2018 and relevant pensions Regulations.~~

~~Current file documents~~

~~Each section of the current file working papers (including planning, audit programmes and completion documentation) are separately available in this section of the manual. See below for further details.~~

~~Permanent file documents~~

~~Each section of the permanent file working papers is separately available and they are all filed in one place in this section. See below for further details.~~

Supplementary forms

This section provides additional forms which may be completed in respect of a change of financial reporting framework and a file review checklist.

Audit approach

The Mercia approach encourages you to adopt a thinking rather than a form filling approach. This is achieved in two main ways:

- Through the use of permanent information. If something that you record is unlikely to change significantly from one year to the next, we believe it is better that this is recorded properly once and then rolled forward, updating where necessary, each year.
- By encouraging those completing audit work not to file surplus copy documentation thus generating the need to sign off, date and evidence as reviewed the excess paperwork. Where additional paperwork is considered necessary, the system encourages you to file these on a non-audit section of the file.

The planning approach (the Permanent file documents and section B within the Current file documents)

The key to an effective audit is effective planning. The various steps to be undertaken at the planning stage, such as updating your knowledge of the client, calculating materiality, etc., are driven by the planning checklist which is filed within the Current file documents planning documentation.

There are different approaches to completing the planning documentation. For more straightforward assignments, as an alternative to completing many of the standard current planning forms, you may choose to adopt a 'free-form' planning memorandum.

In such cases, you may opt for the Mercia proforma free-form memorandum which must also be completed alongside the free-form memorandum planning checklist, and the other documents provided within this section, where required, to ensure you have covered all necessary matters.

Whilst completing the memorandum, you should read guidance provided on what is required in certain areas.

It is for the firm to decide the criteria as to when the free-form planning memorandum should be used to replace other standard forms. We recommend that such criteria include:

- the client has been audited by the firm for at least the immediate preceding period;
- there has been no history of controversial issues arising from the previous audits;
- the client contains characteristics indicative of a simple scheme as set out below.

The following characteristics may be indicative of a simple scheme:

- membership is concentrated in a small number of individuals who may be actively involved in managing the scheme; and
- the operations are uncomplicated with few sources of income and straight-forward investment activities; and
- processes and accounting systems are simple; and
- internal controls are relatively few.

Such entities are likely to include schemes which are exempt from audit, but which choose nonetheless to have a voluntary audit, as well as other schemes that are also relatively simple.

The fieldwork approach (sections D onwards within the Current file documents)

Once the audit plan has been formed and tailored audit programmes have been produced (see the section named 'The structure of each audit section' within these notes), the audit evidence should be obtained in accordance with these programmes.

The completion approach (section A within the Current file documents)

At the completion stage, the planning must be reviewed alongside the evidence obtained and all matters need to be drawn together and concluded upon. Completion of the appropriate forms on this section (including a full record of review points, notes of discussions with the client and evidence of clearance of all of these points) will help to achieve the required objectives.

The current file

The current audit file provides the documentary record of the audit and constitutes the evidence of what was done and why. In conjunction with the permanent file, it supports the report on the financial statements.

The report not only consists of the opinion but also contains a statement that the audit has been carried out in accordance with auditing standards, thus the two files must demonstrate compliance with the International Standards on Auditing (ISA) (UK), the Ethical Standard and any other regulatory requirements.

The principal objectives of the current audit file are to provide:

- evidence of the planning process, including the risk assessment procedures, and any changes from the original plan;
- a record of the nature, timing and extent of auditing procedures undertaken, the results of such procedures and conclusions drawn;
- a record of the figures included in the financial statements and evidence supporting these figures;
- evidence of control and review;
- a record of problems encountered, weaknesses discovered, and any contentious issues raised and how they were resolved;
- a record of communications with the client relevant to the audit; and
- evidence of the opinion formed.

The permanent file

The principal purpose of the permanent file is to improve the efficiency of the assignment by providing a good understanding of the scheme. It is an intrinsic part of the audit assignment. Therefore, the permanent file must be comprehensive and up to date. Each year, the permanent file should be reviewed, updated and signed to evidence that this has been done.

The permanent file contains information of a permanent and semi-permanent nature, being information which will be of continuing importance to assignments over a number of years.

Although there is a standard index to the file, as with all aspects of an audit, the file should only contain mandatory information required to comply with auditing standards, and other legislation and regulation, along with information which will aid the efficiency of the audit. The content and form of the file is therefore likely to be different for each client and must be decided upon by the Responsible Individual and manager.

However, a permanent file will normally include the following information:

- information concerning the legal and organisational structure of the scheme, including information regarding related parties;
- extracts of important legal documents and agreements;
- any sector specific data;
- details of the accounting systems and internal control environment;
- an appraisal of those systems;
- a summary of key ratios and figures over a period of years;
- general pension scheme information; and
- accounts information of ongoing value.

The Mercia approach also encourages users to develop tailored audit programmes which can be held on the permanent file. If held on the permanent file, in future years these must be reviewed and, if necessary, updated as appropriate.

The structure of each audit section

Divider cards (see current file indexes within the current file documents)

The divider cards include recommended standard references for working papers, as well as the conclusions, for each section of the audit file.

The audit conclusions should be signed by the person completing the work and should then be signed by the reviewer.

For non-audit assignments the conclusions are not needed. However, the divider cards and standard references may be useful.

Audit plan

Where individual audit sections have been planned separately using the standard individual area audit plans, a copy of the working paper can be placed on the planning section, the permanent file and / or the front of each section of the audit file (where it is filed behind the relevant lead schedule, as this helps to ensure that the section is audited in accordance with the plan).

The use of the individual area audit plan schedules also helps to focus the selection of appropriate audit programmes.

Audit programmes

The audit programme is very flexible and must be carefully tailored for each audit area at the planning stage.

We generally have a choice of sections as follows:

- A General and mandatory tests
- B Tests of controls
- C Non-audit services
- D Analytical procedures
- E Tests of detail (blank programme), or
- F Tests of detail (tailorable programme)

The only sections where this choice is not available are the Accounting Estimates (Q), Going Concern (R) and Subsequent Events (S) audit programmes. In programmes R and S, only the A section is available. For programme Q, this is a supplementary form which must be used where there are key accounting estimates. A separate Q programme is used for each individual key accounting estimate. For example, if there are three key accounting estimates documented in planning, then there would be three Q programmes. The Q programmes can either be filed in the Q section or with the relevant fieldwork for that key accounting estimates (eg. for an impairment provision, it could be filed either at Q or in the F Investments and related income section).

Section A (General and mandatory tests)

This section is nearly always applicable, as this deals with general file completion issues in addition to mandatory ISA testing. Selecting section A will ensure that each programme generated has the correct heading and objectives at the top.

Also included in this section, where applicable, are:

- a prompt to record the risk assessment procedure confirming the design and implementation of key controls; and
- certain procedures mandated by the ISAs.

Section B (Tests of controls)

This section is a prompt to the tests required when assurance is to be placed on the effective operation, throughout the period, of one or more control procedures, as established on the individual area audit plans.

Section C (Non-audit services)

This section is useful when non-audit procedures (such as involvement in the compiling of numbers for the financial statements) are to be carried out and used as part of the audit evidence.

Section D (Analytical procedures)

This section is a menu of possible procedures that could be utilised to achieve the objectives.

Section E (Tests of detail (blank programme))

This section is a page highlighting the key audit assertions for the individual audit area. It should be used either:

- to record any additional tests for objectives not achieved by sections A to D above; or
- on a very low risk area, to record all the tests required for the section.

Section F (Tests of detail (tailorable programme))

This section can be used:

- to record the additional procedures for objectives not achieved by sections A to D above; or
- as the main audit programme for the individual audit area.

NB. If this section is selected, it is very likely that it will need to be tailored, with a number of the procedures crossed through or deleted.

Each individual section of the audit file has its own audit programme. The tailoring process takes place in two stages. Firstly, you should select which of the standard pages are appropriate. Once this decision has been made, further tailoring on a line by line basis is required to select / design the appropriate tests.

The four main areas are referenced consistently for each individual section. Using the contributions receivable and related debtors section as an illustrative example:

- H3 General and mandatory tests and tests of controls
  This must be selected for nearly all audits as it ensures general and mandatory ISA tests are performed. The controls - operating effectiveness programme should be selected when some or all of the evidence is to be obtained from testing some or all of the operating effectiveness of controls.
- H3 Non-audit services programme
  This is the programme to select when some or all of the evidence is to be obtained from non-audit services, such as financial statements compilation.
- H3 Analytical procedures
  This is the programme to select when some or all of the evidence is to be obtained from analytical procedures.
- H4 Blank additional programme
  The programme to select either:
    - to record any further tests on objectives not met by work planned on the above tests at H3; or
    - to record all the tests required in a low risk area, when H3 are not selected.

These pages could be used in every section of a very low risk assignment.

- H5 Bank of 'tests of detail'
  This programme can be used in a variety of ways, for example:
    - as the main programme; or
    - as a reference document to select tests for recording on H4; or
    - as an additional programme to H3.

Selecting appropriate audit programmes for each section is the answer to eliminating over auditing and improving efficiency.

Regardless of which audit programmes are selected as the starting point, individual tests must be added or deleted depending on the specific knowledge of the client.

All combinations and permutations of programmes are acceptable. It is extremely unlikely that all of the tests on any of the programmes will be necessary. This is particularly true of the 'bank of tests of detail' programme (H5).

Audit exemption

Your Pension Schemes Manual also includes other complimentary documentation:

Ear-marked schemes - Audit of contributions schedule

This pack is suitable for an ear-marked pension scheme which does not need to have a true and fair audit but where only a report on the contributions schedule is required. The following documentation is available for such a scheme:

- an example engagement letter;
- an example statement about contributions; and
- a separate work programme covering contributions receivable only.

Other documentation included within the Pension Schemes Manual (for example, disclosure checklists, permanent file documents, lead schedules and file divider cards) may also be tailored and used on audit exempt assignments.

Non-audit

Your manual also includes an example engagement letter and guidance on accountants' reports which are suitable for an accounts preparation assignment.

18.5 What's changed

Update – September 2023

What's changed

We are pleased to issue updates to your Mercia Pension Schemes Manual (dated 09/23).

The principal technical changes in this update include:

- The introduction of a new (optional) statistical sampling approach; and
- The restructuring of the guidance notes.

In addition a number of other minor improvements and amendments have been made to the manual.

See below for a full list of changes.

New (optional) statistical sampling approach

A new (optional) statistical sampling approach has been added to sit alongside the extant judgemental sampling approach. For many audits the extant judgemental approach, particularly where populations are smaller, will remain appropriate, however it is not suitable for use on audits where populations are very large. As such a new statistical sampling approach which does not include a sample size cap has been added to the methodology for use on audits where the judgemental approach is not considered appropriate.

Guidance notes

The guidance notes have been restructured to make them more user-friendly and to ensure a consistent approach to guidance notes across Mercia's suite of products.

Contact us

We are always pleased to receive feedback on our manuals, including any improvements that you would like to see incorporated. Please contact me if you have any comments to make.

Andy Holton

September 2023

September 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
Guidance	
Contents	• Updated to reflect the new Guidance notes structure.
Guidance notes	• The guidance notes have been restructured to make them more user friendly and to ensure a more consistent approach across the suite. • Appendix 5a to the guidance notes includes guidance on the new statistical sampling approach.
Getting started for new manual users	• The Accessing the manual section has been removed.
What's changed	• A copy of this What's changed notice has been added to the manual.
Example accounts	
All example accounts	• Updated to state the accounts are based on standards and amendments in issue at 1 April 2023 (no technical changes to the content of the accounts).
Accounts disclosure checklists	
A32 Pension Schemes Annual Report Checklist	• Updated to state that the checklist reflects standards and amendments in issue as at 1 April 2023 (no technical changes to the content of the checklist).
Current file documents	

A29 Reporting on irregularities, including fraud in the auditor's report (individual and group)	• An additional column has been added to enable comments to be cross referenced back to where the underlying work has been performed.
B40 Audit plans	• Guidance in sampling section updated to refer to sampling plan(s) / sampling form(s) as appropriate.
CSF Controls sampling form (individual, freeform and group)	• Updated to new format (no substantive technical changes).
SSF Substantive sampling form - Judgemental (individual, freeform and group)	• Updated to new format including more space to justify sample sizes.
SSF Substantive sampling form - Statistical (individual, freeform and group)	• New form for use with the new statistical sampling approach.
Permanent file documents	
PF1-7 Using the work of an expert	• Auditor's expert section expanded.

Update - February 2023

What's changed

We are pleased to issue updates to your Mercia Pension Schemes Manual (dated 02/23).

The principal technical changes in this update include the removal of content relating to the now superseded ISQCs and consequential amendments arising as a result of this. The Pension Schemes Manual, together with the Audit Procedures Manual, address engagement level quality management, with the Quality Management Manual addressing firm wide requirements.

In addition a number of minor amendments / improvements have been made to other sections of the Pension Schemes Manual, including updating engagement letters to reflect latest guidance.

See below for a full list of changes.

Contact us

We are always pleased to receive feedback on our manuals, including any improvements that you would like to see incorporated. Please contact me if you have any comments to make.

Andy Holton

February 2023

February 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
Guidance	
Contents	• Updated for relocation of file review checklists to Supplementary forms section.
Guidance notes	• Updated to reflect the fact there is no longer a requirement for schemes to have a year end of 5 April in order for small schemes to be exempt from the requirement to appoint an auditor. • Updated to reflect changes to the Codes of Practice (CoP).
What's changed	• A copy of this What's changed notice has been added to the manual.
File review checklist (p/c before 15 Dec 21)	• File review checklist moved to Supplementary forms section.
File review checklist (p/c on or after 15 Dec 21)	• File review checklist moved to Supplementary forms section.
Example letters	
Engagement – Covering letter	• Updated the 'professional services provided' section to include a new paragraph which confirms whether disbursements are expected to be incurred. • A new section detailing how communication will be maintained throughout the engagement has been added. • Updated the 'agreement of terms' section to include reference to the firm's privacy notice on their website and reference to the standard terms of business in relation to instances of variation or termination of the engagement.
Engagement - schedule of professional services – audit	• Moved the paragraph highlighted the client's responsibility towards publishing electronic information from the 'Scope of audit' section to the 'Your responsibilities' section. • Included a paragraph in 'Our responsibilities' confirming that the client is to be informed should matters or significant facts arise that may raise ethical concerns. • A paragraph was added to the 'Scope of audit' section explaining that the auditors may also use analytical tools in their work.

Engagement - schedule of professional services - audit of non-statutory report	• Moved the paragraph highlighted the client's responsibility towards publishing electronic information from the 'Scope of audit' section to the 'Your responsibilities' section. • Included a paragraph in 'Our responsibilities' confirming that the client is to be informed should matters or significant facts arise that may raise ethical concerns. • A paragraph was added to the 'Scope of audit' section explaining that the auditors may also use analytical tools in their work.
Engagement - schedule of professional services - accounts compilation	• An optional paragraph has been included where clients have asked firms to convert the financial statements into the iXBRL format. • Clarification has been included to inform clients that, consent must be received from the firm, should they want to share the report with any third parties.
Engagement - terms of business	• Updated paragraphs in the 'Fees and payment terms' section clarifying the use of insurance policies to cover fees, circumstances where clients are unable to pay fees and the rights of the firm to exercise a lien over all funds have also been added. • Added a new section detailing standard business terms in relation to confidentiality. • Clarification of potentials actions of the firm, should a dispute arise between parties within the engagement.

Current file documents

Current file indices (both p/c before and on or after 15 Dec 21)	• Updated to more accurately reflect naming of A21-1, A21-2, A21-3 and B03/B14.
A21-2 Engagement quality review checklist (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
A21-2 Engagement quality review checklist (p/c before 15 Dec 21)	• Updated to ISQM version of form.
A21-3 Consultation review (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
A21-3 Consultation review (p/c before 15 Dec 21)	• Updated to ISQM version of form.
A31 Audit completion checklist (p/c on or after 15 Dec 21)	• References to ISA (UK) 240 updated to reflect the FRC's reissued ISA which includes corrected numbering aligned to the international version.
A46 Fraud update and evaluation (p/c on or after 15 Dec 21)	• References to ISA (UK) 240 updated to reflect the FRC's reissued ISA which includes corrected numbering aligned to the international version.
B03 Preliminary engagement quality review (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
B10 Engagement review (p/c on or after 15 Dec 21)	• Under the 'New client checklist' heading, the wording has been updated from "We have completed B13..." to "We have completed / reviewed B13..." to reflect the fact that relevant matters should also be identified in future years when the client is not new.
B14 Preliminary engagement quality review (p/c before 15 Dec 21)	• Updated to ISQM version of form.
B32A-E Key accounting estimate (individual and freeform) (p/c on or after 15 Dec 21)	• Updated wording of the key assertions relevant to the accounting estimate which may be selected for clarity.

Permanent file documents

PF5 Permanent audit planning documentation (both p/c before and on or after 15 Dec 21)	• Additional table added to list engagement team members each year if desired.
Supplementary forms	
File review checklist (p/c before 15 Dec 21)	• File review checklist moved from Guidance section.
File review checklist (p/c on or after 15 Dec 21)	• File review checklist moved from Guidance section.

19 LLP manual

19.1 Contents

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	Appendices
	Appendix 1a: Notes for completion of planning form B25 - Materiality
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	Appendix 2.1a: Notes for completion of planning form B40 Audit plan - Other audit areas - Trial balance (use of ADA)
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	Getting started for new manual users
	What's changed

19.2 Guidance notes

1 Introduction

1.1 Scope

This manual provides you with all the programmes, documents and guidance needed to undertake the audit of a UK Limited Liability Partnership (LLP) subject to the Limited Liability Partnerships Act 2000 under the International Standards on Auditing (ISAs) (UK) and the FRC Ethical Standard.

The manual is suitable for audits of groups as well as standalone entities.

In addition, this manual also provides you with certain audit exemption documentation. Other documentation which is primarily aimed at audit assignments included in the manual (for example disclosure checklists, permanent file documents, lead schedules and file divider cards) may also be tailored and used on audit exempt assignments.

1.1.1 Specialist Assignment Manuals (SAMs)

Where an entity is an LLP of a specialist nature, or is not an LLP, a Specialist Assignment Manual (SAM) specifically designed for that type of entity should be used, or in some cases it may be appropriate to tailor this manual to meet the specialist requirements of the entity concerned.

In addition to the Audit Manual (UK) dealing with the audit of companies Mercia provides a wide range of SAMs including:

- Academies;
- Charities;
- ~~Clubs (GB);~~
- ~~Clubs (NI);~~
- Pension Schemes;
- ~~Registered Social Housing Providers (RSHPs); and~~
- Societies and Community Interest Companies (CICs)*.

** This is a supplementary manual designed to be used in conjunction with the Audit Manual (UK).*

1.1.2 Exclusions

Whilst it may provide a useful starting point, this manual is not intended to be used for the audit of Public Interest Entities (PIEs).

1.1.3 Quality management

Forms relevant to ensuring quality at the engagement level are included within this manual, with firm wide quality management aspects addressed in the Quality Management Manual (UK) which is available to purchase separately.

1.2 What else is needed?

You should have access to the Audit Procedures Manual (UK), included as part of the Audit Manual Package (UK) or available to purchase separately, which contains supporting audit methodology and guidance.

You will also need access to the applicable versions of the following:

- The Limited Liability Partnerships Act 2000;
- SI 2001/1090 The Limited Liability Partnerships Regulations 2001;
- SI 2008/1911 The Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008;
- SI 2008/1912 The Small Limited Liability Partnerships (Accounts) Regulations 2008;
- SI 2008/1913 The Large and Medium-Sized Limited Liability Partnerships (Accounts) Regulations 2008; and
- Statement of Recommended Practice - Accounting by LLPs (SORP), which was last revised in December 2021 and is effective for accounting periods beginning on or after 1 January 2022.

2 Sector overview

2.1 Legal and Regulatory Framework

2.1.1 Introduction

LLPs are body corporates formed and registered under the Limited Liability Partnerships Act 2000. They have a separate legal personality from their members - they are, therefore, able to enter directly into contracts and are able to own property. They may also issue debentures and grant fixed or floating charges over their assets.

LLPs combine the organisational flexibility and taxation treatment of a partnership with limited liability for members. The number of members permitted is unlimited.

Members of an LLP (not strictly speaking to be known as partners) can generally limit their personal liability to their investment in the LLP, unless they, themselves, give, for example, negligent advice.

Legislation governing LLPs is contained within the Limited Liability Partnerships Act 2000 (the LLP Act) and is supported by Regulations (the Regulations).

LLPs are incorporated in a similar way to limited companies and must send appropriate information to Companies House. They are broadly subject to the requirements of company law, as applied by the Regulations.

The detailed accounting requirements relating to LLPs are set out in the Regulations. These apply, with appropriate modifications, the accounts and audit provisions of the Companies Act 2006 for private limited companies to LLPs. There may, however, be delays between legislation being applied to companies and subsequently to LLPs and not all company law is applied to LLPs.

2.1.2 Limited Liability Partnerships Act 2000

The Limited Liability Partnerships Act 2000 (the LLP Act) creates the framework for establishing and operating an LLP. It addresses incorporation, membership and taxation, as well as giving the power for regulations to be made with respect to LLPs.

Formation

An LLP is formed in a similar way as a limited company. Two or more persons (a person includes individuals and body corporates) associated for carrying on a lawful business with a view to a profit must subscribe to an incorporation document and the document must be delivered to the Registrar at Companies House. A statement of compliance must be completed by a solicitor involved in the formation or by any subscriber to the incorporation document (Form LL IN01).

The incorporation document (Form LL IN01) must contain various items of information including:

- the name of the LLP (which is subject to certain restrictions);
- the address of the registered office (situated in England and Wales, in Wales or in Scotland);
- the names and addresses of the persons who will be members on incorporation and whether all or some are to be designated members; and
- the statement of compliance.

There is no minimum level of capital required to incorporate an LLP and none of the company law provisions in respect of capital maintenance apply to LLPs.

There must be at least two designated members (who should be appointed on incorporation and subsequently by agreement). If no designated members are appointed (or if only one member is designated) then all members become designated. The role of a designated member is to perform the administrative and filing duties of the LLP (in a company these would be done by a company secretary or the directors).

The Registrar will issue a certificate of incorporation at which date the LLP is deemed to be in existence.

If membership falls to only one member, and the LLP continues to carry on business for more than six months, the benefits of limited liability will be lost.

2.1.3 Companies Act 2006 as applied to LLPs

Whilst LLPs are not directly subject to the requirements of the Companies Act 2006, SI 2008/1911 The Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008 and SI 2009/1804 The Limited Liability Partnerships (Application of the Companies Act 2006) Regulations 2009 do apply several key aspects of the Companies Act (with appropriate modifications) to LLPs. Most notably this include requirements around audit and accounts as well as a number of administrative matters. These accounting and reporting requirements are addressed further in Section 3 of these notes.

Due to regulations being needed to apply aspects of the Companies Act 2006 to LLPs, there can, on occasion, be a delay between changes in legislation for companies and the corresponding changes for LLPs coming into force.

2.1.4 The Regulations

As noted above, LLPs are subject to a number of regulations which apply aspects of the Companies Act 2006 to LLPs, notably:

- SI 2008/1911 The Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008; and
- SI 2009/1804 The Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009.

Additionally, SI 2001/1090 The Limited Liability Partnerships Regulations 2001 apply further aspects of company law, including aspects connected to winding up.

There are two further regulations which include accounting requirements and requirements with regard to the content and format of accounts and reports for small and medium / large LLPs respectively:

- SI 2008/1912 The Small Limited Liability Partnerships (Accounts) Regulations 2008; and
- SI 2008/1913 The Large and Medium-Sized Limited Liability Partnerships (Accounts) Regulations 2008.

Both have been updated multiple times since they initially came into force. They are very similar to one another with regard to the accounting requirements, but differ with regard to reporting and disclosure requirements as medium and large LLPs are generally required to disclose more than small LLPs.

Relevant requirements form the regulations are included within the disclosure checklists and example accounts. They are also discussed further in Section 3 of these notes.

2.2 Governing documents

Whilst not strictly mandatory, an LLP will usually have its own governing document - a members' agreement. This is a private document which is not publicly available.

It is possible for templates to be used as a starting point for a members' agreement.

Care should be taken to review the agreement carefully as it may necessitate an audit (even where an exemption might otherwise be claimed), or could have other implications such as prohibiting certain transactions, or requiring certain processes or procedures to be followed.

2.2.1 Members' agreements

The LLP Act provides that every member of the LLP is an agent of the LLP but also provides that an LLP will not be bound by the acts of a member if the member does not have authority to bind the LLP and the third person either knows that the member does not have authority, or does not know or believe the member to be a member of the LLP.

As with partnerships formed under the Partnership Act 1890, it is important for Limited Liability partners to consider and determine the authority of each member to bind the LLP. This is probably more important than for partnerships formed under the Partnership Act 1890.

An agreement made before the incorporation of a limited liability partnership between the persons who subscribe their names to the incorporation document may impose obligations on the limited liability partnership (to take effect at any time after its incorporation). As a result potential members should consider pre-incorporation agreements which cover actual authority obligations.

If a member ceases to be a member of an LLP for any reason the Act provides that such a member can still be treated as a member by any third party dealing with the LLP unless:

- the third party has notice of the fact that the member has ceased to be a member; or
- notice that the member has ceased to be a member has been registered with the Registrar.

Any change in membership must be notified to the Registrar within 14 days; changes in a member's name or address must be notified with 28 days. Failure to notify is a criminal offence and any conviction can lead to a fine.

Section 6(4) of the Limited Liability Partnerships Act 2000 provides: "*Where a member of a limited liability partnership is liable to any person (other than another member of the limited liability partnership) as a result of a wrongful act or omission of his in the course of the business of the limited liability partnership or with its authority, the limited partnership is liable to the same extent as the member.*" Whilst this clearly provides for a form of vicarious liability on the LLP following an act of default by a member, it also suggests the possibility of individual liability for a member's own defaults.

A member ceases to be a member of an LLP by:

- leaving;
- dying;
- becoming bankrupt;
- being wound up (if a corporate member);
- granting a trust deed for the benefit of creditors;
- assigning the whole or part of his share in the LLP.

The LLP Act provides: "*Except as far as otherwise provided by this Act or any other enactment, the mutual rights and duties of the members of a limited liability partnership, and the mutual rights and duties of a limited liability partnership and its members, shall be governed:*

- *by agreement between the members, or between the limited liability partnership and its members; or*
- *in the absence of agreement as to any matter, by any provision made in relation to that matter by regulations under section 15(c).*"

As with partnerships set up under the Partnership Act 1890, it is important to recognise the rules that will apply in the absence of an agreement. Although not legally obligatory, the creation of an LLP agreement is really essential.

The default rules, mainly introduced by regulation, largely follow the rules set out in the Partnership Act 1890 but with some subtle changes:

- all members are entitled to an equal share in the capital and profits of the LLP;
- the LLP must indemnify members against payments and liabilities arising:
    - in the ordinary and proper course of business; or
    - anything done for the preservation of the LLPs business or property;
- every member may take part in the management of the business;
- no member is entitled to remuneration for acting in the business or management. Section 4(4) of the LLP Act provides "*A member of a limited liability partnership shall not be regarded for any purpose as employed by the limited liability partnership unless, if he and the other were partners in a partnership, he would be regarded for that purpose as employed by the partnership*";
- no person may become a member without the consent of all existing members;
- no member may voluntarily assign an interest in an LLP without the consent of all the members;
- ordinary decisions connected with the business may be decided by majority vote of the members; no change in the nature of the business can be effected without the consent of all members;
- the books and records of the LLP are to be kept at the place of business and every member must have access to inspect and copy any of them;
- each member must render true accounts and information to other members;
- if a member carries on a competing business of the same nature without the consent of the LLP, that member must account to the LLP for all profits made in that business;
- if a member derives benefit from any transaction concerning the LLP or property, name or business of the LLP without the LLPs consent, that member must account for such benefit to the LLP;

- no majority of members can expel a member unless express agreement has been conferred in an agreement between the members;
- any member can petition the court for an order on the grounds that the affairs are being conducted in an unfairly prejudicial manner unless this right has been expressly excluded by a unanimous agreement which will bind future members (section 994 Companies Act 2006, extended to LLPs by regulation);
- any member can cease to be a member by giving reasonable notice to other members;
- former members, assignees, PRs of deceased members and trustees of bankrupt members cannot interfere in the management of the business.

The LLP agreement can be between the members of the LLP or between the LLP and the members. It is important to note:

- the agreement should be concluded before the LLP commences and it can impose obligations on the LLP itself;
- the agreement should be as comprehensive as possible trying to ensure that everything is dealt with;
- the agreement should be in writing; and
- it should be ensured that the agreement can be modified, if necessary later, to reflect changes in the way courts interpret the internal regulation of LLPs.

2.2.2 Essential terms of a members' agreement

A members' agreement should address the following areas:

- **Status of members**
  Identify the status, rights and titles of different members.

- **Designated members**
  State how to become and be removed from the position of designated member.

- **Admission of new members**
  Identify the procedures necessary.

- **Capital contributions**
  The existing separation of capital and current accounts can continue and as the LLP can itself borrow, loans can be raised from members (subject to claw backs in the event of liquidation).

- **Assets of the LLP**
  Which assets (eg. property) will be owned by the LLP and clarification as to whether an asset vested in a partners' name but used by the LLP would be treated as LLP property.

- **Sharing of profits and losses**
  The members can choose whatever they like and may wish to continue with their existing methods. The sharing of income and capital profits / losses should be provided for.

- **Decision making**
  The members can adopt any structure they wish and can appoint non members to committees (though there may be a risk that such a person may be treated as a shadow member). The agreement should generally ensure that "minority shareholder protection provisions" are excluded. It is possible for certain members to be disenfranchised such as a member on garden leave. Issues that must be clear include:
    - the required majority for different types of decision;
    - formulation for meetings such as necessary notices, quorum etc.;
    - voting requirements including proxies or weighting for votes.

- **Possible limitations on the authority of a member**
  Such limitations may be appropriate and there may need to be an explicit reference that no member has the authority to act as the agent of any other member.

- **Duties of members**
  Most standard partnership obligations such as being full time and giving necessary attention should be carried over but care should be taken over the wording of duties of good faith. The issue arises as to whom such duty is owed (ie. is it to the LLP, other members, or both?)

- **Retirement of members**
  The agreement should be able to deal with issues such as voluntary and / or compulsory retirement of members and could include retirement on age grounds and "no fault" compulsory retirement. The LLP Act deals with issues of death and dissolution. Retirement procedures will follow any existing partnership provisions except that notices may be served on or by the LLP itself. Generally a specified period of notice should be referred to.

- **Expulsion of members**
  The agreement needs to include an appropriate provision for expulsion with notice being served by the LLP. The agreement could include a right to a fair hearing.

- **The entitlement of outgoing members**
  Members effectively have "shares" in an LLP which are capable of being assigned and there are no restrictions on an LLP purchasing a members share. Possible practical approaches include:
    - repayment by the LLP of capital and current account balances as in the case of a normal partnership;
    - the sale of the outgoing members' share to the LLP on agreed terms;
    - the sale of that share to the continuing members on agreed terms (which could involve continuing members undertaking additional personal liability);
    - retention of the share within the LLP on agreed terms.

  Indemnities from outgoing partners will not be as critical as would normally be the case as most liabilities are undertaken by the LLP itself but it may be appropriate for the outgoing member to indemnify the LLP against his / her own acts and defaults. The agreement must refer to the need to notify clients / customers etc. of the member's retirement / departures.

- **Competition from outgoing members**
  Clients or customers are those of the LLP itself. The agreement could include restrictive covenant clauses.

- **Dissolution**
  The term dissolution does not apply to LLPs and LLPs will be subject to either a voluntary winding up or a winding up by the Court. The agreement should provide for the circumstances where a voluntary winding up becomes desirable.

- **Resolution of disputes**
  It may be appropriate to include clauses as to when arbitration or mediation may be necessary.

- **Amendments to existing agreements**
  Where an existing partnership converts to an LLP, the existing agreement is likely to form the basis of a draft agreement but care will be needed. The terms must be modified to reflect the separate legal existence of the LLP and the existing contractual rights and obligations between members must be analysed into the rights and obligations members owe each other and the rights and obligations they owe to the LLP. Current partnerships are generally based on the "duty of good faith" (an obligation to be entirely honest, straightforward and open in all dealings between partners and to disclose all material facts) but this concept is not central to an LLP. In particular, be sure to deal with the following:
    - "partner" should be replaced with "member";
    - "firm" should be replaced with "LLP";
    - right and duties need to be with the LLP (though may be between members as well).

2.3 Types of LLP

Unlike companies which may have limited or unlimited liability and may be public or private companies, there are no such different types of LLP.

The liability of the members of an LLP is limited.

2.4 LLP and group size

The size of an LLP or (if applicable) a group is important to determine as it affects accounting, reporting and audit requirements. A LLP may be:

- A micro-entity;
- Small;
- Medium-sized; or
- Large.

2.4.1 Micro

In a LLP's first financial year, it will quality as a micro-entity if the qualifying conditions (see below) are met in that year.

If it is not the first financial year of the LLP, a two-year rule applies. This means that in a subsequent financial year of the LLP, where on its balance sheet date it meets or ceases to meet the qualifying conditions, that affects its qualification as a micro-entity only if it occurs in two consecutive financial years. In other words, it takes two consecutive years to change size.

If the LLP is a parent LLP, it will only qualify as a micro-entity if the group it heads qualifies as a small group (see below).

2.4.1.1 Qualifying conditions

The qualifying conditions are met by an LLP in a year in which it satisfies two or more of the below requirements:

Criteria	LLP
Turnover *Adjust proportionately if not a year.*	Not more than £632,000
Balance sheet total *The aggregate of the amounts shown as assets in the LLP's balance sheet.*	Not more than £316,000
Number of employees *This is not the full time equivalent.*	Not more than 10

2.4.1.2 LLPs excluded from being treated as micro-entities

An LLP is excluded from being treated as a micro-entity if at any time within the year:

- it was an LLP excluded from the small LLPs regime (see below);
- it would have been an investment undertaking as defined in Article 2(14) of Directive 2013/34/EU of 26 June 2013 on the annual financial statements etc. of certain types of undertakings were the United Kingdom a member State;
- it would have been a financial holding undertaking as defined in Article 2(15) of that Directive were the United Kingdom a member State;
- it was a credit institution within the meaning given by Article 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 Article 4(1)(2A) of that Regulation; or
- it would have been an insurance undertaking as defined in Article 2(1) of Council Directive 91/674/EEC of 19 December 1991 on the annual accounts of insurance undertakings were the United Kingdom a member State;

An LLP is also excluded if:

- it is a parent LLP which prepares group accounts for the year; or
- it is not a parent LLP but its accounts are included in group accounts for the year.

2.4.2 Small

In an LLP's first financial year, it will qualify as small if the qualifying conditions (see below) are met in that year.

If it is not the first financial year of the LLP, a two-year rule applies. This means that in a subsequent financial year of the LLP, where on its balance sheet date it meets or ceases to meet the qualifying conditions, that affects its qualification as small only if it occurs in two consecutive financial years. In other words, it takes two consecutive years to change size.

If the LLP is a parent LLP, it will only qualify as small if the group it heads qualifies as a small group (see below).

2.4.2.1 Qualifying conditions

The qualifying conditions are met by an LLP in a year in which it satisfies two or more of the below requirements:

Criteria	LLP	Group*
Turnover *Adjust proportionately if not a year.*	Not more than £10.2 million	Not more than £10.2 million net (or £12.2 million gross)
Balance sheet total *The aggregate of the amounts shown as assets in the LLP's balance sheet.*	Not more than £5.1 million	Not more than £5.1 million net (or £6.1 million gross)
Number of employees *This is not the full time equivalent.*	Not more than 50	Not more than 50

** Gross or net thresholds may be cherry picked.*

2.4.2.2 LLPs excluded from the small companies regime

The small LLPs regime does not apply to an LLP that was at any time within the financial year to which the accounts relate:

- a traded LLP;
- an LLP that:
  - is an authorised insurance company, a banking LLP, an e-money issuer, a MiFID investment firm or a UCITS management company;
  - carries on insurance market activity; or
  - is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1);
- a member of an ineligible group.

A group is ineligible if any 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 or small LLP*) who has permission under Part 4A of the Financial Services and Markets Act 2000 (c. 8) to carry on a regulated activity;
- an e-money issuer;
- a small company or small LLP* that is an authorised insurance company, a banking company or banking LLP, a MiFID investment firm or a UCITS management company;
- a person who carries on insurance market activity; or
- a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021] (interpretation of Part 1).

** A company or LLP is a small company or LLP for this purpose if it qualified as small in relation to its last financial year ending on or before the end of the financial year to which the accounts relate.*

2.4.3 Medium

In an LLP's first financial year, it will quality as medium-sized if the qualifying conditions (see below) are met in that year.

If it is not the first financial year of the LLP, a two-year rule applies. This means that in a subsequent financial year of the LLP, where on its balance sheet date it meets or ceases to meet the qualifying conditions, that affects its qualification as medium-sized only if it occurs in two consecutive financial years. In other words, it takes two consecutive years to change size.

If the LLP is a parent LLP, it will only qualify as medium-sized if the group it heads qualifies as a medium group (see below).

2.4.3.1 Qualifying conditions

The qualifying conditions are met by an LLP in a year in which it satisfies two or more of the below requirements:

Criteria	**LLP**	**Group***
Turnover *Adjust proportionately if not a year.*	Not more than £36 million	Not more than £36 million net (or £43.2 million gross)
Balance sheet total *The aggregate of the amounts shown as assets in the LLP's balance sheet.*	Not more than £18 million	Not more than £18 million net (or £21.6 million gross)
Number of employees *This is not the full time equivalent.*	Not more than 250	Not more than 250

** Gross or net thresholds may be cherry picked.*

2.4.3.2 LLPs excluded from being treated as medium-sized

An LLP may not be treated as medium-sized if it was at any time within the financial year in question:

- a traded LLP;
- an LLP that:
  - has permission under Part 4A of the Financial Services and Markets Act 2000 (c. 8) to carry on a regulated activity; or
  - carries on insurance market activity; or
  - is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1); or

- an e-money issuer; or
- a member of an ineligible group.

A group is ineligible if any 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 or small LLP*) who has permission under Part 4A of the Financial Services and Markets Act 2000 to carry on a regulated activity;
- an e-money issuer;
- a small company or small LLP* that is an authorised insurance company, a banking company or banking LLP, a MiFID investment firm or a UCITS management company;
- a person who carries on insurance market activity; or
- a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1).

** A company or LLP is a small company or LLP for this purpose if it qualified as small in relation to its last financial year ending on or before the end of the financial year to which the accounts relate.*

2.4.4 Large

A large LLP is any LLP that does not qualify as a micro-entity, for the small LLPs regime or as medium-sized.

2.5 Taxation

For the purposes of income and capital gains tax, an LLP carrying on a trade, profession or business with a view to profit is treated as a partnership.

The members are treated as partners for tax purposes and taxed on their share of the partnership / profit. The basis period rules apply to each partner personally.

If, on conversion from a partnership to an LLP, the LLP succeeds to all of the business previously carried on by the partnership, there is no cessation for income tax purposes and no disposal of assets by the partners.

Members of an LLP, who are individuals, are generally entitled to claim interest relief on the loans they obtain in order to defray money for a qualifying purpose.

There is a restriction on the sideways use of loss relief for members of an LLP which carry on a trade, not a profession. The restriction is computed on an annual basis.

Where an LLP ceases to carry on a trade, profession or business with a view to profit, the LLP will be taxed as a company from that point forward. However, a concession allows temporary periods of non-trading to be ignored if the LLP is wound up and the proceedings are not unduly protracted.

For inheritance tax, the LLP is always treated as a partnership.

For Stamp Duty Land Tax, there is relief for transferring property to a newly incorporated LLP within one year of incorporation. There is also relief on transfers of assets from a partnership to an LLP provided that all the partners are the same both before and after.

Many areas of taxation including demerging an LLP, converting to an LLP, the payment of annuities and capital gains for partners are covered in the Revenue's Business Income Manual 82100.

There are special anti-avoidance rules for investment and property investment LLPs.

There are certain limited circumstances where an LLP can be taxed as a corporate entity, for example, where there is a gap in business or during insolvency. Deferred tax may also be applicable in these (rare) circumstances.

Where LLPs fall under s59A TCGA 1992, Statement of Practice D12 applies.

The Finance Act 2014 introduced anti-avoidance rules for partnerships, including LLPs, with corporate members. It also introduces anti-avoidance rules for certain salaried members of LLPs.

3 Accounting and reporting

3.1 Preparation of accounts

The members of every LLP must prepare accounts for the LLP for each of its financial years (unless the LLP is entitled to the dormant subsidiaries exemption*). The accounts must be true and fair and will be accruals based accounts.

The accounts must comply with the applicable accounting standard (see below) and the requirements of the regulations (see Section 2).

** The dormant subsidiaries exemption is set out in s394A of the Companies Act 2006 as applied to LLPs and includes extensive requirements including the need for the parent to guarantee all outstanding liabilities of the subsidiary at the end of the financial year.*

3.1.1 Accounting standards

Under the Act, most LLPs have a choice of which accounting standard to apply as shown in the following table.

	FRS 105	FRS 102 Section 1A	FRS 102	FRS 101 (for qualifying entities* only)	UK-adopted IFRS
Micro	Yes	Yes	Yes	Yes	Yes
Small	No	Yes	Yes	Yes	Yes
Medium	No	No	Yes	Yes	Yes
Large	No	No	Yes	Yes	Yes

Most LLPs will tend to use the left most standard they are permitted to use in the above table as this will typically be the most straightforward to apply for the LLP, however certain LLPs such as those acting in certain sectors may however have that choice restricted. Additionally LLPs which are part of a group may be required to adhere to a particular standard for consistency with the group.

** A qualifying entity is a member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation. Charities and entities most insurance companies are excluded from being qualifying entities.*

3.1.2 Group accounts

If at the end of its financial year an LLP is a parent LLP, the members must, as well as preparing individual accounts for the year, prepare group accounts, unless the LLP is exempt from that requirement.

Group accounts (also referred to as consolidated accounts or consolidated financial statements) are the financial statements of a parent and its subsidiaries presented as those of a single economic entity.

There are four possible exemptions:

- S399(2A) for small LLPs;
- S400 for LLPs included in UK accounts of a larger group;
- S401 for LLPs included in non-UK accounts of a larger group; or
- S402 for LLPs none of whose subsidiaries need to be included in the consolidation.

Each of these is set out in further detail in the following subsections. Note that LLPs operating in certain sectors may be required to prepare group accounts even if they would otherwise be exempt according to the above criteria.

3.1.2.1 S399(2A)

An LLP is exempt from the requirement to prepare group accounts if at the end of its financial year, the LLP is subject to the small LLPs regime.

Requirements

There are no further requirements set out in the Act.

Exclusions

A LLP is excluded from this exemption if it is a member of a group which, at any time during the financial year, has an undertaking which is:

- established under the law of any part of the UK;
- has to prepare accounts in accordance with Part 15 of the Companies Act 2006; and
- either;
    - is an undertaking whose transferable securities are admitted to trading on a UK regulated market;
    - is a credit institution within the meaning given by Article 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 Article 4(1)(2A) of that Regulation; or
    - would be an insurance undertaking within the meaning given by Article 2(1) of Council Directive 91/674/EEC of the European Parliament and of the Council on the annual accounts of insurance undertakings were the United Kingdom a member State.

3.1.2.2 S400

An LLP may be exempt from the requirement to prepare group accounts if it is included in UK group accounts of a larger group.

Requirements

The LLP must be a subsidiary and its immediate parent must be a parent undertaking established under the law of any part of the UK. In order to claim the exemption:

- the LLP must be a wholly-owned subsidiary of that parent undertaking; or
- the parent undertaking must hold 90% or more of the shares in the LLP and the remaining members must have approved the exemption; or
- the parent must hold more than 50% (but less than 90%) of the shares in the LLP and notice requesting the preparation of group accounts has not been served on the LLP by members holding in aggregate at least 5% of the shares in the LLP.

Exemption is conditional upon compliance with the following conditions:

- the LLP must be included in consolidated accounts for a larger group drawn up to the same date, or to an earlier date in the same financial year, by a parent undertaking established under the law of any part of the United Kingdom;
- those accounts must be drawn up and audited, and that parent undertaking's annual report must be drawn up:
  - if the undertaking is a company, in accordance with the requirements of this Part of the Act, or, if the undertaking is not a company, the legal requirements which apply to the drawing up of consolidated accounts for that undertaking; or
  - in accordance with UK-adopted international accounting standards;
- the LLP must disclose in the notes to its individual accounts that it is exempt from the obligation to prepare and deliver group accounts;
- the LLP must state in its individual accounts the name of the parent undertaking that draws up the group accounts referred to above and:
  - the address of the undertaking's registered office; or
  - if it is unincorporated, the address of its principal place of business;
- the LLP must deliver to the registrar, within the period for filing its accounts and reports for the financial year in question, copies of:
  - those group accounts; and
  - the auditor's report on them;
- any requirement of Part 35 of the Act as to the delivery to the registrar of a certified translation into English must be met in relation to any document comprised in the accounts and reports delivered in accordance with the previous bullet point.

Exclusions

An LLP is excluded from this exemption if it is a traded LLP.

3.1.2.3 S401

An LLP may be exempt from the requirement to prepare group accounts if it is included in non-UK group accounts of a larger group.

Requirements

The LLP must be a subsidiary and its parent must not be established under the law of any part of the UK. In order to claim the exemption:

- the LLP must be a wholly-owned subsidiary of that parent undertaking; or
- the parent undertaking must hold 90% or more of the shares in the LLP and the remaining members must have approved the exemption; or
- the parent must hold more than 50% (but less than 90%) of the shares in the LLP and notice requesting the preparation of group accounts has not been served on the LLP by the shareholders holding in aggregate at least 5% of the shares in the LLP.

Exemption is conditional upon compliance with the following conditions:

- the LLP and all of its subsidiary undertakings must be included in consolidated accounts for a larger group drawn up to the same date, or to an earlier date in the same financial year, by a parent undertaking;
- those accounts must be drawn up:
  - in a manner equivalent to consolidated accounts and consolidated reports drawn up in accordance with the requirements of Part 15 of the Companies Act 2006;
  - in accordance with UK-adopted international accounting standards; or
  - in accordance with accounting standards which are equivalent* to such international accounting standards, as determined pursuant to Commission Regulation (EC) No. 1569/2007 of 21 December 2007 establishing a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities pursuant to Directives 2003/71/ EC and 2004/109/ EC of the European Parliament and of the Council;
- the group accounts must be audited by one or more persons authorised to audit accounts under the law under which the parent undertaking which draws them up is established;
- the LLP must disclose in its individual accounts that it is exempt from the obligation to prepare and deliver group accounts;
- the LLP must state in its individual accounts the name of the parent undertaking that draws up the group accounts referred to above and:
  - the address of the undertaking's registered office; or
  - if it is unincorporated, the address of its principal place of business;
- the LLP must deliver to the registrar, within the period for filing its accounts and reports for the financial year in question, copies of:
  - those group accounts; and
  - the auditor's report on them;
- any requirement of Part 35 of the Companies Act 2006 as to the delivery to the registrar of a certified translation into English must be met in relation to any document comprised in the accounts and reports delivered in accordance with the previous bullet point.

Exclusions

An LLP is excluded from this exemption if it is a traded LLP.

* Guidance on equivalence is included in the application guidance to FRS 101.

3.1.2.4 S402

A parent LLP is exempt from the requirement to prepare group accounts if under s405 of the Companies Act 2006 as applied to LLPs, all of its subsidiary undertakings could be excluded from consolidation.

A subsidiary may be excluded from consolidation under s405:

- if its inclusion is not material for the purpose of giving a true and fair view (but two or more undertakings may be excluded only if they are not material taken together);
- severe long-term restrictions substantially hinder the exercise of the rights of the parent LLP over the assets or management of that undertaking;
- extremely rare circumstances mean that the information necessary for the preparation of group accounts cannot be obtained without disproportionate expense or undue delay; or
- the interest of the parent LLP is held exclusively with a view to subsequent resale.

3.1.3 Statement of Recommended Practice (SORP)

Statements of Recommended Practice (SORPs) are sector-driven recommendations on financial reporting for specialised industries, sectors or areas of work which supplement Financial Reporting Council (FRC) standards and other legal and regulatory requirements in light of special factors prevailing or transactions undertaken in that particular industry, sector or area of work that are not addressed in the FRC standards. SORPs also address matters that are addressed in FRC standards, but about which additional guidance is considered necessary.

The Statement of Recommended Practice - Accounting by Limited Liability Partnerships (the LLP SORP or in this manual, simply the SORP) applies to LLPs incorporated in the UK under the Limited Partnerships Act 2000 that report under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. The SORP does not therefore apply to LLPs complying with IFRS, FRS 101 or FRS 105.

The LLP SORP complements and does not replace accounting standards. The SORP should be used in conjunction with the Regulations and the accounting standards. In the event of conflict, the Regulations and accounting standards take precedence over the SORP.

3.1.3.1 Small LLPs

The SORP is clear in that there are no recognition and measurement simplifications for small entities and small LLPs must therefore comply with the recognition and measurement requirements of both FRS 102 and the SORP. However, small LLPs can choose to apply section 1A of FRS 102. Paragraph 27A of the SORP confirms that small LLPs choosing to apply the disclosure requirements of section 1A do not follow the disclosure requirements of the SORP but instead the requirements of section 1A of FRS 102. However, the SORP does mandate one additional disclosure, over and above section 1A, of how loans and other debts due to members rank in relation to other unsecured creditors (as required by paragraphs 63 and 64 of the SORP). This is mandated by the SORP as the disclosure is deemed necessary to show a true and fair view as LLPs do not have any of the capital maintenance provisions that apply to companies.

Paragraph 27B confirms that the accounts must give a true and fair view and judgement is needed when considering whether further disclosures over and above those required by section 1A are required in order to show a true and fair view. Dependent on facts and circumstances, some or all of the disclosures included in the SORP and the rest of FRS 102 may be needed in order for financial statements to show a true and fair view.

Section 1A of FRS 102 effectively allows for three different types of format for the accounts:

- full;
- abridged;
- adapted, providing the information given is at least equivalent to the information required by the formats set out in the regulations (ie. 'full').

3.1.3.2 Contents of the annual reports and accounts

The SORP requires the annual accounts of an LLP to include all the statements required by the Regulations and by FRS 102. It therefore requires that the Annual Report includes:

- the financial statements;
- a statement of members' responsibilities in relation to the production of financial statements;
- a report on the financial statements by a registered auditor, if required by the Regulations.

The financial statements should comprise (subject to the exemptions for small sized LLPs):

- a statement of financial position;
- either:
    - a single statement of comprehensive income displaying all items of income and expense recognised during the period including those items recognised in determining profit or loss and items of other comprehensive income; or
    - a separate income statement and a separate statement of comprehensive income;
- a statement of changes in equity (NB. This is 'encouraged' for small LLPs applying section 1A of FRS 102 but is not mandatory);
- a statement of cash flows (NB. This is not required for small LLPs applying section 1A of FRS 102); and
- notes.

There is no requirement for an LLP to prepare a separate Members' Report, unless required by the members' agreement, however certain disclosures can still be disclosed in a separate Members' Report, if desired, or they can be made elsewhere within the notes. These disclosures are:

- the principal activities of the LLP (and its subsidiary undertakings) indicating any significant changes during the year;

- an indication of the existence of any branches outside the UK;
- the identity of anyone who was a designated member during the year; and
- the policy of the LLP regarding members' drawings [Updated in SORP 2021 to drawings on account and distributions of profit] and the subscription and repayment of amounts subscribed or otherwise contributed by members.

Other information may be disclosed as desired.

For small sized LLPs applying section 1A of FRS 102, these 'narrative type disclosures' are not required.

3.1.3.3 Terminology

The SORP contains a number of definitions to supplement those in the Regulations and accounting standards. The key ones are outlined below.

It should be noted the definitions provided within the SORP were updated in the SORP 2021. The key changes are noted below and we have provided the definitions from SORP 2018 and 2021 for ease of reference.

The SORP 2021 also explains that "*different terminology may be used in members' agreements; accordingly, it is important to focus on the underlying principles of the agreement rather than the terminology used*".

- **[SORP 2018] Allocated profits** - Profits (after deducting members' remuneration charged as an expense) that have been allocated during the year as a result of the members deciding on a division of profits.

  The decision to divide profits, which gives rise to a liability in respect of allocated profits, must be distinguished from the arrangements for profit sharing. A provision in an agreement between the members which sets out the profit shares of the members does not of itself constitute an agreement for the division of profits. It merely sets out the respective profit shares of the members that will apply to those profits that the members decide to divide among themselves.

  Accordingly, the default rule that is applied by virtue of Regulation 7(1) of the Limited Liability Partnerships Regulations 2001 (which provides for the members of an LLP to share equally in the capital and profits of an LLP in the absence of agreement to the contrary) does not constitute a default rule as to the automatic division of profits between the members. (As explained further in paragraph 48 (of the SORP), where the agreement between the members provides for the automatic division of profits, those divided profits will form part of members' remuneration charged as an expense and will be credited directly to the current accounts of the members without being first shown under the balance sheet heading 'Other reserves'.) Allocated profits are debts due to members which, unless otherwise agreed by the members, rank pari passu with ordinary creditors in the event of a winding up. The total amount of profit allocated following a decision to divide may be less (or more) than the amount of profit earned by the LLP in the relevant year.

  The above definition was deleted in the SORP 2021. The following definitions were, instead, included:

- **[SORP 2021] Divided profits** - Debt due to members as a result of a division of profits (a debt due to members is a financial liability as defined in FRS 102's glossary). Note that, where a member already owes an amount to the LLP (eg. as a consequence of drawings on account), division may reduce that asset rather than giving rise to a separate liability. For ease of reading, when the SORP refers to a debt due to members arising as a result of a division of profits, this is intended also to capture a reduction in such an asset.

  The decision to divide profits, which gives rise to a liability in respect of divided profits, must be distinguished from the arrangements for profit sharing.

- **[SORP 2021] Division of profits** - A division of profits is the mechanism by which the profits of an LLP become a debt due to members. A division may be automatic or discretionary, may relate to some or all of the profits for a financial period, and may take place during or after the end of a financial period.

- **[SORP 2018] Automatic division of profits** - An automatic division of profits is one where the LLP has an unconditional obligation to divide those profits based on the LLP agreement in force at the time. Such a pre-agreed automatic division of profits could be in respect either of the entire profits for the year or a portion or fixed amount thereof. The fact that the actual amount to be divided is contingent on the existence of profits in the first place does not negate the LLP's unconditional obligation in respect of those profits nor the member's unconditional entitlement to those profits should they come into existence. A division of profits that requires a decision of the LLP does not constitute an automatic division because the LLP has an unconditional right to refuse payment of profits for a particular year.

  The above definition was replaced in the SORP 2021 with the following:

- **[SORP 2021] Automatic division of profits** - An automatic division of profits is one where the LLP does not have an unconditional right to avoid making a division of an amount of profits based on the members' agreement in force at the time. The fact that the actual amount to be divided is contingent on the existence of profits in the first place does not negate the LLP's unconditional obligation in respect of those profits nor the member's unconditional entitlement to those profits should they come into existence.

  The following definition has also been included in SORP 2021:

- **[SORP 2021] Discretionary division of profits** - A division of profits that requires a decision to be made by the LLP, which the LLP has the unconditional right to avoid making. It does not constitute an automatic division because the LLP has an unconditional right to avoid delivering cash or other assets to members in respect of those profits. When profits are divided on a discretionary basis the LLP could instead have chosen never to divide those profits.

- **[SORP 2018] Unallocated profit** - Profits of the LLP (after deducting members' remuneration charged as an expense) that have been ascertained but which are not yet divided among the members. After the profits have been ascertained, in the absence of any agreement between members to the contrary, the balance will be unallocated profit and will need to be shown under 'Other reserves' on the balance sheet, pending a decision to divide the profits among the members. It is open to the members of an LLP to agree that all, or a proportion of, the profits of the LLP shall be automatically divided between the members after they have been ascertained; in that event, the LLP will not have an unconditional right to avoid delivering cash or other assets to a member in respect of those amounts. This is a matter of construction of the members' agreement. Where this is the case, any amounts automatically divided will form part of members' remuneration charged as an expense ie. they will be deducted in arriving at retained profit or loss for the financial year available for discretionary division among members. Accordingly, where all the profits are automatically divided, a nil amount will be reported as retained profit or loss for the financial year available for discretionary division among members, and there will be no unallocated profits. (See also the legal opinion in the SORP.)

  The above definition was replaced in the SORP 2021 with the following:

- **[SORP 2021] Undivided profit** - Profits of the LLP which are not yet divided among the members. Undivided profits are shown under 'Other reserves' on the balance sheet, pending a discretionary decision to divide the profits. As explained in paragraph 48B, by definition, the LLP will always have discretion over whether to divide undivided profits.

Other key definitions, some of which contain limited changes as a result of SORP 2021 (as indicated), are as follows:

- **Members' other interests** - Members' interests other than debt due to them by the LLP, which constitute equity in the LLP, are included in balance sheet item K in the accounts formats set out in the LLP Regulations (SI 2008 1913/1912 schedule 1, part 1, section B). Members' other interests include 'Members' capital' that is classified as equity in accordance with section 22 of FRS 102, 'Revaluation reserve' and 'Other reserves'.

- **Members' capital** - Amounts subscribed or otherwise contributed by members that are classified as capital by the constitutional arrangements of the LLP. Such amounts will require analysis as to whether they are considered equity or debt in accordance with section 22 of FRS 102. Members' capital is a component of 'Members' other interests' or 'Loans and other debts due to members' depending on its classification under this section of FRS 102.

- **Members' remuneration** - The definition has been updated in SORP 2021, both versions are given here for ease of reference:

  [SORP 2018] Any outflow of benefits to a member. It may include or comprise, but is not limited to, one or more of the following elements: salary, interest, bonus, risk premium and allocated share of profits. The form that remuneration takes will be a matter of agreement between the members.

  [SORP 2021] Any outflow of benefits to a member. It may include or comprise, but is not limited to, one or more of the following elements: salary, interest, bonus, risk premium and shares of profits (fixed or variable). The form that remuneration takes will be a matter of agreement between the members.

- **Members' remuneration charged as an expense** - The definition has been updated in SORP 2021, both versions are given here for ease of reference:

  [SORP 2018] Remuneration that is payable to a member, which falls to be treated as a charge against profits and not an allocation of profits. The treatment of members' remuneration is determined by reference to the nature of the participation rights that give rise to the remuneration. If those rights were to give the members an unconditional right to the division of profits or to other forms of remuneration, for example those items set out in paragraph 20 of the SORP, then they give rise to a liability for that remuneration in accordance with section 22 of FRS 102, and the remuneration is charged as an expense. Members' remuneration charged as an expense is not restricted to amounts that are payable by the LLP regardless of the existence or extent of profits; it also includes, for example, any profits that are automatically divided between members by virtue of a members' agreement. Members' remuneration charged as an expense may in some exceptional circumstances be a negative amount.

  [SORP 2021] Remuneration that is payable to a member, which is treated as a charge against profits and not as a discretionary division of profits. The treatment of members' remuneration is determined by reference to the nature of the participation rights that give rise to the remuneration.6 If those rights were to give the members an unconditional right to the division of profits or to other forms of remuneration, for example those items set out in paragraph 20 above, then they give rise to a liability for that remuneration in accordance with section 22 of FRS 102, and the remuneration is charged as an expense. Members' remuneration charged as an expense is not restricted to amounts that are payable by the LLP regardless of the existence or extent of profits; it also includes, for example, any profits that are automatically divided between members by virtue of a members' agreement. Members' remuneration charged as an expense may in some exceptional circumstances be a negative amount.

The SORP clarifies that "*a member may also have a contract to provide services to the LLP, which may be referred to as a contract of employment. Remuneration covered by such a contract is classified as members' remuneration charged as an expense, including amounts relating to pension obligations and share-based payments (if any)*".

- **Members' agreement** - Any express or implied agreement between an LLP and its members that determines the mutual rights and duties of the members in their capacity as such and their rights and duties in relation to the LLP. An agreement between the members, to which the LLP is not party - for example, an agreement to guarantee a minimum or specified remuneration for a particular member - does not constitute a members' agreement for the purposes of the SORP. The amendment as a result of SORP 2021 clarifies that the agreement may take a variety of forms and need not be in writing.

- **Members' participation rights** - All the rights of a member against the LLP that arise under the members' agreement (for example, in respect of amounts subscribed or otherwise contributed, remuneration and profits).

- **Puttable instrument** - The definition of 'puttable instrument' is contained in section 22 of FRS 102. A puttable instrument is a financial instrument that gives the holder the right to sell that instrument back to the issuer for cash or another financial asset or is automatically redeemed or repurchased by the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder (paragraph 22.4(a) of FRS 102). In practice for LLPs, puttable instruments may include certain types of capital or members' loans that carry rights for the member (or other holder) to obtain repayment from the LLP.

3.1.3.4 Analysing members participation rights

The SORP states that members' participation rights in the earnings or assets of an LLP should be analysed between those that give rise to, from the LLP's perspective, either a financial liability or equity, in accordance with section 22 of FRS 102. Members' different participation rights should be analysed separately into liability and equity elements. Depending on the terms of the members' agreement, members' participation rights may give rise to equity or liabilities or both.

Under section 22 of FRS 102, a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to deliver either cash or another financial asset to another party. Critical, therefore, to determining whether the LLP has a financial liability to a member, or alternatively the member holds equity in the LLP, is whether there exists a contractual obligation on the part of the LLP to deliver cash (or other financial assets) to the member - for example, upon the member retiring from or otherwise leaving the LLP. Generally, a member's participation right will result in a liability unless the LLP has an unconditional right to avoid delivering cash or other assets to the member (ie. the right to any payment or repayment is discretionary on the part of the LLP).

However, puttable instruments and amounts payable on liquidation meeting the conditions in paragraph 22.4 of FRS 102 are also classified as equity. Such instruments (or components of such instruments) will be classified as equity even though the LLP does not have an unconditional right to avoid delivering cash or other assets to the member. In the remainder of this document, we will refer to this equity classification by exception as the 'puttables exception'.

Participation rights in respect of amounts subscribed or otherwise contributed should be analysed separately from participation rights in respect of remuneration (which may include, inter alia, salary, interest, bonus, risk premium and allocated share of profits), except where the remuneration, or part thereof, is clearly identifiable as a return on amounts subscribed or otherwise contributed. To the extent that remuneration cannot be clearly identified as a return on amounts subscribed it is regarded, for accounting purposes, as separate from the instrument that consists of the amount subscribed and the return thereon.

For example, profit share payable at the discretion of the LLP would be accounted for as an equity interest, even if the member's capital is treated as a liability.

Where remuneration, or part thereof, is clearly identifiable as a return on the amounts subscribed - for example, non-discretionary interest payments - rather than a return for the services provided by the members, then the amounts subscribed and that part of the remuneration that is clearly identifiable as a return on the amounts subscribed would be analysed together for accounting purposes.

Non-discretionary amounts becoming due to members in respect of participation rights in the profits of the LLP for the financial year that give rise to liabilities should be presented as an expense within profit or loss (within the heading "Members' remuneration charged as an expense"). Where there are no equity participation rights in the profits for the year, it follows that all amounts becoming due to members in respect of those profits will be presented within members' remuneration charged as an expense.

Amounts becoming due to members in respect of equity participation rights, following a discretionary division of profits, should be debited directly to equity in the year in which the division occurs. Such amounts should not be presented as an expense within profit or loss. A discretionary division of profits that takes place after the balance sheet date is a non-adjusting event under section 32 of FRS 102 'Events after the End of the Reporting Period'.

3.1.3.5 Amounts contributed by members and returns thereon

For some LLPs, the terms of the members' agreement may result in all members' participation rights being classified as giving rise to financial liabilities ie. not equity participation rights. This may be the case if, for example, all profits are automatically divided between members (see paragraph 48 of the SORP), and if individual members have the right to demand payment of amounts subscribed or otherwise contributed to the LLP. The ability of a member to exercise a contractual right may be conditional on a future event, for example, a member may only be able to demand amounts subscribed or otherwise contributed on retirement. Despite the fact that the member's right is conditional on a future event, the LLP does not have an unconditional right to avoid making the payment, so, unless the conditions under the puttables exception are met, a financial liability exists.

If the LLP does not have an unconditional right to refuse repayment of amounts subscribed (and the conditions under the puttables exception have not been satisfied), such amounts will be classed as liabilities and included within loans and other debts due to members. Conversely, if the LLP has an unconditional right to refuse repayment of members' capital, the appropriate classification is determined by the other rights that attach to the capital, for example, if the LLP has an unconditional right to refuse repayment to members of amounts subscribed or otherwise contributed by them then, providing there is no obligation to pay a return on those amounts, such amounts will be classed as equity.

However, if interest is mandatorily payable on members' capital, then a liability will be recognised on subscription reflecting the present value of minimum non-discretionary outflows. In many cases, this will be the same as the relevant amount of members' capital. However, following the principle set out in paragraph 34 of the SORP, any other remuneration would fall to be accounted for separately.

Puttables exception

The puttables exception affects the classification of puttable financial instruments and obligations arising on liquidation. In certain limited circumstances, rights of members which meet the definition of a financial liability under paragraph 22.3 of FRS 102 will fall to be classified as equity provided the conditions for the puttables exception are met.

In considering whether members' participation rights fall under the puttables exception it is first necessary to consider how the principles set out in paragraph 34 of the SORP are being applied. Accordingly, in cases where, under the principles of paragraph 34, participation rights in respect of remuneration are treated as separate instruments this does not in itself affect the classification of the capital under the puttables exception.

Additional guidance is given in paragraphs 40 to 42 of the SORP.

3.1.3.6 Divisions of profit

Amounts becoming due to members in respect of participation rights in the profits of the LLP for the year that give rise to a liability might include, for example, salary, interest on capital balances and any automatic division of profits, to the extent that the LLP does not have an unconditional right to avoid delivering cash or other assets to a member in respect of such amounts.

Where there are no equity participation rights in the profits for the year, it follows that all amounts becoming due to members in respect of those profits will be presented within members' remuneration charged as an expense. In these circumstances, LLPs should refer to the presentational guidance given below and the illustrative examples in appendix 1 of the SORP.

Where profits are automatically divided as they arise or are determined, so that the LLP does not have an unconditional right to refuse payment based on the LLP agreement in force at the time, the amounts arising that are due to members are in the nature of liabilities. They should therefore be treated as an expense in profit or loss in the relevant year and, to the extent they remain unpaid at the year end, they should be shown as liabilities in the balance sheet. This will also be the case where there is a requirement to divide all profits but the actual allocation of those profits between individual members is not determined until after the balance sheet date. Conversely, where there is no automatic division of profits because the LLP has an unconditional right to refuse payment of the profits of a particular year until those profits are divided by a decision taken by the LLP, those profits are classed as an appropriation of equity rather than as an expense. They are therefore shown as a residual amount available for appropriation. Once profits are divided, the amount of the divided profits is treated as an appropriation which is deducted from equity and, to the extent that any divided profits remain unpaid at the year end, the amount unpaid will be recorded as a liability.

It is possible that a combination of these circumstances may arise, for example if 50% of profits are automatically divided, but the remaining profits are only divided at the discretion of the LLP, then the former will be treated as an expense / liability and the latter as an appropriation / equity.

Paragraph 3 of the Legal Opinion in appendix 5 of the SORP addresses the division of profits and may be helpful in determining whether payments are discretionary.

The LLP accounts should include a note within accounting policies confirming compliance with, or departures from, the SORP. This is an 'encouraged' and not a mandatory disclosure for small sized LLPs applying section 1A of FRS 102.

3.1.3.7 Members' remuneration: Presentation

Under FRS 102, an entity has a choice whether to present total comprehensive income for the period in one statement (a statement of comprehensive income) or two statements (an income statement - which is the profit and loss account required by the LLP Regulations - and a statement of comprehensive income).

The prescribed formats set out in the LLP Regulations require disclosure on the face of the profit and loss account (or statement of comprehensive income) of a sub-total, being 'Profit or loss for the financial year before members' remuneration and profit shares' (SI 2008 1913/1912 schedule 1, part 1, section B). The total of members' remuneration charged as an expense, as defined in paragraph 21 of the SORP, should be disclosed separately and deducted from this balance. Disclosure on the face of the profit and loss account (or statement of comprehensive income) should be as follows:

Profit or loss for the financial year before members' remuneration and profit shares	x
Members' remuneration charged as an expense	(x)

Profit or loss for the financial year available for discretionary division among members	x
	=======

Para. 54 of the SORP summarises how members' remuneration in the profit and loss should be treated:

Nature of element of a member's remuneration:	**Treat as:**
Remuneration that is paid under a contract to provide services to the LLP, which may be referred to as an employment contract. Other payments, arising from components of members' participation rights in the profits for the year that give rise to liabilities in accordance with section 22 of FRS 102, such as mandatory interest payments. Automatic division of profits.	Expense, described as 'Members' remuneration charged as on expense', and deducted after arriving at 'Profit for the financial year before members' remuneration and profit shares'
Any share of profits arising from a division of profits that is discretionary on the part of the LLP (ie. where the decision to divide the profits is taken after the profits have been made). [SORP 2021: Any share of profits arising from a discretionary division of profits(ie. where the LLP can choose never to divide the profits, and the decision to divide the profits is taken after the profits have been made)]	Allocation of profit [SORP 2021: Distribution in equity]

3.1.3.8 Members' interests: presentation and disclosure

'Loans and other debts due to members' (balance sheet item J in the prescribed formats set out in the LLP regulations) and 'Members' other interests' (balance sheet item K in the prescribed formats in the LLP regulations) should be disclosed separately on the face of the balance sheet (SI 2008 1913/1912 schedule 1, part 1, section B). Balance sheet item J includes 'Loans and other debts due to members' and 'Members' capital' in so far as it is classified as a liability

Balance sheet item K includes 'Members' capital', 'Revaluation reserve' and 'Other reserves', in so far as they are classified as equity, which are also each required to be disclosed separately on the face of the balance sheet.

The prescribed formats in the LLP regulations require all amounts due to members to be presented within 'Loans and other debts due to members'. This heading will include any unpaid element of 'Members' remuneration charged as an expense together with any unpaid allocated profits arising from a discretionary division of profits made during the year. It will also include members' capital classified as a liability. The SORP includes a table that illustrates how the movements on members' other interests and on loans and other debts due to members should be disclosed.

In addition, the total of items J and K less any amounts due from members in debtors, should be disclosed as a memorandum item on the face of the balance sheet, being described as 'total members' interests'.

The SORP requires the notes to the accounts to explain where amounts in 'Loans and other debts due to members' (other than members' capital classified as debt) would rank in relation to other creditors who are unsecured in the event of a winding up. The notes should disclose details of any protection afforded to other creditors in such an event which is legally enforceable and cannot be revoked solely by a decision of the members. The notes should also disclose what restrictions or limitations exist on the ability of the members to reduce the amount of 'Members' other interests' or state that there are no such restrictions. This is the only disclosure for small LLPs which the SORP mandates over and above the requirements of section 1A of FRS 102.

The SORP clarifies the position for small LLPs in terms of the exemption available from the requirement to discount basic loan financing transactions in FRS 102.11.13A. FRS 102 provides this exemption on the basis that the financing transaction in question is a "*…loan from a person who is within the directors' group of close family members when that group contains at least one shareholder in the entity*". The meaning of the term 'director' has not been defined in FRS 102 for an LLP. Therefore, CCAB concluded that further guidance should be given to clarify that for the purpose of applying this, the term 'director' should be taken to mean a member, who is a person, with an equivalent role in the LLP (dependent on the small LLP, this may include all members or it may only be a member who is part of a governing body or management board).

3.1.3.9 Cash flow statement: Presentation

The March 2018 edition of FRS 102 requires an entity to disclose the changes in net debt between the beginning and end of the financial period. For an LLP, 'loans and other debts due to members' comprises borrowing for the purposes of the definition of net debt but are not external financing. 'Loans and other debts due to members' would be considered borrowings for the purposes of the definition of net debt, they are not external financing. The SORP provides guidance on how this information can be presented for an LLP which includes example presentation.

Guidance was extended in the December 2021 edition of the SORP. Paragraph 74A(1) of the SORP (2021) states that LLPs are required to disclose their accounting policy for classifying distributions of profits and to classify the cash flows consistently from period to period. Paragraph 74A(1) of the SORP (2021) goes on to comment that Section 7 of FRS 102 does not dictate how automatic or discretionary distributions of profit should be classified in the cash flow statement. Accordingly, LLPs should determine the classification that is appropriate to their business. The paragraph then goes on to suggest appropriate classifications.

3.1.3.10 Retirement benefits of employees and members

The SORP states post-employment benefits provided for employees of the LLP should be accounted for as required by section 28 'Employee Benefits' of FRS 102. This will include post-employment benefits payable to members that are based on any salary paid to the member under an employment contract. Where members are not employees, section 28 of FRS 102 does not apply.

3.1.3.11 Other post-retirement payments to members: Recognition and measurement

Where an LLP has an actual or constructive obligation to make payments to members at and after the point they cease to be members, it should provide for the future cost of those obligations. Commonly, such payments are referred to as 'annuities'.

Therefore, LLPs should analyse their contractual or constructive obligations (including any relating to early retirement options) to make payments to members in their capacity as members at and after the point of their ceasing to be members of the LLP, between:

- those that meet the definition of an insurance contract and, therefore, fall within the scope of FRS 103 Insurance Contracts;
- those that give rise to financial liabilities falling within the scope of section 11 'Basic Financial Instruments' of FRS 102;
- those that give rise to financial liabilities falling within the scope of section 12 'Other Financial Instruments' Issues of FRS 102; and
- those that give rise to non-financial liabilities of uncertain timing and amount falling within the scope of section 21 'Provisions and Contingencies' of FRS 102.

In the case of an unconditional contractual obligation that meets the definition of an insurance contract, this will fall within the scope of FRS 103. As explained further in paragraph 80A of the SORP, this will be the case where, for example, the total amount payable by the LLP may be significantly affected by how long the former member lives.

In the case of an unconditional contractual obligation to deliver cash or other financial assets, this will give rise to a financial liability and will fall within the scope of either section 11 or section 12 of FRS 102 unless it meets the definition of an insurance contract. In the case of a constructive obligation of uncertain timing or amount, or a contractual obligation that is conditional on further service from a member, any obligation for past service will fall within the scope of section 21 of FRS 102.

In the case of a constructive obligation of certain timing and amount, this will fall to be accounted for as a liability under the general provisions of the Companies Act (as applied to LLPs) / GAAP.

Paragraph 76B of the SORP provides a summary flowchart to assist in determining which guidance applies to a particular obligation.

Annuity payments may be either 'pre-determined' or 'profit-dependent':

- **Pre-determined annuity payments** are amounts payable that are fixed at the time of retirement; for example, by reference to historical earnings (such as a percentage of the final year's profit share) or fixed at an amount, which may be index-linked or linked to a measure independent of the LLP's future profit. The period for which they are payable may or may not be pre-determined. The payment of the retirement benefit is thus not dependent on the LLP earning profits in the post-retirement period.
- **Profit-dependent annuity payments** are amounts payable to former members that are, in effect, a share of the LLP's on going profits, by way of a preferential first share, profit-points, profit-dependent bonus or some other mechanism. Many different arrangements exist, and there may be no amount payable in a year in which no or insufficient profits are earned.

Additional specific guidance in relation to constructive obligations, conditional and unconditional obligations, and mortality risk is given in paragraphs 79 to 80 of the SORP. It is important that those with retirement benefits refer to the guidance within the SORP.

If the rights to an annuity are earned over a period, then costs should be recognised over that period. This is consistent with the guidance on executory contracts in section 21 of FRS 102, under which the LLP has either an obligation or a constructive obligation to pay the annuity which builds up over time.

If the liability falls within the scope of section 21 of FRS 102, eg. because it is conditional on future service, the LLP should assess the probability of a future cash outflow applying the measurement requirements of that section. Any such liability for post-retirement payments to members earned to date and therefore recognised in the accounts should reflect the latest expectations in respect of:

- the likely date of ceasing to be a member; and
- the amounts likely to be payable from that date.

The value of the liability should be based on the best estimate of the current value of future cash flows.

The liability should be recalculated annually to take account of changes in membership, eligibility for post-retirement payments, financial estimates and actuarial assumptions. Examples of the applicable guidance for particular scenarios are given in paragraph 87A of the SORP.

3.1.3.12 Post-retirement payments to members: Presentation

Amounts recognised in respect of current members should be charged to the profit and loss account (or statement of comprehensive income) within members' remuneration charged as an expense. The SORP requires that the recognition of and changes in the liability for post-retirement payments to or in respect of current members and to or in respect of former members should be shown separately. The change in the liability in respect of former members should be expensed in the relevant expense item (that is, not in members' remuneration) in the profit and loss account (or statement of comprehensive income). The change in the liability in respect of current members should be charged to the profit and loss account (or statement of comprehensive income) within members' remuneration charged as an expense.

The liability for post-retirement payments to or in respect of current members and to or in respect of former members should be shown separately. The liability in respect of former members should be shown in the prescribed balance sheet formats set out in the LLP regulations under 'Provisions for liabilities' or 'Creditors' as appropriate, as 'Post-retirement payments to former members'. The liability in respect of current members should be shown separately, if material, as a component of 'Loans and other debts due to members in the prescribed balance sheet formats in the LLP regulations'. In the year in which a member retires, a transfer should be made between the balance in respect of current members and the balance in respect of former members.

Where the liability has been discounted (for example, as required by section 21 of FRS 102 where the effect is material), the SORP requires that the unwinding of the discount should be presented next to the interest cost line in the profit and loss account (or statement of comprehensive income), to the extent that it relates to former members. Where it relates to current members it should be included in members' remuneration charged as an expense.

Additional annuities granted after the date of a member's retirement should be recognised in full in the profit and loss account (or statement of comprehensive income) within operating profit as soon as the award is granted to the former member.

3.1.3.13 Post-retirement payments to members: Disclosure

The LLP's accounting policy note should disclosure the LLP's policy in respect of post-retirement payments to members.

3.1.3.14 On transition of a partnership or other undertaking to an LLP

Where an LLP makes post-retirement payments to members of a predecessor partnership or other organisation, the extent to which the LLP has an actual or constructive liability for such payments should be considered. Where an actual or constructive liability exists, this should be recognised in the balance sheet of the LLP. Where there is merely recourse to the LLP in the event of a default of a third party and such default has not occurred and is not probable, this should be disclosed as a contingent liability.

3.1.3.15 Taxation

The SORP recognises that tax on members' remuneration is a personal liability and should not be disclosed in the profit and loss account (or statement of comprehensive income). Any amount retained to meet such tax liabilities should be included in 'Loans and other debts due to members'.

Where LLP group accounts are prepared, tax liabilities of group companies should be recorded within both the profit and loss account (or statement of comprehensive income) and the balance sheet as normal.

3.1.3.16 Stocks

The SORP makes it clear that the principles of section 13 of FRS 102 should be applied to the stocks of an LLP and section 23 of FRS 102 should be applied to contracts in the same way as they apply to any business. The specific guidance given is:

- when calculating the cost of stock in accordance with section 13 of FRS 102, the cost of members' time should be considered. The cost of members' time will include only those elements that would be expensed in the profit and loss account (or statement of comprehensive income) ie. members' remuneration charged as an expense;
- however, regardless of whether the time input by a member is a cost to be included in stock, any overhead related to that time should be included in the cost of stock.

3.1.3.17 Provisions and other implications of Section 21 of FRS 102

The SORP recommends that the requirements of section 21 of FRS 102 should apply to LLPs in exactly the same way that they apply to any other entity and that this should cause no greater problem than it does with those other entities.

However, the SORP goes on to say that where a partnership converts to an LLP this may cause a significant change in practice. Partnerships are often run on a more equitable basis than other entities and costs may be spread over a number of years in a way that would not be acceptable under FRS 102 in order to be fair to incoming or outgoing partners.

The SORP does remind LLPs that they can base the allocation of profit to members on different accounting policies from those used in the annual financial statements.

Where the LLP has entered into any agreement or indemnity with respect to the borrowings of a member(s) personally, the existence of such a guarantee or indemnity should be either disclosed as a note to the accounts (where it is unlikely that the guarantee or indemnity would be called) or provided for in the primary statements where there is an actual or constructive liability as defined under section 21 of FRS 102 and it is probable that the guarantee or indemnity will be called.

3.1.3.18 Related party disclosures

The SORP applies section 33 of FRS 102 to LLPs:

- an LLP under the control of another LLP, partnership, company or other entity will be a related party of that other entity;

- the fact that some members of an LLP are members of another LLP or partners in another partnership does not in itself make the businesses related parties - this will be determined by the extent of common control;
- predecessor partnerships to an LLP should be treated as a related party;
- the key management of an LLP will be related parties. It may not appropriate to consider all members to be related parties - the nature and extent of their involvement in management will be the determining factor. The SORP notes that in the case of smaller LLPs, where all members play a part in the management of the entity, it will frequently be the case that all members are related parties;
- the company law concept of 'shadow director' is also extended to LLPs.

3.1.3.19 Losses

One aspect of accounting for LLPs that may give rise to possible difficulties is the allocation of losses. There are two aspects to consider and it is the members' agreement that should always be referred to in the first instance to determine the appropriate treatment. 'Losses' may arise when:

- members' drawings exceed available profits; or
- there is an actual trading loss.

3.1.3.20 Business combinations and group accounts

The SORP provides guidance on business combinations and group accounts, following section 9 of FRS 102, together with relevant sections of the LLP Regulations.

The transfer of all or the majority of the assets, liabilities and business of an existing partnership, limited company or other undertaking into an LLP incorporated for that purpose could be dealt with as a group reconstruction where the requirements of paragraph 19.27 of FRS 102 are met. FRS 102 offers a choice in these cases; however the SORP recommends that the merger accounting method should be used. The initial 'opening' balance sheet should follow the accounting policies of the LLP.

Where existing undertakings are transferred in to an LLP, they should be accounted for using the merger accounting method provided that the transfer meets the definition of a group reconstruction and the conditions of paragraph 19.27 of FRS 102.

Single-entity LLPs that are formed for the purpose of the transfer of existing undertakings or partnerships, which meet the definition of a group reconstruction and the requirements of paragraph 19.27 of FRS 102 should, as noted above use merger accounting for the initial transfer of business, and reflect the transfer of the assets and liabilities at book value. They should also disclose comparative pro-forma amounts in the financial statements of the first period after incorporation. Those comparative amounts should be stated on the basis of the accounting policies adopted by the LLP. The initial statutory reporting period may or may not be a 12 month period.

In some cases there may be a hiatus between the formation of the LLP and the transfer of the existing undertaking. Where this occurs, and the merger accounting method is used, the principles of merger accounting are such that the net assets at book values should be reflected in the financial statements at the date of the transfer, and the results should be included for the period from the transfer to the end of the accounting period. A pro-forma profit and loss account (or statement of comprehensive income), including corresponding amounts, should be given for the whole of the original entity's accounting period spanning the transfer. These issues are considered in appendix 4 of the SORP.

The restatement of comparatives to consistent accounting policies will often result in a difference between the amount reported as attributable to owners by the predecessor undertaking (eg. the total interests of partners in the predecessor firm shown by its final balance sheet), and the members' interests in the opening balance sheet of the LLP. The SORP requires that such differences are not dealt with in the financial statements of the LLP. Additional considerations are noted in paragraph 117A of the SORP.

The accounting policies note should refer to the LLPs compliance with the SORP or detail areas of non-compliance and any reasons therefore, in accordance with section 19 of FRS 102.

3.1.3.21 Members' drawings exceed available profits

Where there are insufficient available profits to cover drawings taken by members, the excess should be treated as a debt due from the members. The members' agreement, or in the absence of this, a decision made by the members, will dictate whether the debt should be repaid or offset against future profit entitlement.

3.1.3.22 Trading losses

In the event that an LLP makes a trading loss, again, the members' agreement, or in the absence of this, a decision made by the members, should be considered to establish exactly what the members intend to happen in this situation. Allocating such a loss to members would seem to defeat the purpose of becoming an LLP and trying to limit liability in the first place, after all, shareholders are not required to make good trading losses in a limited company!

Unless the members' agreement or a decision by the members dictates otherwise, losses would generally be held in a 'negative' reserve. It would then be up to the members to decide what to do with this, for example, by using future profits to reduce this over time or to leave it as outstanding.

3.1.3.23 Disclosures for LLPs applying full FRS 102 under the SORP (eg. non-small LLPs)

One issue of disclosure which may be particularly sensitive is that of disclosures of members' remuneration. The following disclosure is required:

- total profit for the year before members' remuneration and profit share;
- the average number of members (allowing an average remuneration to be calculated);

- profit (including remuneration) attributable to the member with the largest entitlement to profit (including remuneration), where the amount of the profit of the LLP for the financial year before members' remuneration and profit shares exceeds £200,000. However, the Regulations do not require the identity of this member to be disclosed.

FRS 102 will apply and require disclosure of relevant material transactions with related parties (the concept of materiality must be considered from both parties).

Movements on the loans and other debts due to members must be disclosed by way of note to the accounts.

3.1.3.24 Members' remuneration disclosures

Where it is considered that it will assist an understanding of the financial performance of the LLP, members' remuneration charged as an expense should be further analysed within the notes to the financial statements, for example, between that which is paid under a contract of employment and that which relates to amounts arising from participation rights that give rise to a liability.

In the case of a group, members' remuneration from all entities in that group that are consolidated into the parent LLP's group accounts should be considered.

3.1.3.25 Members' interests: Disclosure

A statement of the changes in equity should be presented as a primary statement (paragraph 6.3 of FRS 102) detailing the movements in 'Members' other interests' (Balance sheet item K in the prescribed formats set out in the LLP regulations). The reconciliation of members' interests may be presented as a primary statement instead of a statement of changes in equity. Where this option is taken comparative amounts should be presented by way of the full table relating to the prior period.

A statement of changes in equity does not need to be prepared if the LLP has no equity, except where the reconciliation of members' interests is provided as a primary statement in accordance with paragraph 60A of the SORP. Where a statement of changes in equity is not included, a statement should be made either on the face of one of the other primary statements or in the notes to the accounts that the LLP has no equity and consequently a statement of changes in equity is not given.

The SORP requires LLPs to disclose the overall policy followed in relation to members' drawings [Updated in SORP 2021 to drawings on account and distributions of profit], including an indication of the policy applicable where the cash requirements of the business compete with the need to allow cash drawings by members [Updated in SORP 2021 to with the need to distribute cash to members]. Such disclosures should include any transfers of members' interests from equity to debt (and vice versa) during the year and up to the date the accounts are approved. The policy under which members contribute or subscribe amounts to the LLP by way of equity or debt and the policy under which their contributions and subscriptions are repayable by the LLP, should also be disclosed.

The SORP repeats the requirements of the Regulations regarding disclosing the average number of members and the amount of profit (including remuneration) of the member with the largest entitlement to profit. This disclosure is required where the profit of the LLP before members' remuneration and profit shares exceeds £200,000. These disclosures are not required if those Regulations do not apply (ie. to a small LLP preparing accounts in accordance with SI 2008/1912).

The SORP requires that the amount disclosed for the highest profit share should be arrived at on a consistent basis and that the policy should be disclosed.

3.1.3.26 Controlling and ultimate controlling party

Where not reporting under section 1A the controlling party and ultimate controlling party, if one exists, should be disclosed in accordance with section 33 of FRS 102. This includes an individual or entity which has the ability to direct the financial and operating policies of the LLP, so as to obtain benefits from its activities even though that party may not be entitled to the majority of profits or have invested the majority of the capital.

3.2 Preparation of annual reports

Unless required by the members' agreement, LLPs are not required to prepare a Members' Report, although may opt to do so.

Where the LLP does not prepare a Members' Report, it must include the following disclosures elsewhere (eg. the notes to the accounts):

- the principal activities of the LLP and its subsidiary undertakings, indicating any significant changes during the year;
- an indication of the existence of any branches outside the UK;
- the identity of anyone who was a designated member during the year; and
- the policy of the LLP regarding drawings on account and division of profits and the subscription and repayment of amounts subscribed or otherwise contributed by members.

An LLP is also not required to prepare a strategic report. unless it is a traded LLP or a banking LLP.

3.2.1 Energy and carbon report

Requirements

LLPs to which these requirements apply must disclose:

- emissions (UK and offshore area only) from:
  - activities for which the entity is responsible involving the combustion of gas, or consumption of fuel for the purposes of transport; and
  - the purchase of electricity by the entity for its own use, including for the purpose of transport;
- energy consumption in kWh (UK only) corresponding to the above;

- comparatives (if not the first year);
- methodologies used to calculate the emissions and energy consumption information disclosed;
- principal measures taken to increase energy efficiency (if any measures have been taken); and
- at least one ratio expressing emissions in relation to a quantifiable factor associated with the LLP's activities (eg. emissions per £m of revenue).

Parent LLPs

If the report is a group report (ie. if group accounts are prepared), the above requirements apply as if references to entity were to the LLP and its subsidiary undertakings included in the consolidation that are companies or LLPs.

The report may however exclude information which relates to a subsidiary which that subsidiary would not be required to include in its own energy and carbon report.

Exemptions

An LLP is exempt from this requirement if:

- it is a subsidiary at the end of the financial year where it is included within a group report of a parent which is prepared for a financial year of the parent that ends at the same time as, or before the end of, the LLP's financial year **and** the report complies with the energy and carbon reporting requirements of the regulations, or those applicable to companies (if the parent is a company);
- the LLP consumed 40,000 kWh of energy or less in the UK during the period in respect of which the energy and carbon report would be prepared **and** the report states that the information is not disclosed for that reason; or
- it meets the criteria below.

An LLP is exempt from these energy and carbon requirements in relation to its first financial year if the qualifying conditions below are met. If it is not the first financial year of the LLP, a two-year rule applies. This means that in a subsequent financial year of the LLP, where on its balance sheet date it meets or ceases to meet the qualifying conditions, that affects the exemption only if it occurs in two consecutive financial years. The qualifying conditions are met by an LLP in a year in which it satisfies two or more of the following. A parent LLP must consider the size of the group it heads against the group thresholds.

Criteria	**LLP**	**Group***
Turnover *Adjust proportionately if not a year.*	Not more than £36 million	Not more than £36 million net (or £43.2 million gross)
Balance sheet total *The aggregate of the amounts shown as assets in the LLP's balance sheet.*	Not more than £18 million	Not more than £18 million net (or £21.6 million gross)
Number of employees *This is not the full time equivalent.*	Not more than 250	Not more than 250

** Gross or net thresholds may be cherry picked.*

Whilst the thresholds currently mirror those for medium-sized LLPs, there is no consideration of ineligibility for the purpose of energy and carbon reporting. An LLP that is large because, despite meeting the qualifying criteria, it is excluded from being treated as medium-sized may nevertheless be able to claim exemption from energy and carbon reporting therefore.

3.3 Circulating and filing accounts and reports

An LLP must circulate copies of accounts and (if applicable) reports and file them with the registrar (Companies House).

Note that additional requirements and different deadlines may apply to traded LLPs and LLPs operating in certain sectors by virtue of sector specific requirements.

3.3.1 Circulating accounts and reports

Every LLP must send a copy of its annual accounts and reports for each financial year to:

- every member of the LLP; and
- every holder of the LLP's debentures.

An LLP must circulate its accounts within nine months* of the end of the relevant accounting reference period, or, if earlier, the date on which it files its accounts with Companies House.

** If the relevant accounting reference period has been shortened by virtue of altering its accounting reference date, the period is the later of the above of three months from the date of the notice given to the registrar to alter its accounting reference date.*

3.3.2 Filing accounts and reports

All LLPs (with the exception of dormant LLPs which meet the requirements of the exemption) must deliver to the registrar (ie. file at Companies House) a copy of the accounts and reports each financial year.

An LLP must do so within nine months* after the end of the relevant accounting reference period.

At present, small and micro-entities are able to 'fillet' their accounts before filing. Broadly, this means the LLP may elect not to file the profit and loss account. Where it chooses this option, the balance sheet must contain a statement that the accounts have been delivered in accordance with the provisions applicable to LLPs subject the small LLPs regime. Where the profit and loss account is not filed, the balance sheet filed must disclose that fact. If the LLP was audited, and the profit and loss account is not filed, the auditor's report would also not be filed - instead a note would need to be included regarding the outcome of the audit. The government is currently consulting on changes to the Companies Act 2006 which would remove the option to file filleted accounts.

** If the relevant accounting reference period has been shortened by virtue of altering its accounting reference date, the period is the later of the above of three months from the date of the notice given to the registrar to alter its accounting reference date.*

4 External scrutiny

4.1 Audit

4.1.1 Requirement for an audit

Under the Companies Act 2006 as applied to LLPs, an LLP must be audited in accordance with Part 16 of the Act unless:

- it is exempt from audit under:
    - s477 (small LLPs);
    - s479A (subsidiary LLPs); or
    - s480 (dormant LLPs).

In all of the above cases, an LLP is not entitled to exemption unless its balance sheet contains a statement by the members to that effect. Additionally, the balance sheet must contain a statement by the directors to the effect that the members acknowledge their responsibilities for complying with the requirements of the Act with respect to accounting records and the preparation of accounts. Such a statement must appear on the balance sheet above the signature.

4.1.1.1 Exemption from audit: Small LLPs

An LLP that qualifies as a small LLP* in relation to a financial year is exempt from the requirements of the Act relating to audit of accounts for that year.

** Whether an LLP qualifies as a small LLP shall be determined in accordance with section 382(1) to (6) of the Act.*

Exclusions

An LLP is not entitled to this audit exemption if it was at any time within the financial year in question:

- an LLP whose securities are admitted to trading on a UK regulated market;
- an LLP that;
    - is an authorised insurance company, a banking LLP, an e-money issuer, MiFID investment firm or a UCITS management company; or
    - carries on insurance market activity; or
    - is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1); or
- an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992 (S.I. 1992/807 (N.I. 5)).

An LLP is also not entitled to this audit exemption in respect of a financial year during any part of which it was a group LLP unless:

- the group qualifies as a small group* in relation to that financial year and was not at any time in that year an ineligible group*; or
- if, throughout the whole of the period or periods during the financial year when it was a group LLP, it was both a subsidiary undertaking and dormant.

** Whether a group qualifies as small shall be determined in accordance with s383 of the Act and ineligible group has the meaning given by s384(2) and (3).*

4.1.1.2 Exemption from audit: Subsidiary LLPs

An LLP is exempt from the requirements of the Act relating to the audit of individual accounts for a financial year if:

- it is itself a subsidiary undertaking; and
- its parent undertaking is established under the law of any part of the UK.

Requirements

The main requirements are that a parent guarantees the outstanding liabilities of the LLP and also prepares consolidated accounts which include that LLP.

Specifically, exemption is conditional on compliance with the following conditions:

- all members of the LLP must agree to the exemption in respect of the financial year in question;
- the parent undertaking must give a guarantee under section 479C in respect of that year;
- the LLP must be included in the consolidated accounts drawn up for that year or to an earlier date in that year by the parent undertaking in accordance with:
    - if the undertaking is a company, the requirements of Part 15 of the Act or, if the undertaking is not a company, the legal requirements which apply to the drawing up of consolidated accounts for that undertaking; or
    - UK-adopted international accounting standards (within the meaning given by section 474(1));
- the parent undertaking must disclose in the notes to the consolidated accounts that the LLP is exempt from the requirements of this Act relating to the audit of individual accounts by virtue of this section; and
- the designated members of the LLP must deliver to the registrar on or before the date that they file the accounts for that year:
    - a written notice of the agreement referred to above;
    - the statement referred to in section 479C(1);
    - a copy of the consolidated accounts referred to in above;
    - a copy of the auditor's report on those accounts; and
    - a copy of the consolidated annual report drawn up by the parent undertaking.

Exclusions

An LLP is not entitled to this audit exemption if it was at any time within the financial year in question:

- a traded LLP;
- an LLP that:
    - is an authorised insurance company, a banking LLP, an e-money issuer, a MiFID investment firm or a UCITS management company;
    - carries on insurance market activity; or
    - is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1), or
- an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992 (S.I. 1992/807) (NI 5).

4.1.1.3 Exemption from audit: Dormant companies

An LLP is exempt from the requirements of the Act relating to the audit of individual accounts for a financial year if:

- it has been dormant* since its formation; or
- it has been dormant* since the end of the previous financial year and:
    - it is entitled to prepare accounts in accordance with the small LLPs regime or would be so entitled but for having been a member of an ineligible group; and
    - it is not required to prepare group accounts for that year.

** An LLP is dormant during any period in which it has no significant accounting transactions. Significant accounting transactions are those that are required by s386 of the Act to be entered into the LLP's accounting records. In determining whether an LLP is dormant the following shall be disregarded:*

- *any transaction consisting of the payment of:*
    - *a fee to the registrar on a change of the LLP's name;*
    - *a penalty under section 453 (penalty for failure to file accounts); or*
    - *a fee to the registrar for the registration of an annual return.*

Exclusions

An LLP is not entitled to this audit exemption if it was at any time within the financial year in question:

- a traded LLP;
- an authorised insurance company, a banking LLP, an e-money issuer, a MiFID investment firm or a UCITS management company; or
- an LLP which carries on insurance market activity.

4.1.2 Appointment as auditor

4.1.2.1 Appointment

An auditor (or more than one, if appropriate) of an LLP must be appointed for each financial year of the LLP, unless the designated members reasonably resolve otherwise on the ground that audited accounts are unlikely to be required. Powers for appointment are broadly set out below (note that additional requirements apply with respect to public interest entities (PIEs)).

The period for appointing auditors

For each financial year where an auditor is to be appointed (other than the LLP's first financial year), the appointment must be made before the end of the period of 28 days beginning with the end of the time allowed for sending out copies of the LLP's annual accounts and reports for the previous financial year; or if earlier, the day on which copies of the LLP's annual accounts and reports for the previous financial year are sent out under s423 of the Act. This is the 'period for appointing auditors'.

Appointment by designated member

The designated members may appoint an auditor:

- at any time before the LLP's first period for appointing auditors;
- following a period during which the LLP (being exempt from audit) did not have any auditor, at any time before the LLP's next period for appointing auditors; or
- to fill a casual vacancy in the office of auditor.

Appointment by members

The members may appoint an auditor:

- during a period for appointing auditors;
- if the LLP should have appointed an auditor during a period for appointing auditors but failed to do so; or
- where the designated members had power to appoint (see appointment by designated members, above), but failed to make an appointment.

Appointment by the Secretary of State

If the LLP fails to appoint an auditor, the Secretary of State may appoint an auditor to fill the vacancy.

4.1.2.2 Ethical considerations

Before accepting appointment or reappointment the auditor must consider whether they would be permitted to do so under the FRC Ethical Standard* and the firm's own policies and procedures (including those related to quality management).

** Guidance on the FRC Ethical Standard is included within Section D of the Audit Procedures Manual and below.*

4.1.3 Conducting the audit

This section outlines a number of considerations when conducting an audit which are specifically relevant for audits of LLPs.

4.1.3.1 The FRC Ethical Standard

In December 2019, the FRC published the FRC Revised Ethical Standard (2019) which became effective from 15 March 2020. The firm's detailed ethical policies and procedures should always be adhered to.

The requirements of the FRC Ethical Standard is effective for audits of LLP financial statements in the same way as it is for private limited companies. It is structured as follows:

Part A:

- Overarching Principals and Supporting Ethical Provisions

Part B:

- Section 1: General Requirements and Guidance
- Section 2: Financial, Business, Employment and Personal Relationships
- Section 3: Long Association with Engagements and with Entities Relevant to Engagements
- Section 4: Fees, Remuneration and Evaluation Policies, Gifts and Hospitality, Litigation
- Section 5: Non-audit / Additional Services
- Section 6: Provisions Available for Audits of Small Entities (PAASE) - see below for criteria

The FRC Ethical Standard imposes ethical requirements on firms of auditors and applies to all LLP audits undertaken in accordance with the ISAs (UK). Section 5 - Non-audit / Additional Services is likely to have the main impact on LLP audit assignments. In addition, Section 6 - Provisions Available for Audits of Small Entities (PAASE) is also likely to be of relevance, as it provides alternative provisions for auditors of smaller clients. Remember, where advantage is taken of PAASE, this is sometimes disclosable in the audit report, with certain disclosures also required in the financial statements.

Ethical threats

Whilst all ethical threats must be identified and described, particular attention may need to be paid to the management and self review threats in an LLP. Problems may specifically arise as a result of the provision of accounting services and the lack of 'informed management'.

The Ethical Standard states that unless there is 'informed management' and there are appropriate safeguards there is a risk of the auditor taking a management role. Auditors of LLPs should therefore record clearly on file who they believe is 'informed management' within the LLP where such threats arise. Where problems exist the provisions available for smaller entities may be useful.

Provisions Available for Audits of Small Entities (PAASE)

To qualify for PAASE, an LLP must be a 'small entity'. To be a 'small entity', an LLP must qualify as a small company under s382 of the Companies Act 2006. PAASE provides an alternative provision and an exemption for an LLP that qualifies as small.

Alternative provision

For LLPs that qualify to apply PAASE, auditors are not required to apply safeguards to address a self-review threat, provided:

- the client has 'informed management'; and
- the audit firm extends the cyclical inspection of completed engagements that is performed for quality management purposes, to include some PAASE clients.

It should be noted that if advantage is being taken of the alternative provision, no disclosure of this is needed in the audit report or notes to the accounts.

Exemption

Where advantage has been taken of the exemption against the management threat in the provision of non-audit services, the Responsible Individual should ensure that:

- the audit report discloses this fact; and
- either the financial statements or the auditor's report discloses the type of non-audit services provided.

The sample wording offered to include in the audit report is:

"*We are independent of the limited liability partnership in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and the provisions available for small entities, in the circumstances set out in note [X] to the financial statements, and we have fulfilled our other ethical responsibilities in accordance with these requirements.*"

Sample wording that can be used to include in the note is:

"*In common with many other limited liability partnerships of our size and nature we use our auditors to prepare and submit returns to the tax authorities and assist with the preparation of the financial statements.*"

Other PAASE exemptions are also available - see your firm's Audit Procedures Manual or Section 6 of the FRC Ethical Standard for details.

4.1.3.2 Requesting information from a predecessor auditor

In addition to usual professional enquiry and handover procedures, for LLPs audited in accordance with the requirements of the Companies Act 2006 as applied to LLPs by the Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008, the auditor may, once formally appointed as auditor of a client, request in writing access to all relevant information the predecessor auditor holds in respect of their audit work, including access to their audit working papers, and permanent or systems files. The right to request this and the procedures to follow in both seeking and providing information are set out in Audit Regulation 3.09.

Working papers in this context include papers prepared to:

- assist in the planning and performance of the audit;
- assist in the supervision and review of the audit work; and
- record the audit evidence resulting from the audit work performed to support the auditor's opinion.

Normally this information will be in respect of any audit report relating to the period falling between the beginning of the last financial statements on which our predecessor reported and the date of cessation of their audit appointment. The obligation to provide access to working papers does not extend to all papers held by the auditor, eg. budgets would not have to be provided. Further guidance on this area can be found in Technical Release 01/08 issued jointly by the Audit & Assurance Faculty of the ICAEW, ICAS and CAI.

4.1.3.3 Materiality

When considering an appropriate benchmark, the following should be considered:

- the nature of the LLP;
- the industry in which it operates;
- whether users focus on particular items in the financial statements; and
- the relative volatility of the benchmark.

The appropriate benchmark should link to what users are most concerned about in the financial statements.

In a commercial owner-managed LLP, profit is usually the starting point. However, gross assets may be more appropriate for an LLP with significantly higher values in the balance sheet compared with its income statement (eg. an investment property LLP).

4.1.3.4 Statutory and other records

As part of the audit of an LLP, it is necessary to check that statutory and other records required to be maintained by the LLP have been properly kept.

The main statutory records which may be required to be kept include:

- register of members;
- register of debenture holders; and
- minute books.

At each audit these records should be examined to ensure that they are up to date.

Company law requires that the LLP's auditors, in preparing their report, carry out investigations to enable them to form an opinion as to whether the LLP has kept adequate accounting records. These records must be sufficient to show and explain the LLP's transactions. The main records that must be kept will therefore probably include the following:

- cash book, containing daily entries;
- where goods are sold other than in the course of ordinary retail trade, purchases and sales records supported by invoices;
- year end stock summaries and supporting stock sheets;
- nominal / general ledger.

It is prudent for the LLP to maintain some form of fixed asset record and it should be recommended that a fixed asset register is kept.

4.1.3.5 Using audit data analytics (ADA) and other technology

4.1.3.5.1 Use of technology

The variety of technology and automated tools which are available for use on an audit engagement is incredibly diverse, ranging from relative routine analysis within a spreadsheet, to the use of sophisticated applications which apply algorithms and machine learning, to the use of drones or online applications. Throughout this manual, audit data analytics (ADA) is referred to as a specific category of technology and automated tools. For the purposes of this manual ADA is defined as data analysis techniques (eg. the filtering and sorting of data to identify outliers, anomalies, deviations and other inconsistencies or detection and evaluation of trends and patterns within a data set) which can be used by the engagement team to perform risk assessment procedures, both controls and substantive testing and completion activities. In most cases, audit teams performing such analysis will have the ability to directly control the parameters used within this analysis, although certain applications may draw on the use of algorithms, artificial intelligence and machine learning to aid users with this analysis. Guidance on the additional considerations needed when planning the use of algorithms, artificial intelligence and machine learning is set out below.

The Audit data analytics assessment form within planning should be used to record how ADA and other technology is intended to be utilised on an engagement and how its use has been considered appropriate. Whilst not an exhaustive list, areas where ADA and other technology could be considered are:

- As part of the risk assessment (for example for its use as part of the preliminary analytical review)
- Highlighting high risk transactions for testing (see section below)
- Stratification of populations for sampling (see Appendix 3 below)

The use other technology which does not meet the definition of ADA should be recorded on the respective Audit plan form within planning when setting out the audit plan for each area (for example use of a drone or video technology to physically verify a fixed asset would be recorded on the Fixed Assets Audit plan).

4.1.3.5.2 Appraising the use of technology on engagements

As noted above, the use of technology on engagements can take various forms and each engagement team will need to appraise the use of technology on each engagement. We shall record our considerations on the Audit data analytics assessment form within planning.

Applicability and potential uses of ADA on an engagement

We will evaluate if the use of technology is appropriate on a client by client basis and it will not be deployed as a blanket approach to all engagements. While it is expected certain technologies and in particular ADA will be appropriate to use on the majority of engagements (with the section above setting out the expected benefits its use would bring, which should form part of our appraisal of the applicability for use), certain complexities for particular clients may mean its use is not appropriate (such as unusual general ledger posting processes or complex business model meaning common algorithms are less applicable to them, etc.). Balanced consideration of these factors will assist us to record whether ADA or technology is applicable for use or not.

For clients where the use of ADA is considered applicable, we should then consider how we intend to use it on an engagement. While not an exhaustive list, areas where its use could be considered are:

- As part of the risk assessment (for example for its use of part of the preliminary analytical review)
- Highlighting high risk transactions for testing (see section below)
- Stratification of populations for sampling (see Appendix 3 below)

Where we plan the use of ADA in other areas, (eg. to gather audit evidence), this should be recorded on the Audit data analytics assessment form within planning and we should also consider if this needed to be recorded on the Audit plan form within planning to confirm the audit plan has been suitable tailored to reflect its use.

Evaluation of the application being used

Before using ADA or other data analysis applications, we need to understand and evaluate the system being used. Such applications may have been developed either internally or sourced from an external provider, but in either case individual engagement files need to record how it was deemed appropriate for use. As a minimum this needs to evaluate the integrity of the application being used and the knowledge, expertise, and competence of the developers (whether internal or external to the firm). While the extent of evaluation needed requires an element of judgement in each case, as a general rule the more complex / sophisticated the application being used is, the extent of evaluation required increases.

We will need to evaluate the independence and expertise of the application developer, much in the same way we would assess an expert. The application itself will also need to have its integrity evaluated, in the same way an internally developed application would. Where the application being used is hosted by a third party, this should be discussed with the client to confirm they understand the role of the third party and respective responsibilities for data handling have been acknowledged and agreed.

Where the use of ADA purely involves analysing data within a spreadsheet, using relatively routine functionality that can be understood and reviewed by most individuals with basic spreadsheet training, this would generally involve explaining which functionality / formula(s) is being used and why they are considered appropriate.

Where we utilise a more bespoke ADA application (for example one which automates the running of analytical tools based upon parameters within the application), this evaluation needs to be expanded to demonstrate an understanding of the automation within the application, how this has been assessed as reliable and as such is appropriate for use (for example via user acceptance testing).

Some efficiencies may be gained by a central team of experts within the firm undertaking the required testing and evaluation of the ADA application being used, which individual engagement teams then look to draw on when completing the Audit data analytics assessment form within planning, rather than the underlying evaluation of the application being performed by each individual audit team. Where teams use a centrally approved ADA application/functionality, they need to ensure the appropriate version is used on their engagement (ie. not rolling forward an old version which is now out of date or accelerating the use of a new version prior to it being approved). Where individual engagement teams use a version of an ADA application that has not been tested and approved centrally, they should document why they are comfortable in using an unapproved version and how it is deemed appropriate for use.

Where we utilise and rely on an algorithm within an application (for example use of machine learning or artificial intelligence), it is essential that development of any algorithms used is tracked, along with an audit trail to show how that algorithm has been tested and confirmed as being appropriate for use. It is expected that such testing (and approval for use) will be undertaken by a central team within the firm and that once approved any applications which utilise algorithms will be deployed and used consistently for a fixed amount of time (for example 1 audit cycle) across all engagements, as this will help to ensure a consistent understanding of the application is in place across the firm. Individual teams looking to use such applications/algorithms will be responsible for confirming and documenting on each file that the version being used is appropriate, referencing where the testing of the version being used can be found and appraising why its use is considered appropriate for that specific engagement (eg. there are no specific factors for that particular client which means it would not be reliable).

Evaluating the data to be used for ADA and other technology

Where applicable, each file should record details of the data set being analysed by ADA or other technological applications. In most cases this will be general ledger data, but could vary from audit to audit, with some analysing multiple data sets, from various sources (eg. sales ledger, purchase ledger or inventory records from client systems).

We will need to perform procedures to confirm the application has a complete and accurate data set(s) to be analysed. For general ledger data, this will generally be done by using the data set for all general ledger transactions during a period to reconcile the opening trial balance to the closing trial balance. We evaluate the integrity of the data being used, in particular considering controls around data extraction and the prevention of the data set being manipulated post extraction and also considering if wider audit procedures indicate any issues with the data set being used (eg. the results the preliminary analytical review) or if audit procedures need to be planned to test the validity of a data set (eg. where sales ledger data is being used, have audit procedures been planned to confirm this is complete and accurate).

Where teams are unable to validate the integrity of the data, then use of ADA is unlikely to be appropriate.

Preparing data for use in an application

In most cases where the application is using general ledger data, the chart of accounts will need to be mapped to the financial statements (ie. which general ledger accounts make up sales, cost of sales, etc.). While the account mapping will generally be rolled forward from one year to the next (with this documentation also being rolled forward), any new accounts will need to be mapped in the first period they are used and an annual review should be performed to confirm if any accounts need to be remapped (for example as a result of an accounting policy change).

For some uses, the application may also require the different document / transaction types within the clients general ledger data to be defined (for example manual journals, automated subledger posting, reversing journal, etc.), as these will generally present different levels of risk. As the coding of the different document / transaction types will vary between client systems this will be done for each engagement (although retaining a central firm wide library of system codes may provide some efficiencies should multiple clients use the same accounting software), with particular attention being paid to any bespoke document/journal types used by the client.

Where non-general ledger data is being analysed, we will also need to define the key data fields used by the application for its analysis. For example where ADA is being used to analyse the aging of debtors, it is likely that the data fields which contain invoice number (as a document identifier), invoice date (to determine age) and invoice amount will be needed. Where necessary we should confirm the data fields which need to be defined with any internal experts or the application developer as applicable.

Where we are unable to obtain sufficient understanding of the parameters needed for the application to analyse the data appropriately, then use of ADA is unlikely to be appropriate.

4.1.3.5.3 Use of audit data analytics (ADA) for identifying high risk journals / transactions

As noted above, ADA can be applied to identify transactions for testing on the basis of risk criteria, including journal entries. This allows testing to be focused more efficiently than it would be using manual sample selection. This could involve using ADA to generate a risk score for each general ledger transaction, which can either be based upon artificial intelligence / machine learning, criteria set manually by the audit team (which is tailored for each client), or a combination of these methods depending on the ADA system being used.

Automated risk scoring

Where transactions have been risk scored using an automated ADA application, the application will usually have pre-set parameters set by the developer. In such cases we should ensure we have understood what these are and evaluate their use for each client, ensuring they are tailored as appropriate. Given the bespoke nature of such applications, a freeform working paper will be needed to record this assessment, and a prompt to reference this included on the Audit plan form (use of ADA) within planning. Some efficiencies may be gained by a central team of experts within the firm undertaking the required evaluation of the pre-set system parameters, which we draw on when completing our assessment. We may also want to consult with a central team of experts or the application developer to confirm the appropriateness of any tailoring made to these parameters, recording details of this in our assessment.

Manual risk scoring

Where we manually apply risk criteria to transactions (eg. when analysing data in a spreadsheet), each of the criteria selected should be allocated a risk score on a scale of 1 to 5 (1 being used for criteria which is considered to be the lowest risk and 5 for criteria which is considered the highest risk). The risk posed by certain factors will vary from client to client, so we will tailor this based upon our knowledge and experience of each client.

There are various criteria we can apply when manually evaluating the level of risk posed by a transaction. While not an exhaustive list, common criteria to apply are as follows:

Risk Condition	**Example of criteria that could be applied**
Large amounts	Greater than or equal to performance materiality
Round sum amounts	Amounts which end 000.00, 999.99, 999.00
Unusual description / key word search	Descriptions which include names / titles of key management, directors and other related parties or unusual words such as adjust, correct etc
Transactions posted at unusual times	Journals posted when the office is usually closed, such as weekends or between 7pm and 8am
Back dated transactions	Journals which post to a prior period (i.e. a journal raised in accounting period 3 which is shown in accounting period 2)
Transactions posted and reviewed by the same person	Where a system had a ‘park and post’ or ‘maker/checker’ function and these roles have been performed by the same person
Transactions posted by an unexpected person	Journal posted by a senior member of staff/non-finance staff who typically are not involved in day to day ledger posting
Unexpected account combinations	Journals which are posted to accounts which would not typically be linked, for example sales and fixed assets
Transactions which bypass the expected transaction flow	System entries which are usually automated/triggered from a sub-ledger but are posted manually

These risk conditions and examples are not exhaustive examples and teams should also use their judgement to consider additional criteria and tailoring which could be applied relevant to the client. The justification for the criteria selected should be documented on file, with a template within the Audit plan form (use of ADA) within planning being provided for this.

Risk enhancers

To further tailor the risk score, certain ADA applications (both automated and manual) may allow us to enhance the risk score of a transaction by applying a multiple. This may be linked to certain document / journal types or members of client staff considered to present a higher risk, the financial statement assertion risks (eg. a high risk area could receive a higher risk multiple) or certain accounts which are considered inherently riskier due to their susceptibility to fraud. Details of enhancers applied should be recorded on the Audit plan form (use of ADA) within planning.

Manually calculating a transactions risk score

A transaction risk score is calculated by taking the sum of any risk scores triggered by a specific risk condition, which is then multiplied by any applicable risk enhancers (where no enhancer is applicable to a particular transaction, this will be assumed to be a multiplier of 1).

Example risk score calculation

Extract example of a manually applied risk criteria:

Risk condition	**Specific definition for this client**	**Risk score applied**
Large Value	£100,000 (performance materiality)	3
Round sum amount or transaction ending in '999'	Amount ending '000.00'	2
Transaction posted at unusual time	Any posting between before 7.30am and after 8.00pm Monday to Friday and at any time on a weekend	5

Extract example of a risk enhancer:

Risk enhancer	Multiple to be applied
Any transactions posted to Revenue	3

Example extract transaction data and scores calculation:

Description	Transaction ID	Account Dr	Account Cr	Value (£)	Time and Date	Risk score
Correction to accrued income	1234	Accrued income	Sales	200,000.00	11pm Friday dd/mm/yyyy	30 [(3+2+5)x3]
Monthly depreciation charge for Motor Vehicles	1235	P&L depreciation (Motor Vehicles)	Accumulated depreciation (Motor Vehicles)	105,000.00	2pm Monday dd/mm/yyyy	5 [(3+2)x1]

Items to be selected for testing

The final element of tailoring is setting the criteria which highlight the transaction to be tested. We will set a risk score and any transactions which score equal or greater than this will be selected for testing. We will consider other specific risk factors which may trigger a transaction to be tested or why it can be excluded from testing (eg. the value of the transaction is trivial or a reversing journals where it can be confirmed the net impact in the period is nil). This criteria, along with our rationale will be recorded on the Audit plan form (use of ADA) within planning.

Where teams are relying on an algorithm (eg. in which risk scoring is done via machine learning or artificial intelligence), their understanding and evaluation of the appropriateness of the algorithm being used should be recorded on the Audit data analytics assessment form within planning.

4.1.3.5.4 Use of ADA for testing and responding to assessed risks

Evaluating the results of testing obtained from ADA

Where we undertake testing utilising ADA, this will generally involve us using the application to develop an expectation for the population being tested. This will draw on our understanding of the entity and ensure the application being used is appropriate for the specific circumstances of the entity.

Upon reviewing the results we may find these are generally in-line with our expectations, with some exceptions that require further testing. However in some circumstances we may find the results do not match our expectations, with a significant number of outliers within the population meaning further analysis is needed before we can begin to test exceptions.

Outliers which cause a deviation to our expectation can arise through one or a multiple of the following factors:

4. Our understanding of the entity was not sufficient to appropriately calibrate and set the parameters within the ADA application.
5. The data may not be of sufficient quality to facilitate the use of the ADA.
6. Our initial evaluation of the appropriateness of the use of ADA for this entity may be inappropriate.

Point two may be overcome through data cleansing activity or discussion with the client to evaluate if a more refined data set is available. Where this is the case we will need to ensure our evaluation on the Audit data analytics assessment form within planning is updated accordingly. Where this is not possible we will need to modify our planned approach accordingly.

The third point will also mean we will need to modify our planned approach accordingly.

For the first point above we may be able to recalibrate the parameters upon revising our understanding of the entity. Should we look to do this, the following points are areas to consider:

- Undertaking careful analysis of the outliers in order to assess which of the parameters used within the ADA require refinement and how this needs to be done. This includes revisiting our understanding of the entity and its environment to determine if parameters can be refined in order to reduce the number of outliers or identify those which are truly exceptions and therefore warrant further investigation as exceptions.
- Discussion with management, in a similar fashion to how we would when refining an expectation when undertaking analytical procedures in line with ISA 520, to understand the underlying data and potential relationships better.

When redefining the parameters used when applying ADA we need to be mindful to not adjust these for inappropriate reasons which include:

- Artificially reducing the amount of work required which ultimately results in obtaining insufficient appropriate audit evidence.
- Attempting to generate the same number of outliers / exceptions as seen in previous periods.
- Adjusting the parameters to compensate for data quality issues.

Once we are comfortable that the ADA application has been configured appropriately such that there are no outliers and any deviations from our expectation are due to true exceptions, we begin substantively testing these.

When testing the exceptions we will first need to consider if the population is homogenous, in which case sampling these can be considered. Where we determine the population is not homogenous we will need to consider if there is scope to stratify the population of exceptions into homogenous sub-populations before beginning sampling and substantive testing of these discrete groups. Where we do stratify the population of exceptions we need to take care that when sampling based on sub-populations, the untested population in a single financial statement line item does not exceed materiality.

Guidance on considerations to make when stratifying populations is given in Appendix 3: Audit sampling (below).

For the remaining population (i.e. that which falls in-line with our expectation), we may be able to leverage testing undertaken elsewhere in the audit file in order to gain comfort over the non-exception population. Where this is not the case we will need to consider what additional procedures are needed.

4.1.3.5.5 The use of ADA and other technology and ethics

The use of certain ADA applications and / or other technology may allow us to communicate more detailed and meaningful insights to management. However we need to mindful that this does not extend beyond feedback that would be seen as being the normal by product of the audit, into wider commentary and analysis that could be seen as offering business advice that could be used in a managerial decision making process.

4.1.4 Auditor's reports

Example auditor's reports are included within the Example Reports section of the manual.

In preparing an auditor's report the latest applicable bulletin, published by the FRC should be followed. The subsections below address a number of LLP specific considerations.

4.1.4.1 Content of an auditor's report

The content of an auditor's report on an LLP is driven not only by the requirements of the ISAs (guidance is provided in the Audit Procedures Manual), but also by the specific requirements in this regard set out in the Companies Act 2006 as applied to LLPs. This includes:

Other information

There is no requirement for the members of an LLP to prepare a Members' Report or a strategic report under either the LLP regulations or the LLP SORP. However, the LLP may choose to prepare such a report. Where there is no other information published with the financial statements of the LLP, there is no need for an other information section in the auditor's report.

Where there is other information, however, the auditor's responsibility is to read the other information* and, in doing so, consider whether this other information is materially inconsistent with the financial statements or the knowledge obtained in the course of the audit. The opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in the auditor's report, no assurance conclusion is formed thereon.

Matters on which the auditor is required to report by exception

The auditor is required to report by exception in respect of the following matters in relation to which the Companies Act 2006 requires them to report by exception if, in their opinion:

- adequate accounting records have not been kept, or returns adequate for the audit have not been received from branches not visited by the auditor; or
- the financial statements are not in agreement with the accounting records and returns; or
- the auditor has not received all the information and explanations required for the audit; or
- the members were not entitled to prepare the financial statements in accordance with the small LLPs regime.

** Other information comprises the information included in the annual report (if provided), other than the financial statements and the auditor's report thereon.*

4.1.4.2 Signing off an auditor's report

The auditor's report must be dated and must be signed:

- in the case of the auditor being a firm, by the senior statutory auditor in their own name, for and on behalf of the firm; and
- in the case of the auditor being an individual, by them, in their own name.

Names (including post nominal initials) must mirror those contained in the Audit Register.

Signatures may be the individual's usual signature, even if this differs from the name on the audit register (eg. Bill Smith rather than William Smith).

4.1.4.3 Modifications to the auditor's report

Where the auditor's report is modified, in addition to the ISA considerations, consideration must be given to the impact on the other aspects of the report required by the Companies Act 2006 as applied to LLPs. Whilst the exact amendments to these elements will depend on the reason for the modification to the rest of the report.

Other information

Where the auditor disclaims an opinion on the financial statements, this section is deleted.

Where there is other information, and the auditor qualifies an opinion on the financial statements or issues an adverse opinion on the financial statements, consideration needs to be given as to whether the other information is also impacted by the same matter, or a related matter to that which gives rise to the qualified opinion or adverse opinion on the financial statements. In certain circumstances, it may therefore be necessary to replace the reference to "*We have nothing to report*" with details of the modification and a conclusion that the other information is materially misstated.

Matters on which the auditor is required to report by exception

Where the auditor disclaims an opinion on the financial statements, it is expected that they are unable to obtain all of the information and explanations required for the audit and unable to determine whether adequate accounting records have been kept (although further matters may also need to be reported). This would usually result in amending the wording to read:

"*Arising from the limitation of our work referred to above:*

- *we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and*
- *we were unable to determine whether adequate accounting records have been kept.*

We have nothing to report in respect of the following matters in relation to which the Companies Act 2006 as applied to limited liability partnerships by the Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008 requires us to report to you if, in our opinion:

- *returns adequate for our audit have not been received from branches not visited by us; or*
- *the financial statements are not in agreement with the accounting records and returns; [or*
- *the members were not entitled to prepare the financial statements in accordance with the small limited liability partnership's regime.]"*

Where the auditor qualifies their opinion on the financial statements or issues an adverse opinion, the wording of this section must be updated to reflect the circumstances. It's likely that there will still be nothing to report on certain matters, but there will be matters to report in respect of others.

4.1.5 Ceasing as auditor

The Act includes detailed requirements with respect to ceasing to hold office as auditor.

The requirements differ depending on whether the auditor:

- resigns; or
- simply ceases to hold office at the end of a period for appointing auditors.

The requirements also differ depending on whether or not the LLP is classified as a public interest entity*.

** For this purpose, a public interest entity is defined by s519A of the Act as:*

- *an issuer whose transferable securities are admitted to trading on a UK regulated market; or*
- *a credit institution within the meaning given by Article 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 Article 4(1)(2A) of that Regulation.*

4.1.5.1 Notice of resignation to the LLP

Where an auditor resigns, they must send notice to that effect to the LLP.

Such a notice of resignation operates to bring the auditor's term of office to an end as of the date on which the notice is received or on such later date as may be specified in it, as long as, in the case of a public interest entity, the notice is accompanied by a s519 statement (see below).

4.1.5.2 S519 statement to the LLP

When a s519 statement is required

A s519 statement is required where:

- the auditor of a public interest entity who is ceasing to hold office (at any time and for any reason); or
- the auditor of a non-public interest entity ceases to hold office except where:
    - o they cease to hold office at the end of a period for appointing auditors; or
    - o the reasons for ceasing to hold office are all exempt reasons* and there are no matters connected with ceasing to hold office that need to be brought to the attention of members or creditors of the LLP.

** Exempt reasons are:*

- *the auditor is no longer to carry out statutory auditor work within the meaning of Part 42;*
- *the LLP is, or is to become, exempt from audit under s477, s479A or s480 and intends to include such an audit exemption statement on its balance sheet;*
- *the LLP is a subsidiary undertaking of a parent undertaking that is incorporated in the UK, that parent prepares group accounts, and the auditor is being replaced as auditor of the LLP by the auditor who is conducting, or is to conduct, an audit of the group accounts and each subsidiary included therein; or*
- *the LLP is being wound up.*

Contents of a s519 statement

Where required, a s519 statement must include:

- the auditor's name and address;
- the auditor's registration number on the register of auditors;
- the LLP's name and registered number; and
- details of any matters connected with the auditor ceasing to hold office that the auditor considers need to be brought to the attention of members or creditors* or a statement that there are no such matters.

** The Act does not provide any guidance on the sorts of matters that should be brought to the attention of members or creditors - it is instead left to professional judgement. Where a decision has been taken not to participate in a tender for an entity previously audited, the firm should consider whether to provide further detail on the specific matters that impacted its decision (eg. a conflict of interest, the audit fee no longer reflecting the extent of the work required etc.). ICAEW has published a guidance paper that discusses auditor resignation statements.*

Timescales

Where a s519 statement is required to be sent to the LLP:

- in the case of a resignation, it must be sent along with the notice of resignation;
- in the case of failure to seek reappointment, not less than 14 days before the end of the time allowed for next appointing an auditor; and
- in any other case, not later than the end of the period of 14 days beginning with the date on which the auditor ceases to hold office.

4.1.5.3 Notifying the registering Institute / Association or the Competent Authority

Where an auditor sends a statement under section 519, they must at the same time send a copy of the statement to the competent authority (the Financial Reporting Council (FRC) for a public interest entity or the Institute or Association for a non-public interest entity).

4.1.5.4 Notifying the registrar

A copy of the s519 statement is only required to be sent to Companies House by the auditor where:

- the LLP is a public interest entity; or
- the LLP is a non-public interest entity and the s519 statement includes matters that need to be brought to the attention of members or creditors of the LLP.

In such cases, the auditor must send the s519 statement to the LLP first, and if the auditor does not receive notice of an application to the court under s520 of the Act (which gives the LLP the right to apply to the court in the rare cases where they consider the contents of the s519 matters include needless publicity for a defamatory matter) within 21 days, they must then send the s519 statement to Companies House within a further seven days.

4.1.5.5 LLP responsibilities

Notifying members or creditors

Where an LLP receives a s519 statement from an auditor who is ceasing to hold office where:

- the LLP is a public interest entity; or
- the LLP is a non-public interest entity and the s519 statement includes matters that need to be brought to the attention of members or creditors of the LLP;

they must, within 14 days of receipt either:

- send a copy of it to every person who under s423 of the Act is entitled to be sent copies of the accounts; or
- apply to the court (and notify the auditor of that application)*.

** The situation where an LLP applies to the court is not addressed further in this guidance.*

Notifying the registering Institute / Association or the Competent Authority

When an auditor ceases to hold office at any time other than at the end of their term of office, and the reasons for auditor ceasing to hold office are not exempt reasons, the LLP is required to provide a statement to the appropriate audit authority within 28 days. The statement should include either:

- an endorsed copy of the auditor's s519 statement; or
- what the LLP considers the reasons to be for the cessation.

4.1.5.6 Other responsibilities on ceasing to act

As a matter of professional courtesy, clients should be advised of their responsibilities where an auditor ceases to act as auditor, such advice is usually included within a disengagement letter. Where an auditor ceases to hold an audit appointment they must, if asked in writing, allow their successor access to all relevant information held by them in relation to their audit work. This includes audit working papers in relation to the last accounting period for which they acted. They should also be prepared to assist their successor by providing oral or written explanations to assist their understanding of working papers.

4.2 Other forms of external scrutiny

Where an LLP claims audit exemption, it may nevertheless wish to subject its annual reports and accounts to some form of external scrutiny.

4.2.1 Assurance Review Engagement

One form of scrutiny that may be selected is that of an assurance review engagement in accordance with ISRE 2400 International Standard for Review Engagements.

ISRE 2400 (Revised) requires the chartered accountant to make enquiries of management, and others, and to carry out analytical procedures to gain a degree of assurance that:

- The financial statements comply with the chosen financial reporting framework and give a true and fair view; and
- Management is aware of its responsibilities for producing the financial statements.

To be able 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;
    - Significant, unusual or complex transactions or events.

Assurance review engagements, like audits, may help the accountant report weaknesses and other issues that come to their attention to the directors. In other words, such engagements can generate much more value for the directors than just the assurance report itself. This represents a substantial degree of understanding of the client's circumstances.

Further substantive testing is not required unless the accountant has reason to be concerned about some aspect of the business.

It is important to note though that a review of financial statements in accordance with ISARE 2400 is a limited assurance engagement, and the procedures performed are substantially less than those performed in an audit conducted in accordance with the ISAs - an audit opinion is not provided.

Where an assurance review engagement is to be undertaken, it is recommended that a specialist manual such as Mercia's Assurance Review Engagement Manual is used.

4.2.2 Independent examination

Certain LLPs may be subject to independent examination where they claim audit exemption (eg. due to the requirements of the members' agreement).

An independent examination is usually carried out in line with a particular set of sector requirements.

Independent examinations are limited assurance engagements and the procedures performed are substantially less than those performed in an audit conducted in accordance with the ISAs.

4.3 Compilation

Whilst not technically a form of scrutiny, firms may be asked to prepare the accounts for an LLP.

Guidance on the compilation of financial statements where an audit is not carried out can be found in:

- ICAEW - TECH 07/16AAF Chartered Accountants' Reports on the Compilation of Financial Statements of Incorporated Entities (Updated March 2016);
- ACCA - Technical Factsheet 163 Audit Exempt Companies - ACCA Accounts Preparation Report; and
- ICAS - Framework for the Preparation of Accounts. Best Practice Guidance by the Institute of Chartered Accountants of Scotland.

Members of the respective Institutes or Association should consult the specific guidance relevant to them when undertaking an audit exempt assignment.

This manual includes an example engagement letter, an example report, planning, work programmes and completion that can be used for such engagements. Other documentation available in the manual, for example, index cards and lead schedules may also be tailored and used on such assignments.

Appendix 1a: Notes for completion of planning form B25 - Materiality

Materiality – Notes for completion
The objective of the materiality form is to determine materiality and performance materiality.

Materiality B25

Objective: To determine materiality and performance materiality

For guidance on materiality, refer to Appendix 4 of the guidance notes in this manual. NB. Shaded areas to be completed at the completion stage of the audit.

		Expected Current Year £'000	Actual Current Year £'000
Benchmarks			
Income			
Adjustments for unusual transactions or items			
Adjusted income			
Surplus			
Assets (state "net" or "gross")			
Other			
Basis for determining materiality			
Adjusted income	%		
Surplus	%		
Assets (state "net" or "gross")	%		
Other (specify ______________)	%		
Justification for materiality level:			
Materiality for the financial statements as a whole			
Justification for performance materiality level:			
Performance materiality			
Amount below which misstatements are clearly trivial			
Audit areas requiring other levels of materiality and performance materiality (e.g. trustees' / directors' transactions / restricted funds):			

Conclusions

Planning materiality
The planned levels of materiality are appropriate for this audit.

Prepared by		Dated:	
Reviewed by		Dated:	

Final materiality
The final level of materiality is appropriate for this audit

Prepared by		Dated:	
Reviewed by		Dated:	

Other could include total expenditure or total funds.

State which benchmark from above and the percentage or level to be adopted. ISA (UK) 320 suggests 5% of unadjusted profit may be used for a profit-orientated entity in a manufacturing industry or 1% of income for a non-for-profit entity but other benchmarks and higher or lower percentages may be appropriate.

Materiality on the financial statements as a whole relates to the level at which misstatements (including omissions) individually or in the aggregate would affect the decisions of users of the financial statements. Materiality is not affected directly by audit risk but some of the factors in determining materiality may also lead to increased audit risk.

Performance materiality is the working level of materiality used throughout the fieldwork as a guide as to which balances and transactions need to be tested.

It is the amount set at less than materiality (ie. for the financial statements as a whole) to reduce to an acceptably low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

Performance materiality may be set at an amount or a percentage of materiality on the financial statements as a whole. This percentage is a matter of judgement but is affected by the auditor's understanding of the entity, updated during the risk assessment procedures, and the expectation of misstatements. For example, where the overall risks are low the auditor may set performance materiality at 90% of materiality. Where the risk of misstatement is higher, the auditor should use a lower percentage of materiality.

Clearly trivial refers to matters which are clearly inconsequential and is of a wholly different (smaller) magnitude than performance materiality (for example the auditor may use up to 5% of materiality). Where there is uncertainty as to whether something is clearly trivial, it should be assumed that it is not.

State the area and the level of materiality and performance materiality.

Revisit the levels of materiality and performance materiality at the closing stages of the audit, and consider if / how this impacts the audit.

Appendix 1b: Notes for completion of planning form B41 - Materiality

Materiality – Notes for completion
The objective of the materiality form is to determine materiality and performance materiality.

Materiality **B41**

Objective: To determine materiality and performance materiality

For guidance on materiality, refer to Appendix 4 of the guidance notes in this manual. NB. Shaded areas to be completed at the completion stage of the audit.

		Expected Current Year £'000	Actual Current Year £'000
Benchmarks			
Income			
Adjustments for unusual transactions or items			
Adjusted income			
Surplus			
Assets (state "net" or "gross")			
Other			
Basis for determining materiality			
Adjusted income	%		
Surplus	%		
Assets (state "net" or "gross")	%		
Other (specify ______________)	%		
Justification for materiality level:			
Materiality for the financial statements as a whole			
Justification for performance materiality level:			
Performance materiality			
Amount below which misstatements are clearly trivial			
Audit areas requiring other levels of materiality and performance materiality (e.g. trustees' / directors' transactions / restricted funds):			

Conclusions

Planning materiality
The planned levels of materiality are appropriate for this audit.

Prepared by		Dated:	
Reviewed by		Dated:	

Final materiality
The final level of materiality is appropriate for this audit

Prepared by		Dated:	
Reviewed by		Dated:	

Other could include total expenditure or total funds.

State which benchmark from above and the percentage or level to be adopted. ISA (UK) 320 suggests 5% of unadjusted profit may be used for a profit-orientated entity in a manufacturing industry or 1% of income for a non-for-profit entity but other benchmarks and higher or lower percentages may be appropriate.

Materiality on the financial statements as a whole relates to the level at which misstatements (including omissions) individually or in the aggregate would affect the decisions of users of the financial statements. Materiality is not affected directly by audit risk but some of the factors in determining materiality may also lead to increased audit risk.

Performance materiality is the working level of materiality used throughout the fieldwork as a guide as to which balances and transactions need to be tested.

It is the amount set at less than materiality (ie. for the financial statements as a whole) to reduce to an acceptably low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

Performance materiality may be set at an amount or a percentage of materiality on the financial statements as a whole. This percentage is a matter of judgement but is affected by the auditor's understanding of the entity, updated during the risk assessment procedures, and the expectation of misstatements. For example, where the overall risks are low the auditor may set performance materiality at 90% of materiality. Where the risk of misstatement is higher, the auditor should use a lower percentage of materiality.

Clearly trivial refers to matters which are clearly inconsequential and is of a wholly different (smaller) magnitude than performance materiality (for example the auditor may use up to 5% of materiality). Where there is uncertainty as to whether something is clearly trivial, it should be assumed that it is not.

State the area and the level of materiality and performance materiality.

Revisit the levels of materiality and performance materiality at the closing stages of the audit, and consider if / how this impacts the audit.

Appendix 2.1a: Notes for completion of planning form B40 Audit plan - Trial balance (use of ADA)

Audit plan - Trial balance (use of ADA) – Notes for completion
The objective of Audit plan - Trail balance (use of audit data analytics) is to tailor the use of ADA when being used to identify journals/significant unusual transactions for testing. This form is only necessary where audit data analytics (ADA) is planned to identify high risk transactions for testing.

To confirm if an automated or manual ADA application is being used to risk score transactions, including an indication of where the parameters used for the risk assessment are set out and have been assessed. For automated, it may be easiest to reference to a printed schedule from the application alongside clear justifications on the parameters.

For manual scoring, indicate if a particular criterion is considered relevant or not (Y/N). NB. the list of risk conditions is not exhaustive and customised risk conditions should be added where relevant.

The specific criteria to be applied to should be defined (eg. what is considered to be a 'large value').

A risk score to be applied should be noted (1 being for the lowest risk and 5 being for the highest risk).

Any risk enhancers should be defined (eg. what particular risk criteria exist which means the risk score for certain transactions should be enhanced by a multiple).

The risk multiple should be recorded.

Audit plan - Trial balance (use of ADA) B40/N2(ADA)

Objective: To record the use of audit data analytics (ADA) when being used to identify journals / significant unusual transactions for testing.

For guidance on completing this audit plan, refer to Appendix 5.1 of the guidance notes in this manual.

B21 must be completed to appraise the use of ADA.

Risk criteria to identify high risk journals / transactions

Transactions have been risk scored using an automated ADA application. The parameters used by the system (including details of any tailoring specific to this client), with justification for why these are considered appropriate are set out on sch______.[1]	☐
Transaction risk criteria is being applied manually[2]. Tailoring of the risk criteria for this client is detailed below or on sch ____.	☐

Risk criteria to be applied manually:[3]

Risk condition	Relevant for this engagement (Y/N)	Specific definition	Risk score applied	Justification
Large value				
Round sum amounts or transactions ending '999'				
Unusual description / key word search				
Transactions posted at an unusual time				
Back dated transactions				
Transactions posted and reviewed by the same person				
Transactions posted by an unexpected person				
Unexpected account combination(s)				
Other (describe):				

Risk enhancers

If applicable, risk enhancer multiply to be applied[4]:

Risk enhancer	Multiple to be applied	Justification

Items to be selected for testing

Criteria to select or exclude transactions for testing[5]:

	Criteria	Justification
Transactions with a risk score[6] equal or greater than:		
De minimis threshold below which journal values can be excluded from testing:		
Other criteria specifically triggering a journal to be tested:		
Other criteria specifically triggering a journal to be excluded from testing:		

Prepared by		Dated:	
Reviewed by		Dated:	

1. The assessment of automated risk scoring is likely to require a freeform assessment. See Section 7 of the guidance notes in this manual.
2. Manual risk scoring is likely to be done in a spreadsheet or similar. See Section 7 of the guidance notes in this manual.
3. Example risk criteria is given in chapter 7 of the guidance notes in this manual.
4. For guidance on the use of risk enhancers to emphasise risk factors for a transaction by applying a multiple to the risk score, see Section 7 of the guidance notes in this manual.
5. Judgement is required when determining the criteria to select transactions for testing., see Section 7 of the guidance notes in this manual.
6. An example risk score calculation is given in Section 7 of the guidance notes in this manual.

The criteria to trigger a transaction to be considered high risk and which should be tested should be recorded (eg. high risk score). Any criteria which would mean a transaction could be excluded from testing should also be recorded here (eg. below a trivial value).

Appendix 2.1b: Notes for completion of planning form B33 Audit plan - Trial balance (use of ADA)

Audit plan - Trial balance (use of ADA) – Notes for completion
The objective of Audit plan - Trail balance (use of audit data analytics) is to tailor the use of ADA when being used to identify journals/significant unusual transactions for testing. This form is only necessary where audit data analytics (ADA) is planned to identify high risk transactions for testing.

Audit plan - Trial balance (use of ADA) B33/N2(ADA)

Objective: To record the use of audit data analytics (ADA) when being used to identify journals / significant unusual transactions for testing.

For guidance on completing this audit plan, refer to Appendix 5.1 of the guidance notes in this manual.

***B20** must be completed to appraise the use of ADA.*

Risk criteria to identify high risk journals / transactions

Transactions have been risk scored using an automated ADA application. The parameters used by the system (including details of any tailoring specific to this client), with justification for why these are considered appropriate are set out on sch______.[1]	☐
Transaction risk criteria is being applied manually[2]. Tailoring of the risk criteria for this client is detailed below or on sch ____.	☐

Risk criteria to be applied manually:[3]

Risk condition	Relevant for this engagement (Y/N)	Specific definition	Risk score applied	Justification
Large value				
Round sum amounts or transactions ending '999'				
Unusual description / key word search				
Transactions posted at an unusual time				
Back dated transactions				
Transactions posted and reviewed by the same person				
Transactions posted by an unexpected person				
Unexpected account combination(s)				
Other (describe):				

Risk enhancers

If applicable, risk enhancer multiply to be applied[4]:

Risk enhancer	Multiple to be applied	Justification

Items to be selected for testing

Criteria to select or exclude transactions for testing[5]:

	Criteria	Justification
Transactions with a risk score[6] equal or greater than:		
De minimis threshold below which journal values can be excluded from testing:		
Other criteria specifically triggering a journal to be tested:		
Other criteria specifically triggering a journal to be excluded from testing:		

Prepared by		Dated:	
Reviewed by		Dated:	

1. The assessment of automated risk scoring is likely to require a freeform assessment. See chapter 7 of the guidance notes in this manual.
2. Manual risk scoring is likely to be done in a spreadsheet or similar. See chapter 7 of the guidance notes in this manual.
3. Example risk criteria is given in chapter 7 of the guidance notes in this manual.
4. For guidance on the use of risk enhancers to emphasise risk factors for a transaction by applying a multiple to the risk score, see chapter 7 of the guidance notes in this manual.
5. Judgement is required when determining the criteria to select transactions for testing, see chapter 7 of the guidance notes in this manual.
6. An example risk score calculation is given in chapter 7 of the guidance notes in this manual.

To confirm if an automated or manual ADA application is being used to risk score transactions, including an indication of where the parameters used for the risk assessment are set out and have been assessed. For automated, it may be easiest to reference to a printed schedule from the application alongside clear justifications on the parameters.

For manual scoring, indicate if a particular criterion is considered relevant or not (Y/N). NB. the list of risk conditions is not exhaustive and customised risk conditions should be added where relevant.

The specific criteria to be applied to should be defined (eg. what is considered to be a 'large value').

A risk score to be applied should be noted (1 being for the lowest risk and 5 being for the highest risk).

Any risk enhancers should be defined (eg. what particular risk criteria exist which means the risk score for certain transactions should be enhanced by a multiple).

The risk multiple should be recorded.

The criteria to trigger a transaction to be considered high risk and which should be tested should be recorded (eg. high risk score). Any criteria which would mean a transaction could be excluded from testing should also be recorded here (eg. below a trivial value).

Appendix 3a: Notes for completion of substantive sampling form (p/c on or after 15 Dec 21)

ISA or ES para

Substantive sampling approach

General information

Introduction

This methodology includes two different sampling approaches. One is for judgemental sampling (and incorporates a sample cap), the other is a statistical sampling approach (which does not incorporate a sample cap). Whilst a different approach may be used on different audits, it would be difficult to justify mixing and matching the different approaches on the same audit. For many audits, particularly where populations are smaller, the judgemental sampling approach will be appropriate, however it is not suitable for use on the audits of PIEs or other audits where the populations are very large. The firm's policy should also be consulted, as some firms may mandate the use of the statistical sampling approach in all cases.

A sample size calculated using either of the substantive sampling approaches is derived on the basis that little error is expected in the population being tested. If this is not be the case and a number of errors are likely, then the form is not appropriate and the level of testing should be set judgementally at a level considered to be sufficient to provide adequate audit assurance. In these cases testing levels are likely to be considerably in excess of the numbers calculated using either of the approaches.

The substantive sampling forms require the documentation of a number of qualities of the test being performed and population being tested in order to evidence due consideration of those factors. The forms encourage the extraction of significant and other key items which would be tested in addition to the calculated sample size for the residual population. This sample size for the residual population is determined by reference to the assessed risk in the population, the planned reliance on other procedures and the size of the residual population. Key factors to consider when completing the substantive sampling forms are highlighted below.

Definition and expectation of error

Errors should be defined when designing the sample. The definition of an error is important because the errors found in a sample will be projected (extrapolated) across the population being sampled.

As noted above, where the expectation of an error occurring is more than low, we should set the sample size judgementally at a level considered to be sufficient to provide adequate audit assurance.

Stratification

Where appropriate, we should divide a population into discrete sub-populations which have an identifying characteristic, this process is termed stratification.

The objective of stratification is to reduce the variability of items within each sub-population (stratum) and therefore allow a reduced sample size to be taken without increasing sampling risk. If revenue is generated in a number of different ways by the entity, it is likely to be appropriate to split each type of revenue into a different stratum, for example. *530.5, 530 App. 1*

Where there is little variation in the population stratification may not be required. For example, if testing debtors for membership fees, stratification may not be necessary as there is little or no variability in the population.

Consideration should be given to increasing the sample size if the population contains sufficient variability to warrant stratification, but a decision is taken not to stratify.

When performing substantive tests of details, the population may be stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement.

Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

If values are not known (eg. unpriced stock), then the population may be stratified in some other way, for example by quantity or by type.

If a class of transactions or an account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

Substantive sampling approach

ISA or ES para

The value of residual population to sample

There may be certain items in the population that we wish to test specifically. This may be due to either their value or some qualitative characteristic (eg intra-group items, transactions or balances with related parties, etc.). We will remove these items from the population and test them separately.

When designing a sample, we determine a level of tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality to a particular sampling procedure and may be the same amount or an amount lower than performance materiality. *530.5*

All items greater than tolerable misstatement should normally be treated as individually significant items. These, along with other key items, are extracted from the population and examined separately. The residual population is then sampled.

Method of selection to use

Once the sample size has been determined we will use one of the following methods to select the sample: *530 App 4*

- random selection;
- systematic selection (ie. every "nth" item);
- monetary unit sampling (items with greater monetary value have a proportionally greater chance of being sampled); or
- haphazard selection (not generally recommended but may be necessary where documents are filed alphabetically).

Whichever method is chosen, the following criteria need to be observed:

- items chosen must be selected in such a way that we can reasonably expect them to represent the whole population;
- each item in the population must have a chance of being selected; and
- conscious bias must be avoided.

Some form of systematic selection is frequently used to arrive at the items to be sampled, although random selection can also be used.

Example: Systematic selection of a sample

f. A sample of 30 items is required from a population of 4,000 items. The sampling interval would be 4,000 / 30 = 133. A random start should be taken from within the first 133 items with every 133rd item chosen thereafter.

g. A sample of 20 items is required from a day book of 50 pages. A random start point somewhere between pages 1 - 10 would be chosen then an item would be sampled from every 2nd page. Depending on the number of entries per page a random number calculator could be used to select a line on each of the pages to be sampled.

Accounting estimates

Sampling techniques are unlikely to be utilised when testing accounting estimates, however certain accounting estimates such as depreciation / amortisation calculations may utilise a sampling approach. Care is needed here regarding clarity over the assertion(s) being tested.

Sample size calculation - Judgemental sampling

When determining the sample size for the residual population in a substantive test of detail the initial sample size will be 60 items. Note that where there are different income or expense streams, that have different systems, each of these should be treated as a separate population – i.e. each stream will need to be sampled separately, with each stream having an initial sample size of 60. This number can be reduced based on various deduction factors that are dependent upon the following:

- the risk of material misstatement associated with the population being tested;
- the planned level of reliance placed on the operating effectiveness of controls;
- the strength of analytical and other related substantive procedures; and
- the size of the residual population (adjusted via a 'materiality factor').

ISA or ES para

Substantive sampling approach

The following table highlights the level of deduction available in each instance. This is followed by guidance on the application of judgement in taking deductions available.

Assessed inherent risk in population		**Planned reliance on internal controls**		**Analytical and other related substantive procedures**		**Materiality factor**	
Level	No.	Level	No.	Strength of evidence	No.	Value	No.
1	20	High	20	Strong	20	Under 15	20
2	15	Medium	10	Moderate	10	15-27	10
3	10	None	0	Weak	0	Over 27	0
4	5						
5	0						

Assessed inherent risk in the population

The assessed inherent risk in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

This assessed inherent risk in the population will depend on the audit area and the particular assertion being tested. For example, it may be deemed within a population of stock that the existence assertion is at a lower risk of material misstatement than the valuation assertion. This could be due to the stock existence being easily verifiable whereas the valuation within the population could be subject to complex accounting estimates. Therefore we may deem it appropriate to calculate separate samples for the existence and valuation testing.

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, eg, valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

Planned reliance on internal controls

Where we only evaluate whether relevant controls are designed effectively and determine whether they have been implemented, we cannot reduce the substantive test sample size for any reliance on controls - this can only be done where we have tested their operating effectiveness.

Tests of operating effectiveness of internal controls are often designed to provide either a high or moderate level of reliance and therefore risk reduction.

- A high level of reliance (low level of risk remaining) applies where the primary evidence is coming from tests of controls.
- A medium level of reliance (medium level of risk remaining) applies where the tests of controls will be combined with other substantive procedures to address a particular assertion.

The type of controls being tested may influence the level of reliance to be placed on them. For example, a control applied to all items in the population is likely to provide a sounder basis for reliance than one only applied to certain types or sizes of transactions.

The extent to which we test controls for the planned level of reliance is a matter of professional judgement; however, in ascertaining an appropriate sample size for tests of controls we may use the tests of controls sampling form.

ISA or ES para

Substantive sampling approach

Analytical and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg. sales or debtors, or the population could be disaggregated into its component parts, eg. different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may "take credit" for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

Materiality factor

The materiality factor is calculated as follows:

total value of population / materiality = materiality factor

The lower the resulting figure for the materiality factor the greater the reduction in sample size. Thus, not surprisingly, the larger the value of the residual population relative to materiality the greater the value of the materiality factor and the larger the final sample size will be.

Where a different specific audit area materiality is set on the **B25** then this materiality rather than the overall materiality should be used to calculate any sample sizes for that particular area.

Minimum sample size

Small samples have an increased risk of being unrepresentative and unreliable. If the total population comprises a relatively small number of items, say fewer than 50 items, then alternative procedures should be considered in place of sampling. For example, this might include analytical procedures or a review for unusual items.

When the calculated sample results in a sample size of 15 items or fewer, then alternative audit procedures should be considered as outlined above. If these are not appropriate, then the minimum sample size should be 15 items.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

Justification

Since this is a judgemental sampling approach, it is necessary to justify the sample size used. The substantive sampling form includes appropriate space to document this justification. It is not acceptable to simply state that that it is appropriate because that is what was calculated by the approach – this is simply an indicative guide to be used as a starting point.

Substantive sampling approach

Example: Transaction tests on income

We have established the following:

Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Assessed inherent risk in population	= 1
Planned reliance on internal controls	= High
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor	= 30

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(20)
Planned reliance on internal controls	(20)
Analytical and other related substantive procedures	(10)
Materiality factor	(0)
Total sample size	**10**

However, the sample size will still be 15 (ie. the minimum sample size) which would therefore require 15 items to be tested substantively.

Alternatively, we may choose not to place any reliance on internal controls and therefore not test the operating effectiveness of controls. The resulting substantive sample size would be 30 items, with no tests of control being necessary. This, in practice, may be a more cost effective approach.

Example: Testing existence of debtor balances

We have established the following:

Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Assessed inherent risk in population	= 3
Planned reliance on internal controls	= None
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor (Residual population value / materiality)	= 250,000 / 10,000 = 25

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(10)
Planned reliance on internal controls	(0)
Analytical and other related substantive procedures	(10)
Materiality factor	(10)
Total sample size	**30**

ISA or ES para

Substantive sampling approach

Example: Testing valuation of stock lines

We have established the following:

Total population value	= £200,000
Monetary value of items over tolerable misstatement	= £130,000
Number of items over tolerable misstatement	= 7
Number of other key items	= 0
Residual population to be sampled	= £70,000
Assessed inherent risk in population	= 5
Planned reliance on internal controls	= Moderate
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor (Residual population value / materiality)	= 70,000 / 7,000 = 10

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(0)
Planned reliance on internal controls	(10)
Analytical and other related substantive procedures	(10)
Materiality factor	(20)
Total sample size	**20**

Therefore, the total number of items to examine will be 27 items (20 sample items + 7 individually significant items).

Sample size calculation - Statistical sampling

When determining the sample size for the residual population in a substantive test of detail the sample size will be based on:

- the risk of material misstatement associated with the population being tested;
- the strength of analytical and other related substantive procedures;
- the tolerable misstatement; and
- the size of the residual population.

Tolerable misstatement is defined in ISA 530 as 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. The tolerable misstatement cannot exceed performance materiality.

Risk of material misstatement

The assessed risk of material misstatement inherent in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements. It should have been assessed as part of the risk assessment process.

This assessed risk in the population will depend on the audit area and the particular assertion being tested. For example, it may be deemed within a population of stock that the existence assertion is at a lower risk of material misstatement than the valuation assertion. This could be due to the stock existence being easily verifiable whereas the valuation within the population could be subject to complex accounting estimates. Therefore we may deem it appropriate to calculate separate samples for the existence and valuation testing.

ISA or ES para

Substantive sampling approach

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, e.g. valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

The risk of material misstatement will also be affected by the control risk. Where a controls based approach is taken to the audit, and it is possible to place reliance on relevant controls (the operating effectiveness of which will be tested as part of controls testing), this may serve to reduce the risk of material misstatement – see **B30**.

Analytical and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg. sales or debtors, or the population could be disaggregated into its component parts, eg. different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may “take credit” for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

The strength of analytical and other related substantive procedures is ultimately a matter of professional judgement; however the following should be considered:

- Weak analytical and other related substantive procedures would generally be where no such procedures were undertaken, or would include simple variance analysis, or other limited procedures which do not confirm to the requirements of ISA 520 Analytical Procedures.
- Moderate analytical and other related substantive procedures would generally include analytical procedures in conformity with the requirements of ISA 520 Analytical Procedures in addition to at least some other substantive work.
- Strong analytical and other related substantive procedures would generally include detailed analytical procedures in conformity with the requirements of ISA 520 Analytical Procedures and extensive further substantive procedures over the population in addition to the testing to be performed on the sample.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

Substantive sampling approach

Note that in some cases it's not possible to calculate a sample size using the statistical approach. This occurs where the analytical and other related substantial procedures are strong and the risk of material misstatement is very low, low or medium; or where the analytical and other related substantial procedures are moderate and the risk of material misstatement is very low. In such cases, statistically, the planned test of details may not be necessary unless specified by regulation or other standards.

Example: Transaction tests on income

We have established the following:

Total population value	= £6,100,000
Tolerable misstatement	= £75,000
Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Risk of material misstatement	= High (4)
Analytical and other related substantive procedures	= Weak

The high risk of material misstatement, coupled with the weak analytical and other substantive procedures would result in a confidence factor of 2.30. The substantive sample size would therefore be (£6,100,000 x 2.30) / £75,000 = 188. This would also be the number of items to be tested in this case.

If stronger work was undertaken on analytical and other related substantive procedures, this can significantly reduce the sample size. For example, if instead the analytical and other related substantive procedures were Strong, the confidence factor would instead be 0.41 and the sample size would only be 34 items.

Of course, in order to change the strength of analytical and other related substantive procedures, additional such procedures would need to be undertaken.

Example: Testing valuation of stock lines

We have established the following:

Total population value	= £200,000
Tolerable misstatement	= £7,000
Number of items over tolerable misstatement	= 7
Monetary value of items over tolerable misstatement	= £130,000
Number of other key items	= 0
Risk of material misstatement	= Very High (5)
Analytical and other related substantive procedures	=Moderate

The very high risk of material misstatement, coupled with the moderate analytical and other related substantive procedures would result in a confidence factor of 2.08. The substantive sample size would therefore be (£70,000 x 2.08) / £7,000 = 21. The total number of items to be tested would therefore be 28 (21 + 7).

Appendix 3b: Notes for completion of substantive sampling form (p/c before 15 Dec 21)

The substantive sampling form requires the documentation of a number of qualities of the test being performed and population being tested in order to evidence due consideration of those factors. The form encourages the extraction of significant and other key items which would be tested in addition to the calculated sample size for the residual population. This sample size for the residual population is determined by reference to the assessed risk in the population, the planned reliance on other procedures and the size of the residual population.

Sample size calculation

When determining the sample size for the residual population in a substantive test of detail the initial sample size will be 60 items. This number can be reduced based on various deduction factors that are dependent upon the following:

- the risk of material misstatement associated with the population being tested;
- the planned level of reliance placed on the operating effectiveness of controls;
- the strength of analytical and other related substantive procedures; and
- the size of the residual population (adjusted via a ‘materiality factor’).

The following table highlights the level of deduction available in each instance. This is followed by guidance on the application of judgement in taking deductions available.

Assessed risk in population		**Planned reliance on internal controls**		**Analytical and other related substantive procedures**		**Materiality factor**	
Level	No.	Level	No.	Strength of evidence	No.	Value	No.
Low	20	High	20	Strong	20	Under 15	20
Medium	10	Medium	10	Moderate	10	15-27	10
High	0	None	0	Weak	0	Over 27	0

Assessed risk in the population

The assessed risk of material misstatement inherent in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

This assessed risk in the population will depend on the audit area and the particular assertion being tested.

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, eg, valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

Accounting estimates

Sampling techniques are unlikely to be utilised when testing accounting estimates, however certain accounting estimates such as depreciation / amortisation calculations may utilise a sampling approach. Care is needed here regarding clarity over the assertion(s) being tested The process for determining the risk assessment of accounting estimates differs from other aspects of the financial statements as it requires inherent risk and control risk to be considered separately.

The inherent risk assessment of an accounting estimate is assessed on a 'spectrum of risk' resulting in an assessment ranging between very low and very high. In order to be able to reflect how this method of assessing the risk inherent in an accounting estimate when determining a sample size for testing the approach should be as follows:

Inherent risk as assessed for an accounting estimate	Assessed risk in the population as used for determining a sample size
1 or 2	Low
3	Medium
4 or 5	High

Control risk is assessed using low / moderate / high and if there is no plan to test the operating effectiveness of controls then control risk is assessed as high.

Planned reliance on internal controls

Where we only confirm the design and implementation of control procedures, we cannot reduce the substantive test sample size for any reliance on controls.

Tests of operating effectiveness of internal controls are often designed to provide either a high or moderate level of reliance and therefore risk reduction.

- A high level of reliance (low level of risk remaining) applies where the primary evidence is coming from tests of controls.
- A medium level of reliance (medium level of risk remaining) applies where the tests of controls will be combined with other substantive procedures to address a particular assertion.

The type of controls being tested may influence the level of reliance to be placed on them. For example, a control applied to all items in the population is likely to provide a sounder basis for reliance than one only applied to certain types or sizes of transactions.

The extent to which we test controls for the planned level of reliance is a matter of professional judgement; however, in ascertaining an appropriate sample size for tests of controls we may use the tests of controls sampling form.

Analytical procedures and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg sales or debtors, or the population could be disaggregated into its component parts, eg different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may “take credit” for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

Materiality factor

The materiality factor is calculated as follows:

total value of population / materiality = materiality factor

The lower the resulting figure for the materiality factor the greater the reduction in sample size. Thus, not surprisingly, the larger the value of the residual population relative to materiality the greater the value of the materiality factor and the larger the final sample size will be.

Where a different specific audit area materiality is set on the B41 then this materiality rather than the overall materiality should be used to calculate any sample sizes for that particular area.

Minimum sample size

Small samples have an increased risk of being unrepresentative and unreliable. If the total population comprises a relatively small number of items, say fewer than 50 items, then alternative procedures should be considered in place of sampling. For example, this might include analytical procedures or a review for unusual items.

When the calculated sample results in a sample size of 15 items or fewer, then alternative audit procedures should be considered as outlined above. If these are not appropriate then the minimum sample size should be 15 items.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

19.3 Getting started for new manual users

Introduction

This 'Getting started' guidance will help you to use the Mercia Limited Liability Partnership (LLP) Manual. You may be a regular user of our products, or this may be the first time that you have used such a manual. Either way, these notes will help you understand the Mercia approach and how to maximise the benefits of the manual.

Guidance

You will find the following documents in this section of the LLP Manual:

- a contents page;
- guidance notes on the LLP sector;
- this getting started guidance for new manual users; and
- 'What’s changed', which provides a summary of the changes made to the manual in the most recent updates.

Audit approach

The Mercia approach encourages you to adopt a thinking, rather than a form filling, approach. This is achieved in two main ways:

- Through the use of permanent information. If something that you record is unlikely to change significantly from one year to the next, we believe it is better that this is recorded properly once and then rolled forward, updating where necessary, each year.
- By encouraging those completing audit work not to file surplus copy documentation, thus generating the need to sign off, date and evidence, as reviewed, the excess paperwork. Where additional paperwork is considered necessary, the system encourages you to file these on a non-audit section of the file.

The planning approach (the permanent file documents and section B within the current file documents)

The key to an effective audit is effective planning. The various steps to be undertaken at the planning stage (such as updating your knowledge of the client, calculating materiality, etc.) are driven by the planning checklist which is filed within the current file documents planning section.

There are different approaches to completing the planning documentation. For more straightforward assignments, as an alternative to completing many of the standard current planning forms, you may choose to adopt a 'free-form' planning memorandum.

In such cases, you may opt for the Mercia proforma free-form memorandum which must also be completed alongside the free-form memorandum planning checklist, and the other documents provided within this section, where required, to ensure you have covered all necessary matters.

Whilst completing the memorandum, you should read guidance provided on what is required in certain areas.

It is for the firm to decide the criteria as to when the free-form planning memorandum should be used to replace other standard forms. We recommend that such criteria include:

- the client has been audited by the firm for at least the immediate preceding period;
- there has been no history of controversial issues arising from the previous audits;
- the client is small, or contains characteristics indicative of a simple business as set out below.

The following characteristics may be indicative of a simple business:

- ownership is concentrated in a small number of individuals (sometimes a single individual) who are actively involved in managing the business; and
- the operations are uncomplicated with few sources of income and activities; and
- business processes and accounting systems are simple; and
- internal controls are relatively few and may be informal.

Such entities are likely to include LLPs which are exempt from audit, but which choose nonetheless to have a voluntary audit, as well as larger entities that are also relatively simple.

The fieldwork approach (sections C onwards within the current file documents)

Once the audit plan has been formed and tailored audit programmes have been produced (see the section named 'The structure of each audit section' within these notes), the audit evidence should be obtained in accordance with these programmes.

The completion approach (section A within the current file documents)

At the completion stage, the planning must be reviewed, alongside the evidence obtained, and all matters need to be drawn together and concluded upon. Completion of the appropriate forms on this section (including a full record of review points, notes of discussions with the client and evidence of clearance of all of these points) will help to achieve the required objectives.

Audit of group accounts

Where you are responsible for the audit opinion of group accounts, the manual contains alternative versions of the planning and completion documentation, as well as additional permanent file documents. This documentation should be used for the audit of the group accounts as it covers both the parent company and the group audit opinions.

Where you are also responsible for the audit opinion of one or more subsidiary companies, you should create standalone documentation, and not use the 'Audit of group accounts' documentation, for these companies and their individual audit files.

The current file

The current audit file provides the documentary record of the audit and constitutes the evidence of what was done and why. In conjunction with the permanent file, it supports the report on the financial statements.

The report not only consists of the opinion but also contains a statement that the audit has been carried out in accordance with auditing standards, thus the two files must demonstrate compliance with the International Standards on Auditing (ISA) (UK), the Ethical Standard and any other regulatory requirements.

The principal objectives of the current audit file are to provide:

- evidence of the planning process, including the risk assessment procedures, and any changes from the original plan;
- a record of the nature, timing and extent of auditing procedures undertaken, the results of such procedures and conclusions drawn;
- a record of the figures included in the financial statements and evidence supporting these figures;
- evidence of control and review;

- a record of problems encountered, weaknesses discovered, and any contentious issues raised and how they were resolved;
- a record of communications with the client relevant to the audit; and
- evidence of the opinion formed.

Because of the significance of the amendments resulting from the changes to ISAs 240 and 315 two versions of the documentation have been included: one for periods commencing before 15 December 2021 reflecting the previous ISA requirements and another for periods commencing on or after 15 December 2021 reflecting the new versions.

The permanent file

The principal purpose of the permanent file is to improve the efficiency of the assignment by providing a good understanding of the organisation. It is an intrinsic part of the audit assignment. Therefore, the permanent file must be comprehensive and up to date. Each year, the permanent file should be reviewed, updated and signed to evidence that this has been done.

The permanent file contains information of a permanent and semi-permanent nature, being information which will be of continuing importance to assignments over a number of years.

Although there is a standard index to the file, as with all aspects of an audit, the file should only contain mandatory information required to comply with auditing standards, and other legislation and regulation, along with information which will aid the efficiency of the audit. The content and form of the file is therefore likely to be different for each client and must be decided upon by the Responsible Individual and manager.

However, a permanent file will normally include the following information:

- information concerning the legal and organisational structure of the organisation, including information regarding related parties;
- extracts of important legal documents and agreements;
- any sector specific data;
- details of the accounting systems and internal control environment;
- an appraisal of those systems;
- a summary of key ratios and figures over a period of years; and
- accounts information of ongoing value.

The Mercia approach also encourages users to develop tailored audit programmes which can be held on the permanent file. If held on the permanent file, in future years these must be reviewed and, if necessary, updated as appropriate.

Because of the significance of the amendments resulting from the changes to ISAs 240 and 315 two versions of the documentation have been included: one for periods commencing before 15 December 2021 reflecting the previous ISA requirements and another for periods commencing on or after 15 December 2021 reflecting the new versions.

The structure of each audit section

Divider cards (see current file indexes within the current file documents)

The divider cards include recommended standard references for working papers, as well as the conclusions for each section of the audit file.

The audit conclusions should be signed by the person completing the work and should then be signed by the reviewer.

For non-audit assignments the conclusions are not needed. However, the divider cards and standard references may be useful.

Audit plan

Where individual audit sections have been planned separately using the standard individual area audit plans, a copy of the working paper can be placed on the planning section, the permanent file and / or the front of each section of the audit file (where it is filed behind the relevant lead schedule, as this helps to ensure that the section is audited in accordance with the plan).

The use of the individual area audit plan schedules also helps to focus the selection of appropriate audit programmes.

Audit programmes

The audit programme is very flexible and must be carefully tailored for each audit area at the planning stage.

We generally have a choice of sections as follows:

- A General and mandatory tests
- B Tests of controls
- C Non-audit services
- D Analytical procedures
- E Tests of detail (blank programme), or

- F Tests of detail (tailorable programme)

The only sections where this choice is not available are the Accounting Estimates (Q), Going Concern (R) and Subsequent Events (S) audit programmes. In programmes R and S, only the A section is available. For programme Q, this is a supplementary form which must be used where there are key accounting estimates. A separate Q programme is used for each individual key accounting estimate. For example, if there are three key accounting estimates documented in planning, then there would be three Q programmes. The Q programmes can either be filed in the Q section or with the relevant fieldwork for that key accounting estimates (eg. for a stock provision, it could be filed either at Q or in the G Stocks section).

Section A (General and mandatory tests)

This section is nearly always applicable, as this deals with general file completion issues in addition to mandatory ISA testing. Selecting section A will ensure that each programme generated has the correct heading and objectives at the top.

Also included in this section, where applicable, are:

- a prompt to record the risk assessment procedure confirming the design and implementation of key controls; and
- certain procedures mandated by the ISAs.

Section B (Tests of controls)

This section is a prompt to the tests required when assurance is to be placed on the effective operation, throughout the period, of one or more control procedures, as established on the individual area audit plans.

Section C (Non-audit services)

This section is useful when non-audit procedures (such as involvement in the compiling of numbers for the financial statements) are to be carried out and used as part of the audit evidence.

Section D (Analytical procedures)

This section is a menu of possible procedures that could be utilised to achieve the objectives.

Section E (Tests of detail (blank programme))

This section is a page highlighting the key audit assertions for the individual audit area. It should be used either:

- to record any additional tests for objectives not achieved by sections A to D above; or
- on a very low risk area, to record all the tests required for the section.

Section F (Tests of detail (tailorable programme))

This section can be used:

- to record the additional procedures for objectives not achieved by sections A to D above; or

- as the main audit programme for the individual audit area.

NB. If this section is selected, it is very likely that it will need to be tailored, with a number of the procedures crossed through or deleted.

Each individual section of the audit file has its own audit programme. The tailoring process takes place in two stages. Firstly, you should select which of the standard pages are appropriate. Once this decision has been made, further tailoring on a line by line basis is required to select / design the appropriate tests.

The four main areas are referenced consistently for each individual section. Using the sales / income and debtors section as an illustrative example:

- **H3 General and mandatory tests and tests of controls**
  This must be selected for nearly all audits as it ensures general and mandatory ISA tests are performed. The controls – operating effectiveness programme should be selected when some or all of the evidence is to be obtained from testing some or all of the operating effectiveness of controls.

- **H3 Non-audit services programme**
  This is the programme to select when some or all of the evidence is to be obtained from non-audit services, such as financial statements compilation.

- **H3 Analytical procedures**
  This is the programme to select when some or all of the evidence is to be obtained from analytical procedures.

- **H4 Blank additional programme**
  The programme to select either:

- to record any further tests on objectives not met by work planned on the above tests at H3; or

- to record all the tests required in a low risk area, when H3 are not selected.

These pages could be used in every section of a very low risk assignment.

- **H5 Bank of 'tests of detail'**
  This programme can be used in a variety of ways, for example:

- as the main programme; or

- as a reference document to select tests for recording on H4; or

- as an additional programme to H3.

Selecting appropriate audit programmes for each section is the answer to eliminating over auditing and improving efficiency.

Regardless of which audit programmes are selected as the starting point, individual tests must be added or deleted depending on the specific knowledge of the client.

All combinations and permutations of programmes are acceptable. It is extremely unlikely that all of the tests on any of the programmes will be necessary. This is particularly true of the 'bank of tests of detail' programme (H5).

19.4 What's changed

Update - September 2023

What's changed

We are pleased to issue updates to your Mercia LLPs Manual (dated 09/23).

The principal technical changes in this update include:

- The inclusion of group audit documents which incorporate changes in relation to ISA (UK) 600 *Special considerations - Audits of group financial statements (Including the work of component auditors)*;
- The introduction of a new (optional) statistical sampling approach; and
- The reconfiguring of the guidance notes.

In addition a number of other minor improvements and amendments have been made to the manual.

See below for a full list of changes.

ISA (UK) 600 Special considerations - Audits of group financial statements (Including the work of component auditors)

In September 2022, the FRC issued a revised ISA (UK) 600. The proposed revisions enhance the risk-based approach to undertaking a group audit and reinforce the need for robust communication and interactions between the group engagement team, group engagement partner and component auditors.

The revised ISA is effective for periods commencing on or after 15 December 2023, although the changes have been early adopted given certain requirements in relation to component auditors are already effectively in place due to the requirements of ISQM 1, and many of the other changes are considered good practice, with some firms already doing a lot of what the new requirements necessitate. An option has, however, been retained on the B30 Inherent and control risk assessment form for use where firms have decided not to early adopt the revisions.

New (optional) statistical sampling approach

A new (optional) statistical sampling approach has been added to sit alongside the extant judgemental sampling approach. For many audits the extant judgemental approach, particularly where populations are smaller, will remain appropriate, however it is not suitable for use on the audits of PIEs or other audits where populations are very large. As such a new statistical sampling approach which does not include a sample size cap has been added to the methodology for use on audits where the judgemental approach is not considered appropriate.

Guidance notes

A new set of guidance notes has been included to reflect the specific requirements of companies. These guidance notes supplement the contents of the Audit Procedures Manual (UK) which support the underlying methodology.

~~Exciting new feature~~

~~We have also developed tailoring and customisation tools to help you filter out the irrelevant parts of the Accounts disclosure checklists through a series of questions. These are available in the 'Customise' screen within the menu on the right.~~

~~By selecting 'Yes' to the question 'Would you like to tailor your accounts disclosure checklist through a series of questions?', you will then be asked a series of questions. Answering these subsequent questions will filter down the disclosure checklist so that only the checklists / sections you require will be shown / available to download / included within the checklist downloaded.~~

What's next

On 4 August 2023, the CCAB published an updated draft of its Statement of Recommended Practice Accounting by Limited Liability Partnerships (the LLP SORP).

Whilst a couple of the changes proposed are in response to recent changes to legislation or amendments to underlying standards, the majority are aimed at providing further guidance on particular issues arising when preparing the accounts of LLPs. The proposed changes are therefore not expected to have a significant impact on LLPs preparing their accounts in accordance with the LLP SORP, as the additional guidance should merely clarify existing treatment.

Comments are invited until 27 October 2023, after which time feedback will be considered before a revised LLP SORP is published. The draft proposes an effective date of periods commencing on or after 1 January 2024, with early adoption permitted. Following this, a further revision to the LLP SORP can then be expected during 2024 to reflect the changes to FRS 102 arising from the ongoing periodic review. We will update your LLPs Manual as soon as possible after the revised LLP SORP is published.

Contact us

We are always pleased to receive feedback on our manuals, including any improvements that you would like to see incorporated. Please contact me if you have any comments to make.

Andy Holton

September 2023

September 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
Guidance	
Contents	• Updated for the new Group documentation and to reflect the new Guidance notes structure.
Guidance notes	• The guidance notes have been reconfigured to make them more user friendly and to ensure a more consistent approach across the suite. • Appendix 3a to the guidance notes includes guidance on the new statistical sampling approach.
Getting started for new manual users	• The Accessing the manual section has been removed.
What s changed	• A copy of this What's changed notice has been added to the manual.
Example letters	
Audit engagements	
2 Engagement - covering letter (group)	• New document added.
3.2 Schedule of professional services - Audit (group)	• New document added.
9 Group audit instruction letter	• New document added which reflects revisions to ISA 600 and best practice updates.
10 Group audit questionnaire	• New document added which reflects revisions to ISA 600 and best practice updates.
Example reports	
6 Unqualified group audit report	• New document added.
Example accounts	
1 Small Full (FRS 102 1A) accounts	• Updated to state the accounts are based on standards and amendments in issue at 1 April 2023 (no technical changes to the content of the accounts).
1a Small Abridged (FRS 102 1A) accounts	• Updated to state the accounts are based on standards and amendments in issue at 1 April 2023 (no technical changes to the content of the accounts).
2 Not Small (FRS 102) accounts	• Updated to state the accounts are based on standards and amendments in issue at 1 April 2023 (no technical changes to the content of the accounts).
3 Micro-entity (FRS 105) accounts	• Updated to state the accounts are based on standards and amendments in issue at 1 April 2023 (no technical changes to the content of the accounts).
Accounts disclosure checklists	
A32 SUMMARY Disclosure checklist summary	• Updated to refer to new group supplementary disclosure checklists.
A32 SMALL FRS 102 1A	• Updated to state that the checklist reflects standards and amendments in issue as at 1 April 2023 (no technical changes to the content of the checklist).
A32 NOT SMALL FRS 102	• Updated to state that the checklist reflects standards and amendments in issue as at 1 April 2023 (no technical changes to the content of the checklist).
A32 MICRO FRS 105	• Updated to state that the checklist reflects standards and amendments in issue as at 1 April 2023 (no technical changes to the content of the checklist).
A34 FRS 102 1AG	• New checklist added.
A34 FRS 102G	• New checklist added.
Current file documents	
Current file indices	• Updated to reflect new documents.
A29 Reporting on irregularities, including fraud in the auditor's report (individual)	• An additional column has been added to enable comments to be cross referenced back to where the underlying work has been performed.

Completion - Group	• A new selection of forms added specifically for group engagements.
B05 Freeform planning memo (freeform)	• An additional row for Profit before tax has been added into the basis for determining materiality section.
B25 Materiality (individual)	• An additional row for Profit before tax has been added into the basis for determining materiality section.
CSF Controls sampling form (individual and freeform)	• Updated to new format (no substantive technical changes).
SSF Substantive sampling form - Judgemental (individual and freeform)	• Updated to new format including more space to justify sample sizes.
SSF Substantive sampling form - Statistical (individual and freeform)	• New form for use with the new statistical sampling approach.
Planning (detailed) - Group	• A new selection of forms added specifically for group engagements.
P Audit programme - Intra group balances, transactions and consolidations	• Expanded to include work in respect of group audits.
Permanent file documents	
Permanent file indices	• Updated to reflect new documents.
PF1-5 Groups	• New document added.
PF1-7 Using the work of an expert	• Auditor's expert section expanded.
PF1-9 Component auditors	• New document added.

Update - March 2023

What's changed

We are pleased to issue updates to your Mercia LLPs Manual (dated 03/23).

The principal technical changes in this update include the removal of content relating to the now superseded ISQCs and consequential amendments arising as a result of this. The LLPs Manual, together with the Audit Procedures Manual, address engagement level quality management, with the Quality Management Manual addressing firm wide requirements.

In addition a number of minor amendments / improvements have been made to other sections of the LLPs Manual, including updating engagement letters to reflect latest guidance.

See below for a full list of changes.

Contact us

We are always pleased to receive feedback on our manuals, including any improvements that you would like to see incorporated. Please contact me if you have any comments to make.

Andy Holton

March 2023

March 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
Guidance	
What's changed	• A copy of this What's changed notice has been added to the manual.
Example letters	
Engagement – Covering letter (Audit and non-audit engagements)	• Updated the 'professional services provided' section to include a new paragraph which confirms whether disbursements are expected to be incurred. • A new section detailing how communication will be maintained throughout the engagement has been added. • Updated the 'agreement of terms' section to include reference to the firm's privacy notice on their website and reference to the standard terms of business in relation to instances of variation or termination of the engagement.
Schedule of professional services – audit (Audit engagements)	• Moved the paragraph highlighted the client's responsibility towards publishing electronic information from the 'Scope of audit' section to the 'Your responsibilities' section. • Added an optional paragraph in the 'Our responsibilities' section highlighting that the auditors have a statutory requirement to communicate with the group auditor. • Included a paragraph in 'Our responsibilities' confirming that the client is to be informed should matters or significant facts arise that may raise ethical concerns. • A paragraph was added to the 'Scope of audit' section explaining that the auditors may also use analytical tools in their work.
Schedule of professional services – compilation (Non-audit engagements)	• An optional paragraph has been included where clients have asked firms to convert the financial statements into the iXBRL format. • Clarification has been included to inform clients that, consent must be received from the firm, should they want to share the report with any third parties.
Schedule of professional services - micro-entity compilation (Non-audit engagements)	• An optional paragraph has been included where clients have asked firms to convert the financial statements into the iXBRL format. • Clarification has been included to inform clients that, consent must be received from the firm, should they want to share the report with any third parties.

Schedule of professional services - LLP taxation (Audit and non-audit engagements)	• Included a paragraph confirming there may be occasions where the firm will need to seek specialist advice. • Added a paragraph confirming that the responsibility for monitoring turnover in respect of VAT registration thresholds lies with the client. • Clarification that the responsibility for employment taxes, pensions and the assessment of employment status for workers, lies with the client has also been included.
Engagement - terms of business (Audit and non-audit engagements)	• Updated paragraphs in the 'Fees and payment terms' section clarifying the use of insurance policies to cover fees, circumstances where clients are unable to pay fees and the rights of the firm to exercise a lien over all funds have also been added. • Added a new section detailing standard business terms in relation to confidentiality. • Clarification of potentials actions of the firm, should a dispute arise between parties within the engagement.

Example reports

3 Statement of members' responsibilities	• Clarified that the reference to material departures is only required where there are any such departures.

Current file documents

Current file indices (both p/c before and on or after 15 Dec 21)	• Updated to more accurately reflect naming of A21-1, A21-2, A21-3 and B03/B14.
A21-2 Engagement quality review checklist (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
A21-2 Engagement quality review checklist (p/c before 15 Dec 21)	• Updated to ISQM version of form.
A21-3 Consultation review (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
A21-3 Consultation review (p/c before 15 Dec 21)	• Updated to ISQM version of form.
A22 Overall review of the financial statements (p/c on or after 15 Dec 21)	• Additional bullet 'requirements for and of a statement of cash flows' added to Q21.
A31 Audit completion checklist (p/c on or after 15 Dec 21)	• References to ISA (UK) 240 updated to reflect the FRC's reissued ISA which includes corrected numbering aligned to the international version.
A46 Fraud update and evaluation (p/c on or after 15 Dec 21)	• References to ISA (UK) 240 updated to reflect the FRC's reissued ISA which includes corrected numbering aligned to the international version.
B03 Preliminary engagement quality review (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
B10 Engagement review (p/c on or after 15 Dec 21)	• Under the 'New client checklist' heading, the wording has been updated from "We have completed B13..." to "We have completed / reviewed B13..." to reflect the fact that relevant matters should also be identified in future years when the client is not new.
B14 Preliminary engagement quality review (p/c before 15 Dec 21)	• Updated to ISQM version of form.

B32A-E Key accounting estimate (individual and freeform) (p/c on or after 15 Dec 21)	• Updated wording of the key assertions relevant to the accounting estimate which may be selected for clarity.
Audit exemption documents: Completion:	
A21 Audit exemption completion checklist, partner review and conclusion	• A new test has been added within the 'Completion checklist' section prompting consideration of matters which appear to indicate the financial statements may be misleading.
A22 Audit exemption overall review of the financial statements	• New tests have been added under the heading 'General' prompting reviews in respect of accounting policies, consideration of information contained in other documents issued with the accounts (including the directors' report and strategic report), etc.
Audit exemption documents: Planning:	
B40-FRF Change of financial reporting framework impact assessment	• A new document has been added to assist in assessing the impact of a change of financial reporting framework (FRF).
B13 New client checklist	• The checklist has been expanded to include a number of general factors when taking on a new client as well as space to record agreed action points.
Audit exemption documents: Detailed work programme:	
All	• Tests have been added and other minor amendments made to bring the work programmes in line with other manuals.
C2 taxation	• Minor amendments to corporation tax section to ensure it is kept up to date.
O2 VAT	• Minor amendments to ensure terminology is kept up to date.

Permanent file documents

PF1-2 The applicable financial reporting framework	• Additional bullet 'Requirements for a statement of cash flows' added.
PF5 Permanent audit planning documentation (both p/c before and on or after 15 Dec 21)	• Additional table added to list engagement team members each year if desired.

20 Charity manual

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20.2 Guidance notes

1 Introduction

1.1 Scope

This manual provides you with all the programmes, documents and guidance needed to undertake the audit of a UK charity under the International Standards on Auditing (ISAs) (UK) and the FRC Ethical Standard.

The manual is suitable for audits of groups as well as standalone entities.

1.1.1 Specialist Assignment Manuals (SAMs)

Where an entity is a charity of a more specialist nature, or is not a charity, a Specialist Assignment Manual (SAM) specifically designed for that type of entity should be used, or in some cases it may be appropriate to tailor this manual to meet the specialist requirements of the entity concerned.

In addition to the Audit Manual (UK) dealing with the audit of companies Mercia provides a wide range of SAMs including:

- Academies;
- ~~Clubs (GB);~~
- ~~Clubs (NI);~~
- Limited Liability Partnerships (LLPs);
- Pension Schemes;
- ~~Registered Social Housing Providers RSHPs; and~~
- ~~Societies and Community Interest Companies (CICs)*.~~

~~** This is a supplementary manual designed to be used in conjunction with the Audit Manual (UK).*~~

1.1.2 Exclusions

Additional requirements over and above those addressed in these guidance notes may also apply to charities operating in specialised sectors.

1.1.3 Quality management

Forms relevant to ensuring quality at the engagement level are included within this manual, with firm wide quality management aspects addressed in the Quality Management Manual (UK) which is available to purchase separately.

1.2 What else is needed?

You should have access to the Audit Procedures Manual (UK), included as part of the Audit Manual Package (UK) or available to purchase separately, which contains supporting audit methodology and guidance.

You will also need access to the applicable versions of the following:

- For company charities:
  - The Companies Act 2006;
  - SI 2008/409 The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008; and
  - SI 2008/410 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008;
- For English and Welsh charities:
  - The Charities Act 2011;
  - The Charities Act 2022;
  - SI 2008/629 The Charities (Accounts and Reports) Regulations 2008; and
  - Guidance from the Charity Commission (CC);
- For Scottish Charities;
  - The Charities and Trustee Investment (Scotland Act) 2005;
  - SI 2006/218 The Charities Accounts (Scotland) Regulations 2006; and
  - Guidance from the Scottish Charity Regulator (OSCR);
- For Northern Irish Charities:
  - The Charities Act (Northern Ireland) 2008;
  - The Charities Act (Northern Ireland) 2022;
  - SI 2015/384 The Charities (Accounts and Reports) Regulations (Northern Ireland) 2015; and
  - Guidance from the Charity Commission for Northern Ireland (CCNI).

2 Sector overview

2.1 Legal and Regulatory Framework

2.1.1 England and Wales

All charities in England and Wales are governed by the Charities Act 2011 (CA11). CA11 requires most charities (see the exceptions below) to register with the regulator; the Charity Commission (CC). Most registered charities (again see below for the thresholds) have to lodge information, including accounts with the CC.

CA11 was a consolidating Act. It repealed and replaced the Recreational Charities Act 1958 (as it affects charities in England and Wales), the Charities Act 1993 and the provisions of the Charities Act 2006 (other than the legislation on public collections). The Charities (Accounts and Reports) Regulations 2008 were not, however, consolidated into the CA11 and therefore remain applicable. Legislation, such as the Charities (Protection and Social Investment) Act 2016 and the Charities Act 2022, have made subsequent amendments to CA11. The Charities Act 2022 made changes to a number of administrative matters for charities, aspects of which are still being implemented by the CC - it did not, however, make any fundamental changes to accounting and reporting requirements.

2.1.2 Scotland

Scottish charities are governed by the Charities and Trustee Investment (Scotland) Act 2005 (CTISA05), together with the Charities Accounts (Scotland) Regulations 2006, which are amended from time to time.

There is a legal requirement for all charities in Scotland to register with the Office of the Scottish Charity Regulator (OSCR).

2.1.3 Northern Ireland

The Charities (Accounts and Reports) Regulations (Northern Ireland) 2015 were finalised on 30 November 2015 and came into force for registered charities with financial years beginning on or after 1 January 2016 (or the date of registration with CCNI if later).

In addition to the accounting regulations, a number of areas of the Charities Act (Northern Ireland) 2008 also came into effect with a commencement date of 1 January 2016, and the Charities Act (Northern Ireland) 2022 came into force on 30 March 2022.

The Charity Commission for Northern Ireland (CCNI) is responsible for the registration and monitoring of charities (previously the Charities Branch of the Voluntary and Community Unit of the Department for Social Development). As the CCNI is managing registration in stages, expected to take a number of years, only organisations which have been called forward by the CCNI, and have received an application password, will be able to apply to register as a charity at present.

2.1.4 Cross border charities

Generally a charity based in England and Wales or Northern Ireland which also acts as a charity in Scotland will need to register not only with the CC / CCNI but also with OSCR. The only exception is where the cross border charity does not carry out any substantive activity in Scotland. Where registration is required with both the CC / CCNI and OSCR there will be dual regulation. If the charity is primarily based in England and Wales or Northern Ireland, then OSCR is likely to be the ‘host’ regulator and the CC / CCNI is likely to be the ‘lead’ regulator. OSCR implemented a bespoke monitoring regime for cross border charities in May 2009.

Registration with OSCR requires the completion of an application form and a trustee declaration form.

Accounts of cross border charities will need to be in line with not only the Charities Act 2011 / Charities Act (Northern Ireland) 2008 but also Scottish legislation, including its regulations. However, OSCR does not require a separate set of accounts to be produced in addition to those compiled in line with England and Welsh or Northern Ireland charity legislation for the CC / CCNI. As such, it is common for one set of accounts to be produced which complies with both Scottish and English and Welsh or Northern Irish legislation. Careful consideration is required here as cross border charities must ensure that they are familiar with the requirements for trustee remuneration under both England and Wales or Northern Ireland legislation and Scottish legislation as there are slightly different rules. Fundraising for benevolent bodies is also different in Scotland compared to England and Wales. The OSCR publication on cross border charity regulation in Scotland details these differences.

Changes to the audit exemption limits for charities in England and Wales became effective for financial years ending on or after 31 March 2015 which increased the income threshold from £500,000 to £1,000,000. From this date there are different audit exemption thresholds across England and Wales and Scotland. This will need to be considered when dealing with cross border charities. The rules governing both jurisdictions must always be abided by, and in practical terms this means the Scottish audit exemption thresholds will need to be applied as these are the most stringent. NB. The audit exemption thresholds for Northern Ireland and Scotland are broadly the same as the income threshold is set at £500,000.

2.2 Governing documents

A charity's governing document(s) will set out:

- its charitable purpose / objects;
- what it can do to carry out its purposes (i.e. powers);
- who runs it;
- how meetings will be held and how trustees will be appointed;
- any rules around paying trustees, investments and holding land;
- whether the trustees can change the governing document, including its charitable objects; and
- how to close the charity.

The exact governing document(s) will depend on the charity's legal structure. The main governing document will usually be a charity's constitution, trust deed / will, or articles of association (for charitable companies).

Templates for governing documents are available from each of the charity regulators which may be used as a starting point.

Care should be taken to review the governing document(s) carefully as they may necessitate an audit (even where an exemption might otherwise be claimed), or could have other implications such as prohibiting certain transactions, or requiring certain processes or procedures to be followed.

2.3 Types of charity and registration requirements

There are three main types of charity:

- Corporate charities (those which are companies and are subject to company law in addition to charity law);
- Charities incorporated under charity law (e.g. Charitable Incorporated Organisations (CIOs) or

Scottish Charitable Incorporated Organisations (SCIOs), which are subject to charity law but not company law);

- Unincorporated charities (e.g. a charitable trust or charitable association).

Each of the charity regulators has different requirements with regard to the need for charities to register with them, as set out in the subsections below.

Charitable Incorporated Organisations (CIOs) and Scottish Charitable Incorporated Organisations (SCIOs)

A CIO/SCIO is an incorporated form of charity which is an alternative to a limited company. A CIO/SCIO only has to register with the CC in England and Wales, OSCR in Scotland or both if a cross border charity. It does not register with Companies House. At the date of publication of this manual, the framework for CIOs in Northern Ireland is not yet effective as that section of the Charities Act (Northern Ireland) 2008 is not yet in force.

The main benefit with SCIOs and CIOs is that the members and trustees are usually personally safeguarded from the financial liabilities of the charity and the charity has its own legal personality which means that the trustees do not have to take out contracts in their own names.

Special case charities

These are defined in The Charities (Accounts and Reports) Regulations 2008 for England and Wales, The Charities (Accounts and Reports) Regulations (Northern Ireland) 2015 for Northern Ireland and The Charities Accounts (Scotland) Regulations 2006 for Scotland. These are made up of charities which are further and higher education institutions or registered social landlords, as defined by the relevant jurisdictional regulations.

The SORP to be applied in the case of a housing association is the current version of the Housing SORP: Statement of Recommended Practice for registered social housing providers issued by the National Housing Federation. The SORP to be applied in the case or a further education or higher education institution is the current version of the Statement of Recommended Practice: Accounting for further and higher education issued by the Further and Higher Education SORP Board. These SORPs are not supported in this manual.

England and Wales

Charities in England and Wales must apply to register with the CC when their gross income is over £5,000 unless they are:

- a Charitable Incorporated Organisation (CIO). CIOs must register with the CC irrespective of their income;
- an exempt charity; or
- an excepted charity with gross income not exceeding £100,000.

The CC does not register charities with an income of less than £5,000. This is purely to reduce the red tape on smaller charities. These charities will still receive all the benefits of charitable status and can apply directly to HM Revenue and Customs (HMRC) for tax relief. Like a registered charity number, an HMRC charity number will generally be accepted by banks and grant funders as evidence of charitable status.

Charities are expected to only register once it is expected that their income will remain above £5,000. For example, the CC would not expect an application to register if a charity received a one-off gift of £5,500 and spends this on its charitable work in the year it was given.

Exempt charities

Exempt charities cannot register with the CC. They must comply with general charity law including the requirement to maintain books and records and prepare accounts, and the SORP is still applicable. However, there is no requirement to file such accounts with the CC. Exempt charities include certain universities, academies, and various other institutions.

Excepted charities

Excepted charities are not required to register with the CC but may choose to do so. Even if they do not register, they are under the CC's supervision who can instigate an investigation if there is a cause for concern.

Examples of excepted charities are those with income of £100,000 or less falling within the following categories:

- funds, not permanent endowments, accumulated for the purposes of local units of the Scout and Guide Associations;
- churches and chapels of some Christian denominations;
- charitable service funds of the armed forces;
- student unions; and
- charities that provide premises for some types of schools.

In practice, some of these charities' income is below £5,000, the normal threshold for registration, so they wouldn't have to register anyway.

Provided that an excepted charity does not choose to register, it is not required by law to prepare an annual report, although the CC recommends that one is prepared as best practice. Accounts must be prepared in the same way as a registered charity with the same income levels or constitution (company or unincorporated). Accounts must be made available to the public on request but do not need to be sent to the CC, unless specifically requested. If accruals accounts are either required (eg. for limited company charities), or are chosen to be produced, then they must follow the requirements of the SORP (and thus will need to include a Statement of Financial Activities).

The scrutiny requirements for an excepted charity are the same as for other charities, ie. an independent examination or audit is required when income is over £25,000. External scrutiny is also needed if the charity's governing document requires it.

If an excepted charity chooses to register with the CC, it needs to comply in full with the requirements of the Act ie. to submit to the CC an annual report, etc.

Scotland

There is a legal requirement for all charities in Scotland to register with the Office of the Scottish Charity Regulator (OSCR).

Northern Ireland

An charity must apply for registration as a charity in Northern Ireland, regardless of its income, size or whether or not it has received charitable tax status from HMRC, if:

- it has exclusively charitable purposes;
- it is governed by the law of Northern Ireland;

- it is an institution, that is, it is an organisation that is an independent body, the hallmarks of which include having control and direction over its governance and resources.

Registration is relatively new in Northern Ireland, and as CCNI is managing registration in stages, only organisations which have been called forward by CCNI, and have received an application password, will be able to apply to register as a charity at present.

Registered charities need to provide information on their activities, governance and finances and submit their accounts and report to the CCNI on an annual basis.

2.4 Charity size

A charity will be deemed to be a large / larger charity if its gross income is in excess of £500,000.

If the charity is also a company, consideration must also be given to the company (and group's) size, as applicable under the Companies Act 2006.

It's important to understand a charity's size as this can affect accounting, reporting and scrutiny requirements.

3 Accounting and reporting

3.1 Preparation of accounts

All charities must prepare accounts for each financial year, although the form and content will vary depending on the size and type of the charity. The trustees are responsible for the preparation of the accounts.

Depending on the size and type of the charity, accounts may be:

- Accruals accounts prepared in accordance with the Charities SORP (FRS 102); or

- Receipts and payments accounts.

3.1.1 Charitable companies

Charitable companies (usually companies limited by guarantee) are subject to the accounting and reporting requirements of the Companies Act 2006. This means that the accounts must be accruals accounts prepared in accordance with the Act, but will also need to adhere to the requirements of the Charities SORP (FRS 102).

3.1.1.1 England and Wales

The financial statements of charitable companies are required to show a true and fair view and therefore they must adopt the accruals accounts method. Charitable company financial statements are prepared using the Companies Act 2006 and applicable regulations and not the Charities Act 2011. For the form and content of their financial statements, the Charities (Accounts and Reports) Regulations 2008 are not applied to a charitable company, although these regulations do set out the disclosure requirements for the Trustees' Report. Charitable companies use the SORP as recommended best practice but there is no 'legal' requirement to use the SORP.

Groups

In addition to the above requirements:

Category	Accounting requirement
Group income* ≤ £1,000,000 and a small company group	No consolidated accounts
If not the above	Consolidated accounts to be prepared

** Group income is post consolidation adjustments.*

3.1.1.2 Scotland

The financial statements of charitable companies are required to show a true and fair view and therefore they must adopt the accruals accounts method. Charitable company financial statements are prepared using the Companies Act 2006 and its applicable regulations and the Charities and Trustee Investment (Scotland) Act 2005 and its applicable regulations. The Charities Accounts (Scotland) Regulations 2006 require charities preparing accruals accounts to prepare their financial statements in accordance with the SORP.

Groups

In addition to the above requirements:

Category	Accounting requirement
Group income* < £500,000 and a small company group	No consolidated accounts
If not the above	Consolidated accounts to be prepared

** Group income is post consolidation adjustments.*

3.1.1.3 Northern Ireland

The financial statements of charitable companies are required to show a true and fair view and therefore they must adopt the accruals accounts method. Charitable company financial statements are prepared using the Companies Act 2006 and applicable regulations and not the Charities Act (Northern Ireland) 2008. For the form and content of their financial statements the Charities (Accounts and Reports) Regulations (Northern Ireland) 2015 are not applied to a charitable company although these regulations do set out the disclosure requirements for the Trustees' Report. Charitable companies use the SORP as recommended best practice but there is no 'legal' requirement to use the SORP.

Groups

In addition to the above requirements:

Category	Accounting requirement
Group income* < £500,000 and a small company group	No consolidated accounts
If not the above	Consolidated accounts to be prepared

** Group income is post consolidation adjustments.*

3.1.1.4 Northern Ireland

The financial statements of charitable companies are required to show a true and fair view and therefore they must adopt the accruals accounts method. Charitable company financial statements are prepared using the Companies Act 2006 and applicable regulations and not the Charities Act (Northern Ireland) 2008. For the form and content of their financial statements the Charities (Accounts and Reports) Regulations (Northern Ireland) 2015 are not applied to a charitable company although these regulations do set out the disclosure requirements for the Trustees' Report. Charitable companies use the SORP as recommended best practice but there is no ‘legal’ requirement to use the SORP.

3.1.2 Non-company charities

As with limited company charities, the rules for unincorporated charities and CIOs/SCIOs vary throughout the UK. At the date of publication of this manual, the framework for CIOs in Northern Ireland is not yet effective.

3.1.2.1 England and Wales

There are regulations issued under Part 8 of the CA11 which set out the requirements for unincorporated charities and CIOs. The key regulations are explained below:

Category	Accounting requirement
Gross income ≤ £250,000	Either receipts and payments accounts or full accruals accounts
Gross income > £250,000	Full accruals accounts

When preparing accruals accounts for non-company charities they must be prepared using the Charities Act 2011 and its applicable regulations. At the time of going to print, The Charities (Accounts and Reports) Regulations 2008 still requires accruals accounts to be prepared in accordance with the SORP (2005). The SORP 2005 is however based on ‘Old UK GAAP’ and this means an inconsistency between the 2008 Regulations and accounting standards for periods beginning on or after 1 January 2015 until The Charities (Accounts and Reports) Regulations 2008 are updated.

The CC's view on this inconsistency is that the requirement to prepare accounts that show a ‘true and fair’ view will take precedence and therefore it is possible to apply the applicable SORP for periods commencing on or after 1 January 2015 even though the 2008 Regulations have not been updated. The CC recommend that this is clearly stated in the notes to the financial statements.

See example accounts section for example wording in the SORP proforma accounts and this is included in the relevant disclosure checklists.

3.1.2.2 Scotland

In Scotland, the accounting requirements for unincorporated charities and SCIOs are set out in the Charities Accounts (Scotland) Regulations 2006. These include the following limits:

Category	Accounting requirement
Gross income < £250,000	Receipts and payments accounts unless the trustees have elected to prepare full accruals accounts
Gross income ≥ £250,000	Full accruals accounts

When preparing accruals accounts for non company charities they are prepared using the Charities and Trustee Investment (Scotland) Act 2005 and its applicable regulations. The Charities Accounts (Scotland) Amendment Regulations 2014 require all charities to prepare their financial statements in accordance with the SORP 2019 for periods commencing on or after 1 January 2019.

3.1.2.3 Northern Ireland

There are regulations issued under Part 8 of the CA08 which set out the requirements for unincorporated charities. The key regulations are explained below:

Category	Accounting requirement
Gross income ≤ £250,000	Either receipts and payments accounts or full accruals accounts
Gross income > £250,000	Full accruals accounts

When preparing accruals accounts for non company charities they must be prepared using the Charities Act (Northern Ireland) 2008 and its applicable regulations. The Charities (Accounts and Reports) Regulations (Northern Ireland) 2015 require accruals accounts to be prepared in accordance with the SORP.

3.1.3 Accruals accounts

3.1.3.1 The Charities SORP

Where a charity prepares accruals accounts, they will need to be prepared in accordance with Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland (the Charities SORP (FRS 102)) effective 1 January 2019.

Statements of Recommended Practice (SORPs) are sector-driven recommendations on financial reporting for specialised industries, sectors or areas of work which supplement Financial Reporting Council (FRC) standards and other legal and regulatory requirements in light of special factors prevailing or transactions undertaken in that particular industry, sector or area of work that are not addressed in the FRC standards. SORPs also address matters that are addressed in FRC standards, but about which additional guidance is considered necessary.

Except where an alternative reporting framework sets out in legislation or regulation, or if another SORP applies, the accounting recommendations of the Charities SORP apply to all charities in the UK that prepare accounts on the accruals basis to give a true and fair view of a charity's financial position and financial activities regardless of their size, constitution or complexity. Company charities will also need to adhere to the requirements of the Companies Act 2006.

Certain types of charity may, however, be required to prepare their accounts in accordance with a different SORP (e.g. registered providers of social housing follow the Housing SORP). Additionally, certain types of charity may also be required to adhere to additional requirements or directions (such as Academies which adhere to the Academy Accounts Direction - a separate manual, the Academies Manual is available for Academies).

The CC / OSCR / CCNI may use non-compliance with the SORP as grounds for commencing an investigation into the charity. In addition they warn that non-compliance may be taken into account in assessing the trustees' responsibilities in subsequent difficulties.

Accounts complying with the SORP should comprise:

- a statement of financial activities (SoFA);
- a separate income and expenditure account (if required - see below);
- a balance sheet;
- a statement of cash flows (small charities, which are defined as those with income under £500,000, may exclude a statement of cash flows); and
- such notes as required by the SORP and Regulations.

These notes do not explain the full contents of the SORPs but some of the most important matters are considered below.

The SORP Committee has published a number of Information Sheets providing guidance on the application of the SORP. Information sheets do not form part of the SORP but are freely available.

Where the SORP is silent on a matter, the requirements of accounting standard (FRS 102) must be followed.

3.1.3.2 Fund accounting

Charities must observe basic rules of fund accounting in preparing their accounts.

In particular, the accounts should differentiate between restricted and unrestricted funds, grouping similar types of fund together if appropriate.

Funds may be classified into:

- Endowment
    - Permanent
    - Expendable
- Restricted
    - by donor
    - appeal related
- Unrestricted
    - may include Designated funds, ie. funds set aside by the trustees for a specific purpose.

Any Gift Aid amount recovered on a donation forms part of that gift and is an addition to the same fund as the original donation unless the donor specifies otherwise.

Restricted funds - are where the charity receives money that is earmarked either by the donor or by the terms of an appeal for particular projects. Such projects represent restricted funds requiring separate accounting. Depending on the materiality of each, the accounts should group the restricted funds under one or more headings.

As a minimum, capital funds must be distinguished from income funds. The columnar format of the Statement of Financial Activities (SoFA) is designed to achieve this.

Any funds in deficit should always be separately disclosed, and a reference made to this matter. An explanation should be given in the Trustees' Annual Report.

Endowment funds - are funds which have been given to a charity subject to the restriction that they are to be held as capital.

The initial gift and subsequent increases and decreases in the amount of any endowment funds should be distinguished in the SoFA as part of those funds.

The notes to the accounts should disclose how such funds have arisen and should analyse the endowment funds between permanent endowment (which cannot be applied as income for the purposes for which the endowment was given) and expendable endowment (which may, at the discretion of the trustees, be applied as income for those purposes) as well as identifying any major individual funds among them.

All income derived from assets held in an endowment fund should be included in the SoFA.

If the application of the income is restricted to a particular purpose the income and expenditure should be appropriately identified in the restricted fund. Any such income not spent at the year end should be carried forward as a restricted fund.

3.1.3.3 Statement of Financial Activities (SoFA)

The overall objective of the SoFA is to show the resources receivable and expended by the charity in the year on all its funds.

The SoFA is structured into broadly five sections:

A Income

B Expenditure

C Transfers between funds

D Other recognised gains/losses

E Reconciliation of funds

Net gains / losses on investments are presented between 'Expenditure' and 'Transfers'.

Income - All income becoming available to the charity during the year should be summarised in the first section, distinguishing between those belonging to the charity's unrestricted funds, its restricted income funds and its endowment funds.

The value of all resources - both for income and endowment funds - accruing to the charity should be recorded in the SoFA as soon as it is *prudent and practicable* to do so. In all cases incoming resources should not be recognised until the conditions for receipt have been met and there is reasonable assurance of receipt. Income recognition will be dependent on the following three factors being met:

- **entitlement** - normally arises when a particular resource is receivable or the charity's right to it becomes legally enforceable;
- **probable** - it is more likely than not that the economic benefits associated with the transaction or gift will flow to the charity;
- **measurement** - when the monetary value of the incoming resource can be measured with sufficient reliability.

All incoming resources should be reported gross whether raised by the charity or its agents. Netting off expenditure against income is only allowable for small fundraising events where it will not materially understate the gross incoming resources and gross resources expended for the event. However, in no circumstances should the charity's own staff costs be netted off against the proceeds of any such events when reported in the accounts.

Income should be analysed into the following categories (where appropriate):

- donations and legacies;
- charitable activities;
- other trading activities;
- investments;
- other incoming resources (eg. net gains on disposals of fixed assets for use by the charity);
- the total by column of the above resources arising in the year.

Income should be further distinguished by fund type. In the notes to the financial statements, endowment fund incoming resources should be analysed between permanent endowment and expendable endowment.

Expenditure - In the next section of the SoFA, all items should be analysed as follows:

- raising funds:
- charitable activities;
- other;
- the total by column of the above resources expended in the year.

Expenditure should be further distinguished by fund type.

Transfers - all transfers between the different classes of funds should be shown (These should not be netted off, but should be shown gross, with supporting explanations in the notes) and must net to nil.

As noted above, gains and losses on investments under the SORP are presented above net income / expenditure and not below.

Each column of the SoFA needs to be totalled to show the net movement in the charity's funds for the year.

The SoFA thus contains a summary of the movements on all of the funds held or operated by the charity. If it has a number of funds, the SoFA should show, in columnar form, the movements in the main different types of funds (unrestricted, restricted income, and endowment) as well as the total movements.

Under the SORP the comparatives are required for all items (eg. broken down by fund). This can be done either on the face of the SoFA or in the notes to the accounts.

Movements in all the material underlying funds should be analysed in the notes to the accounts, using the headings from, and reconciling with, the main SoFA.

Under the SORP the SoFA would then comprise two parts, (which should be appropriately sub-titled):

h. the account of income and expenditure for the year, terminating in: "net income / expenditure for the year"; and
i. the statement of comprehensive income for the year comprising "net income / expenditure" - as a single line - and the amounts of any revaluation gains or losses, resulting in "net movement in funds for the year".

In a case where (as only occasionally happens) the charity has discontinued any of its operations or acquired new ones, the first part of the SoFA should also distinguish between continuing, discontinued and acquired operations, in order to comply with FRS 102.

Reconciliation of funds - The net movement for the year of the charity's funds shown in the SoFA should then be reconciled to the total funds as shown in the Balance Sheet, as follows:

- net movement in funds for the year;
- total funds brought forward;
- total funds carried forward.

3.1.3.4 Summary Income and Expenditure Account

In order to comply with the accounting and reporting standards the accounts of certain charities (see below) must include a statement of income and expenditure for the year and, where consolidated accounts are prepared, for the group, in the required format.

This should take the form of a Summary Income and Expenditure Account derived from, and cross-referenced to, the corresponding figures in the SoFA.

The Summary need not distinguish between unrestricted and restricted income funds, but should show separately in respect of continuing operations, acquisitions and discontinued operations:

- income excluding endowments (can be analysed in further detail);
- net gains / losses from investments;
- interest and investment income (or can be disclosed in the notes);
- total income (this will be the total of all incoming resources - of all the income funds but not for any endowment funds);
- expenditure (can be analysed in further detail);
- interest payable (or can be disclosed in the notes);
- depreciation and impairment charges for fixed assets (or can be disclosed in the notes);
- total expenditure out of the charity's income funds;
- net income or expenditure for the year;
- if relevant any tax payable and net income or expenditure after tax.

A Summary Income and Expenditure Account is required as follows:

- never required for an unincorporated charity, CIO or SCIO;
- always required for a charitable company with movements on an endowment fund - the Companies Act does not permit capital to be taken to income and expenditure account;
- possibly for other incorporated charities.

Limited company charities

The Companies Act requires a statement showing all the realised gains and losses for the year. The question is, therefore, whether the statement of other comprehensive income, which is included in the SoFA, means that a separate Income and Expenditure Account is required. The SORP suggests this is not the case provided the SoFA is amended so that:

- the title clearly indicates that it includes an income and expenditure account and statement of total recognised gains and losses (if required); and
- there is a prominent sub-total entitled "net income / (expenditure) for the year" which replaces or is in addition to the heading of "net incoming / (outgoing) resources for the year".

3.1.3.5 Balance Sheet

Much of the balance sheet is similar to that of a normal company. The key points to note are:

Funds - These should be grouped together in the balance sheet according to their type, distinguishing between unrestricted, restricted income and endowment funds.

Fixed assets - These should be sub-divided between intangible assets, tangible assets, heritage assets and investments.

- All fixed assets should be capitalised (included donated assets) except where:
  - o the asset is a heritage asset (eg. ancient monument, historic building), or;
  - o in exceptional circumstances it is not practical to obtain a valuation.
- Fixed assets should be distinguished between assets for the charity's use (whether intangible, tangible or heritage) and investment assets.
- Assets for own use can be carried at cost or valuation in accordance with the normal rules.
- Investments must be carried at fair value or the trustees' best estimate of market value.

At the end of a financial year, the charity must assess whether there is any indication that an asset may be impaired. If there is no indication of impairment, then it is not necessary to estimate the recoverable amount whilst if there is an indication that an asset is impaired, then its recoverable amount must be estimated (higher of fair value less costs to sell and its value in use). Its value in use can be calculated using the present value of its cash flow if the assets generates a commercial return otherwise the present value of the assets service potential would be used (eg. for a specialist building then depreciated replacement cost would be a suitable method). An impairment loss must be recognised if, and only if, the recoverable amount of an asset is less than its carrying amount.

Indicators of impairment include:

- a significant decline in an asset's market value;
- significant changes in technology or markets, or in the economic or legal environment, which have an adverse effect on the charity's activities;
- an asset becoming idle, or plans being made for its disposal earlier than expected;
- evidence of an asset's obsolescence or physical damage; and
- evidence of worse than expected results or cash flow from the use of an asset.

The SORP prohibits the reversal in a subsequent period of impairment losses previously recognised for goodwill.

The SORP requires inventories held for distribution at no or nominal consideration shall be measured at the lower of cost adjusted, when applicable, for any loss of service potential and replacement cost. Where replacement cost is the economic cost incurred if the charity was to replace the service potential of the donated goods at its own expense in the most economic manner

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Concessionary loans payable or receivable (either interest free or below market rate) will either fall into the category of a programme related investment or a mixed motive investment. Concessionary loans are made wholly or in part to advance charitable purposes for the benefit of a charity's beneficiaries. For loans repayable on demand on within one year, no adjustment to the carrying amount (the loan amount) is required. However if over one year, there is a policy choice; though the same policy has to be used for both loans payable and receivable:

- initially recognise at the loan amount and then adjust the carrying amount in subsequent years to reflect repayments / receipts and any interest; or
- initially recognise at fair value and subsequently at amortised cost using the effective interest method. This would lead to a financing cost or interest income element being accounted for.

Liabilities - The recognition of provisions follow the same rules as FRS 102 (ie. provisions should be recognised when there is a legal or constructive obligation as a result of a past event).

3.1.3.6 Smaller charity exemptions

Charities with gross income of less than or equal to £500,000 that are preparing accruals accounts can claim the following exemptions:

- the level of detail in the various sections of the annual report can be restricted to a brief summary of the main activities and achievements of the charity during the accounting period in relation to its objects.
- the analysis by activities of incoming resources and resources expended on the face of the SoFA may be omitted to be replaced by suitable classifications (eg. wages and salaries, repairs and maintenance etc.).

Where accounts are prepared using the above exemptions, an accounting policy should make this fact clear. Unincorporated charities in England and Wales can follow separate guidance published by the CC (CC17). This enables users to submit handwritten accounts on forms already set out in the prescribed format.

Companies

Limited company charities which meet the small company criteria as defined by the Companies Act are entitled to prepare accounts taking advantage of the reduced disclosure requirements set out in the Act. There is unlikely to be any value in filing accounts at Companies House in line with small companies' filing exemptions since the full accounts are freely available on the regulators website.

3.1.3.7 Group accounts

Before preparing accounts, trustees must be quite clear as to the legal structure of the charity. In particular, they must be clear to what extent the charity operates by way of branches and subsidiary undertakings.

3.1.3.7.1 Subsidiary undertakings

Subsidiary undertakings can be identified by the measure of control exercised by the parent charity. FRS 102 outlines how such control can be determined in the context of voting rights (mainly stemming from share ownership) and dominant influence over the board or activities of the subsidiary. This embodies the requirements of the Companies Act which should be followed by those undertakings registered under this Act.

A non-company charity can only be regarded as a subsidiary undertaking where the parent charity can be shown to be exercising control over the subsidiary, either directly or indirectly. Per the SORP in addition to holding more than half of the voting rights, this can arise in any of the following situations:

c. the charity trustees and/or members and or employees of the parent charity are, or have the right to appoint or remove, a majority of the charity trustees of the subsidiary charity;
d. the charity trustees and/or members have the power to cast the majority of votes at meetings of the board of directors (or equivalent governing body) of the subsidiary charity; and
e. the governing document of the subsidiary charity reserves to the parent charity's trustees and/or members the power to govern the financial and operating policies of the entity under a statute or an agreement.

The basis for treating a non-company charity as a subsidiary is that the connection between it and some other charity is such that the operating and financial policies of the former are likely to be set in accordance with the wishes of the latter. This is likely to be the case where one of the relationships described in the previous paragraph exists, but trustees may, in a particular case, be able to produce evidence to the contrary.

A further instance where the relationship is similar to that of a parent and subsidiary undertaking may arise where the parent charity transacts with another undertaking in such a way that all the risks and rewards of the transactions remain with the parent undertaking. For instance transfers of assets to another entity whilst retaining exclusive use of those assets and the costs of maintaining them. Such undertakings are regarded as quasi subsidiaries and should be accounted for in accordance with FRS 102.

The SORP defines a subsidiary as an entity that is controlled by a parent entity. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Although a charity is controlled and managed by its trustees, it can be a subsidiary for accounting purposes when the criteria for control are met. As such the scenario above (transfer of assets to another entity whilst retaining exclusive use of those assets and the costs of maintaining them) would lead to the undertaking being classified as a subsidiary.

3.1.3.7.2 Branches

Branches are entities or administrative bodies set up, for example, to conduct a particular aspect of the business of the reporting charity, or to conduct the business of the reporting charity in a particular geographical area. They may or may not be legal entities which are separate from the reporting charity. Per the SORP, a branch is either:

- simply part of the administrative machinery of the reporting charity;
- a special trust (in England and Wales) and similar arrangements (S287 of Charities Act 2011);
- a separate legal entity which is administered by or on behalf of the reporting charity and whose funds are held for specific purposes which are within the general purposes of the reporting charity;
- in Scotland, charities that are connected under Regulation 7 of the Charities Accounts (Scotland) Regulations 2006;
- in England and Wales, a separate legal entity which the CC has deemed should be treated as linked to the reporting charity for accounting purposes unless it is a company; or,
- joint venture arrangements that do not involve a joint venture entity being established.

Some of the characteristics of a branch are:

- it uses the name of the reporting charity within its title;
- it exclusively raises funds for the reporting charity and/or for its own local activities;
- it uses the reporting charity's registration number on its letterheads, publicity and website;
- it uses the reporting charity's registration number to receive tax relief on its activities;
- it is perceived by the public to be the reporting charity's local representative or its representative for a particular purpose;
- it receives support from the reporting charity through advice, publicity materials, etc.

If the branch exists to carry out the primary objects of the charity, typically it will receive funds from the reporting charity for its work and may be staffed by employees of the reporting charity. If the branch is not a separate legal entity, all funds held by the branch will be the legal property of the reporting charity, whether or not the branch has a separate bank account.

Some charities may be known as "branches" within a particular organisational or network structure. However, if their level of administrative autonomy from the reporting charity is such that legislation requires them to be treated as separate accounting entities, then they should not be regarded as "branches" for accounting purposes but should prepare separate accounts for submission to the appropriate regulatory authority.

Other examples of organisations which are not "branches" for the purpose of these recommendations include groups of people who occasionally gather together to raise funds for one or a number of different charities and special interest groups who are affiliated to a particular charity, but do not themselves undertake charitable activities.

Branches should be accounted for as part of the whole charity. But if both reporting charity and the branches are companies, company law requires each entity to prepare its own accounts. In such a case, a single annual report should normally be prepared to cover both the reporting charity and its branch(es) and consolidated accounts should be prepared in accordance with the SORP.

Separate legal entities which may be known as branches but do not fall within the SORP definition of a branch should prepare their own annual report and accounts and, if they are connected charities the relationship should be explained in the trustees' report.

All branch transactions should be accounted for gross in the reporting charity's own accounts excluding those transactions which net off eg. branch to branch transactions or those between the branches and the head office. Similarly all assets and liabilities of the branch including, for example, funds raised but not remitted to the reporting charity at the year end should be incorporated into the reporting charity's own balance sheet. This provision need not apply where the transactions and balances of the branches in aggregate are not material to the charity's accounts.

Funds raised by a branch for the general purposes of the reporting charity will be accounted for as unrestricted funds in the accounts of the main charity. Funds raised by a branch for specific purposes of the reporting charity will need to be accounted for as restricted funds in the accounts of the main charity. Funds held for the general purposes of a branch which is a separate charity should usually be accounted for as restricted funds in the accounts of the reporting charity. When accounting for special trustees the financial statements should separately identify the special trust (s) as a component of restricted funds.

Where a branch is not a separate legal entity, its accounts must form part of the accounts of the reporting charity but it may be in the interests of local supporters and beneficiaries for additional accounts to be prepared covering only the branch.

3.1.3.7.3 Accounting for subsidiary undertakings

A parent charity must prepare consolidated accounts including all its subsidiary undertakings except where:

c. the net income of the group (ie. after removing intra-group transactions) in the accounting period is no more than the audit threshold under the relevant charity legislation (ie. in England and Wales, CA11);
d. the subsidiary undertaking or undertakings results are not material to the group;
e. the accounts have to be aggregated under the relevant charity legislation.

Chapter 9 of FRS 102 allows subsidiaries to be excluded from consolidation in certain limited circumstances. It is unlikely that these exclusions will apply to a charitable group except on rare occasions. The difference between profit and not for profit undertakings is not sufficient of itself to justify non-consolidation. However, where a subsidiary undertaking is a registered company, is insolvent and being wound up (in liquidation) then the subsidiary undertaking can be excluded from consolidation on the basis of severe long term restrictions. If a subsidiary is held purely for resale then this would also be grounds for exclusion of the subsidiary in consolidated financial statements.

Consolidated accounts should be prepared for the reporting charity and its charitable subsidiary undertakings whether or not the subsidiaries are also companies. However, where the subsidiary undertaking is a non-company charity it will normally be accounted for in the consolidated accounts in the same manner as a branch (see paragraph 9.2 above). Similarly charities, whether companies or not, which use non-charitable subsidiary undertakings to carry out their charitable purposes should prepare consolidated accounts for the charity and such subsidiary undertakings.

Accounts for each member of the group, ie. parent and subsidiary undertakings, should be prepared for approval by the respective boards of trustees and/or directors. The consolidated group accounts should then be prepared by the parent charity.

Consolidated accounts must be prepared under accounting standards in order to give a true and fair view of the group.

The FRS 102 Triennial Amendments (December 2017) clarified how Gift Aid payments made by subsidiaries to a charitable parent should be accounted for. These changes are reflected in the SORP 2019. In essence, the subsidiary must have a legal obligation to make the payment to the parent, for example a deed of covenant, for the gift aid payment to be recognised at the reporting date.

Where the subsidiary does not have a legal obligation to distribute its profits to its owners at the reporting date by way of gift aid payment, it would have taxable profits and need to recognise a tax expense in profit or loss. However, paragraph 29.14A of FRS 102 requires the tax effects of the expected gift aid payment to be taken into account when it is probable that the gift aid payment will be made within 9 months of the reporting date. Therefore FRS 102 requires the gift aid relief to be recognised at the reporting date before the gift aid payment is reflected in its financial statements in circumstances where there is no legal obligation at the reporting date. The tax charge and corresponding tax relief effectively net off, resulting in an overall nil tax charge. The relief must be presented in profit or loss, in accordance with paragraph 29.22A of FRS 102. 4.2 For further details see 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.

In England and Wales, the CA11 requires the individual charity's accounts to be filed with the CC. To meet these requirements, where the group and parent charity's accounts are included in the same set of consolidated accounts, as well as two balance sheets there should be two SoFAs (one for the group and one for the parent). However consolidated accounts are often filed with the CC omitting the SoFA for the parent charity. Historically the CC has prepared to accept these accounts as long as the assets and liabilities of the charity can be distinguished from those of its subsidiary/ies and that the turnover and results of the subsidiary/ies are clearly stated (noted in SORP 2005). There is no equivalent paragraph in the SORP 2015 / 2019 as this was deemed to be outside of the scope of the SORP however it is not anticipated that this will change the current situation. However, the CC retains the power to require the production and filing of any individual charity SoFA and similarly members of the public have a legal right to request this statement.

'Guidance for ICAS members acting for Scottish charities: accounts prepared under the Charities Accounts (Scotland) Regulations 2006 (as amended)' stated:

"A parent charity is required to prepare and file individual accounts, including a SoFA, even if it is also preparing consolidated accounts. However, it is generally accepted accounting practice for these to be combined in the same document".

Charities in Scotland therefore are expected to include two SoFA's (both consolidated and parent only) within the financial statements as the requirement stems from the Charities Accounts (Scotland) Regulations 2006.

3.1.3.7.4 Method of consolidation

The normal rules will apply regarding the method of consolidation, which should be carried out on a line by line basis as set out in FRS 102.

All items of incoming resources and resources expended should be shown gross after the removal of intra-group transactions. Clearly it is desirable that similar items are treated in the same way. For instance operating activities for generating funds in the charity should be combined with similar activities in the subsidiary, and charitable activities within the charity should be combined with charitable activities in the subsidiary. Similarly costs of generating funds and or administration costs in the subsidiary should be aggregated with those of the charity.

Each charity should choose appropriate line headings within the permissible format of the SoFA and suitable amalgamations of activities. The headings should be expanded and changed to reflect the underlying activities of the group. In practice it may not be possible to find exactly matching items between the subsidiary undertaking and the parent charity in which case segmental information should be provided so that the results of the parent charity and each subsidiary undertaking are transparent.

There are useful examples of the layout of consolidated accounts in the example accounts published on the SORP micro-site.

3.1.3.7.5 Merger accounting

Two or more charities coming together in partnership for mutual sharing of risks and benefits constitutes a merger. This usually creates a new charity although neither of the original charities obtain control. In these scenarios it may not be beneficial to use acquisition accounting as described above.

Merger accounting can only be used if the following criteria are met:

- no party to the combination is portrayed as either acquirer or acquire (either by its governing body / management / another party to the combination);

- all parties to the combination participate in establishing the management structure of the combined charity and in selecting the management personnel;
- no significant change to the class of beneficiaries of the combining entities or the purpose of the benefits provided; and
- it is permitted by the statutory framework.

The update also states that due to changes in UK company law, charities that are UK registered companies and enter into a business combination with a third party, will no longer be able to apply merger accounting to that combination. Unincorporated charities, CIOs and SCIOs and non-UK registered companies will continue to be able to apply merger accounting if they meet the above criteria. If a charitable company is considering a true and fair override in order to use merger accounting it is encouraged to read Appendix IV: Note on legal requirements of FRS 102.

The FRS 102 Triennial Amendments (December 2017) expanded the definition of a group reconstruction to incorporate the transfer of a business of one group entity to another, and this permits merger accounting to be used provided it is not prohibited by company law or other relevant legislation. Accordingly, the SORP 2019 includes this change, and in particular the common example where a charity transfers activities to a wholly-owned subsidiary undertaking, normally to undertake non-charitable trading activities.

Merger accounting involves combining the assets, liabilities and funds of the combining charities and presenting them as if they had always been part of the same charity. Irrespective on when the merger occurs, the current year and comparative figures will add together the results of the combining charity. Care must be taken to ensure that restrictions on funds are still accounted for as such under the combined results.

The use of merger accounting is helpful in scenarios whereby the charity changes its legal form but its purposes and beneficiary class remain unchanged (eg. unincorporated trust establishing itself as a charitable company or charitable incorporated organisation). These are in effect a reconstruction and they should be treated as mergers and not acquisitions provided that:

- the use of the merger accounting method is not prohibited by company law or other legislation;
- the beneficiary class is not significantly changed;
- the purposes for which funds are held are not significantly changed;
- the persons who constitute the trustee body are not significantly changed; and
- no non-controlling interest in the net assets of the charity is altered by the transfer.

3.1.4 Receipts and payments accounts

In England and Wales and in Northern Ireland, unincorporated charities and CIOs (England and Wales only) with income of no more than £250,000 may prepare Receipts and Payments Accounts and a Statement of Assets and Liabilities. In Northern Ireland, if the governing document or the trustees require true and fair accounts to be produced, then accruals accounts must be prepared.

In Scotland, unincorporated charities and SCIOs with income of no more than £250,000 may prepare Receipts and Payments Accounts and a Statement of Assets and Liabilities unless the charity's constitution or any enactment require true and fair accounts to be produced, or the trustees have elected to prepare full accruals accounts.

Separate guidance has been published by the CC (CC16), the OSCR (Receipts and Payments Work Pack) and CCNI (ARR03) which includes specimen layouts and forms (which, again, can be completed by hand) for charities to use in preparing receipts and payment accounts. Although the accounting is simpler, the requirement to isolate and report on the various types of fund is the same as in the SORP and a statement of assets and liabilities is required which includes non-cash items such as debtors and liabilities.

A receipts and payments accounts disclosure checklist is available in this manual for when such accounts are being prepared (see accounts disclosure checklist section of this manual).

In selecting whether a receipts and payments basis or an accruals basis is appropriate, the trustees should be consistent. The charity has two options. It should be noted that if a charity chooses the receipts and payments method it must not include any accruals, prepayments or depreciation. Such items constitute accruals accounting and the full SORP (including a SoFA) would therefore need to be adopted.

3.2 Preparation of annual reports

3.2.1 Trustees' report

3.2.1.1 Introduction

Regardless of whether or not the charity is a limited company, the trustees are jointly responsible for preparing an annual report and accounts for each financial year. Although technically the accounts and trustees' report are separate legal documents, they are normally presented together.

Care should be taken to ensure that the annual report is ready for signature with the annual accounts, approved by a majority of the trustees. If the annual report is not ready, then the accounting policy note on compliance with the SORP and the wording of the audit report (if applicable) should be considered carefully.

For all charities in England and Wales the disclosure requirements regarding the Trustees' Report are driven by the Charities (Accounts and Reports) Regulations 2008 and the SORP. These Regulations require the use of the SORP 2005. The CC has confirmed however that the disclosure requirements for Trustees' Reports in the SORP have built upon the existing reporting framework and did not remove any of the existing legal requirements. As such it is permissible to comply with the 2008 Regulations and follow the SORP 2019 by providing additional information in the Trustees' Reports as required by the new SORP. The CC however recommends that reference is made in the Trustees' Report regarding compliance with relevant laws and regulations.

See example accounts section for example wording in the proforma accounts and this is included in the relevant disclosure checklists. These additional disclosures are not required for Scottish or Northern Irish charities.

3.2.1.2 Contents of the trustees' report

Whilst there are exemptions from detailed disclosure of some of the information set out below for smaller charities, the basic structure suggested by the SORP is as follows:

- Objectives and activities;
- Achievements and performance;
- Financial review;
- Structure, governance and management;
- Reference and administrative details;
- Exemptions from disclosure;
- Funds held as custodian trustee on behalf of others;
- Plans for future periods (larger charities only).

The detailed disclosure requirements are set out in Module 1 in the SORP. They are included in the accounts disclosure checklist contained in this manual (see accounts disclosure checklist section of this manual).

England and Wales

The Charities (Protection and Social Investment) Act 2016 (Commencement No. 1 and Transitional Provision) Regulations 2016 were made in parliament on 27 July 2016 and brought section 13 (fund-raising) into force on 1 November 2016. There are additional trustees' report disclosure requirements, mandatory for financial years ending on or after 1 November 2016. The disclosures are relevant for larger charities required to have an audit by the Charities Act 2011. These additional disclosures have been added to the trustees' report section of your SORP disclosure checklists and have been included in the relevant proforma accounts.

Cross border charities

OSCR has confirmed that it expects cross border charities operating in Scotland to provide some narrative in their charity trustees' report of the activities undertaken in Scotland.

3.2.1.3 Common issues

Some of the points required within the narrative section of the trustees' report have been a cause of concern for charity trustees. Four areas in particular are highlighted below.

Risk management statement (England and Wales only)

The Charities (Accounts and Reports) Regulations 2008 (England and Wales only) require disclosure of the fact that the trustees have identified the major risks to which the charity is exposed and that systems or procedures have been established to manage those risks when a statutory audit is performed. This statement is part of the "Structure, governance and management" section of the report.

CC26 Charities and risk management provides further guidance. This includes a suggested process for identifying and managing risk, and examples of potential risk areas.

There is no such requirement under the SORP and as such charities outside of England and Wales applying the SORP will have no requirement to explicitly disclose the fact that the trustees have identified the major risks to which the charity is exposed and that systems or procedures have been established to manage those risks.

Achievements and performance

The SORP places emphasis on enabling the reader to understand and assess the achievements of the charity.

Statement of the charity's reserves policy

Within the "financial review" section of the report, paragraph 1.22 of the SORP requires the charity to disclose its reserves policy. This applies to all charities regardless of their size. The three key questions are:

- What is meant by reserves?
- What constitutes an acceptable reserves policy?
- How should this policy be disclosed?

The CC has provided some useful guidance on these issues which is available from its website. CC19 Charities and reserves was most recently updated in January 2016 and sets out help on the three questions above. There is also Operational Guidance (OG43) which gives practical examples of both acceptable and unacceptable reserves policies and their disclosure.

Public benefit

Charities must demonstrate that they are providing a public benefit, and trustees have a duty to report in their Trustees' Annual Report on this. The level of detail that trustees need to disclose will depend on whether the charity has income above or below £500,000. All charities must disclose their main activities in their Trustees' Annual Report.

However for charities in England and Wales and Northern Ireland, the main activities information needs to be set in the context of the charity's aims to show how in practice the aims have been carried out for the public benefit. In addition these England and Welsh and Northern Irish charities must also confirm that they had regard to the CC / CCNI public benefit guidance where relevant.

The CC / CCNI are not prescriptive about the number of words or pages needed, but a charity that said nothing on public benefit in its Trustees' Annual Report, or produced only the briefest of statements with no detail, would be in breach of its public benefit reporting requirement.

For larger charities with income of more than £500,000, irrespective of their jurisdiction, trustees are required to provide a fuller explanation in their Trustees' Annual Report of the significant activities undertaken in order to carry out the charity's aims for the public benefit, as well as their aims and strategies. They are required to explain the charity's achievements, measured by reference to the charity's aims and to the objectives set by the trustees. It is up to the charity's trustees to decide how much detail they want to provide to clearly illustrate what their charity has done in the reporting year to meet the requirements.

3.2.1.4 Smaller charities

A 'larger charity' is defined as those charities with a gross income exceeding £500,000.

The minimum disclosure requirements are set out in the accounts disclosure checklists in this manual highlight which disclosures are not required for smaller charities.

'Larger charities' require more detailed disclosure than other charities (ie. smaller charities). It should be noted that far less detail is required for smaller charities on "structure, governance and management" (and specifically no statement on risk management is required) and "achievements and performance" noted above. However all charities, regardless of size, need to disclose their reserves policy (albeit in more detail for charities which are defined as 'larger').

In practice, the CC / OSCR / CCNI will review all trustees' reports on their merits and will expect smaller and less complex charities to have less detail accordingly. However, the SORP encourages as much detail as is possible (not least as this could encourage prospective donors to give the charity support).

3.2.2 Other annual reports

In addition to the requirements for a trustees' report, as outlined above, charities may be required to prepare other annual reports for inclusion within their annual accounts and reports.

In addition to the requirements of the SORP, limited company charities are required to produce a strategic report (for non-small companies) and a directors' report. The SORP committee issued guidance in the form of a SORP Information Sheet 5 on how to implement certain strategic report requirements in relation to non-small charitable companies and this information is reflected in the SORP. The trustees' report generally fulfils the directors' report requirement for charitable companies although, those companies that do not take advantage of small company exemptions, require some additional disclosures. These additional disclosures are included in the accounts disclosure checklist.

3.3 Circulating and filing accounts and reports

The trustees are responsible for publishing the annual accounts and reports of the charity and filing them as appropriate. Requirements vary by jurisdiction and type of charity.

In addition to the requirements set out below, company charities must also comply with the circulation and filing requirements of company law.

3.3.1 England and Wales

The accounts of all charities must be made available on request.

If the charity is a CIO, it will always need to file its annual accounts and reports with the CC irrespective of size. Otherwise a charity will only need to file its annual accounts and reports with the CC if its income is in excess of 25,000, or if its income is in excess of £10,000 and the CC request it to file its accounts.

The deadline for filing accounts and reports with the CC is ten months after the accounting year end. Accounts are generally available for public inspection and freely available on the CC's website.

3.3.2 Scotland

Registered charities have to lodge their accounts with OSCR. The deadline for filing accounts is nine months after the accounting year end.

OSCR publish Scottish charities' accounts on its website if they have income over £25,000 or any level of income if they are a Scottish Charitable Incorporated Organisation (SCIO).

OSCR will monitor a cross border charity by requiring that accounts are filed with them nine months after the year end (note that this is a shorter time period than the filing deadline for the CC).

3.3.3 Northern Ireland

Registered charities must submit their accounts and reports to the CCNI within ten months of the charity's financial period end.

3.4 Annual returns

Most charities are required to prepare and submit an annual return to their regulator(s).

3.4.1 England and Wales

Registered charities must file an annual return with the CC, although the requirements vary according to the type of charity. CIOs will need to file a full annual return. The requirements for other charities are set out in the below table.

Income levels	Annual Return Form		Confirmation of no serious incidents
	Part A (charity information)		Part B (financial information)
£10,001 - £25,000	Update publicly available information	No	No
£25,001 - £500,000	Yes	No	Yes
£50,001 - £1,000,000	Yes	Yes	Yes
>£1,000,000	Yes	Yes	Yes

3.4.2 Scotland

OCSR also requires all charities to complete an Annual Return and charities with gross income of more than £25,000 also need to complete a supplementary monitoring return.

The deadline for filing the relevant returns with the OSCR is nine months after the accounting year end.

3.4.3 Northern Ireland

Registered charities need to provide information on their activities, governance and finances in the annual monitoring return to the CCNI on an annual basis.

If the registered charity is preparing receipts and payments accounts then only parts A and B of the annual monitoring return need to be completed. For registered charities preparing accruals accounts, parts A, B and C of the annual monitoring return need to be completed.

Registered charities must complete and submit their annual monitoring return, accounts and reports to the CCNI within ten months of the charity's financial period end.

4 External scrutiny

4.1 Scrutiny requirements

4.1.1 Company charities

4.1.1.1 England and Wales

Non-group charities

Category	Scrutiny Requirements
Gross income ≤ £25,000 and eligible for small companies audit exemption	No scrutiny requirement
Gross income > £25,000 but ≤ £250,000, and eligible for small companies audit exemption	Independent examination (by person who has the requisite ability and practical experience)
Gross income > £250,000 but ≤ £1,000,000, balance sheet total (eg. total assets) ≤ £3,260,000, and eligible for small companies audit exemption	Independent examination (by a member of one of the listed professional bodies)
If none of the above	Audit

The above thresholds are based on the current year only (and should not be pro-rated if the financial year is not in fact a year). However, when considering eligibility for the small companies audit exemption under the Companies Act 2006, a two year test does apply. Given that charities may have relatively volatile income streams, the two year rule may be important.

It should be noted that, in spite of meeting the above criteria for exemption, an audit may be required for any of the following reasons:

- the charity is part of a group (see below);
- an audit is required by the charitable company's constitution;
- an audit is required by the trustees or a significant donor.

If the charitable company is not entitled to the small companies audit exemption under the Companies Act 2006, it will need to be audited under that act. Whilst this makes little practical difference to the audit, care is needed to ensure the correct audit report is attached to the accounts.

If the charitable company is entitled to the small companies audit exemption under the Companies Act 2006, but requires an audit under the Charities Act 2011 (eg. income > £1,000,000), it can be audited under the Charities Act 2011, but will need a Companies Act audit exemption statement on its balance sheet. (An example of this statement is available in the example reports section of this manual.) Alternatively, given that a true and fair audit is still required, you may deem it simpler NOT to include an exemption statement on the balance sheet and therefore carry out an audit under the Companies Act.

If this option is chosen it should be remembered that all the provisions of the Companies Act must be complied with, thus:

- the audit report must be signed by the senior statutory auditor;
- it is a criminal offence to submit a false or misleading audit report;
- the audit firm must comply with all the cessation requirements;
- information must be provided to successor auditors.

All the example audit/examination reports are available in the example reports section of this manual together with a summary at the front of the section.

Independent examinations carried out on charities with income of more than £250,000 will have to be undertaken by a qualified independent examiner.

Group charities

Category	Accounting and Scrutiny Requirement
Group Income* ≤ £1,000,000 and a small company group	No consolidated accounts and no audit*
If not the above	Consolidated accounts to be prepared and an audit of those accounts

** Group income is post consolidation adjustments.*

+ CC guidance 'CC32 Independent examination of charity accounts: directions and guidance for examiners' issued September 2017 now permits groups to have their non-statutory consolidated accounts independently examined provided that the requirements of Section 4 in CC32 are complied with (see Section 4 of CC32 for further details). CC32 is mandatory for examiner reports dated 1 December 2017 onwards.

Small charitable company groups (in the context of the small company group criteria in Companies Act

2006) must apply Charity legislation and its regulations.

Where a limited company charity is part of a group, the size of the group needs to be taken into consideration when determining audit requirements for the individual entity. Companies Act 2006 requires audit of all individual entities within the group if the group is not-small, irrespective of the size of the individual company.

The s479A audit exemption by parent guarantee under Companies Act audit exemption is potentially available, subject to satisfying certain conditions, to qualifying subsidiary companies. Conditions include a parent guarantee of all the outstanding liabilities of the subsidiary at the balance sheet date. Care needs to be taken here as in theory a parent company could guarantee incorporated non-charitable or charitable subsidiaries within a medium or large sized group. The CC has issued guidance which states that it would be inappropriate for a parent charity to guarantee the liabilities of a non-charitable trading subsidiary because it risks charitable funds being used for non-charitable purposes if the guarantee was called upon, which would be a breach of trust. If the subsidiary is a charity then this guarantee could be given but only if the guarantee was in the parent charity's interest. If a guarantee is taken the charitable subsidiary would nevertheless have to consider whether an audit or independent examination under the Charities Act remained a requirement.

ISA (UK) 600 matters on audits of group financial statements would also need to be carefully considered in this situation.

4.1.1.2 Scotland

Non-group charities

Category	**Scrutiny Requirements**
Gross income < £500,000, balance sheet total (eg. total assets) ≤ £3,260,000 and eligible for small companies audit exemption	Independent examination (by a member of one of the listed professional bodies)
If not the above	Audit

The above thresholds are based on the current year only (and should not be pro-rated if the financial year is not in fact a year). However, when considering eligibility for the small companies audit exemption under the Companies Act 2006, a two year test does apply. Given that charities may have relatively volatile income streams, the two year rule may be important.

It should be noted that, in spite of meeting the above criteria for exemption, an audit may be required for any of the following reasons:

- the charity is part of a group (see below);
- an audit is required by the charitable company's constitution;
- an audit is required by the trustees or a significant donor.

The Institute of Chartered Accountants of Scotland strongly recommends to its members that charitable companies should be audited under both company law and Scottish charity law and that they should not take advantage of exemption from the Companies Act audit where they are required to be audited under charity law.

Unlike England and Wales, all charities are subject to some form of external scrutiny so, in the absence of an audit, there must always be an independent examination. The independent examination has to be undertaken by a qualified examiner irrespective of the level of income.

Group charities

Category	**Accounting and Scrutiny Requirement**
Group Income* < £500,000 and a small company group	No consolidated accounts and no audit

Category	Accounting and Scrutiny Requirement
If not the above	Consolidated accounts to be prepared and an audit of those accounts

** Group income is post consolidation adjustments.*

Small charitable company groups (in the context of the small company group criteria in Companies Act 2006) must apply Charity legislation and its regulations.

Where a limited company charity is part of a group, the size of the group needs to be taken into consideration when determining audit requirements for the individual entity. Companies Act 2006 requires audit of all individual entities within the group if the group is not-small, irrespective of the size of the individual company.

The s479A audit exemption by parent guarantee under Companies Act audit exemption is potentially available, subject to satisfying certain conditions, to qualifying subsidiary companies. Conditions include a parent guarantee of all the outstanding liabilities of the subsidiary at the balance sheet date. Care needs to be taken here as in theory a parent company could guarantee incorporated non-charitable or charitable subsidiaries within a medium or large sized group. OSCR states that charitable trustees should consider any decision to use the exemption carefully as it may be a breach of their trustee duties by providing a guarantee. OSCR strongly advises charities to take professional advice. If the subsidiary is a charity then this guarantee could be given but only if the guarantee was in the parent charity's interest. If a guarantee is taken the charitable subsidiary would nevertheless have to consider whether an audit or independent examination under the Charities and Trustee Investment (Scotland) Act remained a requirement.

ISA (UK) 600 matters on audits of group financial statements would also need to be carefully considered in this situation.

4.1.1.3 Northern Ireland

Non-group charities

Category	Scrutiny Requirement
Gross income ≤ £250,000 and eligible for small companies audit exemption	Independent examination (by person who has the requisite ability and practical experience)
Gross income > £250,000 but ≤ £500,000, and eligible for small companies audit exemption	Independent examination (by a member of one of the listed professional bodies)
If not the above	Audit

The above thresholds are based on the current year only (and should not be pro-rated if the financial year is not in fact a year). However, when considering eligibility for the small companies audit exemption under the Companies Act 2006, a two year test does apply. Given that charities may have relatively volatile income streams, the two year rule may be important.

It should be noted that, in spite of meeting the above criteria for exemption, an audit may be required for any of the following reasons:

- the charity is part of a group (see below);
- an audit is required by the charitable company's constitution;
- an audit is required by the trustees or a significant donor.

If the charitable company is not entitled to the small companies audit exemption under the Companies Act 2006, it will need to be audited under that act. Whilst this makes little practical difference to the audit, care is needed to ensure the correct audit report is attached to the accounts.

If the charitable company is entitled to the small companies audit exemption under the Companies Act 2006, but requires an audit under the Charities Act (Northern Ireland) 2008 (eg. income > £500,000), it can be audited under the Charities Act (Northern Ireland) 2008, but will need a Companies Act audit exemption statement on its balance sheet. (An example of this statement is available in the example reports section of this manual.) Alternatively, given that a true and fair audit is still required, you may deem it simpler NOT to include an exemption statement on the balance sheet and therefore carry out an audit under the Companies Act.

If this option is chosen it should be remembered that all the provisions of the Companies Act must be complied with, thus:

- the audit report must be signed by the senior statutory auditor;
- it is a criminal offence to submit a false or misleading audit report;
- the audit firm must comply with all the cessation requirements;
- information must be provided to successor auditors.

All the example audit/examination reports are available in the example reports section of this manual together with a summary at the front of the section.

Independent examinations carried out on charities with income of more than £250,000 will have to be undertaken by a qualified independent examiner. The CCNI also recommends that trustees should consider selecting a qualified independent examiner even when the charity's income does not exceed £250,000 due to the complexity of preparing accruals accounts.

Group charities

Category	Accounting and Scrutiny Requirement
Group Income* < £500,000 and a small company group	No consolidated accounts and no audit
If not the above	Consolidated accounts to be prepared and an audit of those accounts

** Group income is post consolidation adjustments.*

Small charitable company groups (in the context of the small company group criteria in Companies Act 2006) must apply Charity legislation and its regulations.

Where a limited company charity is part of a group, the size of the group needs to be taken into consideration when determining audit requirements for the individual entity. Companies Act 2006 requires audit of all individual entities within the group if the group is not-small, irrespective of the size of the individual company.

The s479A audit exemption by parent guarantee under Companies Act audit exemption is potentially available, subject to satisfying certain conditions, to qualifying subsidiary companies. Conditions include a parent guarantee of all the outstanding liabilities of the subsidiary at the balance sheet date. Care needs to be taken here as in theory a parent company could guarantee incorporated non-charitable or charitable subsidiaries within a medium or large sized group. The CC has issued guidance which states that it would be inappropriate for a parent charity to guarantee the liabilities of a non-charitable trading subsidiary because it risks charitable funds being used for non-charitable purposes if the guarantee was called upon, which would be a breach of trust. If the subsidiary is a charity then this guarantee could be given but only if the guarantee was in the parent charity's interest. OSCR states that charitable trustees should consider any decision to use the exemption carefully as it may be a breach of their trustee duties by providing a guarantee. OSCR strongly advises charities to take professional advice. Although the CCNI has not issued guidance on this area, it is assumed that they would follow the CC and the OSCR in respect of this area. If the subsidiary is a charity then this guarantee could be given but only if the guarantee was in the parent charity's interest. If a guarantee is taken the charitable subsidiary would nevertheless have to consider whether an audit or independent examination under the Charities Act (Northern Ireland) remained a requirement.

ISA (UK) 600 matters on audits of group financial statements would also need to be carefully considered in this situation.

4.1.1.4 Cross border charities

Non-group charities

Category	Reporting Requirement
Gross income < £500,000, balance sheet total (eg. total assets) ≤ £3,260,000, and eligible for small companies audit exemption	Independent examination (by a member of one of the listed professional bodies)
If not the above	Audit

Cross border charities operating in Scotland follow the same external scrutiny levels as Scottish charities, irrespective of whether the charity is also registered in England and Wales or Northern Ireland. The audit exemption thresholds in Scotland are different to the levels for English and Welsh charities as in Scotland the 'income test' is £500,000 whilst in England and Wales it is £1,000,000. As such the lower Scottish limit of £500,000 must be used. A further difference between the England and Wales and Scottish legislation regarding scrutiny requirements is that in Scotland all charities require some form of external scrutiny irrespective of their income levels and for charitable companies, independent examinations must be performed by a qualified individual (see Section 8 of these guidance notes). The rules between Scotland and Northern Ireland are more aligned however it is only a recommendation and not a requirement for independent examiners of charitable companies in Northern Ireland to be qualified.

When auditing a cross border charity there needs to be careful consideration of the audit report wording and an audit engagement letter would also need to be tailored to ensure that it refers to not only English and Welsh legislation or Northern Ireland legislation but also Scottish legislation.

4.1.2 Non-company charities

It should first of all be noted, that in spite of meeting the various criteria for exemption below, an audit / examination may be required for any of the following reasons:

- the charity is part of a group which does not meet the audit exemption criteria (see below);
- an audit / examination is required by the governing document (eg. trust deed). CC guidance, 'CC32 Independent examination of charity accounts: directions and guidance for examiners' issued September 2017; states that if the constitution has been written before 1 March 1992, reference to 'audit' in the constitution may not require an audit to be performed as prior to the Charities Act 1993 there was no statutory framework for charity audit. The trustees should consider whether legal advice is required (see paragraph 1.17 of CC32 for further guidance);
- an audit / examination is required by the trustees or a significant donor.

4.1.2.1 England and Wales

Non-group charities

Category	Scrutiny Requirement
Gross income ≤ £25,000	No scrutiny required
Gross income > £25,000 but ≤ £250,000	Independent examination
Gross income > £250,000 but ≤ £1,000,000 and assets ≤ £3,260,000	Independent examination
If none of the above	Audit

It should be noted that under these rules, there is no reference to previous accounting periods.

The income limits refer to a financial period. This means that if the charity prepares accounts for a period of more than 12 months, the income should NOT be adjusted on a pro-rata basis.

Independent examinations carried out on charities with income of more than £250,000 will have to be undertaken by a qualified independent examiner.

Group charities

In addition to the above requirements:

Category	Accounting and Scrutiny Requirement
Group Income* ≤ £1,000,000	No consolidated accounts and no audit*
If not the above	Consolidated accounts to be prepared and an audit of those accounts

*Cross border charities operating in Scotland follow the same external scrutiny levels as Scottish charities, irrespective of whether the charity is also registered in England and Wales or * Group income is post consolidation adjustments.*

+ CC guidance, 'CC32 Independent examination of charity accounts: directions and guidance for examiners' issued September 2017 now permits groups to have their non-statutory consolidated accounts independently examined provided that the requirements of Section 4 in CC32 are complied with (see Section 4 of CC32 for further details).

ISA (UK) 600 matters on audits of group financial statements would also need to be carefully considered in this situation.

4.1.2.2 Scotland

Non-group charities

Category	Scrutiny Requirement
Gross income < £500,000 and total assets ≤ £3,260,000	Independent examination
If not the above	Audit

It should be noted that under these rules, there is no reference to previous accounting periods.

The income limits refer to a financial period. This means that if the charity prepares accounts for a period of more than 12 months, the income should NOT be adjusted on a pro-rata basis.

Unlike England and Wales, all charities are subject to some form of external scrutiny so, in the absence of an audit, there must be an independent examination.

Independent examinations carried out on charities where accruals accounts have been prepared will have to be undertaken by a qualified independent examiner.

Group charities

In addition to the above requirements:

Category	Accounting and Scrutiny Requirement
Group Income* < £500,000	No consolidated accounts and no audit
If not the above	Consolidated accounts to be prepared and an audit of those accounts

** Group income is post consolidation adjustments.*

ISA (UK) 600 matters on audits of group financial statements would also need to be carefully considered in this situation.

4.1.2.3 Northern Ireland

Non-group charities

Category	Scrutiny Requirement
Gross income ≤ £500,000	Independent examination
If not the above	Audit

It should be noted that under these rules, there is no reference to previous accounting periods.

The income limits refer to a financial period. This means that if the charity prepares accounts for a period of more than 12 months, the income should NOT be adjusted on a pro-rata basis.

Unlike England and Wales, all charities are subject to some form of external scrutiny so, in the absence of an audit, there must be an independent examination.

Independent examinations carried out on charities where accruals accounts have been prepared will have to be undertaken by a qualified independent examiner.

NB. For those charities which are not as yet registered with the CCNI, there are no statutory requirements for an audit or independent examination.

Group charities

In addition to the above requirements:

Category	Accounting and Scrutiny Requirement
Group Income* < £500,000	No consolidated accounts and no audit
If not the above	Consolidated accounts to be prepared and an audit of those accounts

** Group income is post consolidation adjustments.*

ISA (UK) 600 matters on audits of group financial statements would also need to be carefully considered in this situation.

4.1.2.4 Cross border charities

Non-group charities

Category	Scrutiny Requirement
Gross income < £500,000 and total assets ≤ £3,260,000	Independent examination
If not the above	Audit

Cross border charities operating in Scotland follow the same external scrutiny levels as Scottish charities, irrespective of whether the charity is also registered in England and Wales or Northern Ireland. The audit exemption thresholds in Scotland are different to the levels for English and Welsh charities as in Scotland the ‘income test’ is £500,000 whilst in England and Wales it is £1,000,000. A further difference between the England and Wales and Scottish legislation regarding scrutiny requirements is that in Scotland all charities require some form of external scrutiny irrespective of their income levels. The rules between Scotland and Northern Ireland are more aligned, although not exactly the same as are based on the same threshold for the ‘income test’.

When auditing a cross border charity then careful consideration of the audit report needs to be made as accounts of cross border charities will need to be in line with not only the Charities Act 2011 (for English and Welsh charities) / Charities Act (Northern Ireland) 2008 (for Northern Irish charities) but also Scottish legislation, including its regulations.

When performing independent examinations, the CC guidance on independent examination (CC32) contains an example report for those English and Welsh charities operating in Scotland. When performing independent examinations, the CCNI guidance on independent examination (ARR07) contains an example report for those Northern Irish charities operating in Scotland.

An independent examination engagement letter would need to be tailored to ensure that it refers to not only English and Welsh / Northern Irish legislation but also Scottish legislation.

Group charities

Cross border charities operating in Scotland follow the same external scrutiny levels as Scottish charities, irrespective of whether the charity is also registered in England and Wales.

4.1.2.5 Co-operative and Community Benefit Society and Friendly Society Charities

The Co-operative and Community Benefit Societies Act 2014, Friendly Societies Act 1974 and Friendly Societies Act 1992 all require accounts to provide a true and fair view. As such, these charities are required to prepare accruals accounts in accordance with the Charities SORP.

Scrutiny requirements are governed not only by charity law but also by the requirements of Co-operative and Community Benefit Societies Act 2014, Friendly Societies Act 1974 or Friendly Societies Act 1992, as appropriate.

~~Further guidance on Co-operative and Community Benefit Societies and Friendly Societies is available in the Clubs Manual.~~

4.2 Audit

4.2.1 Appointment as auditor

4.2.1.1 Appointment

Where a company charity is to be audited under the Companies Act 2006, the provisions of that Act will apply to the appointment of the auditor.

In other cases, it will be for the trustees of the charity to appoint the auditor.

4.2.1.2 Ethical considerations

Before accepting appointment or reappointment the auditor must consider whether they would be permitted to do so under the FRC Ethical Standard* and the firm's own policies and procedures (including those related to quality management).

4.2.2 Conducting the audit

4.2.2.1 Introduction

The audits of charities (whether or not the audit is conducted under the Companies Act) needs to comply, in all respects, with the requirements of the International Standards on Auditing (UK) - ISAs (UK).

The Financial Reporting Council published Practice Note 11 (Revised) in November 2017 which includes guidance on the application of auditing standards to the audits of charities.

4.2.2.2 Principal requirements

The ISAs (UK) relating to audit risk, fraud and quality have a significant impact. The standards generally require the audit team to think about the implications of risk in some depth, and to adopt a rigorous approach in planning and completing audit work.

The standards dealing with risk (ISA (UK) 315 and ISA (UK) 330) require documentation of risk assessments and are prescriptive on the audit approach to be adopted. There is an emphasis on auditors gaining an understanding of the entity's objectives and strategies and management's procedures for identifying and addressing business risks, and on the evaluation of the design and implementation of internal controls. Controls must be tested unless the auditor concludes that audit evidence from substantive procedures will be sufficient to reduce the risk of material misstatement to an acceptably low level.

ISA (UK) 240 requires professional scepticism to be maintained throughout the audit, regardless of any past experience of the client's honesty and integrity. The standard includes examples of fraud risk factors and the audit team should consider whether any of these might be present and assess how a fraud might be perpetrated.

Where fraud risk factors are identified, the audit must include additional procedures to address the related risks.

The audit team are also specifically required to discuss risk issues, including the possibility of fraud, as part of the planning process. This discussion should be documented and the engagement partner is responsible for ensuring that relevant issues are properly communicated to any individuals, such as tax or VAT specialists, who have an involvement in the audit but were not party to the discussion.

ISA (UK) 550 recognises that transactions outside the normal scope of the entity's operations can pose a significant threat and that transactions with related parties in general can affect the risk of misstatement. As all charities have a number of related parties, this standard affects charity audits significantly.

4.2.2.3 Special features of charities

Knowledge of the charity's activities and organisation is essential for ascertaining the risk of material misstatement arising from fraud, error, or non-compliance with applicable law and regulations. The auditor considers special features of charities (ie. the nature and sources of income, restricted funds, trading and charitable status, taxation and operating structures and branches), in order to plan and carry out audit work effectively and efficiently and to provide a yardstick against which to evaluate the evidence gained from audit procedures.

Sources of income often include grants, for example from public authorities or other charities. Such grants are often made for specific purposes and are subject to conditions, breach of which can have serious implications for the charity. Developments in the public sector mean that auditors of a public authority donor may have, or seek, the right of access to the charity's records to follow through and verify the use made of the grant. In addition grants from public bodies are increasingly subject to clawback provisions requiring repayment if a charity breaches specified conditions.

Where charities receive funding to undertake operational activities, the auditor should ascertain whether such income is received under contract (which is generally unrestricted income) or by way of grant for provision of a specific service, (which normally gives rise to restricted income). As well as distinguishing whether the income is restricted or not, the nature of the terms and conditions may affect taxation considerations (eg. the VAT treatment).

4.2.2.4 Groups and components

A component can be significant either due to:

a. its individual financial significance to the group (we will refer to this as 'financially significant.' This may be determined by a percentage to a chosen benchmark (eg. 15% of income or 15% of assets); or
b. because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances (referred to as 'risk significant' in this manual).

The approach should be:

For 'financially significant' components:

- an audit of the component using component materiality.

For 'risk significant' components:

- an audit of the component using component materiality; or
- an audit of one or more transactions / balances (relating to the specific risk areas); or
- specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements.

For non-significant components:

- analytical procedures at group level; or
- an audit of the component using component materiality; or.
- an audit of one or more transactions / balances (where this is necessary to obtain sufficient appropriate evidence on the group financial statements as a whole); or
- specified procedures.

4.2.2.5 Risks arising from an assessment of accounting systems and internal controls

The maintenance of an effective system of internal control is at least as important, if not more so, for charities as it is for other entities, since it is a fundamental duty of charity trustees to protect the property of their charity and to secure its application for the objects of the charity. Failure to do so can render the trustees personally liable for any loss occasioned to the charity. Guidance in 'Internal financial controls for charities' - CC8 has been published by the CC and this provides a useful point of reference for auditors.

4.2.2.6 Control environment

The role, attitude and actions of the trustees are fundamental in shaping the control environment of a charity. Factors to consider include:

- the amount of time committed by trustees to the charity's affairs;
- the skills and qualifications of individual trustees;
- trustees' understanding of the charity and its legal and regulatory environment;
- the regularity and effectiveness of trustees' meetings and the level of attendance at these meetings;
- the adequacy of minutes of trustees' meetings;
- the independence of trustees from each other;
- the policy on dealing with trustee conflicts;
- the processes for managing trustee conflicts of interest;
- the supervision by the trustees of relatively informal working arrangements which are common when using volunteers;
- the degree of involvement in key decision-making or monitoring transactions and engagement with charity staff;
- the attitude of trustees to previously identified control deficiencies;
- the level of delegation by trustees to senior management and the formality of this delegation; and
- the committee structure of the organisation.

Other features of the control environment will depend on the size, activities, organisation and corporate governance structures of the charity but might include:

- a recognised plan of the charity's structure showing clearly the areas of responsibility and lines of authority and reporting. Where the charity does not have staff and is administered entirely by the trustees, there can still be an agreed division of duties, provided there is adequate monitoring by the body of trustees as a whole;
- segregation of duties where charities have more than one member of staff (whether paid or not). In larger charities, such segregation could include involvement of staff from outside the finance department in certain transactions, for example in providing a first signatory for cheques;
- supervision by trustees of activities of staff where segregation of duties is not practical;
- competence, training and qualification of paid staff and any volunteers appropriate to the tasks they have to perform;
- involvement of the trustees in the recruitment, appointment and supervision of senior executives;
- access of trustees to independent professional advice where necessary;

- budgetary controls in the form of estimates of income and expenditure for each financial year and comparison of actual results with the estimates on a regular basis; and
- communication of results of such reviews to the trustees on a regular basis so as to facilitate their review of performance and enable them to initiate action where necessary.

Guidance for trustees “The essential trustee” can be found on the CC website (CC3). Further guidance from the CC27 ‘It’s your decision: charity trustees and decision making’ can also be consulted. For Scottish charities, “Guidance and good practice for charity trustees” should be consulted and in Northern Ireland, CCNI EG024 “Running your charity” is helpful.

4.2.2.7 Fraud

The trustees of a charity are responsible for the prevention and detection of fraud in relation to the charity, even if they have delegated some of their executive functions to senior staff. They are expected to safeguard charity assets and reserves through the implementation of appropriate systems of control. The auditor of a charity is responsible for forming an opinion as to whether financial statements show a true and fair view and to this end the auditor plans, performs and evaluates audit work in order to have a reasonable expectation of detecting material misstatements in the financial statements arising from error or fraud.

Many charities receive funds which have restrictions placed upon them. These funds are held on trust and must be applied to the purpose for which they were given. The misappropriation of funds constitutes a breach of trust or duty, whether it was intentional or accidental. In planning, performing and evaluating the audit work the auditor considers the risk of material misstatement arising from such breaches of trust.

The auditor considers the possibility that the charity’s records of income to which it is legally entitled may be incomplete as a result of fraud. A common type of fraud against charities is the diversion of donations. Sources of audit evidence as to whether income from appeals and other ‘non-routine’ sources have been fully recorded can involve the assessment and testing of internal controls, and comparison of donations actually received by the charity to past results for similar appeals, to budgets and to statistics for response rates for charities in general. A further example is where a charity recognises income that it may never receive, for instance on the back of an informal pledge for which there is no formal agreement or payment plan, to provide assurance that the pledged monies will be forthcoming.

Certain features of charities may increase the risk of fraud. These include:

- limited involvement of trustees in key decision-making or monitoring transactions and limited engagement with charity staff;
- widespread branches or operations, such as those established in response to emergency appeals in countries where there is no effective system of law and order;
- reliance on volunteers and staff with limited management or supervision and a lack of segregation and rotation of duties;
- transactions (income and expenditure) often undertaken in cash;
- unpredictable patterns of giving (in cash, by cheque, and through donations in kind) by members of the public, both in terms of timing and point of donation;
- informal banking or cash transfer methods used in areas remote from conventional banking systems;
- inconsistent regulation across international borders;
- international transfer of funds;
- diversion of grants payable.

Reviewing the minutes of meetings of the board of trustees, finance committee and audit committee helps the auditor evaluate whether one or more fraud risk factors are present.

A particular difficulty in applying analytical procedures to the audit of charities is that certain items in the financial statements can be very difficult to predict. The usefulness of individual procedures depends on the scale and nature of activities undertaken, but examples of measures that can be adopted include:

- comparison of actual income and expenditure to prior years’ figures and trends;

- comparison of actual to budgeted results;
- comparison of actual income to successful bids, legacy notifications and potential legacies reported in the minutes;
- comparison of actual expenditure to the auditor's own estimate of the expenditure that would be reasonable for the particular transaction under review;
- comparison of results of an individual branch to those of similar branches of the main charity;
- checking charity shops' sales revenue between different periods (eg. monthly) and to other shops operating in similar locations;
- analysis of efficiency ratios such as staff or administration costs as a percentage of benefits delivered or grants made, or the ratio of operating costs to income (in this respect, care needs to be taken to compare the results of charities of similar sizes, since larger charities tend to benefit from economies of scale); and
- comparison of actual cash donations received as a result of fund-raising activities to the amount which could be expected on the basis of charity statistics, if any are available. It is likely to be helpful to analyse voluntary income into its different sources and then design analytical techniques appropriate to each source. For example, funds can be raised through television or radio appeals, street collections, trading activities, special events, telephone canvassing and postal appeals. The income raised through special events may be predicted and controlled through budgeting, whereas industry statistics and the charity's own past experience may provide a useful indication of the amount likely to be raised from a postal appeal.

When using analytical procedures as main of the audit evidence, the requirements of ISA (UK) 520 must be applied. Section D of your audit programmes highlights those requirements.

4.2.2.8 Communication with the client

Another aspect of the ISAs (UK) is that a distinction is drawn between "management" and "those charged with governance". For many audits, they are one and the same people. However, on some charity audits there is a clear distinction between the management of a charity and the overall board of trustees.

Under ISAs (UK), the auditor is required to discuss various matters, including:

- the management's / trustees' arrangements for assessing, identifying and responding to fraud risk;
- how, if at all, management / trustees communicate this to each other and to other staff and volunteers;
- any knowledge of actual, suspected or alleged fraud affecting the charity.

Practice Note 11 states that ISA (UK) 260 stresses the need for effective two-way communication between the auditor and those charged with governance. Communications from the auditor need to be understandable and 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.

4.2.2.9 The FRC Ethical Standard

In December 2019, the FRC published the FRC Revised Ethical Standard (2019) which became effective from 15 March 2020. The firms detailed ethical policies and procedures should always be adhered to.

The requirements of the FRC Ethical Standard is effective for audits of charity financial statements in the same way as it is for private limited companies. It is structured as follows:

Part A:

- Overarching Principals and Supporting Ethical Provisions

Part B:

- Section 1: General Requirements and Guidance
- Section 2: Financial, Business, Employment and Personal Relationships
- Section 3: Long Association with Engagements and with Entities Relevant to Engagements
- Section 4: Fees, Remuneration and Evaluation Policies, Gifts and Hospitality, Litigation
- Section 5: Non-audit / Additional Services
- Section 6: Provisions Available for Audits of Small Entities (PAASE) - see below for criteria

The FRC Ethical Standard imposes ethical requirements on firms of auditors and applies to all charity audits undertaken in accordance with the ISAs (UK). Section 5 - Non-audit / Additional Services is likely to have the main impact on charity audit assignments. In addition, Section 6 - Provisions Available for Audits of Small Entities (PAASE) is also likely to be of relevance, as it provides alternative provisions for auditors of smaller clients. Remember, where advantage is taken of PAASE, this is sometimes disclosable in the audit report, with certain disclosures also required in the financial statements.

Ethical threats

Whilst all ethical threats must be identified and described, particular attention may need to be paid to the management and self review threats in a charity. Problems may specifically arise as a result of the provision of accounting services and the lack of 'informed management'.

The ES states that unless there is 'informed management' and there are appropriate safeguards there is a risk of the auditor taking a management role. Auditors of charities should therefore record clearly on file who they believe is 'informed management' within the charity where such threats arise. Where problems exist the provisions available for smaller entities may be useful.

Provisions Available for Audits of Small Entities (PAASE)

To qualify for PAASE, a charity must be a 'small entity'. To be a 'small entity', a non-company charity's income must be less than the turnover threshold applicable to small companies in s382 of the Companies Act 2006 (currently £10.2m). A company charity must, in addition, qualify as a small company under s382 of the Companies Act 2006.

Alternative provision

For Charities that qualify to apply PAASE, auditors are not required to apply safeguards to address a self-review threat, provided:

- the client has "informed management"; and
- the audit firm extends the cyclical inspection of completed engagements that is performed for quality purposes, to include some PAASE clients.

It should be noted that if advantage is being taken of the alternative provision, no disclosure of this is needed in the audit report or notes to the accounts.

Exemption

Where advantage has been taken of the exemption against the management threat in the provision of non-audit services, the Responsible Individual should ensure that:

- the audit report discloses this fact; and
- either the financial statements or the auditor's report discloses the type of non-audit services provided.

The sample wording offered to include in the audit report is:

"We are independent of the [charity / charitable company] in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and the provisions available for small entities, in the circumstances set out in note [X] to the financial statements, and we have fulfilled our other ethical responsibilities in accordance with these requirements."

Sample wording that can be used to include in the note is:

"In common with many other charities of our size and nature we use our auditors to prepare and submit returns to the tax authorities and assist with the preparation of the financial statements."

Other PAASE exemptions are also available - see your firm's audit procedures manual or section 6 of the FRC Ethical Standard for details.

4.2.2.10 Opening balances

For initial engagements, we consider whether sufficient appropriate evidence can be obtained to confirm the client's opening balances. Specifically, we confirm:

- opening balances do not contain material misstatement affecting the current year's figures;
- appropriate accounting policies have been consistently applied or, when changed, have been properly accounted for and presented.

If we become auditors of a previously audited charity then there is no responsibility to re-audit the financial statements of the preceding period. The sufficiency and appropriateness of the audit evidence regarding opening balances required by us as incoming auditors depends on such matters as:

- the accounting policies followed by the charity;
- whether the preceding period's financial statements were audited and, if so, whether the auditors' report was qualified;
- the nature of the opening balances, including the risk of their misstatement; and
- the materiality of the opening balances relative to the current period's financial statements.

As incoming auditors normally the audit work on the current period provides evidence regarding opening balances. Other procedures which incoming auditors might perform include the following:

- requesting information from the predecessor auditor (for charitable companies only);
- consultations with management and review of records, working papers and accounting and control procedures for the preceding period; and
- substantive testing of any opening balances in respect of which the results of other procedures are considered unsatisfactory. Particular emphasis may need to be given to such testing where the previous financial statements were unaudited.

When the previous period's financial statements have not been audited, for example a charity had taken advantage of audit exemption in the previous year, there needs to be disclosure in the audit report (in an Other Matter paragraph) and financial statements that the comparatives are unaudited. In some instances where we are unable to gain evidence regarding opening balances it might be necessary to qualify our opinion on the results for the year, but not the state of affairs (ie. the balance sheet), due to a limitation of scope.

4.2.2.11 Materiality

Materiality is calculated on the materiality form in the planning section of the manual. Appendix 4 to these guidance notes for further guidance on completion of the Materiality form.

ISA (UK) 320 suggests that an appropriate benchmark for not for profit entities might be total income with Practice Note 11 also noting expenditure or net assets as being relevant benchmarks. For example, where income fluctuates then a benchmark based on expenditure which may remain stable could be considered. These suggestion are not prescriptive and income may, for example, be adjusted for one-off receipts such as legacies or unusual donations. Practice Note 11 states that it is relatively rare to use net result for the year as a sole benchmark when determining materiality.

It should also be considered that different benchmarks may be appropriate for different disclosures.

4.2.2.12 Accounting estimates and work of experts

Whilst often unavoidable, the use of accounting estimates in the preparation of the accounts gives rise to increased risk of material misstatement. Accounting estimates are identified and assessed on the permanent file (form **PF1-8**).

ISA (UK) 540 lists a number of examples of situations where accounting estimates, other than fair value accounting estimates, may be required. Appendix 1 to PN11 provides a further list of examples specifically related to charities. One area that is central to many charities is the use of estimates for allocating income and expenditure both between different SoFA headings and between different types of funds. Therefore, if it wasn't already highlighted as a key area, classification of income and expenditure may well be a significant area.

Further examples of accounting estimates may include:

- allocation of income / expenditure between SoFA headings (as noted above);
- provision for doubtful debts;
- allowance of costs between funds;
- stock provisions;
- depreciation method / asset life;
- valuation of defined benefit pension schemes;

- valuation of investments;
- valuation of fixed assets (including heritage);
- valuation of income (including donated goods, services and facilities);
- outcomes of litigation;
- outcomes of long term contracts.

During risk assessment procedures, the auditor must gain sufficient understanding of the client's use of accounting estimates. The focus is on estimates with a high level of estimation uncertainty. Examples of situations where there is relatively low estimation uncertainty include non-complex operations, routine transactions, simple methods of estimation or well established models used to make the estimation.

The auditor should also assess the degree to which assumptions may be biased by managers / trustees' of the charity.

An expert is an individual or organisation with expertise in a field other than auditing. In order to comply with ISA (UK) 500 Audit Evidence to the extent necessary, taking into account the significance of the expert's work for the purposes of the audit, the auditor shall:

- obtain an understanding of the work performed;
- evaluate their competence, capabilities and objectivity; and
- evaluate the appropriateness of the work in relation to the relevant audit assertion.

This information and evaluation is recorded on **PF1-7** and appending schedules, as part of work performed to understand the entity and its environment, and the applicable financial reporting framework driven from the completion of **PF1-1** and **PF1-2**.

For each individual key accounting estimate that is identified using **PF1-8** at the planning stage, we also complete a supporting Key Accounting Estimates Summary to document the risk assessment process specific to that estimate, along with the proposed audit procedures to be performed in response to the assertion risks that are identified. We replace the 'X' in the reference with a corresponding page number, eg. if there are three key accounting estimates, then we will complete three separate forms.

To complete our risk assessment at the planning stage, we detail whether the key accounting estimate poses a risk of material misstatement. If so, the risk will also need to be documented on the Risk Assessment.

Having identified the key areas of risk, we determine what our audit approach will be in response. The planned approach will be documented in full on the key accounting estimates audit plan and the **Q audit programme** must be tailored for each key accounting estimate and completed during the fieldwork stage of the audit. More detailed guidance on the use of these forms to document the audit approach is provided in Appendix 5 to these guidance notes. The **Q audit programme** on key accounting estimates is designed to ensure that the detailed requirements of ISA 540 are being complied and that sufficient appropriate audit evidence has been obtained that enables us to be able to draw a conclusion on the reasonableness of the key accounting estimate, regardless of the approach that is being followed to test the accounting estimate.

We then consolidate all our individual accounting estimate work to formulate an overall conclusion for accounting estimates on **A44**.

See ISA s (UK) 500, 540 and 620 and your firm's audit procedures manual for further guidance. Guidance on completing the substantive sampling form can be found within Appendix 6 and 6A

4.2.2.13 Going concern

An understanding of the entity and its environment in relation to going concern is considered on **PF1-10** and then an initial risk assessment is made at the planning stage, although we should always be alert to additional events or conditions which may cast significant doubt on the entity's ability to continue as a going concern throughout the audit. An audit plan is included and an audit programme is included for Section **R** along with update and evaluation procedures at the completion stage at **A42**.

4.2.2.14 Subsequent events

In addition to the going concern audit programme within fieldwork, a subsequent events audit plan is included within planning and a subsequent events audit programme (**S audit programme**) is included in fieldwork. An update and subsequent evaluation of the work is recorded at **A41**.

See ISA 560 and your firm's Audit Procedures Manual for further details.

4.2.2.15 Planning the audit approach

Having assessed risks using the risk assessment forms, materiality and considered the use of analytical procedures etc. auditors should prepare an overall plan, and then tailor the audit programmes to the charity.

More detailed guidance on the use of these forms to document the audit approach is provided in Appendix 5 to these guidance notes.

4.2.2.16 Using audit data analytics (ADA) and other technology

Use of technology

The variety of technology and automated tools which are available for use on an audit engagement is incredibly diverse, ranging from relative routine analysis within a spreadsheet, to the use of sophisticated applications which apply algorithms and machine learning, to the use of drones or online applications. Throughout this manual, audit data analytics (ADA) is referred to as a specific category of technology and automated tools. For the purposes of this manual ADA is defined as data analysis techniques (eg. the filtering and sorting of data to identify outliers, anomalies, deviations and other inconsistencies or detection and evaluation of trends and patterns within a data set) which can be used to perform risk assessment procedures, both controls and substantive testing and completion activities. In most cases, audit teams performing such analysis will have the ability to directly control the parameters used within this analysis, although certain applications may draw on the use of algorithms, artificial intelligence and machine learning to aid users with this analysis. Guidance on the additional considerations needed when planning the use of algorithms, artificial intelligence and machine learning is set out below.

The Audit data analytics assessment form within planning should be used to record how ADA and other technology is intended to be utilised on an engagement and how its use has been considered appropriate. Whilst not an exhaustive list, areas where ADA and other technology could be considered are:

- As part of the risk assessment (eg. for its use of part of the preliminary analytical review)
- Highlighting high risk transactions for testing (see below)
- Stratification of populations for sampling (see below).

The use other technology which does not meet the definition of ADA should be recorded on the respective Audit plan form within planning when setting out the audit plan for each area (for example, use of a drone or video technology to physically verify a fixed asset would be recorded on the fixed asset audit plan).

Appraising the use of technology on engagements

The use of technology on engagements can take various forms and each engagement team will need to appraise the use of technology on each engagement. Considerations are recorded on the Audit data analytics assessment form within planning.

Applicability and potential uses of ADA on an engagement

The use of technology is evaluated on a client by client basis and is not deployed as a blanket approach to all engagements. While it is expected certain technologies and in particular ADA will be appropriate to use on the majority of engagements, certain complexities for particular clients may mean its use is not appropriate (such as unusual general ledger posting processes or complex business model meaning common algorithms are less applicable to them etc). Balanced consideration of these factors is recorded on the Audit data analytics assessment form within planning whether ADA or technology is applicable for use.

For clients where the use of ADA is considered applicable, how it is intended to be used is considered. While not an exhaustive list, areas where its use could be considered are:

- As part of the risk assessment (eg. for its use for the preliminary analytical review);
- Highlighting high risk transactions for testing (see below); and
- Stratification of populations for sampling (see below).

Where the use of ADA in other areas is planned, (eg. to gather audit evidence), this should be recorded on the Audit data analytics assessment form within planning and if applicable, on the Audit plan form within planning to confirm the audit plan has been suitable tailored to reflect its use.

Evaluation of the application being used

Before using ADA or other data analysis applications, the system being used needs to be understood and evaluated. Such applications may have been developed either internally or sourced from an external provider, but in either case, individual engagement files need to record how it was deemed appropriate for use. As a minimum this needs to evaluate the integrity of the application being used and the knowledge, expertise, and competence of the developers (whether internal or external to the firm). While the extent of evaluation needed requires an element of judgement in each case, as a general rule the more complex / sophisticated the application being used is, the extent of evaluation required increases.

The evaluation of the independence and expertise of the application developer needs to be considered, much in the same way auditors assess an expert. The application itself needs to have its integrity evaluated, in the same way an internally developed application would. Where the application being used is hosted by a third party, this should be discussed with the client to confirm they understand the role of the third party and respective responsibilities for data handling have been acknowledged and agreed.

Where the use of ADA purely involves analysing data within a spreadsheet, using relatively routine functionality that can be understood and reviewed by most individuals with basic spreadsheet training, this would generally involve explaining which functionality / formula(s) is being used and why they are considered appropriate.

Where a more bespoke ADA application is utilised (eg. one which automates the running of analytical tools based upon parameters within the application), this evaluation needs to be expanded to demonstrate an understanding of the automation within the application, how this has been assessed as reliable and as such is appropriate for use (eg. via user acceptance testing).

For larger firms, some efficiencies may be gained by a central team of experts within the firm undertaking the required testing and evaluation of the ADA application being used, which individual engagement teams then look to draw on when completing the Audit data analytics assessment form within planning, rather than the underlying evaluation of the application being performed by each individual audit team. Where teams use a centrally approved ADA application/functionality, they need to ensure the appropriate version is used on their engagement (i.e. not rolling forward an old version which is now out of date or accelerating the use of a new version prior to it being approved). Where individual engagement teams use a version of an ADA application that has not been tested and approved central, they should document why they are comfortable in using an unapproved version and how it is deemed appropriate for use.

Where an application utilises and relies on an algorithm (eg. use of machine learning or artificial intelligence), it is essential that development of any algorithms used is tracked, along with an audit trail to show how that algorithm has been tested and confirmed as being appropriate for use. It is expected that such testing (and approval for use) will be undertaken by a central team within the firm and that once approved any applications which utilise algorithms will be deployed and used consistently for a fixed amount of time (eg. 1 audit cycle) across all engagements, as this will help to ensure a consistent understanding of the application is in place across the firm. Individual teams looking to use such applications/algorithms with be responsible for confirming and documenting on each file that the version being used is appropriate , referencing where the testing of the version being used can be found and appraising why its use is considered appropriate for that specific engagement (eg there are no specific factors for that particular client which means it would not be reliable).

Evaluating the data to be used for ADA and other technology

Where applicable, each file should record details of the data set being analysed by ADA or other technological applications. In most cases this will be general ledger data, but could vary from audit to audit, with some analysing multiple data sets, from various sources (eg sales ledger, purchase ledger or inventory records from client systems).

Procedures to confirm the application has a complete and accurate data set(s) to be analysed will be performed. For general ledger data, this will generally be done by using the data set for all general ledger transactions during a period to reconcile the opening trial balance to the closing trial balance. The integrity of the data being used is evaluated, in particular considering controls around data extraction and the prevention of the data set being manipulated post extraction and also considering if wider audit procedures indicate any issues with the data set being used (eg. the results the preliminary analytical review) or if audit procedures need to be planned to test the validity of a data set (eg. where sales ledger data is being used, have audit procedures been planned to confirm this is complete and accurate).

Where teams are unable to validate the integrity of the data, then use of ADA is unlikely to be appropriate.

Preparing data for use in an application

In most cases where the application is using general ledger data, the chart of accounts will need to be mapped to the financial statements (eg. which general ledger accounts make up sales, cost of sales etc). While the account mapping will generally be rolled forward from one year to the next (with documentation also being rolled forward), any new accounts will need to be mapped in the first period they are used and an annual review should be performed to confirm if any accounts need to be remapped (eg. as a result of an accounting policy change).

For some uses, the application may also require the different document / transaction types within the clients general ledger data to be defined (for example manual journals, automated subledger posting, reversing journal etc), as these will generally present different levels of risk. As the coding of the different document / transactions types will vary between client systems this will be done for each engagement (although retaining a central firm wide library of system codes may provide some efficiencies should multiple clients use the same accounting software), with particular attention being paid to any bespoke document/journal types used by the client.

Where non-general ledger data is being analysed, the definition of the key data fields used by the application for its analysis will be considered. For example where ADA is being used to analyse aging of debtors, it is likely that the data fields which contain invoice number (as a document identified), invoice date (to determine age) and invoice amount. Where necessary the data fields which need to be defined with any internal experts (or the application developer) are confirmed.

Where sufficient understanding of the parameters needed for the application to analyse the data appropriately cannot be obtained, then use of ADA is unlikely to be appropriate.

Use of audit data analytics (ADA) for identifying high risk journals / transactions

As noted above, ADA can be applied to identify transactions for testing on the basis of risk criteria, including journal entries. This allows testing to be focused more efficiently than it would be using manual sample selection. This could involve using ADA to generate a risk score for each general ledger transaction, which can either be based upon artificial intelligence / machine learning, criteria set manually by the audit team (which is tailored for each client), or a combination of these methods depending on the ADA system being used.

Automated risk scoring

Where transactions have been risk scored using an automated ADA application, the application will usually have preset parameters set by the developer. These need to be understood and evaluated for their use for each client, ensuring they are tailored as appropriate. Given the bespoke nature of such applications, a freeform working paper will be needed to record this assessment, and a prompt to reference this included on the Audit plan form (use of ADA) within planning. For larger firms, some efficiencies may be gained by a central team of experts within the firm undertaking the required evaluation of the preset system parameters, wand this is considered when completing the assessment. Consultation where relevant with the central teams of experts or the application developer to confirm the appropriateness of any tailoring made to these parameters should be recorded.

Manual risk scoring

Where risk criteria are manually applied to transactions (eg when analysing data in a spreadsheet), each of the criteria selected should be allocated a risk score on a scale of 1 to 5 (1 being used for criteria which is considered to be the lowest risk and 5 for criteria which is considered the highest risk). The risk posed by certain factors will vary from client to client, and is tailored based upon the knowledge and experience of each client.

There are various criteria that can be applied when manually evaluating the level of risk posed by a transaction. While not an exhaustive list, common criteria to apply are as follows:

Risk Condition	**Example of criteria that could be applied**
Large amounts	Greater than or equal to performance materiality
Round sum amounts	Amounts which end 000.00, 999.99, 999.00
Unusual description / key word search	Descriptions which include names / titles of key management, directors and other related parties or unusual words such as adjust, correct etc
Transactions posted at unusual times	Journals posted when the office is usually closed, such as weekends or between 7pm and 8am
Back dated transactions	Journals which post to a prior period (i.e. a journal raised in accounting period 3 which is shown in accounting period 2)
Transactions posted and reviewed by the same person	Where a system had a ‘park and post’ or ‘maker/checker’ function and these roles have been performed by the same person
Transactions posted by an unexpected person	Journal posted by a senior member of staff/non-finance staff who typically are not involved in day to day ledger posting
Unexpected account combinations	Journals which are posted to accounts which would not typically be linked, for example sales and fixed assets

Transactions which bypass the expected transaction flow	System entries which are usually automated/triggered from a sub-ledger but are posted manually

These risk conditions and examples are not exhaustive examples and teams should also use their judgement to consider additional criteria and tailoring which could be applied relevant to the client. The justification for the criteria selected should be documented on file, with a template within the Audit plan form (use of ADA) within planning being provided for this.

Risk enhancers

To further tailor the risk score, certain ADA applications (both automated and manual) may allow us to enhance the risk score of a transaction by applying a multiple. This may be linked to certain document / journal types or members of client staff considered to present a higher risk, the financial statement assertion risks (eg. a high risk area could receive a higher risk multiple) or certain accounts which are considered inherently riskier due to their susceptibility to fraud. Details of enhancers applied should be recorded on the Audit plan form (use of ADA) within planning.

Manually calculating a transactions risk score

A transaction risk score is calculated by taking the sum of any risk scores triggered by a specific risk condition, which is then multiplied by any applicable risk enhancers (where no enhancer is applicable to a particular transaction, this will be assumed to be a multiplier of 1).

Example risk score calculation

Extract example of a manually applied risk criteria:

Risk condition	**Specific definition for this client**	**Risk score applied**
Large Value	£100,000 (performance materiality)	3
Round sum amount or transaction ending in '999'	Amount ending '000.00'	2
Transaction posted at unusual time	Any posting between before 7.30am and after 8.00pm Monday to Friday and at any time on a weekend	5

Extract example of a risk enhancer:

Risk enhancer	**Multiple to be applied**
Any transactions posted to Revenue	3

Example extract transaction data and scores calculation:

Description	Transaction ID	Account Dr	Account Cr	Value (£)	Time and Date	Risk score
Correction to accrued income	1234	Accrued income	Sales	200,000.00	11pm Friday dd/mm/yyyy	30 [(3+2+5)x3]
Monthly depreciation charge for Motor Vehicles	1235	P&L depreciation (Motor Vehicles)	Accumulated depreciation (Motor Vehicles)	105,000.00	2pm Monday dd/mm/yyyy	5 [(3+2)x1]

Items to be selected for testing

The final element of tailoring is setting the criteria which highlight the transaction to be tested. A risk score is set and any transactions which score equal or greater than this will be selected for testing. Consideration of other specific risk factors which may trigger a transaction to be tested or why it can be excluded from testing (eg. the value of the transaction is trivial or a reversing journals where it can be confirmed the net impact in the period is nil) and the rationale for using is recorded on the Audit plan form (use of ADA) within planning.

Where teams are relying on an algorithm (eg. in which risk scoring is done via machine learning or artificial intelligence), the understanding and evaluation of the appropriateness of the algorithm being used should be recorded on the Audit data analytics assessment form within planning.

Use of ADA for testing and responding to assessed risks

Evaluating the results of testing obtained from ADA

Where we undertake testing utilising ADA, this will generally involve us using the application to develop an expectation for the population being tested. This will draw on our understanding of the entity and ensure the application being used is appropriate for the specific circumstances of the entity.

Upon reviewing the results we may find these are generally in-line with our expectations, with some exceptions that require further testing. However in some circumstances we may find the results do not match our expectations, with a significant number of outliers within the population meaning further analysis is needed before we can begin to test exceptions.

Outliers which cause a deviation to our expectation can arise through one or a multiple of the following factors:

1. Our understanding of the entity was not sufficient to appropriately calibrate and set the parameters within the ADA application.
2. The data may not be of sufficient quality to facilitate the use of the ADA.
3. Our initial evaluation of the appropriateness of the use of ADA for this entity may be inappropriate.

Point two may be overcome through data cleansing activity or discussion with the client to evaluate if a more refined data set is available. Where this is the case we will need to ensure our evaluation on the Audit data analytics assessment form within planning is updated accordingly. Where this is not possible we will need to modify our planned approach accordingly.

The third point will also mean we will need to modify our planned approach accordingly.

For the first point above we may be able to recalibrate the parameters upon revising our understanding of the entity. Should we look to do this, the following points are areas to consider:

- Undertaking careful analysis of the outliers in order to assess which of the parameters used within the ADA require refinement and how this needs to be done. This includes revisiting our understanding of the entity and its environment to determine if parameters can be refined in order to reduce the number of outliers or identify those which are truly exceptions and therefore warrant further investigation as exceptions.

- Discussion with management, in a similar fashion to how we would when refining an expectation when undertaking analytical procedures in line with ISA 520, to understand the underlying data and potential relationships better.

When redefining the parameters used when applying ADA we need to be mindful to not adjust these for inappropriate reasons which include:

- Artificially reducing the amount of work required which ultimately results in obtaining insufficient appropriate audit evidence.
- Attempting to generate the same number of outliers / exceptions as seen in previous periods.
- Adjusting the parameters to compensate for data quality issues.

Once we are comfortable that the ADA application has been configured appropriately such that there are no outliers and any deviations from our expectation are due to true exceptions, we begin substantively testing these.

When testing the exceptions we will first need to consider if the population is homogenous, in which case sampling these can be considered. Where we determine the population is not homogenous we will need to consider if there is scope to stratify the population of exceptions into homogenous sub-populations before beginning sampling and substantive testing of these discrete groups. Where we do stratify the population of exceptions we need to take care that when sampling based on sub-populations, the untested population in a single financial statement line item does not exceed materiality.

Guidance on considerations to make when stratifying populations is given in your firm's Audit Procedures Manual.

For the remaining population (i.e. that which falls in-line with our expectation), we may be able to leverage testing undertaken elsewhere in the audit file in order to gain comfort over the non-exception population. Where this is not the case we will need to consider what additional procedures are needed.

The use of ADA and other technology and ethics

The use of certain ADA applications and / or other technology may allow us to communicate more detailed and meaningful insights to management. However, this does not extend beyond feedback that would be seen as being the normal by product of the audit, into wider commentary and analysis that could be seen as offering business advice that could be used in a managerial decision making process.

4.2.3 Auditor's reports

Example audit reports can be found in FRC Bulletin 'Illustrative Auditor's Reports On United Kingdom Private Sector Financial Statements (August 2021)', which are prepared in accordance with the requirements of ISA (UK) 700 (Revised November 2019) and ISA (UK) 570 (Revised September 2019). The Bulletin can be found at www.frc.org.uk/auditors/audit-assurance/standards-and-guidance/bulletins. The only example reports included are for companies.

Revised ISA 700 requires auditors to explain in the auditor's report to what extent the audit was considered capable of detecting irregularities, including fraud. The Audit and Assurance Faculty of the ICAEW have published a guide for auditors on reporting on irregularities, including fraud and can be found at: https://www.icaew.com/insights/viewpoints-on-the-news/2020/oct-2020/guide-for-auditors-on-reporting-on-irregularities-including-fraud

Under revised ISA 570, where the auditor concludes the going concern basis is appropriate and no material uncertainty exists, a positive conclusion regarding going concern is now required under 'Conclusions related to going concern' or other appropriate heading.

Example audit reports for charities have been updated in accordance with this and can be found in the example reports section of this manual.

[For England and Wales]

As noted earlier in these guidance notes, at the time of publication of this manual The Charities (Accounts and Reports) Regulations 2008 still refer to non-company charities in England and Wales preparing accounts under the SORP 2005. The FRC Feedback Statement published alongside PN 11 in November 2017 stated the following in this regard:

"The Charity Commission in England and Wales has provided guidance which effectively requires preparers of non-company charities' financial statements to depart from the requirement in the Regulations to prepare the financial statements in accordance with the 2005 SORP and instead prepare them in accordance with the new SORP. Provided that the financial statements disclose why a departure from UK GAAP is necessary for the financial statements to give a true and fair view in accordance with the provisions set out in UK GAAP, then the auditor should not need to refer to the matter in the auditor's report. As with any other true and fair override, the auditor would not need to qualify the auditor's opinion for a breach of the relevant law. This will be resolved when the Charities Regulations are updated, however, until then we have drawn attention to this in this feedback statement rather than the Practice Note to avoid the risk of it quickly becoming out of date."

If a parent charitable company is deemed small in the context of small group size criteria per company law then a similar issue arises as these 'small' charitable groups also follow The Charities (Accounts and Reports) Regulations 2008.

This issue does not affect single entity charitable companies in England and Wales or any charity in Scotland or Northern Ireland.

4.2.3.1 Responsibilities in connection with the trustees' report

ISA (UK) 720 requires that the auditor reads 'other information' included in the annual report (eg. the trustees report) and, in doing so, considers whether it is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit, or otherwise appears to be materially misstated. If material inconsistencies or apparent material misstatements are identified, the auditor must determine whether there is a material misstatement in the financial statements or a material misstatement of the 'other information'. If based on the work performed, it is concluded that there is a material misstatement of 'other information', this fact is reported.

Work undertaken on the trustees' report to satisfy the requirements of ISA (UK) 720 includes evaluation with consistency, comparison of selected amounts with financial statement information and considering whether, in the context of audit evidence obtained and conclusions reached in the audit, there is a material inconsistency with knowledge obtained in the audit.

Due to charity law driven auditor reporting requirements on consistency of the trustees' report with the financial statements, requirements applicable to the audit of 'statutory other information' also apply to audits of charities. ISA (UK) 720 includes requirements to understand the requirements for 'statutory other information', how the entity complies with those requirements and perform such procedures as necessary to comply with the relevant legislative reporting requirements.

The auditor reports in accordance with relevant law and regulation and the requirements of ISA (UK) 720 paragraph 22. For non-company charities, charity law requires the auditor to report by exception on such matters.

Limited company charity audits

In addition to the above, company law requires the auditor to state an opinion based on the work undertaken in the course of the audit as to whether the information given in the directors report and strategic report (if applicable) is consistent with the financial statements and that these narrative reports have been prepared in accordance with the applicable legal requirements.

It is also a requirement to separately state whether in light of the auditor’s knowledge and understanding of the charity and its environment obtained during the course of the audit, they have identified material misstatements in the directors report and strategic report (if applicable). The quality of information within these narrative reports will therefore be considered. Members of the team have the skill and experience to use professional judgement to interpret the requirements of legislation in order to be able to assess these opinions.

For limited company charities, the auditor reports in accordance with relevant law and regulation and the requirements of ISA (UK) 720 paragraphs 22 to 22D-1.

The relevant example audit reports are included in the example reports section of this manual include these requirements.

4.2.4 Ceasing as auditor

Where the charity is audited under the Companies Act 2006, the auditor cessation requirements of that Act will apply.

In addition, for all charities, 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(s) concerned.

4.3 Independent examination

Guidance on the independent examination of charities is included within the Charities Independent Examination Manual ~~(included as part of the Charities Manual Package).~~

5 Other reporting requirements

5.1 Reporting to the regulator

5.1.1 Introduction

Auditors and independent examiners of charities in England and Wales, Scotland and Northern Ireland have a common statutory duty to report matters of material significance to charity regulators.

In 2017, the Charity Commission for England and Wales (CC), the Office of the Scottish Charity Regulator (OSCR) and the Charity Commission for Northern Ireland (CCNI) agreed a common list of matters of material significance to assist auditors or independent examiners in reporting important matters on a timely basis and published joint guidance on doing so.

The guidance is available at https://www.gov.uk/government/publications/guidance-for-auditors-and-independent-examiners-of-charities and was reissued in April 2020. Further guidance on auditors reporting to the regulator is also included in PN 11.

Legal requirements across the different legislative frameworks are summarised below.

England and Wales

The Charities Act 2011 (CA11), sections 156 to 159, places a duty on the auditors and independent examiners of both a non-company charity and a company charity to report matters of "material significance" to the CC.

Scotland

In Scotland, section 46 of the Charities and Trustee Investment (Scotland) Act 2005 provides a similar duty to report to the OSCR. This duty applies to all auditors and independent examiners, regardless of whether the charity is incorporated or not.

Northern Ireland

In Northern Ireland, sections 67 (non-company charities) and 103 (charitable companies) of the Charities Act (Northern Ireland) 2008 provides a similar duty to report to the CCNI.

Cross border charities

In the case of cross border charities, if there is any doubt due to the fact that the charity is registered in more than one jurisdiction, then the auditor or independent examiner should make the report to all relevant regulators.

5.1.2 What must be reported

The duty to report arises where the auditor / examiner, in the course of their work, identifies a matter, which relates to the activities or affairs of the charity, or of any connected institution or body, and which they have reasonable cause to believe is likely to be of material significance for the purposes of the exercise by the regulator of its functions.

Auditors / examiners are only required to communicate matters described as being of material significance in the context of the regulator's functions. In England and Wales, these functions are set out under sections 46, 47 and 50 (inquiries) and 76 and 79 to 82 (power to act for protection of charities) of the CA11. In Scotland, the functions are set out in sections 28, 30 and 31 of the Charities and Trustee Investment (Scotland) Act 2005. In Northern Ireland these functions are laid out in part 5 of the Charities Act (Northern Ireland) 2008.

Determining whether a matter is reportable involves consideration both of 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 regulator. The regulations do not require auditors or examiners 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, in circumstances where they identify that a reportable matter may exist, they should carry out such extra work, as considered necessary, to determine whether the facts and circumstances give them 'reasonable cause to believe' that the matter does in fact exist. It should be noted that the work done does not need to prove that the reportable matter exists.

In charity law the term 'material significance' is used to determine which matters should be reported to the charity regulators. Auditors and independent examiners must report any matters of material significance which they become aware of during their appointment. It should be noted that in this context materiality is not only financial materiality. It includes all matters which would be of material significance to a regulator in carrying out their function such as a safeguarding issue affecting beneficiaries or an issue that could impact on the charitable status of an organisation.

The determination of whether a matter is, or is likely to be, of material significance to the regulator inevitably requires auditors to exercise their judgement. In forming such judgements, 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.

In order to recognise whether a situation is likely to be of material significance to a regulator's function an understanding is needed of those matters which either due to their nature or potential financial impact are likely to require evaluation and, where appropriate, investigation by the regulator.

The CC / OSCR / CCNI will always consider the following to be of material significance and hence reportable:

- matters suggesting dishonesty or fraud involving a significant loss of, or a material risk to, charitable funds or assets;

- 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;

- knowledge or suspicion that the charity or charitable funds, including its 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;

- 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 the UK (with the exception of matters related to a qualifying offence as defined by Section 3(7) of the Northern Ireland (Sentences) Act 1998);

- 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 significance risk of abuse or mistreatment;

- single or recurring breach(es) of either a legislative requirement or of the charity's trusts leading to material charitable funds being misapplied;

- evidence suggesting a deliberate or significant breach of an order or direction made by a regulator under statutory powers including suspending a trustee, prohibiting a particular transaction or activity or granting consent on particular terms involving significant charitable assets or liabilities;

- on making a modified audit opinion, emphasis of matter or 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; and

- evidence that significant conflicts of interest have not been managed by the trustees and / or related party transactions have not been fully disclosed in all respects required by the applicable SORP, or applicable Regulations.

A whistleblowing checklist is included in the relevant current file / work programme sections of this manual which may be completed to help identify possible reportable matters.

5.1.3 Timing of report

In reaching their conclusion as to whether a report is required, auditors / examiners may wish to take appropriate advice and consult with colleagues, a professional body or lawyers.

Unless the matter casts doubt on the integrity of the trustees this should not preclude discussion of the matter with trustees and seeking such further advice as is necessary, so that a decision can be made on whether or not a duty to report exists. Such consultations and discussions are however undertaken on a timely basis to enable auditors / examiners to conclude on the matter without undue delay.

The regulators expect a report to be made in accordance with the following timescales:

- as soon as possible on becoming aware of an immediate risk to charitable funds, a material loss due to fraud, or doubts as to the integrity of trustees or key management personnel; or
- in instances where the auditor or examiner concludes that the trustees and / or key management personnel are uncooperative, deliberately unresponsive, or unreasonably slow in responding to the auditor or examiner seeking to discuss a reportable matter, then the report is made as soon as possible and in such cases the auditor or examiner should include reference to this behaviour in their report; or
- on signing or making a modified audit opinion, an audit opinion with an emphasis of matter or material uncertainty regarding going concern; or
- on signing or making an independent examination report where the regulator's guidance identifies there is a duty to report; or
- for those accounts that must be tabled before a Parliament or a Governmental Assembly, once the tabling process has been completed; or
- for other circumstances not listed above, reporting is done as soon as possible following on from any discussion(s) had with trustees.

5.1.4 Signing a modified report

The CC / OSCR / CCNI guidance notes that where an auditor or independent examiner makes reference to obsolete regulatory references to an old SORP in their report (see paragraphs 7.15 and 8.5) such a reference is not considered to be a matter of material significance to the charity regulator.

5.1.5 Contents of a report to the regulator

The method of reporting is by email for each of the regulators as follows:

CC: AuditIEMoMS@charitycommission.gov.uk

OSCR: Section46@oscr.org.uk

CCNI: concernsaboutcharities@charitycommissionni.gov.uk

- a header 'Matter(s) of material significance reported';

- the auditor's / examiner's name and contact address, telephone number and / or e-mail address;
- the charity's name and registration number (if applicable);
- a statement that the report is made in accordance with section 156 of the Charities Act 2011 (England and Wales only);
- under which of the nine headings of reportable matters the report is being made;
- describe the matter giving rise to concern and the information available on the matter reported and, where possible, provide an estimate of the financial implications;
- where the trustees are attempting to deal with the situation, a brief description of any steps being taken by trustees of which the examiner has been made aware;
- if the report concerns terrorist, money laundering or other criminal activity whether you have notified the National Crime Agency and / or Police as appropriate;
- if the report concerns the abuse of vulnerable beneficiaries whether you have informed the Police and / or social services.

Auditors / examiners are not relieved of their duty to make a written report where an oral report has been previously made to the CC / OSCR / CCNI or by any informal discussions of the issue with CC / OSCR / CCNI staff. Similarly, they are not relieved of their duty to report on the basis that any other party has provided relevant information, whether written or oral, to the CC / OSCR / CCNI.

5.1.6 Reporting to the National Crime Agency (NCA) and to the Regulator

It should be noted that the submission of a report to NCA under the Anti-Money Laundering Regulations does not relieve an auditor of a duty to report that matter to charity regulators where the information is of material significance to the Regulator's function.

5.1.7 What may be reported?

A separate statutory right (as opposed to a duty) to report to the appropriate regulator also exists and may be used by auditors / examiners. Auditors / examiners may become aware of circumstances which in their opinion does not give rise to a duty to report to the regulator but which should, in the auditor's / examiner's professional judgement, be brought to their attention. Where any report is made auditors / examiners rely on the protection afforded by general law.

In May 2019 CC / OSCR / CCNI updated their joint guidance on reporting of relevant matters of interest to UK charity regulators. The guidance provides examples of the types of matters that the regulators consider to be relevant. The guidance is available at:

https://www.gov.uk/government/publications/reporting-relevant-matters-of-interest-to-uk-charity-regulators

Reporting to CC (England and Wales)

Reports to CC should be made to the email address outlined in paragraph 10.5 until such time as digital notification using an online form is established. The e-mail should be headed 'Reporting of relevant matters of interest to the Commission' and should provide the following information:

- the auditor's / examiner's name and contact address, telephone number and / or e-mail address;

- the charity's name and registration number (if applicable);
- a statement that the report is made in accordance with section 156 of the Charities Act 2011;
- describe the matter giving rise to concern and the information available on the matter reported and, where possible, provide an estimate of the financial implications;
- where the trustees are attempting to deal with the situation, a brief description of any steps being taken by trustees of which the examiner has been made aware.

Reporting to OSCR / CCNI

Reports to OSCR / CCNI should be made to the respective email addresses outlined in paragraph 10.5 and the email subject line should include reference to reporting of one or more relevant matters and the body of correspondence should identify:

- the party reporting and the charity;
- an explanation of the issue of concern;
- identification of any supporting evidence regarding the matter under report; and
- a method of contact to follow up on the information received.

11 Other sources of information

England, Wales, Scotland and Northern Ireland

HM Revenue & Customs:

- Charities, Savings and International 2 HM Revenue and Customs BX9 1BU
- Telephone: 0300 123 1073
- Website: www.gov.uk/charities-and-tax
- Online contact: www.gov.uk/government/organisations/hm-revenue-customs/contact/charities-and-community-amateur-sports-clubs-cascs

England and Wales

Charity Commission:

- Charity Commission Direct, PO Box 1227, Liverpool. L69 3UG.
- Central telephone help line: 0300 066 9197
- Website: https://www.gov.uk/government/organisations/charity-commission

Scotland

Office of the Scottish Charity Regulator

- OSCR, 2nd Floor, Quadrant House, 9 Riverside Drive, Dundee. DD1 4NY.
- Telephone: 01382 220 446
- Website: www.oscr.org.uk

Northern Ireland

The Charity Commission for Northern Ireland

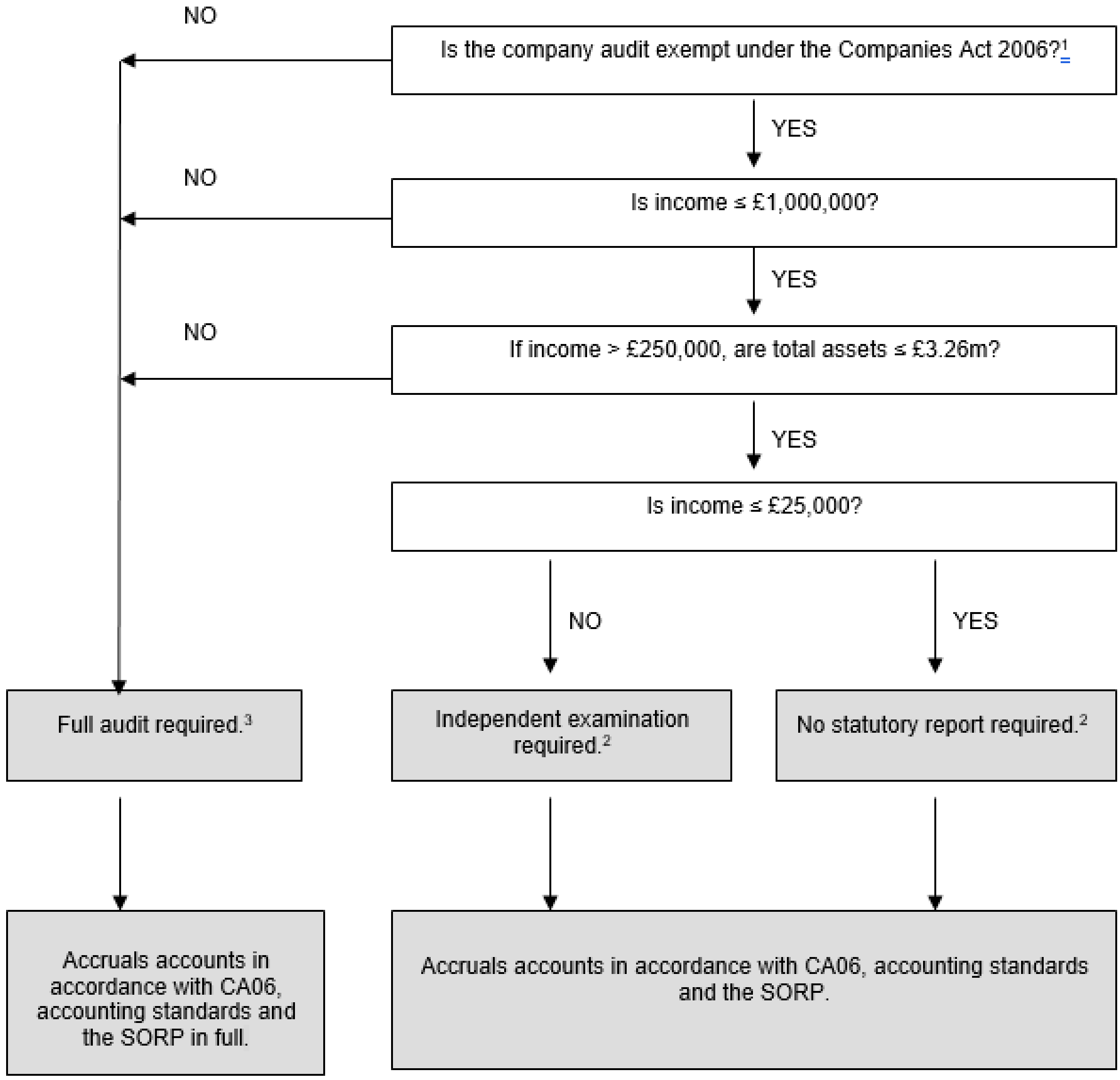
- The Charity Commission for Northern Ireland, 257 Lough Road, Lurgan, Craigavon, BT66 6NQ
- Telephone: 028 3832 0220
- Website: www.charitycommissionni.org.uk

Charities SORP Micro Site

- Website: http://www.charitysorp.org/

This manual reflects existing legislation and current best practice. However the sector has seen an increasing rate of change in recent years, and the professional adviser needs to keep up to date with relevant developments.

Appendix 1a: Accounting and reporting requirements flowchart - England and Wales: limited company charities



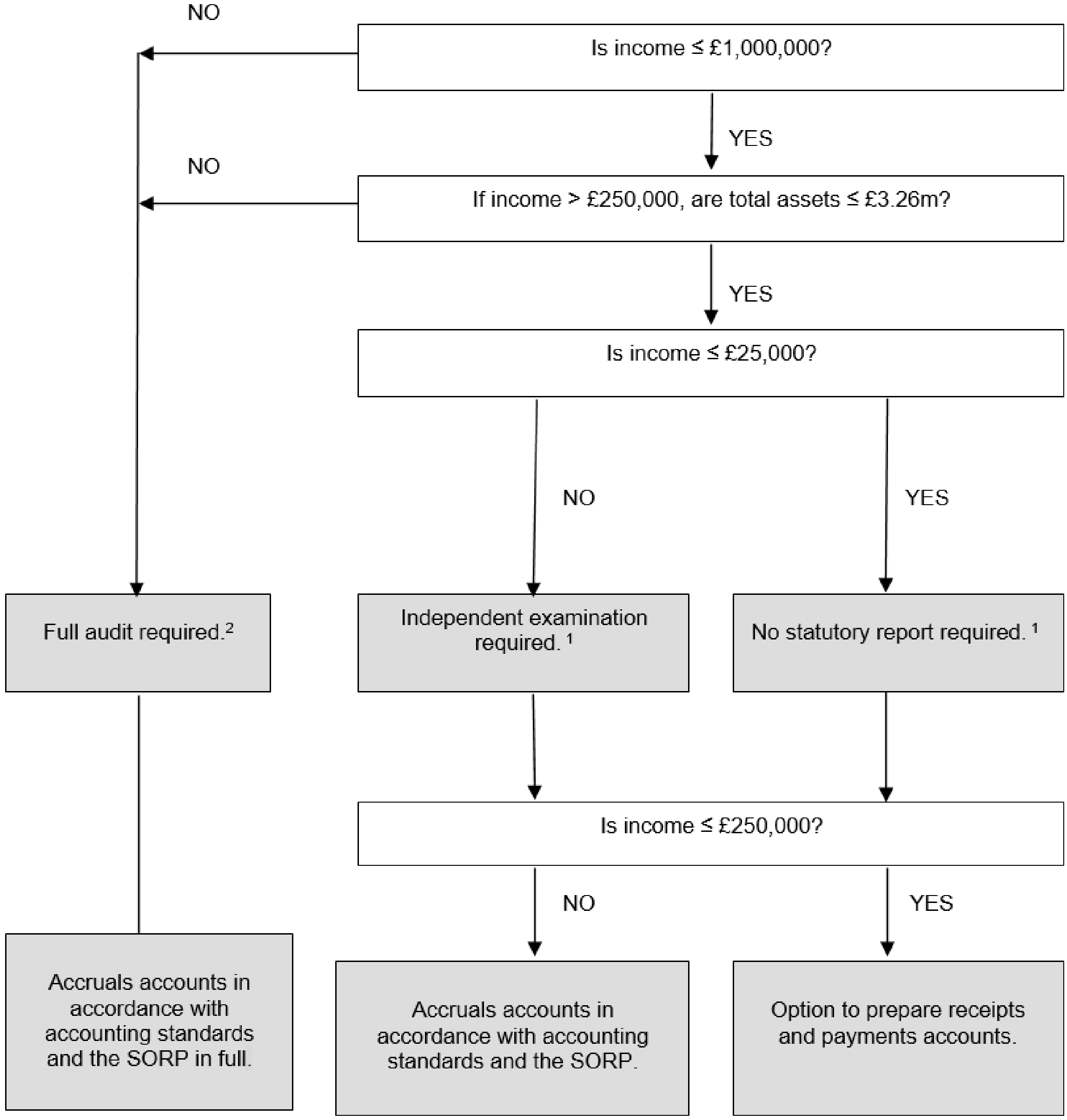
[1] *In order to qualify for audit exemption a company must qualify as a small company in relation to that year (NB. This will require consideration of size per the qualifying condition in both the current and previous year and what size the company reported as in the previous year). The qualifying conditions are met by a company in a year in which it satisfies two or more of the following requirements:*

- *Turnover: Not more than £10.2m*
- *Total assets: Not more than £5.1m*
- *Average number of employees: Not more than 50*

[2] *If there is an audit requirement in the charitable company's governing document or more than 10% of members have requested an audit, a full audit is required.*

[3] *Where a Companies Act 2006 audit is not required an audit under the Charities Act 2011 may be selected. If so the Balance Sheet must include an exemption statement, stating that the company is not required to have an audit under s477/s480 of the Companies Act. This statement can be clarified to explain that, however, an audit is required under the Charities Act 2011.*

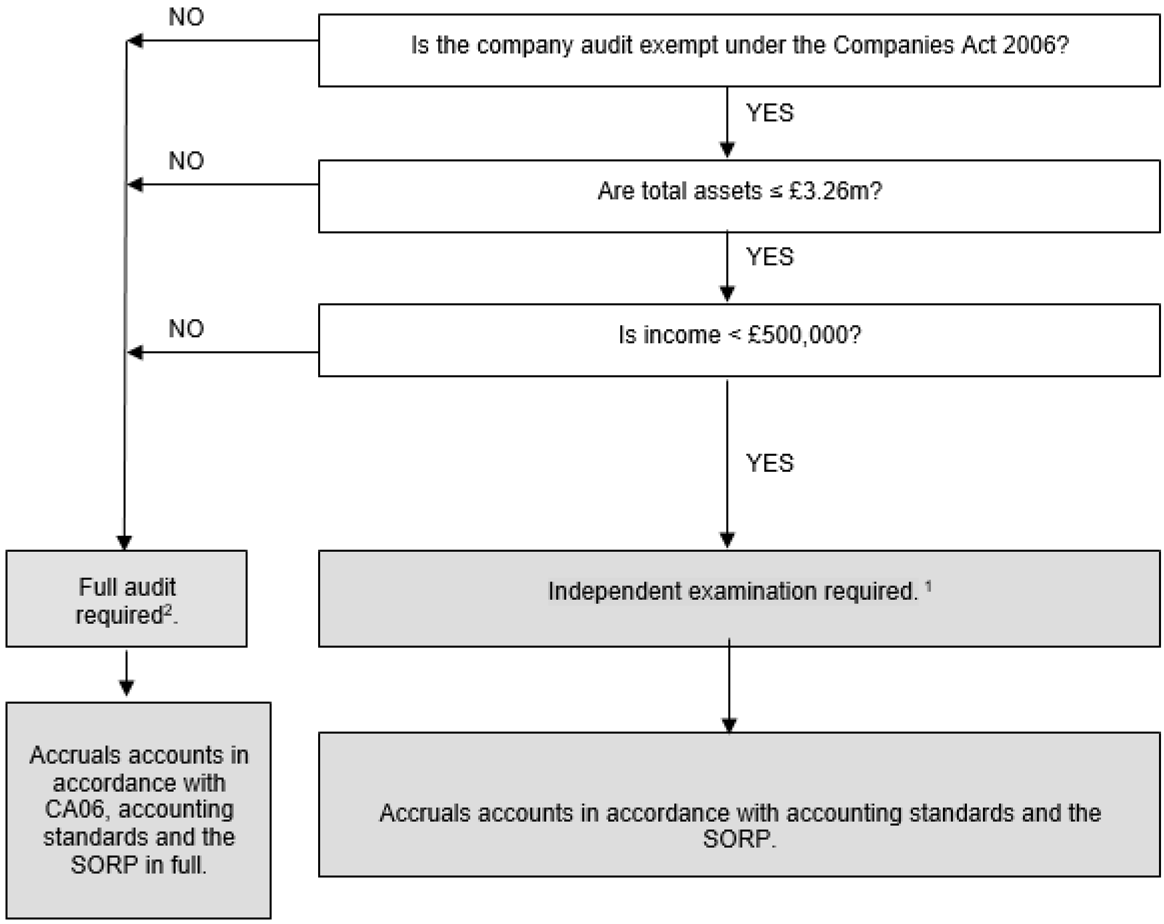
Appendix 1b: Accounting and reporting requirements flowchart - England and Wales: unincorporated charities and CIOs



[1] *If there is an audit requirement in the charity's governing document, a full audit is required, in accordance with the Charities Act 2011. See paragraph 3.6 of these guidance notes if the governing document was written prior to 1 March 1992.*

[2] *A full audit in accordance with the Charities Act 2011.*

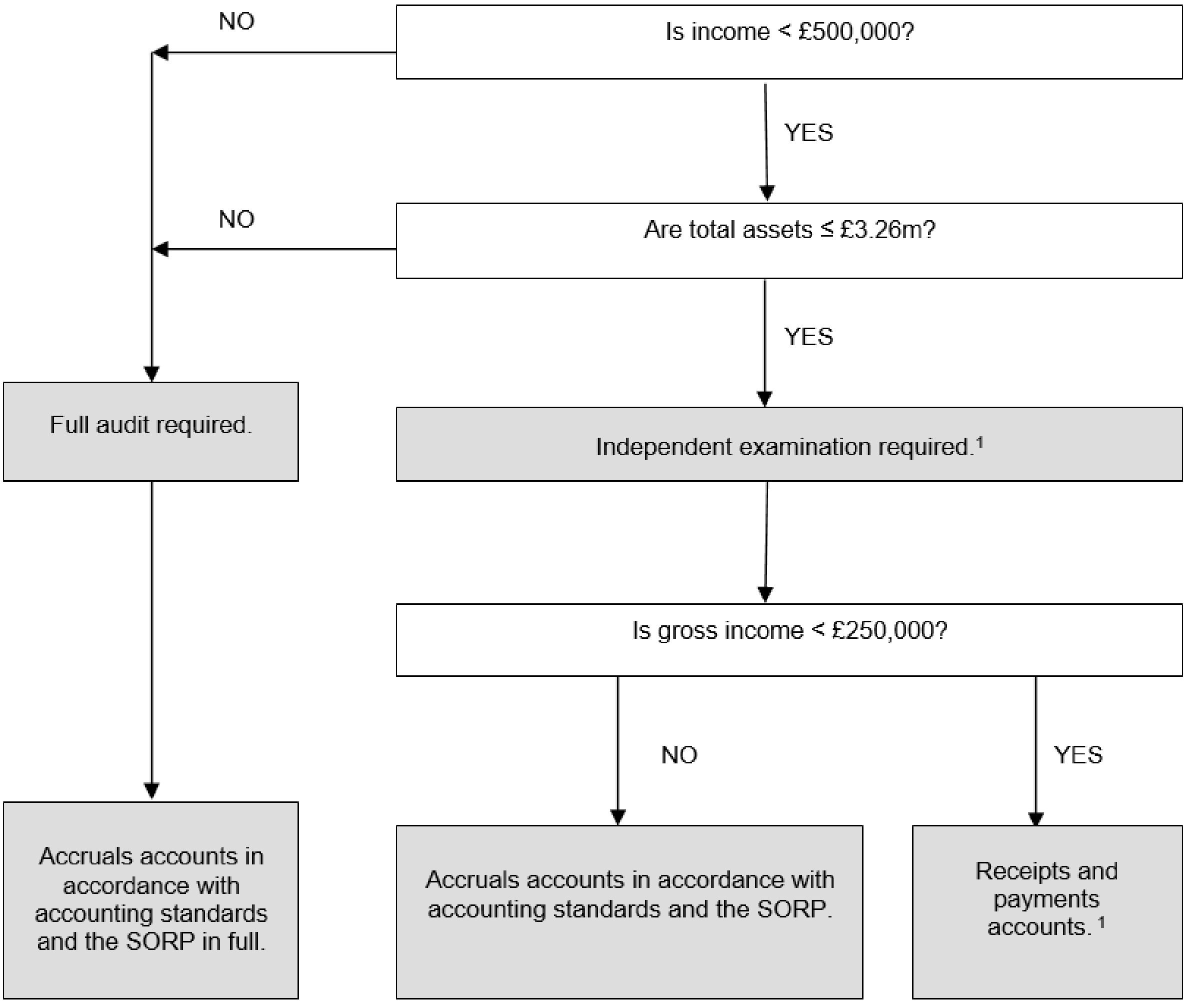
Appendix 2a: Accounting and reporting requirements flowchart - Scotland: limited company charities



[1] If there is an audit requirement in the charitable company's governing document, or more than 10% of members have requested an audit, a full audit is required.

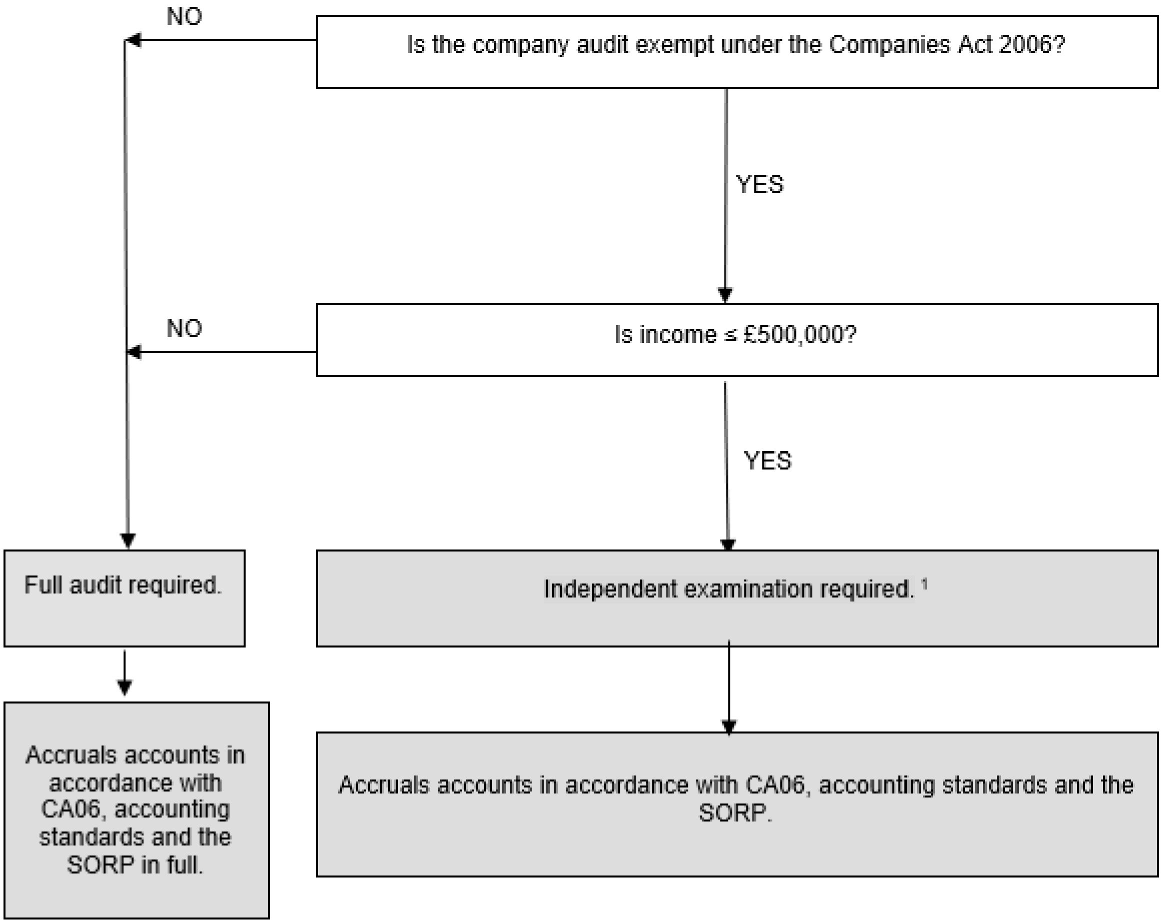
[2] The Institute of Chartered Accountants of Scotland strongly recommends that a full audit is carried out in accordance with both company and Scottish charity law and that exemption from the Companies Act audit should not be taken.

Appendix 2b: Accounting and reporting requirements flowchart - Scotland: unincorporated charities and SCIOs



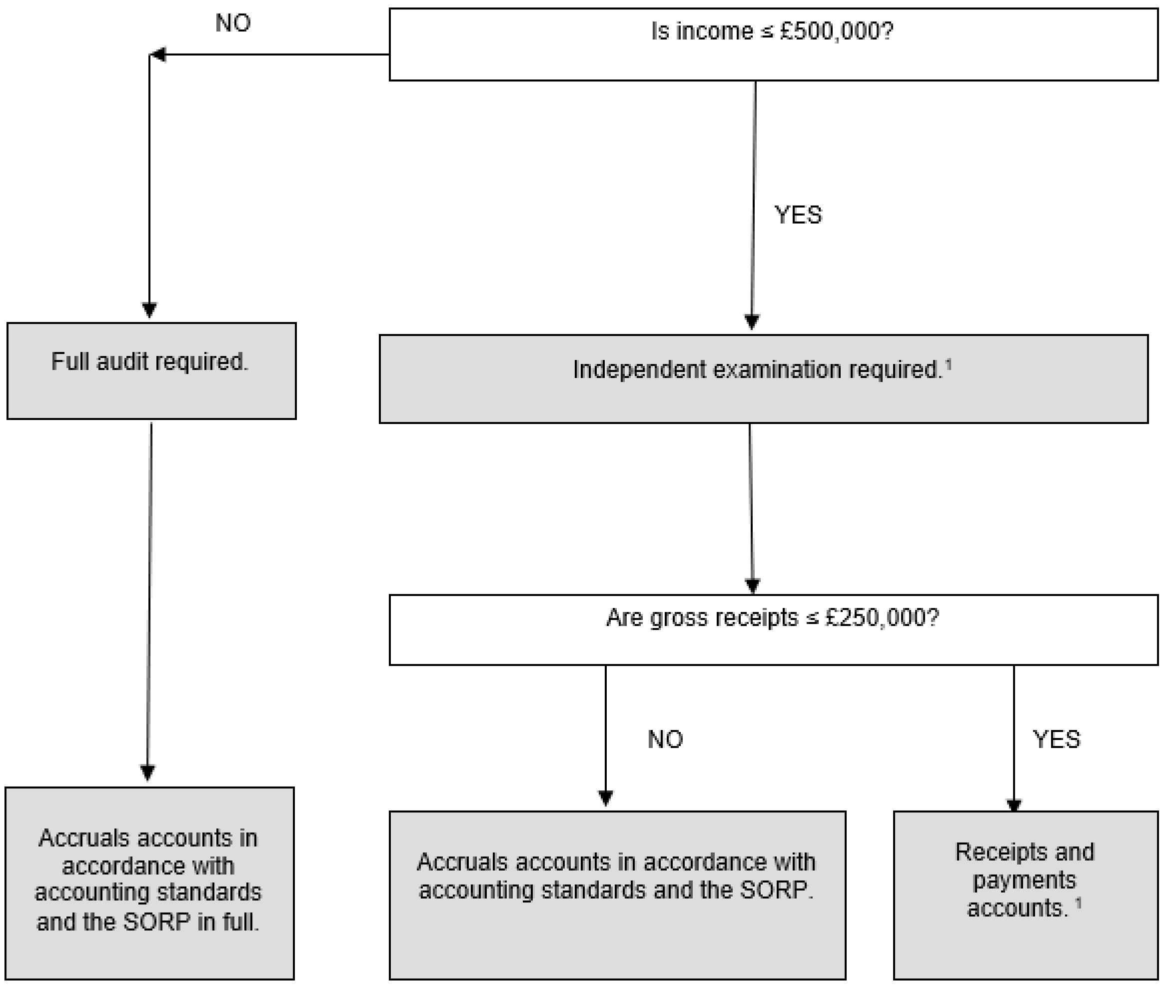
[1] If there is an audit requirement in the charity's governing document, a full audit is required, and accruals accounts must be prepared.

Appendix 3a: Accounting and reporting requirements flowchart - Northern Ireland: limited company charities



[1] *If there is an audit requirement in the charitable company's governing document, or more than 10% of members have requested an audit, a full audit is required.*

Appendix 3b: Accounting and reporting requirements flowchart - Northern Ireland: unincorporated charities



[1] *If there is an audit requirement in the charity's governing document, a full audit is required, and accruals accounts must be prepared.*

Appendix 4a: Notes for completion of planning form B25 - Materiality

Materiality – Notes for completion
The objective of the materiality form is to determine materiality and performance materiality.

Materiality B25

Objective: To determine materiality and performance materiality

For guidance on materiality, refer to Appendix 4 of the guidance notes in this manual. NB. Shaded areas to be completed at the completion stage of the audit.

		Expected Current Year £'000	Actual Current Year £'000
Benchmarks			
Income			
Adjustments for unusual transactions or items			
Adjusted income			
Surplus			
Assets (state "net" or "gross")			
Other			
Basis for determining materiality			
Adjusted income	%		
Surplus	%		
Assets (state "net" or "gross")	%		
Other (specify ____________________)	%		
Justification for materiality level:			
Materiality for the financial statements as a whole			
Justification for performance materiality level:			
Performance materiality			
Amount below which misstatements are clearly trivial			
Audit areas requiring other levels of materiality and performance materiality (e.g. trustees' / directors' transactions / restricted funds):			

Conclusions

Planning materiality
The planned levels of materiality are appropriate for this audit.

Prepared by		Dated:	
Reviewed by		Dated:	

Final materiality
The final level of materiality is appropriate for this audit

Prepared by		Dated:	
Reviewed by		Dated:	

Other could include total expenditure or total funds.

State which benchmark from above and the percentage or level to be adopted. ISA (UK) 320 suggests 5% of unadjusted profit may be used for a profit-orientated entity in a manufacturing industry or 1% of income for a non-for-profit entity but other benchmarks and higher or lower percentages may be appropriate.

Materiality on the financial statements as a whole relates to the level at which misstatements (including omissions) individually or in the aggregate would affect the decisions of users of the financial statements. Materiality is not affected directly by audit risk but some of the factors in determining materiality may also lead to increased audit risk.

Performance materiality is the working level of materiality used throughout the fieldwork as a guide as to which balances and transactions need to be tested.

It is the amount set at less than materiality (ie. for the financial statements as a whole) to reduce to an acceptably low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

Performance materiality may be set at an amount or a percentage of materiality on the financial statements as a whole. This percentage is a matter of judgement but is affected by the auditor's understanding of the entity, updated during the risk assessment procedures, and the expectation of misstatements. For example, where the overall risks are low the auditor may set performance materiality at 90% of materiality. Where the risk of misstatement is higher, the auditor should use a lower percentage of materiality.

Clearly trivial refers to matters which are clearly inconsequential and is of a wholly different (smaller) magnitude than performance materiality (for example the auditor may use up to 5% of materiality). Where there is uncertainty as to whether something is clearly trivial, it should be assumed that it is not.

State the area and the level of materiality and performance materiality.

Revisit the levels of materiality and performance materiality at the closing stages of the audit, and consider if / how this impacts the audit.

Appendix 4b: Notes for completion of planning form B41 - Materiality

Materiality – Notes for completion
The objective of the materiality form is to determine materiality and performance materiality.

Materiality B41

Objective: To determine materiality and performance materiality

For guidance on materiality, refer to Appendix 4 of the guidance notes in this manual. NB. Shaded areas to be completed at the completion stage of the audit.

		Expected Current Year £'000	Actual Current Year £'000
Benchmarks			
Income			
Adjustments for unusual transactions or items			
Adjusted income			
Surplus			
Assets (state "net" or "gross")			
Other			
Basis for determining materiality			
Adjusted income	%		
Surplus	%		
Assets (state "net" or "gross")	%		
Other (specify ____________________)	%		
Justification for materiality level:			
Materiality for the financial statements as a whole			
Justification for performance materiality level:			
Performance materiality			
Amount below which misstatements are clearly trivial			
Audit areas requiring other levels of materiality and performance materiality (e.g. trustees' / directors' transactions / restricted funds):			

Conclusions

Planning materiality
The planned levels of materiality are appropriate for this audit.

Prepared by		Dated:	
Reviewed by		Dated:	

Final materiality
The final level of materiality is appropriate for this audit

Prepared by		Dated:	
Reviewed by		Dated:	

Other could include total expenditure or total funds.

State which benchmark from above and the percentage or level to be adopted. ISA (UK) 320 suggests 5% of unadjusted profit may be used for a profit-orientated entity in a manufacturing industry or 1% of income for a non-for-profit entity but other benchmarks and higher or lower percentages may be appropriate.

Materiality on the financial statements as a whole relates to the level at which misstatements (including omissions) individually or in the aggregate would affect the decisions of users of the financial statements. Materiality is not affected directly by audit risk but some of the factors in determining materiality may also lead to increased audit risk.

Performance materiality is the working level of materiality used throughout the fieldwork as a guide as to which balances and transactions need to be tested.

It is the amount set at less than materiality (ie. for the financial statements as a whole) to reduce to an acceptably low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

Performance materiality may be set at an amount or a percentage of materiality on the financial statements as a whole. This percentage is a matter of judgement but is affected by the auditor's understanding of the entity, updated during the risk assessment procedures, and the expectation of misstatements. For example, where the overall risks are low the auditor may set performance materiality at 90% of materiality. Where the risk of misstatement is higher, the auditor should use a lower percentage of materiality.

Clearly trivial refers to matters which are clearly inconsequential and is of a wholly different (smaller) magnitude than performance materiality (for example the auditor may use up to 5% of materiality). Where there is uncertainty as to whether something is clearly trivial, it should be assumed that it is not.

State the area and the level of materiality and performance materiality.

Revisit the levels of materiality and performance materiality at the closing stages of the audit, and consider if / how this impacts the audit.

Appendix 5.1a: Notes for completion of planning form B40

Audit plan - Trial balance (use of ADA)

Audit plan - Trial balance (use of ADA) – Notes for completion
The objective of Audit plan - Trail balance (use of audit data analytics) is to tailor the use of ADA when being used to identify journals/significant unusual transactions for testing. This form is only necessary where audit data analytics (ADA) is planned to identify high risk transactions for testing.

Audit plan - Trial balance (use of ADA) B40/N2(ADA)

Objective: To record the use of audit data analytics (ADA) when being used to identify journals / significant unusual transactions for testing.

For guidance on completing this audit plan, refer to Appendix 5.1 of the guidance notes in this manual.

B21 must be completed to appraise the use of ADA.

Risk criteria to identify high risk journals / transactions

Transactions have been risk scored using an automated ADA application. The parameters used by the system (including details of any tailoring specific to this client), with justification for why these are considered appropriate are set out on sch______.[1]	☐
Transaction risk criteria is being applied manually[2]. Tailoring of the risk criteria for this client is detailed below or on sch ____.	☐

To confirm if an automated or manual ADA application is being used to risk score transactions, including an indication of where the parameters used for the risk assessment are set out and have been assessed. For automated, it may be easiest to reference to a printed schedule from the application alongside clear justifications on the parameters.

Risk criteria to be applied manually:[3]

Risk condition	Relevant for this engagement (Y/N)	Specific definition	Risk score applied	Justification
Large value				
Round sum amounts or transactions ending '999'				
Unusual description / key word search				
Transactions posted at an unusual time				
Back dated transactions				
Transactions posted and reviewed by the same person				
Transactions posted by an unexpected person				
Unexpected account combination(s)				
Other (describe):				

For manual scoring, indicate if a particular criterion is considered relevant or not (Y/N). NB. the list of risk conditions is not exhaustive and customised risk conditions should be added where relevant.

The specific criteria to be applied to should be defined (eg. what is considered to be a 'large value').

A risk score to be applied should be noted (1 being for the lowest risk and 5 being for the highest risk).

Risk enhancers

If applicable, risk enhancer multiply to be applied[4]:

Risk enhancer	Multiple to be applied	Justification

Any risk enhancers should be defined (eg. what particular risk criteria exist which means the risk score for certain transactions should be enhanced by a multiple).

The risk multiple should be recorded.

Items to be selected for testing

Criteria to select or exclude transactions for testing[5]:

	Criteria	Justification
Transactions with a risk score[6] equal or greater than:		
De minimis threshold below which journal values can be excluded from testing:		
Other criteria specifically triggering a journal to be tested:		
Other criteria specifically triggering a journal to be excluded from testing:		

Prepared by		Dated:	
Reviewed by		Dated:	

1. The assessment of automated risk scoring is likely to require a freeform assessment. See Section 7 of the guidance notes in this manual.
2. Manual risk scoring is likely to be done in a spreadsheet or similar. See Section 7 of the guidance notes in this manual.
3. Example risk criteria is given in chapter 7 of the guidance notes in this manual.
4. For guidance on the use of risk enhancers to emphasise risk factors for a transaction by applying a multiple to the risk score, see Section 7 of the guidance notes in this manual.
5. Judgement is required when determining the criteria to select transactions for testing., see Section 7 of the guidance notes in this manual.
6. An example risk score calculation is given in Section 7 of the guidance notes in this manual.

The criteria to trigger a transaction to be considered high risk and which should be tested should be recorded (eg. high risk score). Any criteria which would mean a transaction could be excluded from testing should also be recorded here (eg. below a trivial value).

Appendix 5.1b: Notes for completion of planning form B33

Audit plan - Trial balance (use of ADA)

Audit plan - Trial balance (use of ADA) – Notes for completion
The objective of Audit plan - Trail balance (use of audit data analytics) is to tailor the use of ADA when being used to identify journals/significant unusual transactions for testing. This form is only necessary where audit data analytics (ADA) is planned to identify high risk transactions for testing.

Audit plan - Trial balance (use of ADA) B33/N2(ADA)

Objective: To record the use of audit data analytics (ADA) when being used to identify journals / significant unusual transactions for testing.

For guidance on completing this audit plan, refer to Appendix 5.1 of the guidance notes in this manual.

B20 must be completed to appraise the use of ADA.

Risk criteria to identify high risk journals / transactions

Transactions have been risk scored using an automated ADA application. The parameters used by the system (including details of any tailoring specific to this client), with justification for why these are considered appropriate are set out on sch______[1]	☐
Transaction risk criteria is being applied manually[2]. Tailoring of the risk criteria for this client is detailed below or on sch ____.	☐

Risk criteria to be applied manually:[3]

Risk condition	Relevant for this engagement (Y/N)	Specific definition	Risk score applied	Justification
Large value				
Round sum amounts or transactions ending '999'				
Unusual description / key word search				
Transactions posted at an unusual time				
Back dated transactions				
Transactions posted and reviewed by the same person				
Transactions posted by an unexpected person				
Unexpected account combination(s)				
Other (describe):				

Risk enhancers

If applicable, risk enhancer multiply to be applied[4]:

Risk enhancer	Multiple to be applied	Justification

Items to be selected for testing

Criteria to select or exclude transactions for testing[5]:

	Criteria	Justification
Transactions with a risk score[6] equal or greater than:		
De minimis threshold below which journal values can be excluded from testing:		
Other criteria specifically triggering a journal to be tested:		
Other criteria specifically triggering a journal to be excluded from testing:		

Prepared by		Dated:	
Reviewed by		Dated:	

1. The assessment of automated risk scoring is likely to require a freeform assessment. See chapter 7 of the guidance notes in this manual.
2. Manual risk scoring is likely to be done in a spreadsheet or similar. See chapter 7 of the guidance notes in this manual.
3. Example risk criteria is given in chapter 7 of the guidance notes in this manual.
4. For guidance on the use of risk enhancers to emphasise risk factors for a transaction by applying a multiple to the risk score, see chapter 7 of the guidance notes in this manual.
5. Judgement is required when determining the criteria to select transactions for testing, see chapter 7 of the guidance notes in this manual.
6. An example risk score calculation is given in chapter 7 of the guidance notes in this manual.

To confirm if an automated or manual ADA application is being used to risk score transactions, including an indication of where the parameters used for the risk assessment are set out and have been assessed. For automated, it may be easiest to reference to a printed schedule from the application alongside clear justifications on the parameters.

For manual scoring, indicate if a particular criterion is considered relevant or not (Y/N). NB. the list of risk conditions is not exhaustive and customised risk conditions should be added where relevant.

The specific criteria to be applied to should be defined (eg. what is considered to be a 'large value').

A risk score to be applied should be noted (1 being for the lowest risk and 5 being for the highest risk).

Any risk enhancers should be defined (eg. what particular risk criteria exist which means the risk score for certain transactions should be enhanced by a multiple).

The risk multiple should be recorded.

The criteria to trigger a transaction to be considered high risk and which should be tested should be recorded (eg. high risk score). Any criteria which would mean a transaction could be excluded from testing should also be recorded here (eg. below a trivial value).

Appendix 6a: Notes for completion of substantive sampling forms (p/c on or after 15 Dec 21)

Substantive sampling approach

ISA or ES para

General information

Introduction

This methodology includes two different sampling approaches. One is for judgemental sampling (and incorporates a sample cap), the other is a statistical sampling approach (which does not incorporate a sample cap). Whilst a different approach may be used on different audits, it would be difficult to justify mixing and matching the different approaches on the same audit. For many audits, particularly where populations are smaller, the judgemental sampling approach will be appropriate, however it is not suitable for use on the audits of PIEs or other audits where the populations are very large. The firm's policy should also be consulted, as some firms may mandate the use of the statistical sampling approach in all cases.

A sample size calculated using either of the substantive sampling approaches is derived on the basis that little error is expected in the population being tested. If this is not be the case and a number of errors are likely, then the form is not appropriate and the level of testing should be set judgementally at a level considered to be sufficient to provide adequate audit assurance. In these cases testing levels are likely to be considerably in excess of the numbers calculated using either of the approaches.

The substantive sampling forms require the documentation of a number of qualities of the test being performed and population being tested in order to evidence due consideration of those factors. The forms encourage the extraction of significant and other key items which would be tested in addition to the calculated sample size for the residual population. This sample size for the residual population is determined by reference to the assessed risk in the population, the planned reliance on other procedures and the size of the residual population. Key factors to consider when completing the substantive sampling forms are highlighted below.

Definition and expectation of error

Errors should be defined when designing the sample. The definition of an error is important because the errors found in a sample will be projected (extrapolated) across the population being sampled.

As noted above, where the expectation of an error occurring is more than low, we should set the sample size judgementally at a level considered to be sufficient to provide adequate audit assurance.

Stratification

Where appropriate, we should divide a population into discrete sub-populations which have an identifying characteristic, this process is termed stratification.

The objective of stratification is to reduce the variability of items within each sub-population (stratum) and therefore allow a reduced sample size to be taken without increasing sampling risk. If revenue is generated in a number of different ways by the entity, it is likely to be appropriate to split each type of revenue into a different stratum, for example. *530.5, 530 App. 1*

Where there is little variation in the population stratification may not be required. For example, if testing debtors for membership fees, stratification may not be necessary as there is little or no variability in the population.

Consideration should be given to increasing the sample size if the population contains sufficient variability to warrant stratification, but a decision is taken not to stratify.

When performing substantive tests of details, the population may be stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement.

Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

If values are not known (eg. unpriced stock), then the population may be stratified in some other way, for example by quantity or by type.

Substantive sampling approach

ISA or ES para

If a class of transactions or an account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

The value of residual population to sample

There may be certain items in the population that we wish to test specifically. This may be due to either their value or some qualitative characteristic (eg intra-group items, transactions or balances with related parties, etc.). We will remove these items from the population and test them separately.

When designing a sample, we determine a level of tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality to a particular sampling procedure and may be the same amount or an amount lower than performance materiality. *530.5*

All items greater than tolerable misstatement should normally be treated as individually significant items. These, along with other key items, are extracted from the population and examined separately. The residual population is then sampled.

Method of selection to use

Once the sample size has been determined we will use one of the following methods to select the sample: *530 App 4*

- random selection;
- systematic selection (ie. every “nth” item);
- monetary unit sampling (items with greater monetary value have a proportionally greater chance of being sampled); or
- haphazard selection (not generally recommended but may be necessary where documents are filed alphabetically).

Whichever method is chosen, the following criteria need to be observed:

- items chosen must be selected in such a way that we can reasonably expect them to represent the whole population;
- each item in the population must have a chance of being selected; and
- conscious bias must be avoided.

Some form of systematic selection is frequently used to arrive at the items to be sampled, although random selection can also be used.

Example: Systematic selection of a sample

a. A sample of 30 items is required from a population of 4,000 items. The sampling interval would be 4,000 / 30 = 133. A random start should be taken from within the first 133 items with every 133rd item chosen thereafter.
b. A sample of 20 items is required from a day book of 50 pages. A random start point somewhere between pages 1 - 10 would be chosen then an item would be sampled from every 2nd page. Depending on the number of entries per page a random number calculator could be used to select a line on each of the pages to be sampled.

Accounting estimates

Sampling techniques are unlikely to be utilised when testing accounting estimates, however certain accounting estimates such as depreciation / amortisation calculations may utilise a sampling approach. Care is needed here regarding clarity over the assertion(s) being tested.

ISA or ES para

Substantive sampling approach

Sample size calculation - Judgemental sampling
When determining the sample size for the residual population in a substantive test of detail the initial sample size will be 60 items. Note that where there are different income or expense streams, that have different systems, each of these should be treated as a separate population – i.e. each stream will need to be sampled separately, with each stream having an initial sample size of 60. This number can be reduced based on various deduction factors that are dependent upon the following:

- the risk of material misstatement associated with the population being tested;
- the planned level of reliance placed on the operating effectiveness of controls;
- the strength of analytical and other related substantive procedures; and
- the size of the residual population (adjusted via a ‘materiality factor’).

The following table highlights the level of deduction available in each instance. This is followed by guidance on the application of judgement in taking deductions available.

Assessed inherent risk in population		**Planned reliance on internal controls**		**Analytical and other related substantive procedures**		**Materiality factor**	
Level	No.	Level	No.	Strength of evidence	No.	Value	No.
1	20	High	20	Strong	20	Under 15	20
2	15	Medium	10	Moderate	10	15-27	10
3	10	None	0	Weak	0	Over 27	0
4	5						
5	0						

Assessed inherent risk in the population

The assessed inherent risk in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

This assessed inherent risk in the population will depend on the audit area and the particular assertion being tested. For example, it may be deemed within a population of stock that the existence assertion is at a lower risk of material misstatement than the valuation assertion. This could be due to the stock existence being easily verifiable whereas the valuation within the population could be subject to complex accounting estimates. Therefore we may deem it appropriate to calculate separate samples for the existence and valuation testing.

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, eg, valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

ISA or ES para

Substantive sampling approach

Planned reliance on internal controls

Where we only evaluate whether relevant controls are designed effectively and determine whether they have been implemented, we cannot reduce the substantive test sample size for any reliance on controls - this can only be done where we have tested their operating effectiveness.

Tests of operating effectiveness of internal controls are often designed to provide either a high or moderate level of reliance and therefore risk reduction.

- A high level of reliance (low level of risk remaining) applies where the primary evidence is coming from tests of controls.
- A medium level of reliance (medium level of risk remaining) applies where the tests of controls will be combined with other substantive procedures to address a particular assertion.

The type of controls being tested may influence the level of reliance to be placed on them. For example, a control applied to all items in the population is likely to provide a sounder basis for reliance than one only applied to certain types or sizes of transactions.

The extent to which we test controls for the planned level of reliance is a matter of professional judgement; however, in ascertaining an appropriate sample size for tests of controls we may use the tests of controls sampling form.

Analytical and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg. sales or debtors, or the population could be disaggregated into its component parts, eg. different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may “take credit” for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

Materiality factor

The materiality factor is calculated as follows:

total value of population / materiality = materiality factor

The lower the resulting figure for the materiality factor the greater the reduction in sample size. Thus, not surprisingly, the larger the value of the residual population relative to materiality the greater the value of the materiality factor and the larger the final sample size will be.

Where a different specific audit area materiality is set on the **B25** then this materiality rather than the overall materiality should be used to calculate any sample sizes for that particular area.

ISA or ES para

Substantive sampling approach

Minimum sample size

Small samples have an increased risk of being unrepresentative and unreliable. If the total population comprises a relatively small number of items, say fewer than 50 items, then alternative procedures should be considered in place of sampling. For example, this might include analytical procedures or a review for unusual items.

When the calculated sample results in a sample size of 15 items or fewer, then alternative audit procedures should be considered as outlined above. If these are not appropriate, then the minimum sample size should be 15 items.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

Justification

Since this is a judgemental sampling approach, it is necessary to justify the sample size used. The substantive sampling form includes appropriate space to document this justification. It is not acceptable to simply state that that it is appropriate because that is what was calculated by the approach – this is simply an indicative guide to be used as a starting point.

Example: Transaction tests on income

We have established the following:

Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Assessed inherent risk in population	= 1
Planned reliance on internal controls	= High
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor	= 30

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(20)
Planned reliance on internal controls	(20)
Analytical and other related substantive procedures	(10)
Materiality factor	(0)
Total sample size	**10**

However, the sample size will still be 15 (ie. the minimum sample size) which would therefore require 15 items to be tested substantively.

Alternatively, we may choose not to place any reliance on internal controls and therefore not test the operating effectiveness of controls. The resulting substantive sample size would be 30 items, with no tests of control being necessary. This, in practice, may be a more cost effective approach.

ISA or ES para

Substantive sampling approach

Example: Testing existence of debtor balances

We have established the following:

Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Assessed inherent risk in population	= 3
Planned reliance on internal controls	= None
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor (Residual population value / materiality)	= 250,000 / 10,000 = 25

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(10)
Planned reliance on internal controls	(0)
Analytical and other related substantive procedures	(10)
Materiality factor	(10)
Total sample size	**30**

ISA or ES para

Substantive sampling approach

Example: Testing valuation of stock lines

We have established the following:

Total population value	= £200,000
Monetary value of items over tolerable misstatement	= £130,000
Number of items over tolerable misstatement	= 7
Number of other key items	= 0
Residual population to be sampled	= £70,000
Assessed inherent risk in population	= 5
Planned reliance on internal controls	= Moderate
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor (Residual population value / materiality)	= 70,000 / 7,000 = 10

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(0)
Planned reliance on internal controls	(10)
Analytical and other related substantive procedures	(10)
Materiality factor	(20)
Total sample size	**20**

Therefore, the total number of items to examine will be 27 items (20 sample items + 7 individually significant items).

Sample size calculation - Statistical sampling
When determining the sample size for the residual population in a substantive test of detail the sample size will be based on:

- the risk of material misstatement associated with the population being tested;
- the strength of analytical and other related substantive procedures;
- the tolerable misstatement; and
- the size of the residual population.

Tolerable misstatement is defined in ISA 530 as 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. The tolerable misstatement cannot exceed performance materiality.

Risk of material misstatement

The assessed risk of material misstatement inherent in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements. It should have been assessed as part of the risk assessment process.

ISA or ES para

Substantive sampling approach

This assessed risk in the population will depend on the audit area and the particular assertion being tested. For example, it may be deemed within a population of stock that the existence assertion is at a lower risk of material misstatement than the valuation assertion. This could be due to the stock existence being easily verifiable whereas the valuation within the population could be subject to complex accounting estimates. Therefore we may deem it appropriate to calculate separate samples for the existence and valuation testing.

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, e.g. valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

The risk of material misstatement will also be affected by the control risk. Where a controls based approach is taken to the audit, and it is possible to place reliance on relevant controls (the operating effectiveness of which will be tested as part of controls testing), this may serve to reduce the risk of material misstatement – see **B30**.

Analytical and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg. sales or debtors, or the population could be disaggregated into its component parts, eg. different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may “take credit” for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

ISA or ES para

Substantive sampling approach

The strength of analytical and other related substantive procedures is ultimately a matter of professional judgement; however the following should be considered:

- Weak analytical and other related substantive procedures would generally be where no such procedures were undertaken, or would include simple variance analysis, or other limited procedures which do not confirm to the requirements of ISA 520 Analytical Procedures.
- Moderate analytical and other related substantive procedures would generally include analytical procedures in conformity with the requirements of ISA 520 Analytical Procedures in addition to at least some other substantive work.
- Strong analytical and other related substantive procedures would generally include detailed analytical procedures in conformity with the requirements of ISA 520 Analytical Procedures and extensive further substantive procedures over the population in addition to the testing to be performed on the sample.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

Note that in some cases it's not possible to calculate a sample size using the statistical approach. This occurs where the analytical and other related substantial procedures are strong and the risk of material misstatement is very low, low or medium; or where the analytical and other related substantial procedures are moderate and the risk of material misstatement is very low. In such cases, statistically, the planned test of details may not be necessary unless specified by regulation or other standards.

Example: Transaction tests on income

We have established the following:

Total population value	= £6,100,000
Tolerable misstatement	= £75,000
Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Risk of material misstatement	= High (4)
Analytical and other related substantive procedures	= Weak

The high risk of material misstatement, coupled with the weak analytical and other substantive procedures would result in a confidence factor of 2.30. The substantive sample size would therefore be (£6,100,000 x 2.30) / £75,000 = 188. This would also be the number of items to be tested in this case.

If stronger work was undertaken on analytical and other related substantive procedures, this can significantly reduce the sample size. For example, if instead the analytical and other related substantive procedures were Strong, the confidence factor would instead be 0.41 and the sample size would only be 34 items.

Of course, in order to change the strength of analytical and other related substantive procedures, additional such procedures would need to be undertaken.

Substantive sampling approach

ISA or ES para

Example: Testing valuation of stock lines

We have established the following:

Total population value	= £200,000
Tolerable misstatement	= £7,000
Number of items over tolerable misstatement	= 7
Monetary value of items over tolerable misstatement	= £130,000
Number of other key items	= 0
Risk of material misstatement	= Very High (5)
Analytical and other related substantive procedures	=Moderate

The very high risk of material misstatement, coupled with the moderate analytical and other related substantive procedures would result in a confidence factor of 2.08. The substantive sample size would therefore be (£70,000 x 2.08) / £7,000 = 21. The total number of items to be tested would therefore be 28 (21 + 7).

Appendix 6b: Notes for completion of substantive sampling form (p/c before 15 Dec 21)

The substantive sampling form requires the documentation of a number of qualities of the test being performed and population being tested in order to evidence due consideration of those factors. The form encourages the extraction of significant and other key items which would be tested in addition to the calculated sample size for the residual population. This sample size for the residual population is determined by reference to the assessed risk in the population, the planned reliance on other procedures and the size of the residual population.

Sample size calculation

When determining the sample size for the residual population in a substantive test of detail the initial sample size will be 60 items. This number can be reduced based on various deduction factors that are dependent upon the following:

- the risk of material misstatement associated with the population being tested;
- the planned level of reliance placed on the operating effectiveness of controls;
- the strength of analytical and other related substantive procedures; and
- the size of the residual population (adjusted via a 'materiality factor').

The following table highlights the level of deduction available in each instance. This is followed by guidance on the application of judgement in taking deductions available.

Assessed risk in population		**Planned reliance on internal controls**		**Analytical and other related substantive procedures**		**Materiality factor**	
Level	No.	Level	No.	Strength of evidence	No.	Value	No.
Low	20	High	20	Strong	20	Under 15	20
Medium	10	Medium	10	Moderate	10	15-27	10
High	0	None	0	Weak	0	Over 27	0

Assessed risk in the population

The assessed risk of material misstatement inherent in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

This assessed risk in the population will depend on the audit area and the particular assertion being tested.

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;

- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, eg, valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

Accounting estimates

Sampling techniques are unlikely to be utilised when testing accounting estimates, however certain accounting estimates such as depreciation / amortisation calculations may utilise a sampling approach. Care is needed here regarding clarity over the assertion(s) being tested   The process for determining the risk assessment of accounting estimates differs from other aspects of the financial statements as it requires inherent risk and control risk to be considered separately.

The inherent risk assessment of an accounting estimate is assessed on a ‘spectrum of risk’ resulting in an assessment ranging between very low and very high. In order to be able to reflect how this method of assessing the risk inherent in an accounting estimate when determining a sample size for testing the approach should be as follows:

Inherent risk as assessed for an accounting estimate	**Assessed risk in the population as used for determining a sample size**
1 or 2	Low
3	Medium
4 or 5	High

Control risk is assessed using low / moderate / high and if there is no plan to test the operating effectiveness of controls then control risk is assessed as high.

Planned reliance on internal controls

Where we only confirm the design and implementation of control procedures, we cannot reduce the substantive test sample size for any reliance on controls.

Tests of operating effectiveness of internal controls are often designed to provide either a high or moderate level of reliance and therefore risk reduction.

- A high level of reliance (low level of risk remaining) applies where the primary evidence is coming from tests of controls.
- A medium level of reliance (medium level of risk remaining) applies where the tests of controls will be combined with other substantive procedures to address a particular assertion.

The type of controls being tested may influence the level of reliance to be placed on them. For example, a control applied to all items in the population is likely to provide a sounder basis for reliance than one only applied to certain types or sizes of transactions.

The extent to which we test controls for the planned level of reliance is a matter of professional judgement; however, in ascertaining an appropriate sample size for tests of controls we may use the tests of controls sampling form.

Analytical procedures and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg sales or debtors, or the population could be disaggregated into its component parts, eg different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may “take credit” for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

Materiality factor

The materiality factor is calculated as follows:

total value of population / materiality = materiality factor

The lower the resulting figure for the materiality factor the greater the reduction in sample size. Thus, not surprisingly, the larger the value of the residual population relative to materiality the greater the value of the materiality factor and the larger the final sample size will be.

Where a different specific audit area materiality is set on the B41 then this materiality rather than the overall materiality should be used to calculate any sample sizes for that particular area.

Minimum sample size

Small samples have an increased risk of being unrepresentative and unreliable. If the total population comprises a relatively small number of items, say fewer than 50 items, then alternative procedures should be considered in place of sampling. For example, this might include analytical procedures or a review for unusual items.

When the calculated sample results in a sample size of 15 items or fewer, then alternative audit procedures should be considered as outlined above. If these are not appropriate then the minimum sample size should be 15 items.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

20.3 Getting started for new manual users

Introduction

This 'Getting started' guidance will help you to use the Mercia Charities Audit Manual. You may be a regular user of our products, or this may be the first time that you have used such a manual. Either way, these notes will help you understand the Mercia approach and how to maximise the benefits of the manual.

Guidance

You will find the following documents in this section of the Charities Audit Manual:

- a contents page;
- guidance notes on the charities sector;
- this getting started guidance for new manual users; and
- 'What's changed', which provides a summary of the changes made to the manual in the most recent updates.

Audit approach

The Mercia approach encourages you to adopt a thinking, rather than a form filling, approach. This is achieved in two main ways:

- Through the use of permanent information. If something that you record is unlikely to change significantly from one year to the next, we believe it is better that this is recorded properly once and then rolled forward, updating where necessary each year.
- By encouraging those completing audit work not to file surplus copy documentation, thus generating the need to sign off, date and evidence, as reviewed, the excess paperwork. Where additional paperwork is considered necessary, the system encourages you to file these on a non-audit section of the file.

The planning approach (the permanent file documents and section B within the current file documents)

The key to an effective audit is effective planning. The various steps to be undertaken at the planning stage (such as updating your knowledge of the client, calculating materiality, etc.) are driven by the planning checklist which is filed within the current file documents planning section.

There are different approaches to completing the planning documentation. For more straightforward assignments, as an alternative to completing many of the standard current planning forms, you may choose to adopt a 'free-form' planning memorandum.

In such cases, you may opt for the Mercia proforma free-form memorandum which must also be completed alongside the free-form memorandum planning checklist, and the other documents provided within this section, where required, to ensure you have covered all necessary matters.

Whilst completing the memorandum, you should read guidance provided on what is required in certain areas.

It is for the firm to decide the criteria as to when the free-form planning memorandum should be used to replace other standard forms. We recommend that such criteria include:

- the client has been audited by the firm for at least the immediate preceding period;
- there has been no history of controversial issues arising from the previous audits;
- the client qualifies as small, as per company law, or contains characteristics indicative of a simple business as set out below.

The following characteristics may be indicative of a simple business:

- ownership is concentrated in a small number of individuals (sometimes a single individual) who are actively involved in managing the business; and
- the operations are uncomplicated with few sources of income and activities; and
- business processes and accounting systems are simple; and
- internal controls are relatively few and may be informal.

Such entities are likely to include companies which are exempt from audit, but which choose nonetheless to have a voluntary audit, small subsidiary companies, as well as larger entities that are also relatively simple.

The fieldwork approach (sections C onwards within the current file documents)

Once the audit plan has been formed and tailored audit programmes have been produced (see the section named 'The structure of each audit section' within these notes), the audit evidence should be obtained in accordance with these programmes.

The completion approach (section A within the current file documents)

At the completion stage, the planning must be reviewed, alongside the evidence obtained, and all matters need to be drawn together and concluded upon. Completion of the appropriate forms on this section (including a full record of review points, notes of discussions with the client and evidence of clearance of all of these points) will help to achieve the required objectives.

Audit of group accounts

Where you are responsible for the audit opinion of group accounts, the manual contains alternative versions of the planning and completion documentation, as well as additional permanent file documents. This documentation should be used for the audit of the group accounts as it covers both the parent company and the group audit opinions.

Where you are also responsible for the audit opinion of one or more subsidiary companies, you should create standalone documentation, and not use the 'Audit of group accounts' documentation, for these companies and their individual audit files.

The current file

The current audit file provides the documentary record of the audit and constitutes the evidence of what was done and why. In conjunction with the permanent file, it supports the report on the financial statements.

The report not only consists of the opinion but also contains a statement that the audit has been carried out in accordance with auditing standards, thus the two files must demonstrate compliance with the International Standards on Auditing (ISA) (UK), the Ethical Standard and any other regulatory requirements.

The principal objectives of the current audit file are to provide:

- evidence of the planning process, including the risk assessment procedures, and any changes from the original plan;
- a record of the nature, timing and extent of auditing procedures undertaken, the results of such procedures and conclusions drawn;
- a record of the figures included in the financial statements and evidence supporting these figures;
- evidence of control and review;
- a record of problems encountered, weaknesses discovered, and any contentious issues raised and how they were resolved;
- a record of communications with the client relevant to the audit; and
- evidence of the opinion formed.

Because of the significance of the amendments resulting from the changes to ISAs 240 and 315 two versions of the documentation have been included: one for periods commencing before 15 December 2021 reflecting the previous ISA requirements and another for periods commencing on or after 15 December 2021 reflecting the new versions.

The permanent file

The principal purpose of the permanent file is to improve the efficiency of the assignment by providing a good understanding of the organisation. It is an intrinsic part of the audit assignment. Therefore, the permanent file must be comprehensive and up to date. Each year, the permanent file should be reviewed, updated and signed to evidence that this has been done.

The permanent file contains information of a permanent and semi-permanent nature, being information which will be of continuing importance to assignments over a number of years.

Although there is a standard index to the file, as with all aspects of an audit, the file should only contain mandatory information required to comply with auditing standards, and other legislation and regulation, along with information which will aid the efficiency of the audit. The content and form of the file is therefore likely to be different for each client and must be decided upon by the Responsible Individual and manager.

However, a permanent file will normally include the following information:

- information concerning the legal and organisational structure of the organisation, including information regarding related parties and any group structure;
- extracts of important legal documents and agreements;
- any sector specific data;
- details of the accounting systems and internal control environment;
- an appraisal of those systems;
- a summary of key ratios and figures over a period of years; and
- accounts information of ongoing value.

The Mercia approach also encourages users to develop tailored audit programmes which can be held on the permanent file. If held on the permanent file, in future years these must be reviewed and, if necessary, updated as appropriate.

Because of the significance of the amendments resulting from the changes to ISAs 240 and 315 two versions of the documentation have been included: one for periods commencing before 15 December 2021 reflecting the previous ISA requirements and another for periods commencing on or after 15 December 2021 reflecting the new versions.

The structure of each audit section

Divider cards (see current file indexes within the current file documents)

The divider cards include recommended standard references for working papers, as well as the conclusions, for each section of the audit file.

The audit conclusions should be signed by the person completing the work and should then be signed by the reviewer.

Audit plan

Where individual audit sections have been planned separately using the standard individual area audit plans, a copy of the working paper can be placed on the planning section, the permanent file and / or the front of each section of the audit file (where it is filed behind the relevant lead schedule, as this helps to ensure that the section is audited in accordance with the plan).

The use of the individual area audit plan schedules also helps to focus the selection of appropriate audit programmes.

Audit programmes

The audit programme is very flexible and must be carefully tailored for each audit area at the planning stage.

We generally have a choice of sections as follows:

- A General and mandatory tests
- B Tests of controls
- C Non-audit services
- D Analytical procedures
- E Tests of detail (blank programme), or
- F Tests of detail (tailorable programme)

The only sections where this choice is not available are the Accounting Estimates (Q), Going Concern (R) and Subsequent Events (S) audit programmes. In programmes R and S, only the A section is available. For programme Q, this is a supplementary form which must be used where there are key accounting estimates. A separate Q programme is used for each individual key accounting estimate. For example, if there are three key accounting estimates documented in planning, then there would be three Q programmes. The Q programmes can either be filed in the Q section or with the relevant fieldwork for that key accounting estimates (eg. for a stock provision, it could be filed either at Q or in the G Stocks section).

Section A (General and mandatory tests)

This section is nearly always applicable, as this deals with general file completion issues in addition to mandatory ISA testing. Selecting section A will ensure that each programme generated has the correct heading and objectives at the top.

Also included in this section, where applicable, are:

- a prompt to record the risk assessment procedure confirming the design and implementation of key controls; and
- certain procedures mandated by the ISAs.

Section B (Tests of controls)

This section is a prompt to the tests required when assurance is to be placed on the effective operation, throughout the period, of one or more control procedures, as established on the individual area audit plans.

Section C (Non-audit services)

This section is useful when non-audit procedures (such as involvement in the compiling of numbers for the financial statements) are to be carried out and used as part of the audit evidence.

Section D (Analytical procedures)

This section is a menu of possible procedures that could be utilised to achieve the objectives.

Section E (Tests of detail (blank programme))

This section is a page highlighting the key audit assertions for the individual audit area. It should be used either:

- to record any additional tests for objectives not achieved by sections A to D above; or

- on a very low risk area, to record all the tests required for the section.

Section F (Tests of detail (tailorable programme))

This section can be used:

- to record the additional procedures for objectives not achieved by sections A to D above; or

- as the main audit programme for the individual audit area.

NB. If this section is selected, it is very likely that it will need to be tailored, with a number of the procedures crossed through or deleted.

Each individual section of the audit file has its own audit programme. The tailoring process takes place in two stages. Firstly, you should select which of the standard pages are appropriate. Once this decision has been made, further tailoring on a line by line basis is required to select / design the appropriate tests.

The four main areas are referenced consistently for each individual section. Using the income and debtors section as an illustrative example:

- **H3 General and mandatory tests and tests of controls**
  This must be selected for nearly all audits as it ensures general and mandatory ISA tests are performed. The controls – operating effectiveness programme should be selected when some or all of the evidence is to be obtained from testing some or all of the operating effectiveness of controls.
- **H3 Non-audit services programme**
  This is the programme to select when some or all of the evidence is to be obtained from non-audit services, such as financial statements compilation.
- **H3 Analytical procedures**
  This is the programme to select when some or all of the evidence is to be obtained from analytical procedures.
- **H4 Blank additional programme**
  The programme to select either:
  - to record any further tests on objectives not met by work planned on the above tests at H3; or
  - to record all the tests required in a low risk area, when H3 are not selected.

  These pages could be used in every section of a very low risk assignment.

- **H5 Bank of 'tests of detail'**
  This programme can be used in a variety of ways, for example:
  - as the main programme; or
  - as a reference document to select tests for recording on H4; or
  - as an additional programme to H3.

  Selecting appropriate audit programmes for each section is the answer to eliminating over auditing and improving efficiency.

Regardless of which audit programmes are selected as the starting point, individual tests must be added or deleted depending on the specific knowledge of the client.

All combinations and permutations of programmes are acceptable. It is extremely unlikely that all of the tests on any of the programmes will be necessary. This is particularly true of the 'bank of tests of detail' programme (H5).

20.4 What's changed

Update - September 2023

What's changed

We are pleased to issue updates to your Mercia Charities Audit Manual (dated 09/23).

The principal technical changes in this update include:

- Changes in relation to ISA (UK) 600 *Special considerations - Audits of group financial statements (Including the work of component auditors)*;
- The introduction of a new (optional) statistical sampling approach;
- The restructuring of the guidance notes; and
- The removal of independent examination content into a separate manual ~~which is included in the new charities package.~~

In addition a number of other minor improvements and amendments have been made to the manual.

See below for a full list of changes.

ISA (UK) 600 Special considerations - Audits of group financial statements (Including the work of component auditors)

In September 2022, the FRC issued a revised ISA (UK) 600. The proposed revisions enhance the risk-based approach to undertaking a group audit and reinforce the need for robust communication and interactions between the group engagement team, group engagement partner and component auditors.

The revised ISA is effective for periods commencing on or after 15 December 2023, although the changes have been early adopted given certain requirements in relation to component auditors are already effectively in place due to the requirements of ISQM 1, and many of the other changes are considered good practice, with some firms already doing a lot of what the new requirements necessitate. An option has, however, been retained on the B30 Inherent and control risk assessment form for use where firms have decided not to early adopt the revisions.

As part of these changes, the manual now also includes documentation in relation to the use of component auditors.

New (optional) statistical sampling approach

A new (optional) statistical sampling approach has been added to sit alongside the extant judgemental sampling approach. For many audits the extant judgemental approach, particularly where populations are smaller, will remain appropriate, however it is not suitable for use on audits where populations are very large. As such a new statistical sampling approach which does not include a sample size cap has been added to the methodology for use on audits where the judgemental approach is not considered appropriate.

Guidance notes

The guidance notes have been restructured to make them more user-friendly and to ensure a consistent approach to guidance notes across Mercia's suite of products.

Independent examination

Documentation in relation to the independent examination of charities has been enhanced and moved into a separate manual. the Charities Independent Examination Manual. This manual has been renamed to the Charities Audit Manual, reflecting its audit focus. ~~Subscribers to the former Charities Manual will now have access to both the Charities Audit Manual and Charities Independent Examination manual as parts of the new Charities Package.~~

September 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
Guidance	
Contents	• Updated for addition of the Group audit instruction letter and Group audit questionnaire to the Example letters section. • Updated to reflect the removal of independent examination content.
Guidance notes	• The guidance notes have been restructured to make them more user friendly and to ensure a more consistent approach across the suite. • Appendix 6a to the guidance notes includes guidance on the new statistical sampling approach.
Getting started for new manual users	• The Accessing the manual section has been removed - guidance on accessing manuals is available on the website.
What’s changed	• A copy of this What's changed notice has been added to the manual.
Example letters	
Schedule of professional services - Audit (all group letters)	• Where appropriate, a minor update to more clearly reference the group and parent. • Additional paragraph added in Section 2 to highlight the group auditor is responsible for the direction, supervision and review of the group audit, and to secure agreement to communicate with component auditors without further consent being required.
Group audit instruction letter	• Added to the manual.
Group audit questionnaire	• Added to the manual.
Example reports	
All audit reports	• Minor updates and amendments to reflect latest guidance.

All group audit reports	• Minor update to wording of last bullet point in the Auditor responsibilities for the audit of the financial statements section where the full responsibilities are included rather than a link to the FRC website.
Group audit reports (England & Wales and Northern Ireland)	• New reports added for charitable companies audited under charity law only.

Example accounts

1 Not Small SORP FRS 102 Financial Statements	• Updated to state the accounts are based on standards and amendments in issue at 1 April 2023 (no technical changes to the content of the accounts).

Accounts disclosure checklists

A32 SUMMARY Charities accounts disclosure checklist summary	• Removed as not applicable for audited charities.
A32 SORP checklist	• Updated to state that the checklist reflects standards and amendments in issue as at 1 April 2023 (no technical changes to the content of the checklist).
A32 Receipts and payments basis	• Removed as not applicable for audited charities.

Current file documents

Current file indices	• Updated to reflect addition of A53 and B26.
A22 Overall review of the group financial statements (group)	• Point 8 updated to include reference to component auditors.
A29 Reporting on irregularities, including fraud in the auditor's report (individual and group)	• An additional column has been added to enable comments to be cross referenced back to where the underlying work has been performed.
A31 Group audit completion checklist (group)	• Four new bullet points added to Evidence section to reflect ISA 600 revisions. • Component auditors section added (shaded section). • References to ISA 600 updated.
A41 Group subsequent events update and evaluation (group)	• Additional shaded point added with respect to component auditors.
A52-1 Communication with group management checklist (group)	• Additional shaded points added with respect to component auditors.
A52-2 Communication with those charged with governance of the group (group)	• Additional shaded point added with respect to component auditors.

A53 Component auditors (group)	• New form added to manual.
B01 Group planning checklist (group)	• Additional point added in pre planning to reflect ISA 600 revisions. • Additional shaded points added with respect to component auditors.
B02 Group audit strategy (group)	• Minor update to wording of guidance to characteristics of the engagement and nature, timing and extent of resources sections to reflect ISA 600 revisions.
B05 Freeform planning memo (freeform)	• An additional row for Income has been added into the basis for determining materiality section.
B25 Materiality (individual)	• An additional row for Income has been added into the basis for determining materiality section.
B25 Materiality (group)	• An additional row for Income has been added into the basis for determining materiality section. • Update to component materiality section to reflect ISA 600 revisions.
B26 Component auditors (group)	• New form added to manual.
B30 Group inherent and control risk assessment (group)	• Minor update to Group audit approach section to reflect ISA 600 revisions.
B35 Group audit team discussion (group)	• Additional shaded point added with respect to component auditors.
B40 Audit plans (individual and group)	• Guidance in sampling section updated to refer to sampling plan(s) / sampling form(s) as appropriate.
B40/P2 Group audit plan - Intra group balances, transactions and consolidations	• Reference to financially significant, risk significant and not significant under components section removed due to ISA 600 revisions.
CSF Controls sampling form (individual, freeform and group)	• Updated to new format (no substantive technical changes).
SSF Substantive sampling form - Judgemental (individual, freeform and group)	• Updated to new format including more space to justify sample sizes.
SSF Substantive sampling form - Statistical (individual, freeform and group)	• New form for use with the new statistical sampling approach.

P Audit programme - Intra group balances, transactions and consolidations	• A - Update to wording of undertaking work on components test to reflect revisions to ISA 600. • F - Updates to two tests under consolidation section to reflect revisions to ISA 600.
Independent examination	• Section removed from manual (an enhanced suite of documentation is available in the Charities Independent Examination Manual).

Permanent file documents

Permanent file indices	• Updated to reflect addition of PF1-9.
PF1-5 Groups	• Additional point added to component entity risks section to reflect ISA 600 revisions.
PF1-7 Using the work of an expert	• Auditor's expert section expanded.
PF1-9 Component auditors	• New form added to manual.

Supplementary forms

File review checklist (p/c on or after 15 Dec 21)	• Groups section updated to reflect ISA 600 revisions.

Update - February 2023

What's changed

We are pleased to issue updates to your Mercia Charities Manual (dated 02/23).

The principal technical changes in this update include the removal of content relating to the now superseded ISQCs and consequential amendments arising as a result of this. The Charities Manual, together with the Audit Procedures Manual, address engagement level quality management, with the Quality Management Manual addressing firm wide requirements.

In addition a number of minor amendments / improvements have been made to other sections of the Charities Manual, including updating engagement letters to reflect latest guidance.

See below for a full list of changes.

February 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
Guidance	
Contents	• Updated for relocation of file review checklists to supplementary forms section.
What's changed	• A copy of this What's changed notice has been added to the manual.
File review checklist (p/c before 15 Dec 21)	• File review checklist moved to Supplementary Forms section.
File review checklist (p/c on or after 15 Dec 21)	• File review checklist moved to Supplementary Forms section.
Example letters	
Engagement – Covering letter (individual charity covering letter)	• Updated the 'professional services provided' section to include a new paragraph which confirms whether disbursements are expected to be incurred. • A new section detailing how communication will be maintained throughout the engagement has been added. • Updated the 'agreement of terms' section to include reference to the firm's privacy notice on their website and reference to the standard terms of business in relation to instances of variation or termination of the engagement.

Engagement – Covering letter (group charity)	• Updated the 'professional services provided' section to include a new paragraph which confirms whether disbursements are expected to be incurred. • A new section detailing how communication will be maintained throughout the engagement has been added. • Updated the 'agreement of terms' section to include reference to the firm's privacy notice on their website and reference to the standard terms of business in relation to instances of variation or termination of the engagement.
Engagement – Schedule of professional services – audit • Charity: audit - Ltd co (UK except Scotland) not small • Charity: audit - Ltd co (England & Wales) small* • Charity: audit - Ltd co (Northern Ireland) small • Charity: audit - Ltd co (Scotland)	• Moved the paragraph highlighted the client's responsibility towards publishing electronic information from the 'Scope of audit' section to the 'Your responsibilities' section. • Added an optional paragraph in the 'Our responsibilities' section highlighting that the auditors have a statutory requirement to communicate with the group auditor. • Included a paragraph in 'Our responsibilities' confirming that the client is to be informed should matters or significant facts arise that may raise ethical concerns. • A paragraph was added to the 'Scope of audit' section explaining that the auditors may also use analytical tools in their work. • *Updated the guidance to confirm this schedule is for "small" limited company charities. (This change is specific to Charity: audit - Ltd co (England & Wales) small).
Engagement – Schedule of professional services – audit • Charity: audit - Unincorp and CIO (England & Wales) • Charity: audit - Unincorp and SCIO (Scotland) • Charity: audit - Unincorp (Northern Ireland) • Charity: group audit - Ltd co (UK except Scotland) • Charity: group audit - Ltd co (Scotland) • Charity: group audit - Unincorp and CIO (England & Wales) • Charity: group audit - Unincorp and SCIO (Scotland) • Charity: group audit - Unincorp (Northern Ireland)	• Moved the paragraph highlighted the client's responsibility towards publishing electronic information from the 'Scope of audit' section to the 'Your responsibilities' section. • Included a paragraph in 'Our responsibilities' confirming that the client is to be informed should matters or significant facts arise that may raise ethical concerns. • A paragraph was added to the 'Scope of audit' section explaining that the auditors may also use analytical tools in their work.
Engagement - Schedule of professional services - Independent examinations • Charity: independent examination - Ltd company (England & Wales)* • Charity: independent examination - unincorporated or CIO (England & Wales)	• Added a paragraph in the 'Your responsibilities' section listing key requirements for the client to follow when preparing the financial statements, for example selecting suitable accounting policies and making judgements that are reasonable and prudent. • Paragraphs to confirm that the client is responsible for safeguarding assets of the entity and the client will make available as and when required all relevant information to complete the independent examination. • *Included a paragraph to confirm it is the clients responsibility to determine that an examination is required under section 145 of the Charities Act 2011. (This change is specific to Charity: independent examination - Ltd company (England & Wales)).

Engagement - Schedule of professional services - Accounting	• Updated the ‘Our responsibilities’ section to clarify that the firm will advise the client on whether their accounting records are appropriate for the preparation of financial statements. • Added a paragraph confirming that the firm has a professional duty to not allow its name to be associated with financial statements that could be misleading. • Included an optional paragraph highlighting the responsibility to provide information in iXBRL format lies with the client, should they ask the firm to convert the financial statements into the iXBRL.
Engagement - Schedule of professional services - Compilation	• An optional paragraph has been included where clients have asked firms to convert the financial statements into the iXBRL format. • Clarification has been included to inform clients that, consent must be received from the firm, should they want to share the report with any third parties.
Engagement - Terms of business	• Updated paragraphs in the ‘Fees and payment terms’ section clarifying the use of insurance policies to cover fees, circumstances where clients are unable to pay fees and the rights of the firm to exercise a lien over all funds have also been added. • Added a new section detailing standard business terms in relation to confidentiality. • Clarification of potentials actions of the firm, should a dispute arise between parties within the engagement.

Example reports

Statement of trustees' responsibilities	• Clarified that the reference to material departures is only required where there are such departures.

Current file documents

Current file indices (both p/c before and on or after 15 Dec 21)	• Updated to more accurately reflect naming of A21-1, A21-2, A21-3 and B03/B14.
A21-2 Engagement quality review checklist (individual and group) (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
A21-2 Engagement quality review checklist (individual and group) (p/c before 15 Dec 21)	• Updated to ISQM version of form.
A21-3 Consultation review (individual and group) (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.

A21-3 Consultation review (individual and group) (p/c before 15 Dec 21)	• Updated to ISQM version of form.
A22 Overall review of the financial statements (individual and group) (p/c on or after 15 Dec 21)	• Additional bullet 'requirements for and of a statement of cash flows' added to Q22.
A31 Audit completion checklist (individual and group) (p/c on or after 15 Dec 21)	• References to ISA (UK) 240 updated to reflect the FRC's reissued ISA which includes corrected numbering aligned to the international version.
A46 Fraud update and evaluation (individual and group) (p/c on or after 15 Dec 21)	• References to ISA (UK) 240 updated to reflect the FRC's reissued ISA which includes corrected numbering aligned to the international version.
B03 Preliminary engagement quality review (individual and group) (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
B10 Engagement review (individual and group) (p/c on or after 15 Dec 21)	• Under the 'New client checklist' heading, the wording has been updated from "We have completed B13..." to "We have completed / reviewed B13..." to reflect the fact that relevant matters should also be identified in future years when the client is not new.
B14 Preliminary engagement quality review (individual and group) (p/c before 15 Dec 21)	• Updated to ISQM version of form.
B32A-E Key accounting estimate (individual, freeform and group) (p/c on or after 15 Dec 21)	• Updated wording of the key assertions relevant to the accounting estimate which may be selected for clarity.

Permanent file documents

PF1-2 The applicable financial reporting framework	• Additional bullet 'Requirements for a statement of cash flows' added.
PF5 Permanent audit planning documentation (both p/c before and on or after 15 Dec 21)	• Additional table added to list engagement team members each year if desired.

Supplementary forms

File review checklist (p/c before 15 Dec 21)	• File review checklist moved from Guidance section.

File review checklist (p/c on or after 15 Dec 21)	• File review checklist moved from Guidance section.

Update - April 2022

What's changed

We are pleased to issue updates to your Mercia Charities Manual (dated 04/22). The principal technical changes in these updates relate to:

- Changes to ISA 240 The auditor's responsibilities relating to fraud in an audit of financial statements;
- Changes to ISA 315 Identifying and assessing the risks of material misstatement; and
- The introduction of the new suite of Quality Management Standards.

The revised ISA 240 and ISA 315 apply for accounting periods commencing on or after 15 December 2021, with early adoption permitted. The revised suite of Quality Management Standards (ISA 220, ISQM 1 and ISQM 2 are effective from 15 December 2022, with early adoption permitted).

Changes to ISA 240 The auditor's responsibilities relating to fraud in an audit of financial statements

In May 2021, the FRC issued a revised ISA (UK) 240.

The revisions build on the earlier version of the standard, with the aim of addressing concerns that auditors are not doing enough to detect material fraud and that this may, at least in part, be due to a lack of clarity as to their obligations with respect to fraud. In addition to a greater focus on processional scepticism, the objectives of the auditor have been updated and a number of new requirements have been introduced. These have been incorporated into the methodology.

As part of the update, as well as revisions to existing forms, a new form at both the planning and completion stages has been added to address the revised requirements and ensure that fraud is given appropriate prominence within the methodology.

See below for a full list of changes to the Charities Manual.

Changes to ISA 315 Identifying and assessing the risks of material misstatement

In July 2020, the FRC issued a revised ISA (UK) 315 to reflect changes made by the IAASB to the standard.

The revised standard is a complete overhaul of the previous version and introduces many key changes to the approach that must be followed when identifying and assessing risks of material misstatement including:

- Restructured and revised requirements in connection with understanding the entity and it's environment, the applicable financial reporting framework and the entity's system of internal control;
- The introduction of the concept of a spectrum of inherent risk when assessing risks of material misstatement (a concept which will be familiar from previous revisions to ISA 540 *Accounting estimates and related disclosures*);
- A requirement for separate assessment of inherent and control risk;
- Increased focus on information technology and general IT controls; and

- New stand-back requirements in a number of areas.

In order to reflect the requirements of the revised standard, the audit methodology has been revised with most planning forms having been updated or replaced, and many consequential amendments to other forms too. Most notably, the methodology now places much greater emphasis on controls (including general IT controls) and requires greater detail when identifying and assessing the risks of material misstatement at both the financial statement and assertion levels.

The updates to the methodology for the ISA revisions have necessitated a restructure of the planning and permanent file sections of the manual. The restructure should facilitate a better flow through these sections of the manual. The independent examination forms have also been restructured for consistency. See below for a mapping of old to new references.

The revised ISA also made a number of consequential amendments to other ISAs which have been reflected in this manual.

Because of the significance of the amendments resulting from the changes to ISAs 240 and 315 two versions of the documentation have been included: one for periods commencing before 15 December 2021 reflecting the previous ISA requirements and another for periods commencing on or after 15 December 2021 reflecting the new versions. Full details of the changes are set out in the Audit Procedures Manual.

See below for a full list of changes to the Charities Manual.

The introduction of the new suite of Quality Management Standards.

In July 2021, the FRC issued a revised suite of Quality Management Standards. The suite includes:

- ISA (UK) 220 (Revised July 2021) Quality management for an audit of financial statements;
- ISQM (UK) 1 Quality management for firms that perform audits or reviews of financial statements, or other assurance related services engagements; and
- ISQM (UK) 2 Engagement quality reviews.

Updates have been made to the Charities Manual to include a new version of the preliminary engagement quality control review form, a new version of the engagement quality control review checklist and a new version of the consultation / ethics review form. From 15 December 2022 (or earlier if the firm early adopts the new quality management suite of standards) the versions denoted 'ISQM version' should be used. Before this time the versions denoted 'ISQC version' should be used.

April 2022

April 2022 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, cross-references to other forms have been updated where appropriate, and minor changes have been made for formatting, grammar, consistency of naming (within group sections) and other editorial amendments. Any content which was relevant for periods commencing prior to 15 December 2019 has been removed.

Updated area	Main reason for change

Guidance

Contents & guidance notes	• Contents page updated for the changes made in this update. • Guidance updated to remove references to the 2015 SORP as no longer applicable.
Getting started for new manual users	• Getting started guidance updated for the changes made in this update.
What's changed	• A copy of this What's changed notice has been added to the manual.
File review checklists	• Moved into a new format. • A new version for p/c on or after 15 December 2021 added.

Example letters

Engagement - terms of business	• Minor change to reflect ICAEW Code of Ethics requirements in respect of commissions.
Representation letters - Audit letter of representation (p/c on or after 15 Dec 21)	• Minor change to reflect revised requirements of ISA 240 in connection with written representations. • Minor amendments to reflect this version is for periods commencing on or after 15 December 2021.

Example accounts

1 Non Small SORP FRS 102 Financial Statements	• Minor updates for consistency, removal of dates which are no longer relevant and recent changes to standards.

Accounts disclosure checklists

A32 SUMMARY Disclosure checklist summary	• Updated to offer more guidance on selecting the appropriate checklists.
A32 SORP Checklist	• Minor updates for recent changes to legislation and other minor editorial amendments.

Current file: Current file indices (p/c on or after 15 Dec 21)

Current file indices	• Moved to start of current file. • Updated to reflect revised file structures.

Current file: Completion - Individual (p/c on or after 15 Dec 21) & Completion - Group (p/c on or after 15 Dec 21)

A21-1 Responsible individual review and conclusion	• Update to footnote.
A21-2 Engagement quality control checklist (ISQC version)	• Renamed to highlight this version of the form applies before the new quality management standards are adopted.
A21-2 Engagement quality checklist (ISQM version)	• A new version of the form applicable when the new quality management standards are adopted.
A21-3 Consultation / ethics review (ISQC version)	• Renamed to highlight this version of the form applies before the new quality management standards are adopted.
A21-3 Consultation review (ISQM version)	• A new version of the form applicable when the new quality management standards are adopted.
A21-3 Consultation / ethics review (ISQC version)	• Renamed to highlight this version of the form applies before the new quality management standards are adopted.

A21-3 Consultation review (ISQM version)	• A new version of the form applicable when the new quality management standards are adopted.
A25 Audit summary memorandum	• Additional section added for key points and work performed over opening balances and consistency of accounting policies as part of best practice amendments.
A27 Summary of misstatements	• Minor amendments to footnotes for clarity and consequential changes as a result of amendments for ISA 240.
A29 Reporting on irregularities, including fraud in the auditor's report	• Additional comment in guidance notes as a result of a consequential amendment made to ISA 700 by the revised ISA 315.
A31 Audit completion checklist	• Minor updates throughout for changes in terminology and requirements in connection with updates to ISAs 240 and 315. • New procedures added with respect to consistency of accounting policies. • Several procedures in respect of fraud have been removed from this form as they are now included in the new A46 instead. • Procedures updated to remove reference to "For periods commencing on or after 15 March 2020" as this date has now passed. • Several procedures have been re-ordered to give a more logical flow to the form.
A45 Audit data analytics and other technology update and evaluation	• Reference changes only.
A46 Fraud update and evaluation	• New form to evaluate key matters with respect to fraud in the completion section, based on the updated ISA 240 requirements.
A51 Written representations checklist	• Minor updates to reflect changes in ISA 240.
A52-1 Communication with management checklist	• Minor updates to reflect changes in ISA 240.
A71 Final analytical procedures	• Additional bullet point added with respect to the revised ISA 240.
Current file: Planning (detailed) - Individual (p/c on or after 15 Dec 21) & Planning (detailed) - Group (p/c on or after 15 Dec 21)	
B01 Planning checklist	• Moved from B11. • Guidance notes updated to reflect ISA 315 changes. • First section renamed pre planning. • Minor amendments to items for clarity, best practice and ISA 315 changes. • New item added requiring completion of new fraud risk assessment form B34 which incorporates changes to ISA 240.

	• New items added to risk assessment procedures and risk assessment / audit approach in relation to team meetings and team briefings given these have now been split in the methodology, and the team meeting section of this form has been removed as a result.
B02 Audit strategy	• New form to ensure best practice in relation to an audit strategy is followed.
B03 Preliminary engagement quality control review (ISQC version)	• Moved from B14. • Renamed to highlight this version of the form applies before the new quality management standards are adopted.
B03 Preliminary engagement quality review (ISQM version)	• A new version of the form applicable when the new quality management standards are adopted.
B10 Engagement review	• New form to summarise the acceptance and appointment section.
B11 Acceptance of appointment or reappointment	• Moved from B12. • Minor amendments due to restructure of the planning and PF sections. • Removed references to "For periods commencing on or after 15 March 2020" as this date has now passed.
B12 Compliance with the Ethical Standard	• Moved from B13. • Minor amendments due to restructure of the planning section. • Minor amendments related to the introduction of the new quality management standards. • Removal of references to "For periods commencing on or after 15 March 2020" and "For periods commencing before 15 March 2020" and consequential updates to footnotes as this date has now passed. • Minor update to wording in consultation and communication section to reflect best practice terminology.
B13 New client checklist	• Moved from PF1.
B14 Opening balances and consistency of accounting policies	• New form to assist in gathering sufficient appropriate audit evidence over opening balances and consistency of accounting policies.
B15 Terms of engagement - placeholder	• New placeholder added.
B20 Information gathering summary	• New form to summarise the information gathering section.
B21 Audit data analytics assessment	• Moved from B20. • Minor amendments for clarity.
B22-1 Communication with management	• Moved from B21-1. • Minor updates to fraud risk section to address ISA 240 changes. • New footnote added with additional guidance.
B22-2 Communication with those charged with governance	• Moved from B21-2. • "Agenda for" removed from title. • Minor updates to fraud risk section to address ISA 240 changes.
B23 Preliminary analytical review	• Moved from B22. • Update to objective in relation to the revised ISA 240. • Updated guidance notes in relation to the revised ISA 240.

	• New box added to conclusions section in relation to the revised ISA 240.
B24 Design and implementation of controls	• New form to summarise design and implementation of controls as part of the revised ISA 315 requirements.
B24X Control form	• New form to document design and implementation of controls as part of the revised ISA 315 requirements.
B25 Materiality	• Moved from B41.
B27 Company searches - placeholder	• New placeholder added.
B30 Inherent and control risk assessment	• New risk assessment form to comply with the requirements of the revised ISA 315 (replaces the previous B32).
B31X Assertion level risk	• New form to assess risk of material misstatement at the assertion level as part of the revised ISA 315 requirements.
B32X Key accounting estimate	• Moved from B30X. • Update to guidance notes to reflect the revised ISA 315 requirements. • Changes to form to reflect revised risk assessment process and linkage with the new B30.
B33 Going concern risk assessment	• Moved from B31. • Consequential amendment to risk assessment procedures section for changes to risk assessment forms.
B34 Fraud risk assessment	• New form to summarise conditions and events that may indicate Risk of Material Misstatement in the financial statements due to fraud and aid compliance with the revised ISA 240.
B35 Audit team discussion	• Moved from B23. • Additional reference to APM added in guidance notes. • Fraud risk section updated for changes to ISA 240. • Approach section removed (now on B41 Audit team briefing).
B40 Audit plans	• Moved from B33.
B41 Audit team briefing	• New form to aid in updating the audit team on changes since the audit team discussion and to brief on the audit approach.
B50 Budget	• Moved from B61.
SSF Substantive sampling form	• Minor update to approach to reflect spectrum of inherent risk.
Current file: Planning (freeform memo) - Individual (p/c on or after 15 Dec 21)	
B01 Planning checklist Freeform memorandum approach	• Moved from B11. • Guidance notes updated to reflect ISA 315 changes. • First section renamed pre planning. • Minor amendments to items for clarity, best practice and ISA 315 changes. • New item added requiring completion of new fraud risk assessment which incorporates changes to ISA 240.

	• New items added to risk assessment procedures and risk assessment / audit approach in relation to team meetings and team briefings given these have now been split in the methodology, and the team meeting section of this form has been removed as a result.
B05 Audit planning memorandum	• Moved from B11 and no longer shares the same reference as the planning checklist. • Updated to reflect revised methodology with respect to updates to ISA 315 and ISA 240.
B13 New client checklist	• A copy of this form has been made available in the Planning (freeform memo) section.
B14 Opening balances and consistency of accounting policies	• New form to assist in gathering sufficient appropriate audit evidence over opening balances and consistency of accounting policies.
B21 Audit data analytics assessment	• A copy of this form has been made available in the Planning (freeform memo) section.
B24X Control form	• New form to document design and implementation of controls as part of the revised ISA 315 requirements.
B31X Assertion level risk	• New form to assess risk of material misstatement at the assertion level as part of the revised ISA 315 requirements.
B32X Key accounting estimate	• A copy of this form has been made available in the Planning (freeform memo) section. • Update to guidance notes to reflect the revised ISA 315 requirements. • Changes to form to reflect revised risk assessment process and linkage with the new B05.
B50 Budget	• Moved from B61.
SSF Substantive sampling form	• Minor update to approach to reflect spectrum of inherent risk.
Current file: Audit programmes (p/c on or after 15 Dec 21)	
Audit programmes C to P	• Minor amendment to wording of one test, highlighting the need to ensure appropriate restatement, where relevant. • Additional test inserted with respect to changes in accounting policies as part of best practice amendments. • Additional test inserted with respect to the revised ISA 240.
D Audit programme - Related parties	• Changes as per above for audit programmes C to P. • Minor amendment to one test in connection with related parties / transactions not previously identified or disclosed.
N Audit programme - Trial balance	• Changes as per above for audit programmes C to P. • A number of additional tests added in relation to the revised requirements of ISA 240. • Additional guidance added by way of footnotes.
Current file: Proforma working papers (p/c on or after 15 Dec 21)	
Proforma working papers	• Sampling forms updated to reflect spectrum of inherent risk.

Current file: Independent examination	
A21-3 Consultation / ethics review (ISQC version)	• Renamed to highlight this version of the form applies before the new quality management standards are adopted.
A21-3 Consultation / ethics review (ISQM version)	• A new version of the form applicable when the new quality management standards are adopted.
B01 Planning checklist	• Moved from B11. • First section renamed pre planning.
B02 Audit exemption eligibility checklist	• Moved from B12. • Minor update for clarity.
B11 Acceptance of appointment or reappointment	• Moved from B13-1. • Additional guidance added to first point under other considerations.
B12 Assessment of independence threats and safeguards	• Moved from B13-2.
B13 New client checklist	• Moved from PF1.
Current file: Staff appraisal form	
Staff appraisal form	• Moved into new format so it displays like other forms within the manual and is no longer treated as a separate attachment.
Permanent file (p/c on or after 15 Dec 21)	
Permanent file indices	• Updated to reflect revised file structures.
PF1-1 The entity and its environment	• Completely revised form to address the requirements of the revised ISA 315.
PF1-2 The applicable financial reporting framework	• New form to aid in understanding the applicable financial reporting framework as part of the revised ISA 315 requirements.
PF1-3 Laws and regulations	• Minor update to guidance in footnote for consequential changes resulting from ISA 315 amendments. • Insertion of additional wording in relation to the yearly sign off.
PF1-4 Related parties	• Now incorporates the content of the former PF1-5. • Minor amendments to wording for consistency with the revised ISA 315. • Minor update to guidance in footnote for consequential changes resulting from ISA 315 amendments. • Insertion of additional wording in relation to the yearly sign off.
PF1-5 Groups	• Moved from PF3-3. • Minor changes to guidance notes and changed to a yes/no (add comments as needed) rather than notes format. • Minor update to guidance in footnote for consequential changes resulting from ISA 315 amendments. • Insertion of additional wording in relation to the yearly sign off.

PF1-6 Using a service organisation	• Updates to wording and requirements of the form to improve clarity of requirements. • Minor update to guidance in footnote for consequential changes resulting from ISA 315 amendments. • Insertion of additional wording in relation to the yearly sign off.
PF1-7 Using the work of an expert	• Minor update to guidance in footnote for consequential changes resulting from ISA 315 amendments. • Insertion of additional wording in relation to the yearly sign off.
PF1-8 Accounting estimates	• Minor updates throughout to reflect ISA 315 amendments. • Minor update to guidance in footnote for consequential changes resulting from ISA 315 amendments. • Insertion of additional wording in relation to the yearly sign off.
PF1-10 Going concern	• Minor update to guidance in footnote for consequential changes resulting from ISA 315 amendments. • Insertion of additional wording in relation to the yearly sign off.
PF2-1 Systems overview	• Minor changes to notes as a result of changes to ISA 315 requirements. • Minor update to guidance in footnote for consequential changes resulting from ISA 315 amendments. • Insertion of additional wording in relation to the yearly sign off.
PF2-2 Key internal controls summary	• Moved from PF2-3. • The presentation of the form has changed and there have been other updates to better reflect the flow of the revised ISA 315.
PF2-3 Internal control overview	• Moved from PF2-2. • Completely revised form to address the requirements of the revised ISA 315.
PF2-4 Using the work of and communication with internal auditors	• Minor change to objective due to changes in ISA 315 requirements. • Additional point added in first section for completeness. • Minor update to guidance in footnote for consequential changes resulting from ISA 315 amendments. • Insertion of additional wording in relation to the yearly sign off.
PF3-1 New client checklist - placeholder	• New placeholder added.

Supplementary forms

All supplementary forms	• Updated so they are no longer period specific.

April 2022 - Remapping summary

The below table provides a list of forms in the planning section of the current file and the permanent file, and indicates where they have moved to, if applicable, as part of this update of the manual.

Original reference and form	Revised reference	Comments (if applicable)
Planning		
B11 Planning checklist	B01	
B11 Audit planning memorandum (freeform only)	B05	
B12 Acceptance of appointment or reappointment	B11	
B13 Compliance with the Ethical Standard	B12	
B14 Preliminary engagement quality control review	B03	Now labelled with '(ISQC version)' with a new version '(ISQM version)' made available for adoption of the new quality management standards.
B20 Audit data analytics assessment	B21	
B21-1 Communication with management	B22-1	
B21-2 Agenda for communication with those charged with governance	B22-2	
B22 Preliminary analytical review	B23	
B23 Audit team discussion	B35	
B30A-E Key accounting estimate summary	B32A-E	Renamed 'Key accounting estimate'.
B31 Going concern risk assessment	B33	
B32 Risk assessment	B30	
B33 Audit plans	B40	
B41 Materiality	B25	
B61 Budget	B50	
CSF Test of controls sampling form	No Change	
SSF Substantive sampling form	No Change	
Permanent file		
PF1- New client checklist	B13 / PF3-1	
PF1-1 The entity and its environment	No Change	

PF1-3 Laws and regulations	No Change	
PF1-4 Related parties	No Change	
PF1-5 Groups	PF1-4	The content of this form has now been moved to PF1-4 Related parties.
PF1-6 Using a service organisation	No Change	
PF1-7 Using the work of an expert	No Change	
PF1-8 Accounting estimates	No Change	
PF1-10 Going concern	No Change	
PF2-1 Systems overview	No Change	
PF2-2 Internal control overview	PF2-3	
PF2-3 Key internal controls summary	PF2-2	
PF2-4 Using the work of and communication with internal auditors	No Change	
PF3-1 Risk analysis	Removed	
PF3-2 Fraud risk analysis	B34	Now included as part of B34.
PF3-3 Group risk analysis	PF1-5	

21 Audit exempt manual

21.1Contents

	Guidance
	Guidance notes
	What do you need to know about this manual?
	Audit Exemption guidance notes
1	Introduction and criteria
2	Effects of the exemptions on audit and accounting requirements
3	Compilation of accounts
4	Micro-entity companies
5	Unincorporated business assignments
	Getting started for new manual users
	What's changed

21.2 Guidance

What do you need to know about this manual?

The Audit Exemption Manual has been developed to enable accountants to:

- check adherence to legislation and regulatory requirements;
- comply with relevant technical guidance; and
- provide audit exempt companies and unincorporated businesses with comprehensive and cost effective accounts compilation services.

What does this manual include?

- The guidance notes summarise the relevant legal and regulatory framework within which audit exempt companies operate. Guidance is also included on the performance of unincorporated entity assignments.

What else do you need?

It is recommended that the manual is read in conjunction with:

- The Companies Act 2006 and relevant statutory instruments (available from www.legislation.gov.uk).
- Financial Reporting Standards.
- ICAEW Audit and Assurance Faculty Technical Release TECH 07/16 AAF Chartered Accountants' Reports on the Compilation of Financial Statements of Incorporated Entities (available from www.icaew.co.uk).
- ACCA Technical Factsheet 163 Audit Exempt Companies - ACCA Accounts Preparation Report (available from www.accaglobal.com).
- ICAS guidance - Framework for the Preparation of Accounts. Best Practice Guidance (available from www.icas.com).
- ICAEW Audit and Assurance Faculty Technical Release TECH 08/16 AAF Chartered Accountants' Reports on the Compilation of Historical Financial Information of Unincorporated Entities (available from www.icaew.co.uk).

Updating
This manual will be updated when changes are required as a result of new guidance specific to accounts compilation assignments, companies or audit exemption. As a user of this manual you will automatically be notified of any significant updates.

For information of users
This manual should be read in conjunction with the detailed legislation or regulations. No responsibility for loss occasioned by any person acting or refraining from action as a result of the material contained in this manual can be accepted by the authors or the firm.

21.3 Audit Exemption guidance notes

1 Introduction and criteria

1.1 Options available

A company may be entitled to audit exemption through a number of separate routes. It may be entitled to take advantage of:

- small companies / groups audit exemption (see 1.2 to 1.7 below);
- dormant companies audit exemption (see 1.8 and 1.10 below);
- subsidiaries audit exemption (see 1.9 below).

Legislation exempting small limited companies from audit was first introduced in 1994 for companies with a turnover of not more than £350,000. The original regime was then simplified during 1997 and the audit turnover threshold was increased again in 2000 to £1 million. In 2004, Regulations introduced a significant change for periods ending on or after 30 March 2004, when the turnover threshold was increased to £5.6m.

Following the introduction of the Companies Act 2006, SI 2008/393 The Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008 were issued. These further increased the audit exemption limits for accounting periods beginning on or after 6 April 2008. The turnover threshold was increased to £6.5m at this stage.

In 2012, the government introduced a change to the audit exemption regime which essentially meant that a company need only meet the small company criteria in order to qualify for audit exemption. A similar change was also made to the qualification criteria for audit exemption of a small company which is part of a small group. SI 2012/2301 - The Companies and Limited Liability Partnerships (Accounts and Audit Exemptions and Change of Accounting Framework) Regulations 2012 made these changes and others (see 1.9 and 1.10 below) for financial years ending on or after 1 October 2012.

In 2013, the government introduced a new sub-classification of small company known as a 'micro-entity'. See section 5 for details and guidance on this type of entity.

In 2015, SI 2015/980 – The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 made a number of changes to company law, including an increase to the small and medium company size criteria. These changes became applicable for accounting periods beginning on or after 1 January 2016 (see 1.2 below).

In 2018, SI 2018/1030 – The Occupational Pension Schemes (Master Trusts) Regulations 2018 introduced a change which resulted in companies which are scheme funders of a Master Trust scheme being excluded from the small companies regime, the small companies audit exemption and excluded from being treated as medium-sized.

In 2019 and 2020, the government made a number of changes to company law as a result of Brexit. Practically, most changes affect financial years commencing on or after 1 January 2021. Changes affect whether a company or group is ineligible for the small companies regime, availability of audit exemption by parent guarantee and availability of consolidation exemptions.

1.2 Small companies audit exemption criteria

In order to qualify for small companies audit exemption in respect of a financial year ending on or after 1 January 2016, a company must qualify as a small company in relation to that year (see the paragraph on 'Small companies / group size limits' below). Further considerations are also required in respect of companies that are part of a group, or are otherwise ineligible to claim small companies audit exemption (see the paragraphs after 'Small companies / group size limits' below).

1.3 Small companies / group size limits

A company (or group) qualifies as small if it meets two out of three criteria relating to turnover, balance sheet total (fixed assets plus current assets) and number of employees (average number of persons employed by the company in the year) as set out below in its first financial year, or in the case of a subsequent year, in that year and the preceding year:

The relevant criteria are:

Small company limits:

- turnover not more than £10.2 million;
- balance sheet total not more than £5.1 million;
- number of employees not more than 50.

The turnover figure should be adjusted proportionately if the accounting period is not a year.

Small group limits:

- turnover not more than £10.2 million net or £12.2 million gross;
- balance sheet total not more than £5.1 million net or £6.1 million gross;
- number of employees not more than 50.

Net figures are those after consolidation adjustments, such as the elimination of intra-group sales and balances. Gross figures are calculated by the simple addition of the amounts appearing in each company's accounts.

A group may qualify on the basis of either the net or gross figures or a combination thereof.

In addition to meeting these limits, a company must also not be excluded from the small companies' regime. A company cannot qualify as a small company in respect of a financial year if it was at any time within that year:

- a public company;
- a company carrying on an insurance market activity;
- an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company (see 'the paragraph on 'Financial services companies' below);
- a scheme funder of a Master Trust scheme with the meanings given by section 39(1) of the Pension Schemes Act 2017 (interpretation of Part 1);

- a parent company or a subsidiary undertaking (but see the paragraph on 'Parent and subsidiary companies' below).

NB. 'MiFID' stands for 'Markets in Financial Instruments Directive'. UCITS stands for 'Undertakings for Collective Investment in Transferable Securities'.

1.4 Companies ineligible for small companies audit exemption

In addition to small company qualification criteria, a company is not entitled to the exemption from audit in respect of a financial year if it is, or was at any time within that year:

- a special register body as defined in section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 or an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992.

1.5 Financial services companies

Many financial services companies that qualify as small companies, under the statutory limits, benefit from audit exemption. Set out below is a brief summary of the position regarding the most common situations.

Provided a company would qualify for audit exemption but for the 'financial services' connection, the following qualify as audit exempt:

- Mortgage and general insurance intermediaries (whether directly authorised with the Financial Conduct Authority or Appointed Representatives of companies who are themselves authorised) provided they do not conduct other investment business (eg. pensions and life assurance).
- Insurance intermediaries (dealing with both life and general insurance), mortgage lenders and administrators, personal investment companies (eg. independent financial advisers), securities and futures companies and investment management companies and Appointed Representatives of such firms.

The above applies unless the company is:

- an authorised insurance company;
- a banking company;
- an e-money issuer;
- a MiFID (see paragraph on 'Small companies / group size limits' above) investment firm; or
- a UCITS (see paragraph on 'Small companies / group size limits' above) management company.

1.6 Right of members to require an audit

Any member or members holding not less than 10% in nominal value of the issued share capital of a company or, if the company does not have a share capital, not less than 10 per cent in number of the members of the company may, by notice, require that the company obtains an audit of its accounts for that year. Under section 476 of the Companies Act 2006, the notice may not be given before the financial year to which it relates and must be given not later than one month before the end of that year.

Where such a notice has been deposited the company is not entitled to the exemption in respect of the financial year to which the notice relates.

1.7 Parent and subsidiary companies

A parent or subsidiary company is not entitled to the S477 small companies audit exemption unless it meets the conditions in Section 479 of the Companies Act 2006:

- any group of which it was a member at any time during the year must qualify as a small group; and
- the company was not at any time in the year an ineligible group.

A group is ineligible if any of its members is:

- a traded company;
- [For periods commencing on or after 1 January 2021] a body corporate (other than company) whose shares are admitted to trading on a UK regulated market/ [For periods commencing before 1 January 2021] a body corporate (other than company) whose shares are admitted to trading on a regulated market in an EEA state;
- a person (other than a small company) who has permission under Part 4A of the Financial Services and Markets Act 2000 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;
- a person who carries on insurance market activity; or
- a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 (interpretation of Part 1).

Per section 474(1) a traded company is a company whose transferable securities are [For periods commencing on or after 1 January 2021] admitted to trading on a UK regulated market / [For periods commencing before 1 January 2021] admitted to trading on a regulated market.

1.8 Dormant companies audit exemption

A dormant company that is small, or would be small but for it being a plc or member of an ineligible group, and that is not required to prepare group accounts, may still claim audit exemption under section 480 of the Companies Act 2006 provided that at any time during the year it was not a traded company, an ineligible financial services company or carrying on insurance market activity. The requirements for a dormant company can be found in sections 480 and 481 of the Companies Act 2006.

1.9 Audit exemption for subsidiaries

Section 479A of the Companies Act 2006 allows qualifying parent companies and their subsidiaries to decide whether or not to have a subsidiary audited, regardless of its size. Instead, a parent company can opt to provide a statutory guarantee over the subsidiary's liabilities.

The qualifying conditions are set out in Section 479A of the Companies Act 2006 and in order for the subsidiary to qualify for audit exemption, all of the conditions must be met:

- the company is itself a subsidiary undertaking;
- its parent undertaking is established under the law of [For periods commencing on or after 1 January 2021] any part of the United Kingdom / [For periods commencing before 1 January 2021] an EEA State;
- all members of the company must agree to the exemption in respect of the financial year in question;
- the parent undertaking must give a guarantee under Section 479C of the Companies Act 2006 in respect of that year;
- the company must be included in the consolidated accounts drawn up for that year or to an earlier date in that year by the parent undertaking in accordance with:

- [For periods commencing on or after 1 January 2021] if the undertaking is a company, the requirements of Part 15 of this Act, or, if the undertaking is not a company, the legal requirements which apply to the drawing up of consolidated accounts for that undertaking / [For periods commencing before 1 January 2021] the provisions of Directive 2013/34/EU of the European Parliament and of the Council on the annual financial statements, consolidated statements and related reports of certain types of undertakings or

- [For periods commencing on or after 1 January 2021] UK-adopted international accounting standards (within the meaning given by Section 474(1) / [For periods commencing before 1 January 2021] international accounting standards

- the parent undertaking must disclose in the notes to the consolidated accounts that the company is exempt from the requirements of the Companies Act 2006 relating to the audit of individual accounts by virtue of this section;
- the directors of the company must deliver to the registrar on or before the date that they file the accounts for that year:

- a written notice of the agreement referred to in subsection (2)(a) of Section 479A;
- the statement referred to in Section 479C(1);
- a copy of the consolidated accounts referred to in subsection (2)(c) of Section 479A;
- a copy of the auditor’s report on those accounts; and
- a copy of the consolidated annual report drawn up by the parent undertaking.

- Section 479A has effect subject to:

- Section 475(2) and (3) of the Companies Act 2006 (requirements as to statements contained in balance sheet); and
- Section 476 of the Companies Act 2006 (right of members to require audit).

Subsidiaries ineligible for section 479A audit exemption

Certain subsidiary companies are excluded from taking this exemption, as set out in Section 479B of the Companies Act 2006:

- a traded company as defined in Section 474(1) of the Companies Act 2006;
- a company that:

- is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company; or
- carries on insurance market activity;

- is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 (interpretation of Part 1).

- a special register body as defined in section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 or an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992.

Under Section 479C of the Companies Act 2006, the directors of the subsidiary are required to deliver the statement of guarantee to the registrar for each relevant financial year. The statement must be authenticated by the parent undertaking and must specify:

- the name of the parent undertaking;
- if the parent undertaking is incorporated in the United Kingdom, its registered number (if any);
- [For periods commencing before 1 January 2021 only] if the parent undertaking is incorporated outside the United Kingdom and registered in the country in which it is incorporated, the identity of the register on which it is registered and the number with which it is so registered;
- the name and registered number of the subsidiary company in respect of which the guarantee is being given;
- the date of the statement; and
- the financial year to which the guarantee relates.

A guarantee given under this section has the effect that:

- the parent undertaking guarantees all outstanding liabilities to which the subsidiary company is subject at the end of the financial year to which the guarantee relates, until they are satisfied in full; and
- the guarantee is enforceable against the parent undertaking by any person to whom the subsidiary company is liable in respect of those liabilities.

1.10 Dormant subsidiary companies

Subsidiary companies which are dormant throughout the period for which they are a subsidiary can claim exemption from audit (section 479(3) of the Companies Act 2006).

The Companies Act 2006 permits dormant subsidiaries to be exempt from the requirement to prepare and file accounts, subject to the provision of a similar guarantee to that noted in the paragraph on 'Audit exemption for subsidiaries' above. The relevant qualifying conditions, including a list of those who are ineligible for this dormant subsidiaries exemption, can be found in sections 448A to 448C of the Companies Act 2006.

1.11 Audit exemption for micro-entities

See the section on 'Micro entity companies' below for guidance on the rules that apply to micro-entities and where these differ to those stated above.

2 Effects of the exemptions on audit and accounting requirements

2.1 Audit exempt companies

An audit report is not required but the company must still:

- prepare full or abridged[1] statutory accounts for the members which give a true and fair view[2];
- file accounts at Companies House (small companies can choose to exclude the directors report and/or profit and loss account for filed accounts)[2, 3];
- maintain adequate accounting records.

The directors remain responsible for these requirements.

[1]Where the balance sheet or the profit and loss account is abridged, the directors must also deliver to the registrar a statement by the company that all members of the company have consented to the abridgement.

[2] Dormant subsidiary companies taking advantage of sections 448A to 448C of the Companies Act 2006 (see the paragraph on 'Dormant subsidiary companies' above) are exempt from these requirements.

[3] A statement confirming that the option not to file the profit and loss account has been taken is required on the balance sheet.

For guidance on micro-entities see the section on 'Micro entity companies' below.

2.2 Directors' statement on the Balance Sheet

A company is only entitled to the exemptions if an appropriate statement is made on the Balance Sheet. Suggested wording for this statement is included in the Example reports section of this manual.

2.3 Ceasing to act as auditor

The Audit Procedures Manual guidance on the legal and regulatory procedures to be followed when ceasing to act as auditor should be consulted in this situation. A new engagement letter should also be issued.

2.4 Articles of association

Under the Companies Act 2006, there is no requirement for a small private limited company to appoint an auditor, or to have an annual audit. The requirement may, however, be affected by the requirements of the company’s Articles of Association.

Many companies adopted, on their formation, the Model Articles contained in the Table A of the Companies Act under which incorporation took place, and the requirement to appoint an auditor will be driven by those Articles. In the case of companies formed under the 1985 / 2006 Companies Act, no further action is required unless the company introduced a specific requirement into the model articles requiring the appointment of an auditor.

Companies which were formed under earlier Acts, and adopted the Table A in force at the time of incorporation, or a more recent company, which introduced a specific requirement for an auditor, will need to pass a special resolution changing their constitution.

It is always good practice to consult a company's constitutional documents when considering if a company is able to dispense with an audit.

2.5 Is an audit desirable?

Some small companies which qualify for audit exemption may still benefit from a full statutory audit. They include any entity wishing to achieve a high level of assurance on the financial statements. Some of the small companies that are now eligible for audit exemption are likely to be quite distinct from those previously eligible. For example, some of these companies are likely to have more sophisticated financial systems, they may be able to produce their own accounts and they may also have a finance director. Their level of borrowings is likely to be different, including the security provided. The services needed by these clients could also be quite different from those required by smaller companies.

These companies will be looking for their accountants to assist them in making a decision concerning potential audit exemption.

In particular, the following matters should be considered in deciding whether an audit would be desirable:

- growing companies (that may soon exceed the exemption limits);
- companies that prepare their own accounts (for adjustments);
- companies that do not prepare their own accounts (marginal cost);
- companies vulnerable to take-over (for negotiations and due diligence);
- companies vulnerable to HMRC investigations;
- companies needing finance and those bound by banking covenants;
- companies with owners nearing retirement; and
- any company seeking to preserve its long term financial health.

The benefits that could be promoted to those that request, or those that may need an audit, include:

- credibility of information (for customers, suppliers, employees, investors, etc.);
- taxation issues (facilitates the payments of corporate, value added and other taxes on time and accurately, helping to avoid interest, penalties and investigations);
- banking covenant compliance;
- deterring and detecting material fraud and error;
- facilitating the purchase and sale of businesses;
- ability to demonstrate good corporate governance; and
- spin-offs, such as advice on the structure and operation of systems.

The manual includes a 'client's needs checklist' to help determine whether an audit may be desirable. This includes consideration of the factors noted above.

Micro-entities

On the understanding of the deregulatory and cost saving aims, and minimum information approach of the micro-entity regulations, it is unlikely that those wishing to take advantage of the micro-entity provisions will then request an audit of the accounts (although this is not prevented). The 'client's needs checklist' in this manual have therefore not been specifically amended to take account of micro-entities.

2.6 When might an auditor be required?

The Companies Act 2006 includes certain provisions where reports or statements are required by registered auditors. These include:

- redemption or purchase by a private company of its own shares out of capital. This requires an auditors' report on the statutory declaration made by the directors (Section 714(6) of the Companies Act 2006);

- statement on the re-registration of a private company as a public company (Section 92 of the Companies Act 2006).

In addition, there are a number of regulatory bodies and other organisations that require their members to retain the services of a registered auditor for specific regulatory purposes.

2.7 Non-statutory audits

Where clients decide that they no longer require a statutory audit and, as such, file audit exempt accounts at Companies House but then realise that they need a non-statutory audit, for example because a loan agreement requires audited accounts, they may request a non-statutory audit. Where firms are considering this type of request, they must consider risk management issues. These principally concern the identity of any bodies to whom they owe a duty of care.

In a non-statutory audit, neither the shareholders nor auditors will have the rights or protections afforded by company law and so it is often preferable for the company to choose to have a statutory audit under the relevant Companies Act.

2.8 Section 479A of the Companies Act 2006 - subsidiary audit exemption

The purpose of this manual is to assist with the accounts compilation exercise and therefore the work programmes are not written for companies with £tens of millions of turnover, that will have their own capable accounts function. However, the programmes may be applicable under the subsidiary exemption rules to small subsidiaries of a holding company that collectively form a non-small group and cannot therefore take advantage of audit exemption under the traditional rules.

The decision over whether qualifying subsidiaries in the context of section 479A of the Companies Act 2006 should be audited must be made in conjunction with the parent company, its legal advisors and the group auditors. Once it has been confirmed that a subsidiary does qualify for the exemption, and a decision is made to go ahead, the parent company must make a related disclosure in the audited group accounts. A written notice of the guarantee must be filed at Companies House. The full qualifying conditions and requirements can be found in sections 479A to 479C of the Companies Act 2006 (see the paragraph on 'Audit exemption for subsidiaries' above).

The requirements of International Standard on Auditing (UK) (ISA (UK)) 600 - Special considerations: Audits of Group Financial Statements (including the work of component auditors) must also be considered. The auditors of the group accounts must comply with this standard in arriving at their opinion. For financially significant components of a group, the standard requires an audit of the financial information of the component using component materiality. So, although the Companies Act may not require a subsidiary to be audited, ISA (UK) 600 may require an audit of its financial information using component materiality instead.

A potentially anomalous situation arises under the rules where a medium-sized subsidiary exists within a group that qualifies as small. The subsidiary cannot qualify for audit exemption under the traditional rules, because it is medium-sized itself. As the group as a whole qualifies as small, it is not required to prepare group accounts. If it is decided that advantage should be taken of the new subsidiary audit exemption rules, and the parent company guarantees the liabilities of the subsidiary, then audited group accounts will be required. Also, as the subsidiary is the main trading component of the group, the requirements of ISA (UK) 600 will also be significant.

In these circumstances, the option of auditing the subsidiary and not preparing group accounts may be preferred.

3 Compilation of accounts

3.1 Introduction

Where the directors have appointed a firm of accountants as their agent to compile the accounts, firms must ensure that the work is performed to a professional standard.

Generally this involves:

- obtaining knowledge of the business;
- planning, controlling and recording the work as appropriate;
- avoiding having their name associated with accounts they consider misleading;
- providing an accountant's report.

The compilation procedures will broadly be the same as those for unincorporated businesses, except that the following specific matters will require consideration:

- the legal requirement that the accounts provide a true and fair view and are properly prepared in accordance with the Companies Act 2006;
- the applicability of accounting standards; and
- the requirement to file the appropriate accounts with the Registrar.

For guidance on micro-entities see the section below.

3.2 True and fair view

The directors have a legal requirement to produce accounts that show a ‘true and fair’ view. Implicit in this requirement is the need to comply with an appropriate financial framework, for example UK Generally Accepted Accounting Principles (UK GAAP). This is acknowledged in their statement on the balance sheet. Some will be incapable of doing this without assistance and will look to professional firms to prepare such accounts on their behalf.

A word on 'going concern'

One important aspect of preparing accounts that show a true and fair view is going concern. UK GAAP requires the directors to satisfy themselves that it is reasonable to prepare financial statements on a going concern basis, considering all available information at the date they authorise the financial statements for issue.

Guidance from the ICAEW (TECH 07/16 AAF - see the paragraph on 'Guidance on the compilation of financial statements' below) suggests the directors' consideration *"should be proportionate in nature and depth, depending on the size, financial risk and complexity of the company and its operations"* and *"should usually cover a period of at least twelve months from the date of approval of the financial statements"*. In addition, *"Disclosures in the financial statements should be balanced, clear and proportionate and include any material uncertainties which may cast significant doubt on the company's ability to continue as a going concern"*.

For guidance on micro-entities see the section below.

Firms must make it clear that they cannot accept any responsibility for the accounts showing a true and fair view without undertaking an audit. In preparing accounts, firms should ensure that they are properly prepared from the records and information provided but their truth and fairness will be dependent upon the completeness and accuracy of the records and information. The directors must understand that accountants are not confirming the completeness or accuracy of the records.

Due to the above, the wording of the section of the letter of engagement relating to accounts preparation is extremely important. The letter should set out clearly the accountant's responsibilities and the limits in respect of the preparation of the accounts.

Suggested wording for this letter is included within this manual. However, this wording needs to be tailored for the specific requirements and circumstances of the client.

Although accountants have no responsibility regarding the truth and fairness of the accounts, they have a professional responsibility to ensure that their name is not associated with misleading information. Where matters come to light that appear to indicate that the financial statements may be misleading, such matters should be discussed with the directors with a view to agreeing appropriate adjustments and / or disclosures in the financial statements.

3.3 Misleading financial information

Accountants, in particular those who are members of a professional body, should not, therefore, knowingly be associated with financial information where they believe that the information:

- contains a materially false or misleading statement;
- contains statements or information furnished recklessly; or
- omits or obscures information required to be included where such omission or obscurity would be misleading.

It is possible, when firms are preparing financial statements, that either adjustments they consider appropriate are not made or appropriate information has not been provided to their satisfaction. In such circumstances, firms should cease to act for the client and should not permit their name to be associated with the financial statements.

If a firm withdraws from an engagement, they should normally explain to the client their reasons for doing so unless this would constitute a breach of legal or other regulatory requirements (including the 'tipping off' provisions of the money laundering legislation).

If the firm concludes that it is appropriate for them to be associated with the financial statements, despite a departure from an applicable standard, or the fact that incomplete information is available (eg. the loss of stock records in a fire) they should check that suitable disclosures are made in the financial statements and may further wish to highlight these disclosures by way of an explanatory paragraph in their report.

3.4 Applicability of accounting standards

Accounting standards apply to all financial statements intended to give a true and fair view They, therefore, apply to the accounts of a company whether or not it is exempt from an audit.

Appendix II: Note on legal requirements of FRS 100 Application of Financial Reporting Requirements highlights that many entities that are not constituted as companies apply accounting standards promulgated by the FRC for the purposes of preparing financial statements that present a true and fair view. The FRC sets accounting standards within the framework of the Companies Act 2006.

Guidance issued by, for example, the ICAEW (in TECH 07/16 AAF - see the paragraph on 'Guidance on the compilation of financial statements' below) makes it clear that the statutory accounts of incorporated entities should comply with both the disclosure requirements of the Companies Act and any applicable financial reporting framework, including UK GAAP, or [For periods commencing on or after 1 January 2021] UK-adopted IFRS / [For periods commencing before 1 January 2021] International accounting standards in conformity with the requirements of the Companies Act 2006.

Tax legislation also requires business profits to be computed in accordance with Generally Accepted Accounting Practice. Tax treatment will follow accounting treatment unless there is a specific tax treatment that requires otherwise.

Where there are departures from accounting standards, and appropriate disclosures are made in the financial statements, accountants may wish to highlight these disclosures in their report by way of an explanatory paragraph.

Suggested wording for such a paragraph is included within this manual.

A relevant company accounts disclosure checklist should be completed whenever firms are compiling accounts. In addition, the normal principles of disclosing departures from standards should be adopted. Accounts disclosure checklists can be found within this manual.

Below are specific guidance notes, analysed by primary statement or note, for the various example accounts included within this manual.

For guidance on micro-entities see the section below.

3.4.1 Small FRS 102 - full accounts

Front cover

The ICAEW Technical Release TECH 07/16 AAF suggests that the financial statements contain a reference to the fact that they are unaudited, either on the front cover or on each page (or both) of the financial statements.

Directors' report

The Directors' report need not be filed if filleted accounts are to be filed.

Accountant's report

The Accountant's report will need to be tailored dependent on whether they have been prepared by an ICAEW, ACCA or ICAS firm.

Balance sheet

Deferred tax is not on the standard Companies Act formats as a line item, however, it may be added to avoid the need for a separate note dependent on its materiality.

The audit exemption statement at the bottom of the balance sheet could be included in the full accounts so that it does not need to be added later to the filleted accounts before filing. The relevant section number for small company audit exemption is section 477. Or, if relevant, for a subsidiary company it is section 479A, for a dormant company, section 480.

Notes to the financial statements

Summary of accounting policies

FRS 102 paragraph 1AE.1 has going concern disclosures in its list of 'encouraged' disclosures, hence it is included as good practice even though not an explicit requirement.

The statement of compliance to FRS 102 Section 1A is not required but is also encouraged (FRS 102-1AE.1).

If the entity receives an interest-free loan from a person who is within a director's group of close family members, when that group contains at least one shareholder, and the entity has adopted FRS 102 paragraph 11.13A(a) (formerly 1.15A) allowing these balances to be initially recorded at transaction price, this policy should also be described.

Interest

Analysis is only required if interest is receivable / payable from / to group undertakings (SI 2008/409 Sch 1.9A (12) & (13)), or required for a true and fair presentation. However, it can be deleted from the filleted accounts filed at Companies House.

Debtors

Though not required under FRS 102 Section 1A accounts, prepayments must be disclosed separately under both FRS 105 and full FRS 102 accounts.

Related party transactions

Advances to, or guarantees granted on behalf of, directors require disclosure. Also, all loans to / from related parties if not under normal market conditions (eg. interest free) (FRS 102-1AC.35, 36).

Parent undertaking

A note is only required where the small entity is a subsidiary.

The Small Company Regulations, Schedule 1.65(b) require the address of the parent's registered office preparing consolidated accounts.

3.4.2 Small FRS 102 - abridged accounts

Front cover

The ICAEW Technical Release TECH 07/16 AAF suggests that the financial statements contain a reference to the fact that they are unaudited, either on the front cover or on each page (or both) of the financial statements.

Directors' report

The Directors' report need not be filed if filleted accounts are to be filed.

Accountant's report

The Accountant's report will need to be tailored dependent on whether they have been prepared by an ICAEW, ACCA or ICAS firm.

Abridged profit and loss account

Whilst abridged accounts do not require the disclosure of turnover, the accounts must still show a true and fair view. The directors / accountant must therefore determine whether the disclosure of turnover is necessary to give a true and fair view.

Abridged balance sheet

Deferred tax is not on the standard Companies Act formats as a line item, however, it may be added to avoid the need for a separate note dependent on its materiality.

The audit exemption statement at the bottom of the balance sheet could be included in the full accounts so that it does not need to be added later to the filleted accounts before filing. The relevant section number for small company audit exemption is section 477. Or, if relevant, for a subsidiary company it is section 479A, for a dormant company, section 480.

All members of the company have to consent to the preparation of an abridged profit and loss account and balance sheet in accordance with section 444(2A) of the Companies Act 2006. This must be confirmed, either by including a statement on the Balance Sheet or by delivering a separate statement to the Registrar.

Notes to the financial statements

Summary of accounting policies

FRS 102 paragraph 1AE.1 has going concern disclosures in its list of 'encouraged' disclosures, hence it is included as good practice even though not an explicit requirement.

The statement of compliance to FRS 102 Section 1A is not required but is also encouraged (FRS 102-1AE.1).

If the entity receives an interest-free loan from a person who is within a director’s group of close family members, when that group contains at least one shareholder, and the entity has adopted FRS 102 paragraph 11.13A(a) (formerly 1.15A) allowing these balances to be initially recorded at transaction price, this policy should also be described.

Interest

Analysis is only required if interest is receivable / payable from / to group undertakings (SI 2008/409 Sch 1.9A (12) & (13)), or required for a true and fair presentation. However, it can be deleted from the filleted accounts filed at Companies House.

Related party transactions

Advances to, or guarantees granted on behalf of, directors require disclosure. Also, all loans to / from related parties if not under normal market conditions (eg. interest free) (FRS 102-1AC.35, 36).

Parent undertaking

A note is only required where the small entity is a subsidiary.

The Small Company Regulations, Schedule 1.65(b) require the address of the parent's registered office preparing consolidated accounts.

3.4.3 Not small FRS 102 accounts

Front cover

The ICAEW Technical Release TECH 07/16 AAF suggests that the financial statements contain a reference to the fact that they are unaudited, either on the front cover or on each page (or both) of the financial statements.

Strategic report

If the company qualifies as small, it could instead take the Companies Act 2006 Section 414B exemption and not present a strategic report.

Large companies must also include a Section 172(1) statement (see SI 2018/860.4).

Directors' report

The Directors’ report must also include:

- For large companies, a section on business relationships (see SI 2018/860.13); and
- For significant companies, a corporate governance statement (see SI 2018/860.14).

Large companies must also include a section on greenhouse gas and energy (see SI 2018/1155).

Accountant's report

The Accountant's report will need to be tailored dependent on whether they have been prepared by an ICAEW, ACCA or ICAS firm.

Profit and loss account

~~The example accounts provided in this manual are prepared using Part 1 General Rules and Formats of Schedule 1 to SI 2008/410. They also present total comprehensive income in two statements as permitted by FRS 102.~~

FRS 102 does not require disclosure of ‘operating profit’. Where disclosed, amounts must be representative of activities that would normally be regarded as ‘operating’.

Statement of cash flows

Overdrafts may be disclosed separately if material.

Cash and cash equivalents should be cross-referenced to the note providing the analysis of net debt.

Notes to the financial statements

Summary of significant accounting policies

If any assets have been revalued, the first sentence should read "Tangible assets are stated at cost (or deemed cost) or valuation less...".

Turnover

If material, turnover should be analysed by activity and by geographical area.

Profit / (loss) before taxation

The title could be amended to 'Operating Profit' if disclosed, and referenced to such in the profit and loss account.

Reconciliation of profit to cash flow from operating activities

A note is required entitled 'Analysis of changes in net debt' (see FRS 102, paragraph 7.22), and referred to in the Statement of Cash Flows: cash and cash equivalents at the end of the year.

3.5 Guidance on the compilation of financial statements

Guidance for members of the main professional bodies on the compilation of financial statements where an audit is not carried out can be found in:

- ICAEW – TECH 07/16 AAF Chartered Accountants' Reports on the Compilation of Financial Statements of Incorporated Entities;
- ACCA – Technical Factsheet 163 Audit Exempt Companies – ACCA Accounts Preparation Report;
- Framework for the Preparation of Accounts – Best Practice Guidance issued by the Institute of Chartered Accountants of Scotland (revised January 2017)

The guidance represents best practice and firms are reminded of the general principles and ethical requirements of their respective Institute or Association. In essence, firms must not allow their names to be associated with financial statements that are misleading.

3.6 What work is, and is not, required?

Firms should use their expertise to collect, classify and present accounting information from the sources available to them. This normally involves summarising detailed data into a manageable and understandable form without a requirement to test the assertions underlying the information. These procedures are not designed, and do not enable accountants, to express any assurance on the financial statements. However, users of the financial statements do derive benefit because the firm carries out work with professional competence and due care and is subject to the ethical and other guidance of their Institute or Association.

If, during the course of an engagement, matters come to light which may appear to indicate that the financial statements may be misleading (for example, ICAEW's TECH 07/16 AAF suggests that this might include the inappropriate use of the going concern basis, or inadequate disclosure respecting going concern, or if firms consider that they have not been provided with the information required in order to compile the financial statements), a firm should request the directors to provide this missing information.

Where such information is not provided, and the firm considers that the financial statements are misleading, the firm should withdraw from the engagement.

3.7 Planning

When undertaking an assignment to compile the financial statements, none of the steps below are mandatory (although firms will want to adhere to their own internal standards to ensure good practice). However, in order to carry out the work as efficiently and as effectively as possible, we have developed programmes which provide guidance on the approach. The approach at the planning stage is driven by the planning checklist (B01).

3.7.1 Acceptance of engagement

As with any assignment, an accountant must take into account any ethical considerations that may prevent them from providing the service or may alter how the service is delivered. Accountants should refer to the code of ethics provided by their Institute or Association.

Also, if an accountant is acting for the client for the first time, new client procedures, including customer due diligence procedures, need to be carried out.

There should be a clear understanding between the client and the firm regarding the terms of the engagement. The client should understand from the outset the responsibility which the firm accepts in relation to the financial statements. This has been incorporated into the example engagement letter in this manual.

3.7.2 Eligibility

The accountant must ensure that the client is entitled to claim audit exemption. The audit exemption eligibility checklist (B02) within planning can be completed to check this. It may also be worth completing a client's needs checklist (B03) to ascertain whether or not the client, though entitled to exemption, would benefit from a full audit.

3.7.3 Information gathering

In order to carry out work for a client, firms need to have an understanding of the client's business. The level of detail needed will vary according to factors such as the complexity of the client's accounting records and the firm's existing experience of the business and industry in which the client operates. Often, the information is obtained by talking to the client's management and staff.

Because much of the background information does not alter significantly from one year to the next, this should be recorded in the permanent file (in sections PF1 and PF2).

Once the accountant has gathered sufficient information, they can then summarise all of the services that have been or are planned to be carried out (recorded on PF4). It is also worthwhile clarifying with the client what information they will be providing to enable the accountant to compile the financial statements.

3.8 Approach

Having established what needs to be done, the accountant should record how and when it is to be done in order to deliver the service(s) as efficiently as possible. It may be useful to complete the overall plan form (filed on B40). This provides prompts to note down the degree of work needed to compile the accounts as well as matters such as what the client regards as material.

If necessary, a more detailed work programme for the assignment as a whole may be drawn up setting out the individual procedures that will need to be carried out in each section of the file. The accountant can either start from a set of blank programmes (inserting the required procedures) or they can tailor down the detailed programme (which contains a list for each section of possible procedures).

3.9 Money Laundering, Terrorist Financing and Transfer of Funds (Information of the Payer) Regulations 2017 (MLR 2017)

The implications of the MLR 2017 must be considered on all assignments. Full details of the firm's Anti-Money Laundering Procedures can be found in the firm's Anti-Money Laundering Compliance Manual.

Prompts are included in the planning and completion sections to remind staff of the need to consider the need to update customer due diligence (CDD) information as well as reminding them of the need to report any suspicious activities observed during the course of their work.

The planning section includes a new client form which should be completed for all for new clients, a copy of which should be filed within the permanent file documentation in future years for future reference. For customer due diligence forms, you should review your firm's Money Laundering Compliance Manual.

3.10 Completion

As with the planning process above, the following points are not mandatory but should be adopted as good practice. The approach at the completion stage is driven by form **A21**, the completion checklist, partner review and conclusion, and the conclusions to be drawn which, importantly, include consideration of whether the financial statements could be misleading.

Firms should consider methods available, such as accounts disclosure checklists, to ensure that relevant disclosures have been made. (See the Accounts disclosure checklists section of this manual.)

If there have been significant adjustments to the figures used at the planning stage, the client's eligibility to claim audit exemption may need to be reconfirmed.

Other matters, typically dealt with at the end of the assignment, include consideration of going concern which, if in doubt, could affect the financial statements significantly. (See also the paragraph on 'True and fair view' above.)

Appropriate documentation may help the firm to demonstrate the adequacy of the work performed and that the engagement was carried out in accordance with the terms of the engagement where the quality of the firm's work is subsequently challenged.

The completion section guides a partner through the review process to ensure all work has been properly recorded and important matters brought to the partner's attention.

Firms should consider obtaining written management representations on matters relating to estimates and the reliability, accuracy and completeness of the information provided. An example letter of representation is included within this manual.

3.11 Accountant's report

Audit exempt companies do not legally need to file an independent report from an accountant with either the full statutory or the abridged accounts. However, the ICAEW, ICAS and the ACCA all recommend in their best practice guidance on accounts compilation assignments (see the paragraph on 'Guidance on the compilation of financial statements' above) that an accountant's report is attached to the financial statements.

~~Suggested wording for such reports is included in the example reports within this manual, based on the now withdrawn CCAB guidance which is reflected in the guidance issued by the member bodies.~~

The guidance issued by the ICAEW emphasises the need to distinguish the work of a Chartered Accountant from that of other, unqualified, accountants, particularly as professionally qualified accountants must comply with their own code of ethics. This can be emphasised in the title of the accountant's report attached to the accounts.

Core and optional paragraphs in the accountant's report

The now withdrawn CCAB guidance on accounts compilation reports (adopted by the ICAEW, ICAS and the ACCA) includes both 'core' and 'optional' paragraphs. The recommendations are as follows:

- Technical Release 07/16 AAF issued by the ICAEW

  The previous version of the Technical Release noted that "professional accountants are advised to include core paragraphs in all CCAB accounts preparation reports ... and recommends that, in order to manage professional liability, practices include the optional paragraphs in their compilation reports".

- Technical Factsheet 163 issued by the ACCA

  The factsheet notes that "the core paragraphs should be present in all ACCA accounts preparation reports. The use of optional paragraphs is left to the practitioner's professional judgement".

- Framework for the Preparation of Accounts – Best Practice Guidance issued by the Institute of Chartered Accountants of Scotland (Revised January 2017)

  The guidance notes that "whilst it is recommended that statements ... (the optional paragraphs) are included in the report issued to management, this is ultimately a risk management decision for each member firm".

For guidance on micro-entities see section below.

Firms are reminded not to include the description 'Statutory Auditor' when signing the report.

3.12 Filing of unaudited accounts

Companies exempt from an audit are still required to file accounts at Companies House, unless they are a dormant subsidiary company taking advantage of section 448A of the Companies Act 2006.

The requirement for a directors' statements on the full balance sheet remain unchanged in respect of small company exemptions claimed but with the addition of an extra statement regarding audit exemption.

For guidance on micro-entities see the section below.

Suggested wording for such statements are included within this manual

Where a small company chooses not to file its directors' report and / or profit and loss account then additional relevant balance sheet statements are also required.

ICAEW's TECH 07/16 AAF recommends that it is best practice for the financial statements to include a reference to the fact that they are unaudited either on the front cover or on each page of the financial statements, or both.

4 Micro-entity companies

4.1 Introduction

In 2013, the government introduced a new sub-classification of small company known as a 'micro-entity'. The legislation followed a European initiative to reduce costs for small and medium-size enterprises.

Micro-entities are permitted to prepare and publish simplified primary financial statements and a very limited number of notes instead of the usual small company accounts for members.

Whilst micro-entity financial statements must be prepared in accordance with:

- UK generally accepted accounting practice for micro-entities (FRS 105); and
- the Companies Act 2006 and regulations made under it; and
- show a true and fair view

the legislation stipulates that many of the usual disclosure requirements of the Companies Act do not apply and that the resulting financial statements are presumed to show a true and fair view.

4.2 Qualification as a micro-entity

A company qualifies as a micro-entity if it meets two out of three criteria relating to turnover, balance sheet total (fixed assets plus current assets) and number of employees as set out below in its first financial year, or in the case of a subsequent year, in that year and the preceding year:

- turnover not more than £632,000;
- balance sheet total not more than £316,000;
- average number of employees not more than 10.

The turnover figure should be adjusted proportionately if the accounting period is not a year.

A company will qualify as a micro-entity in relation to its first financial year if the qualifying conditions are met in that year.

In the case of a company which is a parent company, the company qualifies as a micro-entity in relation to a financial year only if:

- the company qualifies as a micro-entity in relation to that year, as determined by section 384A(1) to (7);
- the group headed by the company qualifies as a small group, as determined by section 383(2) to (7) of the Companies Act 2006; and
- the company has not voluntary elected to prepare group accounts.

4.3 Entities that are excluded from preparing and submitting micro-entity accounts

The micro-entity provisions cannot be applied in relation to a company's accounts for a particular financial year if the company at any time within that year:

- was a company excluded from the small companies regime by virtue of Section 384 of the Companies Act 2006;
- would have been an investment undertaking as defined in Article 2(14) of Directive 2013/34/EU of 26 June 2013 on the annual financial statements, etc. of certain types of undertakings were the United Kingdom a member State;
- would have been a financial holding undertaking as defined in Article 2(15) of that Directive were the United Kingdom a member State;
- [For periods commencing on or after 1 January 2021] a credit institution within the meaning given by Article 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 Article 4(1)(2A) of that Regulation / [For periods commencing before 1 January 2021] a credit institution as defined in Article 3 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013, other than one listed in Article 2 of Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and investment firms;
- would have been an insurance undertaking as defined in Article 2(1) of Council Directive 91/674/EEC of 19 December 1991 on the annual accounts of insurance undertakings were the United Kingdom a member State; or
- was a charity.

The micro-entity provisions also do not apply in relation to a company's accounts for a financial year if:

- the company is a parent company which prepares group accounts for that year as permitted by Section 399(4) of the Companies Act 2006; or
- the company is not a parent company but its accounts are included in consolidated group accounts for that year.

In summary, therefore, it is particularly important to remember that a company that is excluded from the small companies regime, or whose accounts are consolidated into a larger group or is a charitable company cannot qualify as a micro-entity.

4.4 Right of members to require an audit

Members have not been given any additional rights in respect of the micro-entity provisions over and above those discussed in section 476 of the Companies Act 2006.

4.5 Accounting requirements

A micro-entity must still:

- prepare (reduced information) statutory accounts which give a true and fair view;
- file these accounts or a copy of the balance sheet only (including the required notes);
- maintain adequate accounting records.

The directors remain responsible for these requirements.

FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime details financial reporting requirements applicable to micro-entities.

4.6 Statutory accounts formats

~~See the Example accounts section of this manual for proforma micro-entity accounts and the Accounts disclosure checklist section for an FRS 105 disclosure checklist.~~

Note that the general rules and accounting principles of the small company regulations must be applied unless these are amended as otherwise by the micro-entity regulations. Therefore, the company is still presumed to be carrying on business as a going concern; accounting policies should be consistent; assets and income and liabilities and expenditure should not be netted off; comparative figures are required and regard should be had to the substance of transactions; etc.

4.6.1 Specific guidance on the micro-entity example accounts

Front cover

The ICAEW Technical Release TECH 07/16 AAF suggests that the financial statements contain a reference to the fact that they are unaudited, either on the front cover or on each page (or both) of the financial statements.

Accountant's report

The Accountant's report will need to be tailored dependent on whether they have been prepared by an ICAEW, ACCA or ICAS firm.

Notes

The following must be shown at the foot of the balance sheet rather than as part of separate notes to the accounts.

Guarantees and other financial commitments

The disclosure must distinguish between financial commitments, guarantees and contingencies, and further analyse each category for pensions.

Average employees

There was an omission in the original versions of FRS 105 and FRS 102 Section 1A such that they omitted the requirement to disclose the number of employees under Companies Act 2006 s.411(1)(1A). This was formally adjusted in FRS 105 for periods beginning on or after 1 January 2017.

True and fair

The government has legislated as follows:

"The following provisions apply to the directors of a company which qualifies as a micro-entity in relation to a financial year in their consideration of whether the Companies Act individual accounts of the company for that year give a true and fair view:

- *where the accounts comprise only micro-entity minimum accounting items, the directors must disregard any provision of an accounting standard which would require the accounts to contain information additional to those items;*
- *in relation to a micro-entity minimum accounting item contained in the accounts, the directors must disregard any provision of an accounting standard which would require the accounts to contain further information in relation to that item; and*
- *where the accounts contain an item of information additional to the micro-entity minimum accounting items, the directors must have regard to any provision of an accounting standard which relates to that item.*

*In the case of the individual accounts of a company which qualifies as a micro-entity in relation to the financial year (see sections 384A and 384B), the micro-entity minimum accounting items included in the company's accounts for the year are **presumed** to give the true and fair view required by section 396, subsection (2)."*

This essentially allows the preparers of accounts to ignore any additional requirements for disclosures from other accounting standards when preparing micro-entity accounts. However, in relation to micro-entity companies, ICAEW 'Chartered Accountants' reports on the Compilation of Financial Information of Incorporated Entities' (TECH 07/16 AAF) states in its updated guidance on the omission of disclosures that:

"should a micro-entity choose to include an item in addition to the minimum accounting items, the professional accountants must, in respect of that item, consider the provisions in the relevant accounting standard and decide if proper disclosure has been made' and that 'there may be rare occasions when professional accountants consider that the information disclosed in accordance with the micro-entity regime is misleading."

First time adoption

There are also a number of simplifications within the micro-entities regime as applied through FRS 105 when compared to FRS 102. For example, revaluations are not permitted in micro-entity accounts as only the historical cost accounting rules may be applied. If a micro-entity wished to retain revalued amounts in its accounts, it would not be able to take advantage of the micro-entity regime.

Where the application of FRS 105 results in a change in accounting policy, for example because fixed assets that were previously revalued are now accounted for at cost less depreciation and impairment, FRS 105 should be considered in accordance with transitional arrangements.

4.7 Filing requirements

The 'full' micro-entity financial statements for members can be filed at Companies House (see the

Example accounts section of this manual). Alternatively, there is an option to file the balance sheet only (including the notes at the foot of the balance sheet). If this option is taken, an additional statement is required on the Balance Sheet that states that the accounts have also been delivered in accordance with the provisions applicable to companies subject to the small companies' regime.

4.8 Audit

Micro-entities are not automatically exempt from audit and therefore it is also necessary, where applicable, for the appropriate statement to be made on the balance sheet as regards audit exemption. This is the same statement as it would be for a small company claiming the exemption.

~~Suggested wording for such a statement is included within this manual.~~

4.9 Audit exemption for subsidiaries

For clarification purposes, as regards section 479A of the Companies Act 2006 subsidiary audit exemption, this will not be applicable to a micro-entity as one of the conditions of this exemption is that the company must be included in consolidated accounts drawn up for that year. See the paragraph on 'Entities that are excluded from preparing and submitting micro-entity accounts' above as regards entities that are excluded from preparing and submitting micro-entity accounts on the basis that the company is not a parent company but its accounts are included in consolidated group accounts for that year.

4.10 Compilation of the accounts

The 'Compilation of the accounts' section, earlier in this guidance, provides guidance on the compilation of accounts. While the approach set out in the 'Compilation of the accounts' section and in the programmes Mercia have drafted for incorporated entities can be followed (where available), for a micro-entity, there is a clear difference in respect of the disclosure requirements for micro-entities and some of the thinking behind the application of accounting standards in contributing to the truth and fairness of financial statements.

From a professional perspective, as members of a professional body, a firm should not be knowingly associated with financial information that they believe contains a materially false or misleading statement, contains statements or information furnished recklessly or omits or obscures information required to be included where such omission or obscurity would be misleading.

4.11 The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017

Whether the client is micro-entity or not, the firm must apply its Anti-Money Laundering Procedures. Please refer to the guidance in the paragraph on 'Money Laundering, Terrorist Financing and Transfer of Funds (Information of the Payer) Regulations 2017 (MLR 2017)' above.

5 Unincorporated business assignments

5.1 Introduction

When compiling accounts for unincorporated businesses, firms are generally under no requirement to express any form of opinion on the accounts. Where this is the case, the accounts are unaudited and the guidelines given in this section may be followed. However, there may be instances where an unincorporated client has requested a full audit or an opinion on certain aspects of the accounts; where this is the case procedures for an audit should be adopted or specific procedures covering those areas on which an opinion has to be given should be followed, as detailed elsewhere in this manual.

Where a firm is asked to compile a set of financial statements in full compliance with the provisions of UK GAAP for an unincorporated business, the procedures for limited company audit exemption assignments should be followed, although clearly, certain disclosures will not be applicable.

The ICAEW has issued a Technical Release, TECH 08/16 AAF, Chartered Accountants' Reports on the Compilation of Historical Financial Information of Unincorporated Entities, which provides guidance on accounts preparation for unincorporated business assignments. The ICAS guidance referred to in the paragraph on 'Guidance on the compilation of financial statements' above also applies to sole traders and partnerships and the ACCA guidance also referred to states that "although this factsheet is not designed for accounts preparation engagements of unincorporated entities, the general principles and the example reports can be appropriately adapted and applied in the performance of such engagements".

5.2 Objective

The objective for an unincorporated assignment is to compile accounts for the client, generally for tax purposes. For the purposes of calculating the profits of a trade, profession or vocation, the Finance Act requires these profits to be calculated "on an accounting basis which gives a true and fair view, subject to any adjustment required or authorised by law in computing profits for those purposes".

In completing this type of assignment, firms are also bound by the fundamental ethical rules of the professional body of which they are a member. These specifically require work to be undertaken with integrity and with proper regard for the technical and professional standards expected of a member. Firms are also bound by the quality assurance scheme that their governing body operates.

In addition, firms must ensure that their name is not associated with misleading accounts.

When preparing unincorporated business accounts, firms should use their accounting expertise to collect, classify and present accounting information from the sources made available. This normally involves summarising detailed data into a manageable and understandable form. There is usually no requirement to test the assertions underlying the information and firms are not able to express any assurance on the financial information being compiled. Nevertheless, users of the financial information prepared will derive benefit because professional accountants are required to carry out the work with professional competence and due care and are subject to ethical and other guidance.

Before accepting an unincorporated business client a firm should discuss with the client the purpose and use of the financial information to be compiled and agree an appropriate accounting basis and format for the compilation of that information. The accounting basis needs to be clearly defined in order that the information presented can be compiled. For example, an agreed accounting basis may be accounts compiled on a basis:

- enabling profits to be calculated such as to meet the requirements of section 25 of the Income Tax (Trading and Other Income) Act 2005; and / or
- which provides sufficient and relevant information to enable the completion of a tax return.

Where an appropriate accounting basis and / or format cannot be agreed then a firm should not accept the engagement.

The accounting basis, purpose and limitations of the information presented should be fully disclosed in an accounting policy note to the accounts and referred to in the accountant's report that accompanies them, to ensure that the accounts are not misleading.

5.3 Letter of engagement

Just as auditors are required to make use of a letter of engagement, firms should seek to clarify their and the client's, responsibilities towards the unaudited accounts. This will ensure there is a clear understanding between the firm and the client of the terms of the engagement. The letter should be drafted to cover the specific type of unincorporated business that the client represents and should confirm that the firm is not auditing the accounts.

The letter should include such matters as:

- the client as addressee;
- the client is responsible for the reliability, accuracy and completeness of the accounting records;
- the client will provide the firm with all information and explanations relevant to the purpose and compilation of the financial information;
- the nature of the engagement, including the purpose and accounting basis of compilation of the financial information;
- that the firm will make enquiries of the client and undertake any procedures that it judges 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;
- neither an audit nor a review will be carried out and so no opinion will be given and no assurance either implied or expressed;
- the financial reporting framework on which the information has been compiled, its purpose and limitations will be disclosed in an accounting policy note to the financial information and referred to in the accountant's report;
- the obligation not to allow the firm's name to be associated with misleading financial information;
- written representations may be required prior to the completion of the engagement and the issuing of our report;
- the client will approve and sign the financial information which includes a statement acknowledging responsibility for the financial information, including the appropriateness of the financial reporting framework, and for having provided all information and explanations necessary to us for its compilation;
- the form of report to be issued.

In addition, after discussion and negotiation with the client, it may be appropriate to include a section on the limitation of liability.

~~An example of suggested wording is given within this manual.~~

5.4 Planning and control

Although firms are not carrying out an audit, they should still organise their work to be as cost effective as possible and to comply with any quality control scheme that their Institute or Association operates. The level of planning undertaken will vary according to the size of the business, the complexity and completeness of the business' accounting records and systems and their experience of the business.

Certain procedures should always be applied, these are:

- speaking to the client before the work is started;
- planning a programme of work to achieve the objectives; and
- reviewing work in accordance with normal control procedures.

5.5 Files and working papers

There are two main files for accountancy work; these are the permanent file (or information section) and the current file. The purpose of these files is similar to their audit equivalents, as are the working papers contained therein, although clearly the requirements for specific, detailed information on matters required by auditing standards is not necessary. Good practice would be to record sufficient 'know your client' information to satisfy the requirements of the Money Laundering Regulations and the relevant Institute's or Association's quality control scheme.

General good practice principles with regard to recording of work should also be followed, and the principles of referencing and cross-referencing should always be applied.

5.6 General approach to the assignment

Firms should obtain a general understanding of the business and its operations. They need to be familiar with the accounting principles and practices of the sector in which the business operates and with the form and content of the accounting information that is appropriate in the circumstances. This understanding of the business is usually obtained through experience of the entity or enquiry of management and staff.

Simple planning procedures should be undertaken. Procedures that can be undertaken to compile the accounts can be found in the unincorporated business documentation included in this manual.

At the end of the assignment firms should consider whether the financial information is consistent with their understanding of the business, appropriate for the purpose for which it is required and whether it is misleading. The principles outlined in the paragraphs on 'Applicability of accounting standards' and 'Guidance on the compilation of financial statements' above apply.

A firm is under no obligation to perform procedures that may be required for assurance engagements such as audits or reviews.

5.7 Documentation

There is no mandatory requirement to document the work that has been carried out, although firms must comply with the requirements of any quality control scheme that their Institute or Association operates. In addition, where the quality of work may be subsequently challenged, documentation may help demonstrate the adequacy of the work performed and that the engagement was carried out in accordance with the terms of engagement.

5.8 Notes and queries

Notes and queries should be listed as they arise and should not be left until the job is finished. They should be cross-referenced to the working papers from which they arise and must be retained in the working papers file even after they have been settled.

All queries should be cleared and a note made against each one explaining how it has been settled.

5.9 Matters affecting future periods

If, during the course of an assignment, staff become aware of facts that may affect future accounts, then details should be noted on a schedule of points to carry forward to the next period.

5.10 Incomplete records

One of the major features of unaudited accounts work is that the records from which the accounts are derived may be incomplete in some way. Whilst it is not practical to provide guidance covering all the possible combinations of incomplete records, some of the major problem areas are addressed below.

It is often the case that clients include personal (ie. non-business) items in the business bank account. Such items should be separately identified as private.

5.10.1 Bank and cash accounts

For many unaudited accounts jobs the only account that balances, before a firm receives it, is the bank account. Therefore, this is often the most useful starting point in getting other accounts to balance. However, although the bank statements themselves will balance, the cash book recording the bank account may not. Where this is the case unrecorded bank items should be scheduled and investigated.

It is often the case that clients include personal (ie. non-business) items in the business bank account. Such items should be separately identified as private.

Similarly business items may go into the client's personal bank account and enquiries should be made to identify such items (most probably when the client is seen to discuss the draft accounts).

In preparing the summary cash account, the likelihood of omissions can be reduced by ensuring that there is the correct number of payments for regularly recurring items (eg. four quarterly rental payments in the year).

Wherever possible, separate cash and bank accounts should be prepared to eliminate the possibility of differences which may be hidden if the accounts are combined.

5.10.2 Cash differences and estimates

All cash differences should be investigated to see how they have arisen. If the client keeps records giving details of cash holdings at points throughout the year, then each holding should be balanced, or a difference noted, rather than having a single aggregate difference for the year. Obviously, cash holdings can only be debit figures; any occurrences of credit balances (which would in effect be negative cash in hand) should be investigated.

A possible cause of a cash difference is an incorrect figure for cash in hand at the end of the year. The amount should be reconciled to the first banking of the new year (taking into account any cash received or paid out in the new year before the banking). The review of the accounts may also provide an explanation of any cash difference.

5.10.3 Stocks

The amount at which stock is stated in the accounts should be consistent with the firm's knowledge of the circumstances of the business.

5.10.4 Drawings

Client's drawings should be scheduled and compared to previous years to ensure that private items have not been treated as business items (and vice versa) by mistake. The client should be encouraged to record all drawings and not merely assume that drawings are the balancing figure on the cash account.

5.10.5 Goods for own consumption

Clients often do not realise that any goods taken out of their business should be treated for the purposes of income tax and VAT as if the goods had been sold to the client by the business. Adjustments will probably have to be made to the accounts to reflect such transactions. Arguably, it is easier if the client can be persuaded to pay for such goods and record the payments in the normal way.

5.10.6 Value added tax

Where any adjustments are made, consideration should be given to the corresponding adjustments in the VAT account and the client should be informed to adjust the next VAT return.

An overall VAT control account should be prepared. Any difference should be recorded and authorisation obtained for the treatment.

5.11 Estimated figures

When, because of the nature of the business records, there are figures in the financial statements that are based upon estimates from the client, such figures should be so described, where material.

5.12 Improvement of client's records

Whilst preparing the accounts, a firm is in the position to assess the accounting records and suggest improvements to the client. It is advisable to record these suggestions in a letter to the client.

5.13 Review of unincorporated business accounts

For the most part, the preceding paragraphs have been concerned with individual aspects of the client's records. However, the global picture given by the accounts as a whole must also be considered by means of a review of the accounts. Form **A22**, overall review of the accounts, within completion, lists the type of questions to be asked as part of this review and can be used for many clients. However, further questions should be added to reflect the particular circumstances of the client. These should reflect the objectives of the engagement.

When, because of the nature of the business records, there are figures in the financial statements that are based upon estimates from the client, such figures should be so described, where material.

Comparisons should be made with previous years' figures and gross profit percentages; the latter should also be compared with the percentage for other similar businesses. Variations do not necessarily indicate accounting deficiencies but should be investigated.

The client's capital / current accounts should be examined to determine if the figures for drawings and capital introduced are consistent with the client's lifestyle and circumstances.

Firms should also review for reasonableness appropriate individual items within the accounts and the overall picture presented by the accounts. Any matters which appear unusual, etc., should be clearly noted for further discussion with the client. If any explanations received from the client are not considered plausible, the partner should be provided with all the information. A decision can then be made regarding how to proceed.

Where appropriate, if for example, because the financial reporting framework adopted is a recognised accounting framework, eg. UK GAAP, the firm may consider using checklists or software packages to check that relevant disclosures have been made, based on the information available.

5.14 Misleading Accounts

Firms have a professional responsibility not to produce or allow their name to be associated with accounts which they believe to be misleading.

If during their work matters come to light which appear to indicate the financial information are misleading, firms should discuss these with the client and make appropriate adjustments or disclosures. Alternatively, the client may produce additional information to satisfy us that the accounts are not misleading.

If the matter cannot be resolved, for example, adjustments or disclosures are not made, a firm should consider:

- disclosing in their report the fact that there is a problem; or
- resign and not issue a report.

In considering whether financial information is misleading, a firm should consider whether the financial information appears to be appropriate for the purpose for which it is being prepared, appropriate in respect of the financial reporting framework agreed and free from material misstatements that appear obvious to us as a result of, for example:

- misclassifications in the financial information;
- mistakes in the application of the adopted financial reporting framework; (NB. where the financial reporting framework adopted is a recognised accounting framework such as UK GAAP, this would include departures from applicable accounting standards and guidance); or
- other significant matters of which the firm is aware, for example, where a firm is engaged to prepare a balance sheet, without notes, to support a lending application, they may nevertheless conclude that this would be misleading if it does not disclose a significant going concern problem.

When a firm withdraws from the engagement, they should normally explain to the client their reasons for withdrawing, unless this would constitute a breach of legal or other regulatory requirement (such as the 'tipping off' provisions of the Money Laundering Regulations).

5.15 Management Representations

In compiling financial information, firms normally rely on representations by the client, particularly in relation to estimates and the reliability, accuracy and completeness of information provided. Firms should therefore consider obtaining written representations on these matters.

5.16 Accountant's report

The main purposes for producing accounts are to use them as a basis for the calculation of the client's tax liability and to furnish information to providers of credit (normally the client's bank). However, accounts may be used for other purposes, of which a firm may not be aware, and therefore unaudited accounts should generally carry an Accountant's Report - an example is given within this manual.

A report also helps prevent users of the accounts from deriving unwarranted assurance from the financial information compiled where an audit has not been performed and a firm has not expressed an opinion.

An accountant's report should include:

- a title identifying the persons to whom the report is addressed;
- a statement that, in accordance with the engagement letter, the firm has compiled the financial information which comprises (state the primary financial statements that have been compiled, such as the Profit and Loss Account, the Balance Sheet and, where relevant, related notes) from the accounting records and information and explanations supplied by the client;
- a reference to the accounting policy note which sets out the accounting basis of compilation and the purpose and limitations of the financial information;
- a statement that the report is made to the client in accordance with the terms of engagement (including 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 client);
- a statement that the accountants have carried out the engagement in accordance with technical guidance issued by the Institute / Association to which they belong and that they have complied with the ethical guidance laid down by the Institute / Association;
- a statement that the client has acknowledged his responsibility for the financial information;
- a statement that the accountants have not verified the accuracy or completeness of the accounting records or information and explanations supplied and that the accountants do not express any opinion on the financial information;
- the name and signature of the accountant and any appropriate designation (but not 'Statutory Auditor');
- the date of the report.

The ICAEW Technical Release TECH 07/16 AAF recommends that the accounts should also contain a reference to the fact that they are unaudited, either on the front cover or on each page (or both) of the financial information.

Approval of financial information

Although not a statutory requirement, the client should also sign a declaration on the face of a copy of the accounts retained by us to show that he or she understands his or her responsibility towards them - an example is given within this manual.

5.17 The Money Laundering, Terrorist Financing and Transfer of Funds (Information of the Payer) Regulations 2017

Whether the client is a limited company, a partnership or an unincorporated business, the firm must apply its Anti-Money Laundering Procedures. Please refer to the guidance in the paragraph on 'Money Laundering, Terrorist Financing and Transfer of Funds (Information of the Payer) Regulations 2017 (MLR 2017)' above.

21.4 Getting started for new manual users

Introduction

This 'Getting started' guidance will help you to use the Mercia Audit Exemption Manual. You may be a regular user of our products or this may be the first time that you have used such a manual. Either way these notes will help you understand the Mercia approach and how to maximise the benefits of the manual.

The manual covers limited company audit exemption assignments. ~~Complimentary unincorporated business assignment documentation is also included.~~

Guidance

You will find the following documents in this section of the Audit Exemption Manual:

- a contents page;
- guidance notes on audit exempt assignments;
- this getting started guidance for new manual users;
- 'What’s changed', which provides a summary of the changes made to the manual in the most recent updates;

Approach

The Mercia approach encourages you to adopt a thinking, rather than a form filling, approach. This is achieved through the use of:

- Permanent information - If something that you record is unlikely to change significantly from one year to the next, we believe it is better that this is recorded properly once and then rolled forward, updating where necessary each year.
- Tailored work programmes - Our ~~“Customise”~~ tool is designed to help you tailor

our detailed work programmes. We have also provided blank programmes, so that you can write your own programme for a specific client. ~~As the programmes can be downloaded in Microsoft Word, they can be edited, saved electronically and rolled forward each year.~~

The planning approach (the permanent file documents and section B within the current file documents)

Effective planning will ensure that the right amount of work is carried out on audit exempt assignments. While firms must maintain their overall high standards, it is important that the unnecessary tests, previously associated with audit work performed, are not continued. Therefore, it is still important to develop tailored work programmes that are approved by the partner and then followed during the course of the work.

The fieldwork approach (sections C onwards within the current file documents)

Once tailored work programmes have been produced (see the section named 'The structure of each section' within these notes), the financial statements should be complied in accordance with the necessary procedures.

The completion approach (section A within the current file documents)

At the completion stage, all matters need to be drawn together and concluded upon. Completion of the appropriate forms on this section will help to ensure that the firm continues to maintain high standards in the work completed.

The current file

The current file provides the documentary record of the work completed and constitutes the evidence of what was done and why it was done and demonstrates that this was in accordance with the terms of the engagement.

The principal objectives of the current file are to provide:

- evidence of the planning process and any changes from the original plan;
- a record of the nature, timing and extent of procedures undertaken;
- a record of the figures included in the financial statements, and evidence supporting these figures;
- evidence of control and review;
- a record of problems encountered, weaknesses discovered and contentious issues raised and how they were resolved;

- evidence that relevant disclosures within the accounts have been made (where applicable);
- evidence that the accounts are consistent with the accountants' knowledge of the business;
- a consideration of whether the accounts are misleading; and
- a record of communications with the client, including any necessary management representations.

The permanent file

The principal purpose of the permanent file is to improve the efficiency of the assignment by providing a good understanding of the business and operations of the entity that may be carried forward from year to year. The permanent file divider cards include a standard index for relevant information to be recorded. However, the content and form of the file is likely to be different for each client and must be decided upon by the partner and manager.

The Mercia approach also encourages users to develop tailored audit exempt programmes which can be held on the permanent file. If held on the permanent file, in future years these must be reviewed and, if necessary, updated as appropriate.

The structure of each audit section

Divider cards (see current file indexes within the current file documents)

The divider cards include recommended standard references for working papers as well as the conclusions for each section of the file. The conclusions should be signed by the person completing the work and should then be signed by the reviewer.

Audit exempt programmes

There are two choices of programme. The detailed programme provides a list of all the possible procedures that might be needed for each section of the file. Where there are only a small number of procedures required to compile the accounts, the blank programme (which allows the necessary procedures for each section to be inserted) may be more appropriate.

Unincorporated assignments

~~Your Audit Exemption Manual also includes certain complimentary unincorporated assignment documentation:~~

- ~~example engagement letters;~~
- ~~example accountant's reports;~~
- ~~current and permanent file documentation; and~~
- ~~a choice of work programmes.~~

21.5 What's changed

Update - April 2023

What's changed

We are pleased to issue updates to your Mercia Audit Exemption Manual (UK) (dated 04/23). The principal changes in this update relate to a number of minor amendments / improvements that have been made to across all sections of the Audit Exemption Manual, including updating engagement letters to reflect latest guidance.

See below for a full list of changes.

Contact us

We are always pleased to receive feedback on our manuals, including any improvements that you would like to see incorporated. Please contact me if you have any comments to make.

Andy Holton

April 2023

April 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
All	• ~~Section names have been changed and shortened for easier navigation and to allow manual users to include longer client names in 'Customiser'.~~ • ~~Current file documents now download into the separate file sections such as planning, completion, etc.~~ • ~~The disclosure checklist customisation now filters the Limited Company lead schedules.~~
Guidance	
Contents	• Updated for the changes made in this update including relocation of Change of financial reporting framework impact assessment and File review checklists to Supplementary forms section.
Guidance notes	
What do you need to know about this manual?	• Updated for the changes made in this update.

Audit Exemption guidance notes	• The section named 'Ceasing to be entitled to audit exemption' has been removed as such guidance should be sought from the Audit Manual Package in such situations.
Getting started for new manual users	• Updated for the changes made in this update.
What's changed	• A copy of this What's changed notice has been added to the manual.
File review checklist	• File review checklist moved to Supplementary forms section.

Example letters

Engagement letters - both (Ltd Co) and (Uninc)	
Covering letter	• Updated the 'Professional services provided' section to include a new paragraph which confirms whether disbursements are expected to be incurred. • A new section detailing how communication will be maintained throughout the engagement has been added. • Updated the 'Agreement of terms' section to include reference to the firm's privacy notice on their website and reference to the standard terms of business in relation to instances of variation or termination of the engagement.
Schedule of professional services - accounts compilation (including Schedule of professional services - micro-entity accounts compilation)	• An optional paragraph has been included where clients have asked firms to convert the financial statements into the iXBRL format. • Clarification has been included to inform clients that, consent must be received from the firm, should they want to share the report with any third parties.
Schedule of professional services - taxation	• Included a paragraph confirming there may be occasions where the firm will need to seek specialist advice. • Added a paragraph confirming that the responsibility for monitoring turnover in respect of VAT registration thresholds lies with the client. • Clarification that the responsibility for employment taxes, pensions and the assessment of employment status for workers, lies with the client has also been included.
Terms of	• Updated paragraphs in the 'Fees and payment terms' section

business	clarifying the use of insurance policies to cover fees, circumstances where clients are unable to pay fees and the rights of the firm to exercise a lien over all funds have also been added. • Added a new section detailing standard business terms in relation to confidentiality. • Clarification of potential actions of the firm, should a dispute arise between parties within the engagement.
Disengagement letter	• Expanded to include tax elements and to reflect changes made to the example Terms of business, in respect of confidentiality, and changes made to the accounts compilation schedule of services, in respect of third parties.
(Ltd Co) Pre year end letter and questionnaire	• Minor format changes.
Example reports	
(Ltd Co) Example reports	
(Ltd Co) Accountant's Reports	• Both the 'Core' and 'Full' examples now show an example explanatory paragraph.
(Uninc) Example reports	
(Uninc) Accountant's Reports	• Separate 'Core' and 'Full' examples provided in line with the examples given for Limited Companies. • The examples given have been drafted so that they can be used by any CCAB member firm. • Old style audit exemption report withdrawn from the product range.
(Uninc) Client's Approval Wording	• Alternative wording expanded.
Accounts disclosure checklists	
A34 FRS 102 1AG FRS 102 1A (Small group)	• A number of disclosure points in relation to parent/subsidiary relations have been moved from Section 3 to Section 1 for clarity on when they apply.
Current file documents	
(Ltd Co) Completion documents	

A22 Overall review of the financial statements	• New tests have been added under the heading 'General' prompting reviews in respect of accounting policies, consideration of information contained in other documents issued with the accounts (including the directors' report and strategic report), etc.
A71 Summary of financial ratios and trends	• Now provided as an Excel document.
(Ltd Co) Planning documents	
B04 Dormant companies checklist	• A new form added.
B13 New client checklist	• The checklist has been expanded to include a number of general factors when taking on a new client as well as space to record agreed action points.
B40-FRF Change of financial reporting framework impact assessment	• Change of financial reporting framework impact assessment moved to Supplementary forms section.
(Ltd Co) Detailed work programmes:	
All	• Tests have been added and other minor amendments made to bring the work programmes in line with other manuals.
O2 VAT	• Minor amendments to ensure terminology is kept up to date.
(Ltd Co) Lead schedules	• The FRS 105 lead schedules have been redrafted.
(Uninc) Completion documents	
A22 Overall review of the accounts	• New tests have been added under the heading 'General' prompting reviews in respect of accounting policies, etc.
A71 Summary of financial ratios and trends	• Now provided as an Excel document.

(Uninc) Planning documents	
B13 New client checklist	• The checklist has been expanded to include a number of general factors when taking on a new client as well as space to record agreed action points.
(Uninc) Detailed work programmes:	
All	• Tests have been added and other minor amendments made to bring the work programmes in line with other manuals.
O2 VAT	• Minor amendments to ensure terminology is kept up to date.
(Uninc) Lead schedules	• A new set of documents tailored for unincorporated assignments.
Permanent file documents	
(Uninc) Permanent file documents	• A new set of documents tailored for unincorporated assignments.
Supplementary forms	
Change of financial reporting framework impact assessment	• Change of financial reporting framework impact assessment moved from (Ltd Co) Planning documents within the Current file documents section.
File review checklist	• File review checklist moved from Guidance section. • Expanded to cover source of assumptions and work done by outside experts as well as one off assignments and hot file reviews.

Update - July 2022

What's changed

We are pleased to issue updates to your Mercia Audit Exemption Manual (dated 07/22). The principal technical changes in this update relate to minor updates for consistency, removal of dates which are no longer relevant and recent changes to standards.

To ensure consistency across our product range, the planning and permanent file sections of the manual have been restructured and for simplicity the changes have been applied with immediate effect in this manual. See below for a mapping of old to new references.

July 2022 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, cross-references to other forms have been updated where appropriate, and minor changes have been made for formatting, grammar and other editorial amendments.

Updated area	Main reason for change
Guidance	
Contents & guidance notes	• Contents page updated for the changes made in this update.
Getting started for new manual users	• Getting started guidance updated for the changes made in this update.
What’s changed	• A copy of this What's changed notice has been added to the manual.
Example letters	
Engagement - terms of business	• Minor change to reflect ICAEW Code of Ethics requirements in respect of commissions.
Example accounts	
All example accounts	• Minor updates for consistency, removal of dates which are no longer relevant and recent changes to standards.
Accounts disclosure checklists	
A32 SUMMARY Disclosure checklist summary	• Updated to offer more guidance on selecting the appropriate checklists.
A32 SMALL FRS 102 1A	• Minor updates for recent changes to legislation and other minor editorial amendments.
A32 NOT SMALL FRS 102	• Minor updates for recent changes to legislation and other minor editorial amendments.
Current file: Current file indices (both for Limited Companies and Unincorporated Businesses)	
Current file indices	• Moved to start of current file. • Updated to reflect revised file structures.
Current file: Current file indices (Unincorporated Businesses only)	
Current file indices	• Indices have been expanded to cover each accounting area in line with those provided for Limited Companies.
Current file: Completion (Unincorporated Businesses only)	
A71 Unincorporated assignment summary of financial ratios and trends	• New document added.
Current file: Planning (both for Limited Companies and Unincorporated Businesses)	
B01 Planning checklist	• Moved from B11.
B13 New client checklist	• Moved from PF1.
B15 Terms of engagement - placeholder	• New placeholder added.

B27 Company / Entity searches - placeholder	• New placeholder added.
B50 Budget	• Moved from B61.
Current file: Planning (Limited Companies only)	
B02 Audit exemption eligibility checklist	• Moved from B12.
B03 Audit exemption client's needs checklist	• Moved from B13.
B40 Audit exemption overall approach	• Moved from B51.
B40-FRF Change of financial reporting framework impact assessment	• New document added.
Current file: Planning (Unincorporated Businesses only)	
B40 Unincorporated assignment overall approach	• New document added.
Current file: Audit programmes (both for Limited Companies and Unincorporated Businesses)	
O Audit programme - VAT	• Test added / amended to include a review of VAT adjustment calculations and include in the VAT summary. • Minor changes to terminology to reflect current VAT schemes / bookkeeping practices.
Current file: Audit programmes (Unincorporated Businesses only)	
Accounts preparation programmes - All	• Tests have been added to bring the work programmes in line with those provided for Limited Companies.
N2 Accounts preparation programme - Trial balance, journal adjustments and nominal ledger	• Renamed for consistency with other manuals. • Tests relating to the opening trial balance have been combined.
R Accounts preparation programme - Permanent information	• Programme has been removed as its content was largely covered by the Permanent file indices.
Current file: Staff appraisal form	
Staff appraisal form	• Moved into new format so it displays like other forms within the manual and is no longer treated as a separate attachment.
Permanent file	
Permanent file indices	• Updated to reflect revised file structures.
PF3-1 New client checklist - placeholder	• New placeholder added.
PF4 Involvement in accounts preparation	• Moved from PF3. • Minor changes to terminology to reflect current bookkeeping practices.

July 2022 - Remapping summary

The below table provides a list of forms in the planning section of the current file and the permanent file, and indicates where they have moved to, if applicable, as part of this update of the manual.

Original reference and form	Revised reference	Comments (if applicable)
Planning - Limited Companies		
B11 Audit exemption Planning checklist	B01	
B12 Audit exemption Planning checklist	B02	
B13 Audit exemption client's needs checklist	B03	
B51 Audit exemption overall approach	B40	
B61 Budget	B50	
Planning - Unincorporated Businesses		
B11 Unincorporated assignment planning checklist	B01	
B61 Budget	B50	
Permanent file		
PF1- New client checklist	B13 / PF3-1	
PF2-2 Systems and control procedures checklist	No Change	
PF3 Involvement in accounts preparation	PF4	

22 Academy manual

22.1 Contents

	Guidance notes
1	Introduction
2	Sector overview
3	Accounting and reporting
4	External scrutiny
5	Other reporting requirements
6	Other
	Appendices
	Appendix 1: Notes for completion of planning form B25 - Materiality
	Appendix 2: Notes for completion of planning form B40 - Audit plan
	Appendix 2.1: Notes for completion of planning form B40 Audit plan - Trial balance (use of ADA)
	Appendix 3: Notes for completion of substantive sampling forms (p/c on or after 15 Dec 21)
	Getting started for new manual users
	What's changed

22.2 Guidance notes

1 Introduction

1.1 Scope

This manual provides you with all the programmes, documents and guidance needed to undertake the audit of an academy trust under the International Standards on Auditing (ISAs) (UK) and the FRC Ethical Standard. It also provides you with programmes, documents and guidance for providing a reporting accountant's report on regularity and the agreed-upon-procedures report in relation to the Teachers Pensions End of Year Certificate.

The manual is suitable for audits of groups as well as standalone entities.

1.1.1 Specialist Assignments Manuals (SAMs)

This manual is only intended for use for entities registered as academy trusts under the Academies Act 2010. For other types of entity, a Specialist Assignment Manual (SAM) specifically designed for that type of entity should be used, although in some cases it may be appropriate to tailor this manual to meet the specialist requirements of the entity concerned.

Mercia provides a wide range of SAMs including:

- Charities Audit Manual
- Clubs (GB)
- Clubs (NI)
- Limited Liability Partnerships (LLPs);
- Pension Schemes;
- Registered Social Housing Providers (RSHPs); and
- Societies and Community Interest companies (CICs)*.

** This is a supplementary manual designed to be used in conjunction with the Audit Manual (UK).*

1.1.2 Exclusions

This manual does not cover the requirement to provide an assurance report on the Academies Annual Return.

1.1.3 Quality management

Forms relevant to ensuring quality at the engagement level are included within this manual~~, with firm wide quality management aspects addressed in the Quality Management Manual (UK) which is available to purchase separately.~~

1.2 What's included in this manual?

This manual includes:

- Guidance notes - which provide detailed guidance on the sector;
- ~~Example letters - including engagement letters;~~
- ~~Example reports - including example auditor's reports and reporting accountant's reports on regularity;~~
- ~~Example accounts - prepared in accordance with the Academies Accounts Direction and Charities SORP;~~
- ~~Accounts disclosure checklist;~~
- ~~Current file documents;~~
- ~~Permanent file documents; and~~
- ~~Supplementary forms - including a file review checklist and an audit programme for the cash flow statement.~~

1.3 What else is needed?

You should have access to the Audit Procedures Manual (UK), or your firm's own audit procedures manual, which contains support audit methodology and guidance.

You will also need access to the applicable versions of the following:

- The Companies Act 2006
- SI 2008/409 The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008; and
- SI 2008/410 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008
- The Charities Act 2011
- SI 2008/629 The Charities (Accounts and Reports) Regulations 2008
- Guidance from the Charity Commission (CC)
- The Academies Act 2010
- Academies Accounts Direction 2022 to 2023
- Academies Model Accounts 2022 to 2023
- Framework and guidance for auditors and reporting accountants of academies trusts 2022 to 2023
- Academies Accounts Direction supplementary bulletin: July 2021

2 Sector overview

2.1 Legal and Regulatory Framework

2.1.1 Charitable status

Academies established prior to July 2010 were registered charities. However, a further provision in section 12(4) of the Academies Act has made academies exempt charities (under Part 3 of the Charities Act 2011) upon the appointment of a principal regulator.

In July 2011, legislation was passed to enable the Secretary of State for Education to be appointed as Principal Regulator, making all academies exempt charities from 1 August 2011.

Like registered charities, academies are permitted to set up subsidiary companies. This is normally for reasons aligned with VAT and the tax treatment of income and expenditure of the academy.

2.1.2 Corporate structure

The Academies Act 2010 deems a qualifying academy proprietor to be a charitable company:

- which is limited by guarantee;
- whose registered office is situated in England and Wales;
- which in pursuance of academy arrangements is the proprietor of an academy; and
- whose objective as expressed in its articles or memorandum of association (or each of whose objects as so expressed) is a charitable purpose.

Therefore, academies are subject to the Companies Act 2006 and the Charities Act 2011 although, in the latter case, some important sections do not apply because academies have exempt status.

Individual schools have the ability to convert and set up either as an individual academy, though more commonly nowadays will set up as a multi-academy trust or join an existing multi-academy trust. There would be one charitable company limited by guarantee in these instances. Within this manual, the term academy is used to describe both the trust and constituent academies, as applicable to the circumstances of the audited entity.

A federation of academies underneath an overarching academy trust or charity may also be formed, though in many regions this is less common.

2.1.3 The role of the Secretary of State for Education

The Secretary of State for Education (DfE) became the Principal Regulator of academies on 1 August 2011 making academies exempt charities under Part 3 of the Charities Act 2011.

2.1.4 The remit of the ESFA

The ESFA's role lies in funding and regulating academies, dovetailing with the role of the Principal Regulator as set out within the terms of its remit.

The ESFA carries out a number of functions in its role of funding academies and supporting the DfE in its role as principal regulator in respect of academies. These functions include (though are not restricted to):

- policy advice to the DfE;
- calculation and payment of grants to academies;
- financial monitoring and assurance of open academies;
- ensuring funding agreement and general funding compliance; and
- investigation of suspected fraud or financial irregularity.

2.1.5 The role of the Charity Commission (CC)

The CC can still use its investigative and protective powers in respect of academies but only after consultation with DfE and, in some cases, only if the CC is requested to open an enquiry by DfE.

The CC will continue to work with DfE as principal regulator for academies, to ensure that:

- academies have exclusively charitable purposes, for the public benefit;
- academies remain independent in their governance and operations;
- academies comply with charity law;
- academies remain accountable to the public; and
- other charitable trusts connected with academies (and other charitable schools converting to academies) are properly protected and, where necessary, the trusts can be updated so that the academy can benefit.

2.1.6 The Academy's Funding Agreement with the Secretary of State for Education

An academy will be party to a funding agreement with the Secretary of State for Education which is a contract outlining the framework within which the academy must operate.

In return for the academy undertaking to establish or maintain an independent school (with the qualities of an academy as laid out in the Academies Act), the Secretary of State will agree, through the funding agreement, to provide funding for payment of recurrent expenditure for at least seven years or indefinitely, terminable on seven years notice.

The funding agreement is seen as central to ensuring accountability and assurance over the use of public funds. The funding agreement sets out, amongst other items, the types of, and terms and conditions attaching to, grants paid by the Secretary of State. These terms and conditions include a number of operational, governance, financial, accounting and reporting requirements as set out elsewhere within these guidance notes.

2.2 Governance in Academies

2.2.1 Governance structure

An academy, a charitable company limited by guarantee, will have been formed by a number of members (as determined by government policy at the time) who are nominated either by DfE or a sponsor (in the case of a sponsored academy). These members will sign the Articles of Association on formation of the academy.

The members will have a number of powers including those in relation to winding up an existing academy, amending the articles of association (the primary governing document of the academy), appointing member governors and removing governors.

The members are in place to take a broad overview of the academy and its activities and to hold the appointed governing body to account.

The articles of association will stipulate the number of governors (or in more recent articles 'trustees') to be responsible for the statutory and constitutional affairs of the academy. These parties, however defined within the articles, are also the directors and trustees of the trust from a company and charity law perspective. Within a multi-academy trust structure, it must also be considered whether other local governors will be trustees from a charity law perspective.

2.2.2 The Accounting Officer

The funding agreement requires that the academy appoints an Accounting Officer (AO). The AO should be the senior executive leader of the academy and is responsible to Parliament for the propriety and regularity of the public finances for which they are answerable. The AO is also responsible for the keeping of proper accounts; for prudent and economical administration; for the avoidance of waste and extravagance; and for the efficient and effective use of all the resources in their charge. The AO may delegate or appoint others to assist in these responsibilities (eg. to a Principal Finance Officer).

2.2.3 The Academy Trust Handbook (also known as the Academies Financial Handbook)

Requirements and guidance on the responsibilities of trustees and the AO are given in the Academy Trust Handbook which acts as the financial guide for governing bodies and senior leadership teams of academies, drawing upon the requirements specified in the academy's funding agreement, company and charity law.

The governing body is required to abide by the requirements of, and have regard to, the guidance in the Academy Trust Handbook as part of the terms of the funding agreement.

The Academy Trust Handbook is updated on an annual basis to reflect sector and legislative changes.

The trustees are encouraged to have reviewed and taken account of the guidance in the DfE's Governance Handbook and Competency Framework for governance, and, where they have done so, to include a statement to that effect in the Governance Statement included in the accounts. This guidance covers strategic leadership, accountability, people skills and experience, organisational structures, compliance with legislation and contracts and the evaluation of governance to improve performance.

The forms within the Mercia Academies Specialist Assignment Manual reflect arrangements in place for the 31 August 2023 period end and thus requirements as laid out within the Academies Financial Handbook 2022 (effective 1 September 2022).

2.2.4 Internal scrutiny

An academy must appoint an audit committee, either dedicated (mandatory if income over £50m) or combined with another committee, and should meet at least three times a year. The chair of trustees should not be chair of the audit committee. Further detail is provided in the Academy Trust Handbook.

All academy trusts must have a programme of internal scrutiny, directed by the audit committee, to provide independent assurance to the board that its financial and other controls, and risk management procedures, are operating effectively.

A number of options are available to this committee in terms of how they deliver this programme of work, including:

- employing an in-house internal auditor;
- a bought-in internal audit service;
- appointment of a non-employed trustee; and
- peer review.

The academy must maintain a risk register, and the internal scrutiny function must produce a report of the areas reviewed, key findings, recommendations and conclusions to each audit committee meeting, together with an annual summary which must also be submitted to the ESFA with the audited annual accounts.

It is strongly recommended that auditors and reporting accountants review in detail the requirements of the Academy Trust Handbook 2021 in this area.

This process should provide an opportunity for the auditor to place reliance on this work in accordance with the requirements of ISA (UK) 610 Using the Work of Internal Auditors.

Relevant ethical issues are considered in section 7.4.

2.2.5 Use of the terms 'trustees' and 'governors'

The term 'trustees' has been used throughout the reports and letters section of the Academies Specialist Assignment Manual as consistent with wording adopted in the Academies Accounts Direction. The term 'governors' has been retained elsewhere to denote those charged with governance, and taken to be inclusive of directors and trustees. The most appropriate term should be used in the context of the academy that you are acting for. Where the constitution of the academy does not support this term, appropriate amendments should be made.

2.3 Types of Academy

2.3.1 What are academies?

Academies are publicly funded independent schools. An academy has freedoms in excess of those granted to maintained schools. These include additional freedom from Local Authority (LA) control, the ability to set its own pay and conditions, curriculum and the length of terms and school days.

Academies receive funding direct from an executive agency of the Department for Education (DfE), the Education and Skills Funding Agency (ESFA), rather than through a LA as is the case with an equivalent maintained school. The ESFA incorporates the roles and responsibilities previously performed by the Education Funding Agency and Skills Funding Agency.

All academies approved by DfE are automatically deemed exempt charities by virtue of section 12 of the Academies Act 2010. The principal regulator for academies is the Secretary of State for Education. Academies are set up using agreed governing documents setting out the charitable objective of advancing education, however some academies may extend their objects to permit other types of income generation and expenditure.

Though academy status within the education sector has become more prominent following the introduction of the Academies Act 2010, some academies and other similar educational institutions have been in existence for a number of years.

The Academies Act 2010, which received Royal Assent on 27 July 2010, significantly changed the framework for academy schools and provided the opportunity for more schools to become academies. The sector has evolved significantly since 2010, with an increasing number of academies now being part of wider multi-academy trusts (a single trust containing more than one academy).

Due to devolution of educational powers, the provisions of the Academies Act 2010 only permit an academy to be established in England.

2.3.2 'Sponsored' academies

The sponsored academy programme saw the first academies set up in 2002. Initially, the academy sponsor, typically entrepreneurs, businesses, charities or other educational institutions, were required to put £2m (or 10% of the academy's capital costs if lower) into an endowment fund and latterly directly into the academy.

Sponsored academies were, and still are, focussed on improving education in deprived areas and replacing existing underperforming schools.

Typically, these academies were subject to significant capital projects and often had subsidiary companies also set up to develop the premises to deal with VAT issues apparent for schools outside the LA umbrella at the time. Additional subsidiary companies could also be set up for activities outside the scope of the academy's educational operations.

Sponsorship could be of a single academy or a network of academies. Since May 2011, sponsors have not been required to make a financial contribution or to establish or support an endowment fund, though they may still wish to do so.

2.3.3 'Convertor' academies

Initially, only schools rated as outstanding by the Office for Standards in Education (Ofsted) could apply to become academies under the new (non-sponsor) regime. This was then extended to schools assessed as 'good with one or more outstanding features' in November 2010. Additionally less well performing schools, in partnership with a school that was performing well, were permitted to apply.

From 7 April 2011, eligibility to apply to become an academy was rolled out further to all schools which could evidence that they were 'performing well'.

The DfE has issued guidance on the criteria to be taken into consideration when deciding whether a school applying to become an academy is 'performing well', which is available from the DfE website.

Nowadays, schools normally convert as part of a multi-academy trust containing more than one school as outlined further in paragraph 3.1.

2.3.4 Free schools

A free school is a school which is set up by any one or more of groups of parents, teachers, charities, trusts, universities and religious or voluntary groups. A free school is set up as an academy, although the application process will differ from that of a converting school as there are additional factors to consider such as facilities, partners and demand.

2.3.5 Other

A number of other types of educational institutions may also set up as academies. These include Technical Academies, University Technical Colleges, Studio Schools, Special Academies, 16-19 academies, alternative provision schools (such as Pupil Referral Units) and sixth form colleges.

2.4 Academy size

All academy trusts are required to follow the Academy Accounts Direction and there are few exemptions from disclosure for academies which would otherwise qualify as small charities or small companies under the relevant legislation.

All academies with an active funding agreement are required to be audited, so there is no exemption on the basis of size.

The Academy Accounts Direction requires all academies, regardless of their size, to include a strategic report as a clearly delineated section within the trustees' report.

Academy trusts which qualify as large under The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Reporting) Regulations 2018 are required to includes relevant energy and carbon information in their annual report. Academy trusts which do not qualify as large under these Regulations are encouraged to report on a voluntary basis, although this may be on their website, rather than in their annual reports.

Where required under the Charities SORP, consolidated financial statements will be required in addition to individual accounts.

Exemption from the requirement to produce consolidated accounts is usually only available where:

- the income of the group (net of any intra-group transactions) in the accounting period is no more than the audit threshold under the Charities Act (currently £1,000,000); or
- the subsidiary undertaking or undertakings results are not material to the group.

The Accounts Direction outlines the disclosures required when exemption from preparation of group accounts is taken.

Where a multi-academy trust exists within one charitable company, the academy will be required to produce one set of financial statements, though disclosures will be required for the DfE within the financial statements for each individual school as laid out in the Accounts Direction. As such, the financial reporting function will need sufficient resource, expertise and software to report to a number of levels, which culminate in a departmental (or school-plus-school) consolidation.

2.5 Academy funding

2.5.1 Revenue funding

The principal source of funding for an academy is grants received from the ESFA and the Local Authority (LA). The academy may be in receipt of a number of grants for both revenue and capital purposes.

Generally, funding for academies received from the ESFA runs from September to August to coincide with the academic year; and funding received directly from the LA relates to the financial year April to March.

The main grant received by the academy is the General Annual Grant (GAG) which is made up of a number of elements. The most significant element is known as the 'school budget share'. This part of the GAG is calculated by the use of a funding formula which calculates funding on a comparable basis to the running costs of maintained schools in the same area.

The principal terms of the GAG are outlined in the academy's funding agreement. The accounting requirements chapter of these guidance notes considers the treatment of the GAG.

Other revenue funding available to academies includes (but not limited to):

- Start-up grant;
- Post opening grant;
- Early years funding;
- PE and Sports premium for primary schools;
- Universal Infant Free School Meals;
- High Needs top up funding;
- Pupil premium;
- Primary academy chain development grant;
- Sixth form funding;
- Funding for special academies;
- Risk protection and insurance;
- National non-domestic rates.

2.5.2 Capital Funding

Academies, like maintained schools, receive Devolved Formula Capital funding for capital maintenance and ICT projects. Academies that have urgent building repairs they are unable to fund themselves, or need to expand to take in more pupils may also apply for funding from the Condition Improvement Fund (CIF), previously called the Academies Capital Maintenance Fund. Further information on academy funding is available from the Department for Education section of the GOV.UK website.

2.5.3 Other Income

An academy may also be in receipt of a number of other sources of government grant funding (eg. teaching school funding). In addition to this, it may generate income from other activities (eg. supplies of staff, letting, room hire, conferencing, catering, and other fundraising).

2.6 Key features

Funding

The ESFA is responsible for funding academies and, under the terms of its remit from the Secretary of State for Education, for supporting the success of academies by funding them fairly; providing high quality support and offering rigorous challenge.

An academy receives funding directly from the ESFA, rather than from the LA as would be the case for a maintained school. In an LA maintained school, funding is given to the LA who use part of the gross funding to finance central services and distribute the net amounts accordingly.

Although the academy will often receive more top line funding directly from the ESFA, it is required to pay for additional costs that would previously have been centrally procured by the LA. The direct receipt of funding gives the academy greater autonomy on how it spends the monies received.

The core funding for academies is subject to a funding agreement with the Secretary of State for Education. This contract outlines the framework within which the academy must operate. The funding agreement lays out a number of requirements in respect of application of funds, governance and reporting requirements.

Freedom from local authority (LA) control

The cited freedom from LA control is largely in relation to autonomy in respect of spending on central LA procured services. LA schools already have considerable autonomy in respect of finance and staffing and a majority of funding is formula driven. Academies do not have a requirement to consult with the LA in some areas, for example on exclusions, but have to ensure that appropriate policies, procedures and services are in place to cover areas previously dealt with by an LA.

National Curriculum and admissions

LA schools already have an element of freedom when it comes to national curriculum. An academy curriculum must be 'broad and balanced' including English, Maths and Science. The National Admissions Code of Practice applies to all schools and schools with existing selection arrangements in place, on conversion to an academy, can continue to select.

Length of terms and school days

Some LA maintained schools (eg. Foundation and Voluntary Aided schools) are permitted to change the length of school days and term dates, provided relevant LA regulations are met and approval is received. The process requires less external approval for an academy although consideration is still needed of the implications for families and school transport (which is still dealt with through the LA).

Employment

Transfer of Undertakings (Protection of Employment) Regulations (TUPE) applies for existing staff on conversion to an academy. This means that the same pay and conditions will apply initially for staff on conversion to an academy. Pay and conditions can subsequently change, although consultation with staff and unions would be likely.

Academies take on responsibilities in respect of the Teachers' Pension Scheme and Local Government Pension Scheme, including payment of the employer contribution which must be remitted, with the employee contribution, to the relevant body. Whilst the school was maintained, the LA was responsible for such matters.

Premises responsibility

The property will either be owned or leased by the academy or occupied through some other arrangement. LA centrally funded repairs and maintenance are funded out of academy income, subject to availability of grant funding.

3 Accounting and reporting

3.1 Preparation of accounts

An academy financial year runs to 31 August to be in line with the academic year. Statutory accounts are prepared up to this date each year. The trustees are responsible for the preparation of the accounts.

An academy trust is a charitable company which is limited by guarantee. Its annual financial statements and reporting requirements are outlined in its funding agreement, which states that the accounts must comply with the Charities' Statement of Recommended Practice (SORP) as if the academy were a non-exempt charity and Parts 15 and 16 of the Companies Act 2006. In preparing its accounts, an academy is also required to abide by the requirements of, and have regard to, information contained within the Academies Financial Handbook.

The Academy Trust Handbook refers to annual accounts requirements in the Academies Accounts Direction, issued annually, which acts as an adjunct to the handbook.

3.1.1 The Academies Accounts Direction

The Academies Accounts Direction is updated and reissued annually. It includes specific disclosure and accounting requirements relevant to academies and supplements the Charities SORP in order to provide a model for best practice and reduce potential diversity in accounting practice within the sector. The Accounts Direction includes a model annual report and financial statements (Coketown Academy Trust) and states that the direction and its associated guidance is mandatory for all academy trusts that have a signed funding agreement at any point in their accounting period. .

The pro-forma accounts included within this manual are based upon the financial statement requirements included within the Accounts Direction and there is also an academies accounts disclosure checklist that can be found in the relevant section of this manual.

The Academies Accounts Direction mandates that the following form the financial statements of an academy trust:

- Statement of financial activities;
- Balance sheet;
- Statement of cash flows;
- Statement of accounting policies; and
- Other notes to the financial statements.

3.1.2 Fund accounting

Academies, like charities, must observe basic rules of fund accounting in preparing their accounts.

In particular, the accounts should differentiate between restricted and unrestricted funds, grouping similar types of fund together if appropriate.

Funds may be classified into:

- Expendable endowments, although this is rare in the academy sector and generally only applies to academy trusts that signed a 'deed of gift' with their sponsor several years ago.
- Restricted
    - by donor
    - appeal related
- Unrestricted
    - may include Designated funds, ie. funds set aside by trustees for a specific purpose.

Any Gift Aid amount recovered on a donation forms part of that gift and is an addition to the same fund as the original donation unless the donor specifies otherwise.

Restricted funds - are where the academy receives money that is earmarked either by the donor or by the terms of an appear for particular projects. Such projects represent restricted funds requiring separate accounting. Depending on the materiality of each, the accounts should group the restricted funds under one or more headings.

As a minimum, capital funds must be distinguished from income funds. The columnar format of the Statement of Financial Activities (SoFA) is designed to achieve this.

The Academies Accounts Direction requires greater disaggregation of restricted funds on the face of the SoFA than typically seen in charity accounts, requiring a column for the Restricted General fund, representing resources which can only be spent for particular purposes, and a Restricted Fixed Asset fund, representing resources to spent for particular capital purposes.

Any funds in deficit should always be separately disclosed, and reference made to this matter. An explanation should be given in the Trustees' Annual Report.

Endowment funds - are funds which have been given to an academy subject to the restriction that they are to be held as capital.

The initial gift and subsequent increases and decreases in the amount of any endowment funds should be distinguished in the SoFA as part of those funds.

The notes to the accounts should disclose how such funds have arisen. If the application of the income is restricted to a particular purpose the income and expenditure should be appropriately identified in the restricted fund. Any such income not spent at the year end should be carried forwards as a restricted fund.

3.1.3 Statement of Financial Activities (SoFA)

The overall objective of the SoFA is to show the resources receivable and expended by the academy trust in the year on all its funds.

The SoFA is structured into broadly five sections:

A Income

B Expenditure

C Transfers between funds

D Other recognised gains/losses

E Reconciliation of funds

Net gains / losses on investments are presented between ‘Expenditure’ and ‘Transfers’.

Income - All income becoming available to the academy during the year should be summarised in the first section, distinguishing between those belonging to the academy’s unrestricted funds, its restricted income funds and its endowment funds.

The value of all resources - both for income and endowment funds - accruing to the academy should be recorded in the SoFA as soon as it is *prudent and practicable* to do so. In all cases incoming resources should not be recognised until the conditions for receipt have been met and there is reasonable assurance of receipt. Income recognition will be dependent on the following three factors being met:

- **entitlement** - normally arises when a particular resource is receivable or the academy’s right to it becomes legally enforceable;
- **probable** - it is more likely than not that the economic benefits associated with the transaction or gift will flow to the academy;
- **measurement** - when the monetary value of the incoming resource can be measured with sufficient reliability.

All incoming resources should be reported gross whether raised by the academy or its agents. Netting off expenditure against income is only allowable for small fundraising events where it will not materially understate the gross incoming resources and gross resources expended for the event. However, in no circumstances should the academy’s own staff costs be netted off against the proceeds of any such events when reported in the accounts.

Income should be analysed into the following categories (where appropriate):

- donations and legacies;
- charitable activities;
- other trading activities;
- investments;
- other incoming resources (eg. net gains on disposals of fixed assets for use by the charity);
- the total by column of the above resources arising in the year.

Income should be further distinguished by fund type. In the notes to the financial statements, endowment fund incoming resources should be analysed between permanent endowment and expendable endowment.

Expenditure - In the next section of the SoFA, all items should be analysed as follows:

- raising funds:
- charitable activities;
- other;
- the total by column of the above resources expended in the year.

Expenditure should be further distinguished by fund type.

Transfers - all transfers between the different classes of funds should be shown (These should not be netted off, but should be shown gross, with supporting explanations in the notes) and must net to nil.

As noted above, gains and losses on investments under the SORP are presented above net income / expenditure and not below.

Each column of the SoFA needs to be totalled to show the net movement in the academy’s funds for the year.

The SoFA thus contains a summary of the movements on all of the funds held or operated by the academy. If it has a number of funds, the SoFA should show, in columnar form, the movements in the main different types of funds (unrestricted, restricted income, and endowment) as well as the total movements.

Under the SORP the comparatives are required for all items (eg. broken down by fund). This can be done either on the face of the SoFA or in the notes to the accounts.

Movements in all the material underlying funds should be analysed in the notes to the accounts, using the headings from, and reconciling with, the main SoFA.

Under the SORP the SoFA would then comprise two parts, (which should be appropriately sub-titled):

j. the account of income and expenditure for the year, terminating in: “net income / expenditure for the year”; and
k. the statement of comprehensive income for the year comprising “net income / expenditure” - as a single line - and the amounts of any revaluation gains or losses, resulting in “net movement in funds for the year”.

In a case where (as only occasionally happens) the academy has discontinued any of its operations or acquired new ones, the first part of the SoFA should also distinguish between continuing, discontinued and acquired operations, in order to comply with FRS 102.

Reconciliation of funds - The net movement for the year of the academy’s funds shown in the SoFA should then be reconciled to the total funds as shown in the Balance Sheet, as follows:

- net movement in funds for the year;
- total funds brought forward;
- total funds carried forward.

3.1.3.1 Treatment of grant income

The General Annual Grant (GAG)

The GAG is paid for the purposes of recurrent expenditure of the academy. Recurrent expenditure is defined in the funding agreement as any expenditure on the establishment, conduct, administration and maintenance of the academy which does not fall within categories of capital expenditure covered by the capital grant funding (see below). The academy’s funding agreement states that ‘the GAG paid by the Secretary of State shall only be spent by the Academy Trust towards the normal running costs of the academy’. Within some academies there are restrictions upon amounts carried forward as a surplus from year to year.

The terms of the funding agreement are more restrictive than to allow for application of funds for the general purposes of the academy as set out within its governing document (ie. the charitable object of advancement of education) and must be applied for particular purposes. Therefore, the Accounts Direction deems that these and other grants received from the DfE/ESFA are treated as restricted funds in line with the Charities SORP.

For some older academies the funding agreement permits only up to 12% of the total GAG payable to be carried forward and restrictions detailing what this carry-forward amount could be spent on. The Accounts Direction requires separate disclosures relating to GAG carry-forward, where applicable.

Capital funding

The Accounts Direction follows the Charities SORP in respect of the treatment of capital grants. Where capital grants are received to finance the purchase of tangible fixed assets the grant is credited to a restricted fixed asset fund and amortised in line with the expected useful life of the assets financed.

3.1.3.2 Accounting for transferred assets and premises

Guidance for the treatment of academy premises and assets transferred on conversion is provided in the Accounts Direction. This guidance applies principles in the Charities SORP in respect of the treatment of gifts in kind. Specifically, fixed assets recognised should be credited to the restricted fixed asset funds account in the Statement of Financial Activities (SOFA). The asset is then depreciated over its useful economic life.

Due to the significant collective value of academy land and buildings within the Sector Annual Report and Accounts, the ESFA normally centrally procure land and property valuations for new academies. Subject to availability within a suitable timeframe, these valuations may be used by the governors to estimate the value of transferred assets for inclusion within the financial statements. Alternatively, in the absence of an ESFA procured valuation, governors may use information obtained from a predecessor Local Authority or other information as the basis for their estimate. The valuation should be considered as an accounting estimate, and audited as such, within the financial statements.

The disclosures relating to transferred assets on conversion as well as transfers of academies between academy trusts are outlined in detail within the Accounts Direction and model accounts.

School records of fixed assets prior to conversion can be inconsistent. They range from full registers, to rudimentary records, to non-existence. As such it is not uncommon that the value of assets transferred is estimated. Estimation may be based upon knowledge of other similar school asset values or physical inspection where records are not present.

3.1.4 Summary Income and Expenditure Account

The Companies Act requires a statement showing all the realised gains and losses for the year. The question is, therefore whether the statement of other comprehensive income, which is included in the SoFA, means that a separate Income and Expenditure Account is required. The Charities SORP suggests this is not the case, provided the SoFA is amended so that:

- the title clearly indicates that it includes an income and expenditure account and statement of total recognised gains and losses (if required); and
- there is a prominent sub-total entitled "net income / (expenditure) for the year" which replaces or is in addition to the heading of "net incoming / (outgoing) resources for the year".

In most cases, academy trusts will not require a summary income and expenditure account, provided the SoFA is amended as above. However, for academy trusts with movements on an endowment fund, a summary income and expenditure account will be required, as the Companies Act does not permit capital to be taken to an income and expenditure account.

The Summary need not distinguish between unrestricted and restricted income funds, but should show separately in respect of continuing operations, acquisitions and discontinued operations:

- income excluding endowments (can be analysed in further detail);
- net gains / losses from investments;
- interest and investment income (or can be disclosed in the notes);
- total income (this will be the total of all incoming resources of all income funds but not for any endowment funds);
- interest payable (or can be disclosed in the notes)
- depreciation and impairment charges for fixed assets (or can be disclosed in the notes);
- total expenditure out of the academy's income funds;
- net income or expenditure for the year;
- if relevant, any tax payable and net income or expenditure after tax.

3.1.5 Balance Sheet

Much of the balance sheet is similar to that of a normal company. The key points to note are:

Funds - These should be grouped together in the balance sheet according to their type, distinguishing between unrestricted, restricted income and endowment funds.

Fixed assets - These should be sub-divided between intangible assets, tangible assets, heritage assets and investments.

- All fixed assets should be capitalised (included donated assets) except where:
    - the asset is a heritage asset (eg. ancient monument, historic building), or;
    - in exceptional circumstances it is not practical to obtain a valuation.
- Fixed assets should be distinguished between assets for the charity's use (whether intangible, tangible or heritage) and investment assets.
- Assets for own use can be carried at cost or valuation in accordance with the normal rules.
- Investments must be carried at fair value or the trustees' best estimate of market value.

At the end of a financial year, the charity must assess whether there is any indication that an asset may be impaired. If there is no indication of impairment, then it is not necessary to estimate the recoverable amount whilst if there is an indication that an asset is impaired, then its recoverable amount must be estimated (higher of fair value less costs to sell and its value in use). Its value in use can be calculated using the present value of its cash flow if the assets generates a commercial return otherwise the present value of the assets service potential would be used (eg. for a specialist building then depreciated replacement cost would be a suitable method). An impairment loss must be recognised if, and only if, the recoverable amount of an asset is less than its carrying amount.

Indicators of impairment include:

- a significant decline in an asset's market value;
- significant changes in technology or markets, or in the economic or legal environment, which have an adverse effect on the charity's activities;
- an asset becoming idle, or plans being made for its disposal earlier than expected;
- evidence of an asset's obsolescence or physical damage; and
- evidence of worse than expected results or cash flow from the use of an asset.

The SORP prohibits the reversal in a subsequent period of impairment losses previously recognised for goodwill.

The SORP requires inventories held for distribution at no or nominal consideration shall be measured at the lower of cost adjusted, when applicable, for any loss of service potential and replacement cost. Where replacement cost is the economic cost incurred if the charity was to replace the service potential of the donated goods at its own expense in the most economic manner

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Concessionary loans payable or receivable (either interest free or below market rate) will either fall into the category of a programme related investment or a mixed motive investment. Concessionary loans are made wholly or in part to advance charitable purposes for the benefit of a charity's beneficiaries. For loans repayable on demand on within one year, no adjustment to the carrying amount (the loan amount) is required. However if over one year, there is a policy choice; though the same policy has to be used for both loans payable and receivable:

- initially recognise at the loan amount and then adjust the carrying amount in subsequent years to reflect repayments / receipts and any interest; or
- initially recognise at fair value and subsequently at amortised cost using the effective interest method. This would lead to a financing cost or interest income element being accounted for.

Liabilities - The recognition of provisions follow the same rules as FRS 102 (ie. provisions should be recognised when there is a legal or constructive obligation as a result of a past event).

3.1.5.1 Academy Pension Schemes

3.1.5.1.1 Introduction

A converting academy is responsible for the pension arrangements for staff transferred, even where the LA is still acting as the payroll provider. There are two principal occupational pension schemes. The Teachers' Pension Scheme is the statutory scheme for teaching staff, with non-teaching staff being subject to the Local Government Pension Scheme. The nature, practicalities and accounting treatment of each of these schemes is further detailed below.

3.1.5.1.2 Teachers' Pension Scheme

Background

Teachers working in an academy fall within the scope of the Teachers' Pension Scheme (TPS), just as if they were employed in a LA maintained school. Staff transferring from a maintained predecessor would simply continue their membership of the Scheme. As the employer, the academy would be responsible for remitting contributions to the TPS and for all other administrative responsibilities that fall to employers who employ teachers who are subject to the teachers' pensions regulations.

Accounting treatment

The Teachers' Pension Scheme is an unfunded, statutory, contributory, multi-employer defined benefit (final salary) scheme. The underlying (notional) assets and liabilities attributable to any one employer cannot be identified. As such, contributions to the scheme are treated in the same manner as contributions to a defined contribution scheme with the cost recognised in the accounts being equal to the contributions payable to the scheme in the accounting period.

These pension costs should be allocated across the relevant resources expended categories in the Statement of Financial Activities (i.e. within the restricted general column of the 'academies educational operations' line within the SOFA).

Disclosures

A standard financial note disclosure is provided by Teachers' Pensions which is updated, published annually and available in the Accounts Direction. The note gives sufficient detail to satisfy the requirements of accounting standards and as such should be included within an academy's financial statements.

Other annual return requirements

The employer is required to submit an End of Year Certificate (EOYC) each year. This certificate sets out the contributions made in the year to 31 March and requires population of additional information and certification by the employer. The return must be submitted by the end of May. Each year, Teachers' Pensions publishes its guidance for reporting accountants (TP05) with respect to certification of the EOYC return. The report of factual findings in connection with this agreed-upon-procedures engagement is submitted in line with guidance included in TP05 no later than 30 September. This is further considered within the audit section of this guidance.

3.1.5.1.3 Local Government Pension Scheme (LGPS)

Background

Non-teaching staff within the academy fall within the remit of the LGPS. The LGPS is a nationwide scheme for employees working in local government. This multi-employer defined benefit pension scheme is administered locally for participating employers through regional pension funds.

An academy's funding agreement requires the academy to offer LGPS membership to all non-teaching staff. Where maintained schools apply to convert to academies under section 3 of the Academies Act 2010 and an Academy order is made under section 4, those existing staff who are already members of the LGPS by virtue of the Administration Regulations would not be affected by the conversion. Their membership of the LGPS would continue unaffected. After conversion, new non-teaching staff will be eligible to join the LGPS and will automatically be enrolled in the Scheme when employed. However, such staff will have the option to opt out of the Scheme if they give notice within three months.

Contributions

Contributions to the LGPS are calculated based on an actuarial assessment carried out by the relevant LGPS administering authority fund actuary (who may, but will not exclusively, be the part of the LA themselves). The contribution rates will differ from academy to academy and may be at a higher or lower rate than that paid prior to conversion due to the nature of the actuarial assessment performed though pooling arrangements may be made with the local authority which can help to ensure that contribution rates remain manageable.

Accounting treatment

Unlike the TPS, LGPS is a funded scheme and can be in surplus or deficit according to investment performance. Most pension funds are currently managing a deficit, and the deficit in respect of pensionable service prior to conversion transfers from a LA to the academy through the transfer agreement signed prior to conversion.

As the individual assets and liabilities attributable to the academy are normally identifiable, this results in the scheme being treated as a defined benefit pension scheme within the academy financial statements and therefore the recognition of a net liability (or asset) on the balance sheet.

On initial transfer of the scheme into the academy the amount will show with other assets and liabilities transferred and a pension reserve created within the restricted funds. Similarly, transfers between trusts will normally create a transfer of obligation to the new employer.

Changes in the LGPS surplus or deficit should be accounted for in line with the financial reporting and disclosure requirements of FRS 102, the Charities SORP and Accounts Direction.

Where, as may be the case for academies containing more than one school, there is more than one LGPS in operation, the financial statements can either make disclosures in total, separately for each scheme or in such groupings considered to be the most useful. Where the academy provides disclosures in total for all LGPSs (as will normally be the case), disclosures provided (eg. of assumptions) shall be provided in the form of weighted averages or relatively narrow ranges.

3.1.6 Group accounts

3.1.6.1 Subsidiary undertakings

Subsidiary undertakings can be identified by the measure of control exercised by the parent academy trust. FRS 102 outlines how such control can be determined in the context of voting rights (mainly stemming from share ownership) and dominant influence over the board or activities of the subsidiary. This embodies the requirements of the Companies Act which should be followed by those undertakings registered under this Act.

In the majority of cases, subsidiaries of academy trusts will be trading subsidiaries in which the academy owns the entire share capital (and voting rights) of the subsidiary, granting it the required control. However, there may be occasions where control of subsidiaries is less clear and greater consideration will be needed in order to identify control.

A non-company charity can only be regarded as a subsidiary undertaking where the parent academy trust can be shown to be exercising control over the subsidiary, either directly or indirectly. Per the SORP in addition to holding more than half of the voting rights, this can arise in any of the following situations:

f. the trustees and/or members and or employees of the parent academy trust are, or have the right to appoint or remove, a majority of the charity trustees of the subsidiary charity;
g. the trustees and/or members have the power to cast the majority of votes at meetings of the board of directors (or equivalent governing body) of the subsidiary charity; and
h. the governing document of the subsidiary charity reserves to the parent academy trust's trustees and/or members the power to govern the financial and operating policies of the entity under a statute or an agreement.

The basis for treating a non-company charity as a subsidiary is that the connection between it and some other charity is such that the operating and financial policies of the former are likely to be set in accordance with the wishes of the latter. This is likely to be the case where one of the relationships described in the previous paragraph exists, but trustees may, in a particular case, be able to produce evidence to the contrary.

A further instance where the relationship is similar to that of a parent and subsidiary undertaking may arise where the parent academy trust transacts with another undertaking in such a way that all the risks and rewards of the transactions remain with the parent undertaking. For instance transfers of assets to another entity whilst retaining exclusive use of those assets and the costs of maintaining them. Such undertakings are regarded as quasi subsidiaries and should be accounted for in accordance with FRS 102.

The SORP defines a subsidiary as an entity that is controlled by a parent entity. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Although an academy trust is controlled and managed by its trustees, it can be a subsidiary for accounting purposes when the criteria for control are met. As such the scenario above (transfer of assets to another entity whilst retaining exclusive use of those assets and the costs of maintaining them) would lead to the undertaking being classified as a subsidiary.

3.1.6.2 Accounting for subsidiary undertakings

Exemption from the requirement to produce consolidated accounts is usually only available where:

- the income of the group (net of any intra-group transactions) in the accounting period is no more than the audit threshold under the Charities Act (currently £1,000,000); or
- the subsidiary undertaking or undertakings results are not material to the group*.

*The Academies Accounts Direction emphasises that where two or more subsidiaries are excluded from consolidation, they must be immaterial when taken together.

Chapter 9 of FRS 102 allows subsidiaries to be excluded from consolidation in certain limited circumstances. It is unlikely that these exclusions will apply to a group headed by an academy trust except on rare occasions. The difference between profit and not for profit undertakings is not sufficient of itself to justify non-consolidation. However, where a subsidiary undertaking is a registered company, is insolvent and being wound up (in liquidation) then the subsidiary undertaking can be excluded from consolidation on the basis of severe long term restrictions. If a subsidiary is held purely for resale then this would also be grounds for exclusion of the subsidiary in consolidated financial statements.

Consolidated accounts should be prepared for the reporting academy trust and its charitable subsidiary undertakings whether or not the subsidiaries are also companies. However, where the subsidiary undertaking is a non-company charity it will normally be accounted for in the consolidated accounts in the same manner as a branch. Similarly charities, whether companies or not, which use non-charitable subsidiary undertakings to carry out their charitable purposes should prepare consolidated accounts for the academy trust and such subsidiary undertakings.

Accounts for each member of the group, ie. parent and subsidiary undertakings, should be prepared for approval by the respective boards of trustees and/or directors. The consolidated group accounts should then be prepared by the parent academy trust.

Consolidated accounts must be prepared under accounting standards in order to give a true and fair view of the group.

The FRS 102 Triennial Amendments (December 2017) clarified how Gift Aid payments made by subsidiaries to a charitable parent should be accounted for. These changes are reflected in the SORP 2019. In essence, the subsidiary must have a legal obligation to make the payment to the parent, for example a deed of covenant, for the gift aid payment to be recognised at the reporting date.

Where the subsidiary does not have a legal obligation to distribute its profits to its owners at the reporting date by way of gift aid payment, it would have taxable profits and need to recognise a tax expense in profit or loss. However, paragraph 29.14A of FRS 102 requires the tax effects of the expected gift aid payment to be taken into account when it is probable that the gift aid payment will be made within 9 months of the reporting date. Therefore FRS 102 requires the gift aid relief to be recognised at the reporting date before the gift aid payment is reflected in its financial statements in circumstances where there is no legal obligation at the reporting date. The tax charge and corresponding tax relief effectively net off, resulting in an overall nil tax charge. The relief must be presented in profit or loss, in accordance with paragraph 29.22A of FRS 102. 4.2 For further details see 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.

3.1.6.3 Method of consolidation

The normal rules will apply regarding the method of consolidation, which should be carried out on a line by line basis as set out in FRS 102.

All items of incoming resources and resources expended should be shown gross after the removal of intra-group transactions. Clearly it is desirable that similar items are treated in the same way. For instance operating activities for generating funds in the charity should be combined with similar activities in the subsidiary, and charitable activities within the charity should be combined with charitable activities in the subsidiary. Similarly costs of generating funds and or administration costs in the subsidiary should be aggregated with those of the charity.

Each academy trust should choose appropriate line headings within the permissible format of the SoFA and suitable amalgamations of activities. The headings should be expanded and changed to reflect the underlying activities of the group. In practice it may not be possible to find exactly matching items between the subsidiary undertaking and the parent charity in which case segmental information should be provided so that the results of the parent charity and each subsidiary undertaking are transparent.

3.2 Preparation of annual reports

3.2.1 Trustees' report

3.2.1.1 Introduction

The content of an academy's annual report, as required by the Accounts Direction, is principally driven by the requirements of the Companies Act 2006 and the Charities SORP. There are, however, items which are specific to these types of entities and disclosures which are required by the Accounts Direction. The Accounts Direction also provides further guidance in respect of the content of the annual report of an academy which should include the following:

- Report of the trustees;
- Governance statement;
- Statement on regularity, propriety and compliance;
- Statement of trustees' responsibilities;

3.2.1.2 Contents of the trustees' report

The structure of the trustees' report is as follows:

- Objectives and activities;
- Achievements and performance;
- Financial review;
- Structure, governance and management;
- Reference and administrative details;
- Exemptions from disclosure;
- Funds held as custodian trustee on behalf of others;
- Plans for future periods (larger charities only).

The detailed disclosure requirements are set out in the Model Accounts. They are included in the accounts disclosure checklist contained in this manual (see accounts disclosure checklist section of this manual).

3.2.1.3 Common issues

The ESFA communicates common issues identified through its assurance work on academy annual reports and financial statements in the Academies Accounts Direction each year.

The main themes of these issues are:

- example text from the model accounts is copied
- text has not been updated from the previous year
- there are inconsistencies, either within the report or between the annual report and other documents (e.g. the external audit or internal scrutiny reports)

For 2022/23 reporting season, the Academies Accounts Direction highlights the following as specific areas where compliance can be improved:

- when describing the organisational structure in the trustees' report section on structure, governance and management, ensure information is included in relation to any subsidiaries, joint ventures and associates.
- In the governance statement:
    - ensure there is adequate information relating to the governance framework for the audit and risk committee
    - ensure there is an adequate description of the processes in place to manage conflicts of interest in the academy trust. These processes should extend beyond requiring declarations of business interests
    - ensure that processes in place to manage conflicts of interest, for any subsidiaries, joint ventures or associates, are included
    - ensure there is an explanation as to why the academy trust chose a particular option for delivering internal scrutiny
- In the note to the financial statement covering related party transactions, trustees remuneration (Note 12 in the model accounts), trusts should remember to make any relevant disclosures and to disclose the name of any staff member who is also a trustee.

3.2.1.4 Other annual reports

In addition to the requirements for a trustees' report, as outlined above, academy trusts are required to prepare other annual reports for inclusion within their annual accounts and reports.

In addition to the requirements of the SORP, academy trusts are required to produce a strategic report and a directors' report. The SORP committee issued guidance in the form of a SORP Information Sheet 5 on how to implement certain strategic report requirements and this information is reflected in the SORP. The trustees' report generally fulfils the directors' report requirement for charitable companies although, those companies that do not take advantage of small company exemptions, require some additional disclosures. These additional disclosures are included in the accounts disclosure checklist.

As publicly funded bodies, academy trusts must also include a governance statement which gives details of the governance framework of the academy trust and confirmation that the trustees have carried out their responsibility for ensuring that effective management systems, including financial monitoring and control systems, have been put in place. It must also include a review of value for money. A model version of the statement is included in the Model Accounts issued by the ESFA, although this must be tailored to the specific circumstances of the academy trust.

The Accounting Officer must include a statement on regularity, propriety and compliance which is a formal declaration that they have met their personal responsibilities to Parliament for the resources under their control during the year.

3.3 Circulating and filing accounts and reports

The accounts must be filed at Companies House within nine months of the year end, however the Accounts Direction notes that academy trusts should consider filing their accounts at Companies House at the same time as they publish their accounts on their relevant website (see below). As exempt charities, there is no requirement to file an annual return and financial statements at the Charity Commission. The accounts and annual report must, however, also be filed with the Secretary of State for Education through the ESFA no later than four months after the accounting period end (i.e. usually by 31 December). The accounts also have to be published on the academy's website within five months of the year end (ie. the end of January the following year). The website should include at least the previous two years accounts and constituent academies within a multi-academy trust should include a prominent link on their website to the financial statements published on the multi-academy trust website.

A continuing academy is required to electronically file its audited accounts and a copy of audit findings report (referred to as the management letter in the templates ~~this manual~~) issued by the auditor with the ESFA within four months of the accounting period end, usually by 31 December.

3.4 Annual returns

In addition to statutory accounts, an academy is required to make a number of other financial returns to the ESFA in respect of governance and grant funding. Most do not require assurance reports from the trust's auditor but there are some where such assurance reports are required.

Examples of those which require assurance reports from the academy trust's auditor including the Academies Accounts Return, which is used by the ESFA to monitor financial health, for benchmarking purposes and the preparation of a Sector Annual Report and Accounts, as well as expenditure reports for certain streams of grant funding.

These assignments are not covered in this manual and firms should refer to specific guidance from the ESFA and DfE for the requirements for such work.

4 External scrutiny

4.1 Scrutiny requirements

There is no provision for academy audit exemption as the requirement for audit is driven from the academy's funding agreement with the Secretary of State for Education. As academies are exempt charitable companies, the academy requires a Companies Act audit (as opposed to an audit under the Charities Act).

In addition to requiring that the auditor reports upon the truth and fairness of the financial statements, the funding agreement also requires the auditor to report that grants were used for the purposes intended.

Part 4 of the Framework and guide for external auditors and reporting accountants of academy trusts contains guidance on regularity reporting. It is strongly recommended that auditors of academies refer to this guidance.

Section 4.3 of the guidance notes in this manual outlines further information in respect of the regularity reporting engagement.

Arrangements for assurance over regularity for future periods will be confirmed annually by the ESFA.

4.2 Audit

4.2.1 Appointment as auditor

4.2.1.1 Appointment

As charitable companies limited by guarantee, the provisions of the Companies Act 2006 apply to the appointment of academy auditors.

4.2.1.2 Ethical considerations

Before accepting appointment or reappointment the auditor must consider whether they would be permitted to do so under the FRC Ethical Standard and the firms own policies and procedures (including those related to quality management).

4.2.2 Conducting the audit

4.2.2.1 Introduction

The audits of academies need to comply, in all respects, with the requirements of the International Standards on Auditing (UK) - ISAs (UK).

The Financial Reporting Council published Practice Note 11 (Revised) in November 2017 which includes guidance on the application of auditing standards to the audits of charities and is also relevant for auditors of academy trusts.

4.2.2.2 Principal requirements

The ISAs (UK) relating to audit risk, fraud and quality management have a significant impact. The standards generally require the audit team to think about the implications of risk in some depth, and to adopt a rigorous approach in planning and completing audit work.

The standards dealing with risk (ISAs (UK) 315 and 330) require documentation of risk assessments and the audit approach to be adopted. There is an emphasis on auditors gaining an understanding of the entity's objectives and strategies and management's procedures for identifying and addressing business risks, and on the evaluation of the design and implementation of internal controls. Controls must be tested unless the auditor concludes that audit evidence from substantive procedures will be sufficient to reduce the risk of material misstatement to an acceptably low level.

ISA (UK) 240 requires professional scepticism to be maintained throughout the audit, regardless of any past experience of the client's honesty and integrity. The standard includes examples of fraud risk factors and the audit team should consider whether any of these might be present and assess how a fraud might be perpetrated.

Where fraud risk factors are identified, the audit must include additional procedures to address the related risks.

The audit team are also specifically required to discuss risk issues, including the possibility of fraud, as part of the planning process. This discussion should be documented and the engagement partner is responsible for ensuring that relevant issues are properly communicated to any individuals, such as tax or VAT specialists, who have an involvement in the audit but were not party to the discussion.

ISA (UK) 550 recognises that transactions outside the normal scope of the entity's operations can pose a significant threat and that transactions with related parties in general can affect the risk of misstatement. As all academies have a number of related parties and there are specific regulatory and disclosure requirements for academy trusts, this standard affects academy audits significantly.

4.2.2.3 Special features of academies

Knowledge of the academy's activities and organisation is essential for ascertaining the risk of material misstatement arising from fraud, error, or non-compliance with applicable law and regulations. The auditor considers special features of academies (ie. the nature and sources of income, restricted funds, trading and charitable status, taxation and operating structures), in order to plan and carry out audit work effectively and efficiently and to provide a yardstick against which to evaluate the evidence gained from audit procedures.

Sources of income include grants from public authorities and other bodies. Such grants are often made for specific purposes and are subject to conditions, breach of which can have serious implications for the academy trust.

Where academy trusts receive funding to undertake operational activities, the auditor should ascertain whether such income is received under contract (which is generally unrestricted income) or by way of grant for provision of a specific service, (which normally gives rise to restricted income). As well as distinguishing whether the income is restricted or not, the nature of the terms and conditions may affect taxation considerations (eg. the VAT treatment).

4.2.2.4 Groups and components

A component can be significant either due to:

f. its individual financial significance to the group (we will refer to this as 'financially significant.' This may be determined by a percentage to a chosen benchmark (eg. 15% of income or 15% of assets); or
g. because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances (referred to as 'risk significant' in this manual).

The approach should be:

For 'financially significant' components:

- an audit of the component using component materiality.

For 'risk significant' components:

- an audit of the component using component materiality; or
- an audit of one or more transactions / balances (relating to the specific risk areas); or
- specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements.

For non-significant components:

- analytical procedures at group level; or
- an audit of the component using component materiality; or.
- an audit of one or more transactions / balances (where this is necessary to obtain sufficient appropriate evidence on the group financial statements as a whole); or
- specified procedures.

4.2.2.5 Risks arising from an assessment of accounting systems and internal controls

The maintenance of an effective system of internal control is at least as important, if not more so, for academy trusts as it is for other entities, since it is a fundamental duty of the trustees to protect the property of their academy trust and to secure its application for the objects of the academy trust. Failure to do so can render the trustees personally liable for any loss occasioned to the academy trust. Guidance in 'Internal financial controls for charities' - CC8 has been published by the CC and this provides a useful point of reference for auditors.

Accounting Officers are also personally responsibility for ensuring the regularity of transactions by the academy trust, ensuring resources are used for those purposes set out by Parliament.

4.2.2.6 Control environment

The role, attitude and actions of the trustees are fundamental in shaping the control environment of an academy trust. Factors to consider include:

- the amount of time committed by trustees to the academy's affairs;
- the skills and qualifications of individual trustees;
- trustees' understanding of the academy trust and its legal and regulatory environment;
- the regularity and effectiveness of trustees' meetings and the level of attendance at these meetings;
- the adequacy of minutes of trustees' meetings;
- the independence of trustees from each other;
- the policy on dealing with trustee conflicts;
- the processes for managing trustee conflicts of interest;
- the supervision by the trustees of relatively informal working arrangements which are common when using volunteers;
- the degree of involvement in key decision-making or monitoring transactions and engagement with academy staff;
- the attitude of trustees to previously identified control deficiencies;
- the level of delegation by trustees to senior management and the formality of this delegation; and
- the committee structure of the organisation.

The Academy Trust Handbook sets out the requirements of trustees, the Accounting Officer and senior management in terms of the controls and processes they must have in place.

Other features of the control environment will depend on the size, activities, organisation and corporate governance structures of the academy trust but might include:

- a recognised plan of the academy's structure showing clearly the areas of responsibility and lines of authority and reporting.
- segregation of duties which could include involvement of staff from outside the finance department in certain transactions, for example in providing a first signatory for cheques;
- supervision by trustees of activities of staff where segregation of duties is not practical;
- competence, training and qualification of paid staff and any volunteers appropriate to the tasks they have to perform;
- involvement of the trustees in the recruitment, appointment and supervision of senior executives;
- access of trustees to independent professional advice where necessary;
- budgetary controls in the form of estimates of income and expenditure for each financial year and comparison of actual results with the estimates on a regular basis; and
- communication of results of such reviews to the trustees on a regular basis so as to facilitate their review of performance and enable them to initiate action where necessary.

Guidance for trustees "The essential trustee" can be found on the CC website (CC3). Further guidance from the CC27 'It's your decision: charity trustees and decision making' can also be consulted.

4.2.2.7 Fraud

The trustees of an academy are responsible for the prevention and detection of fraud in relation to the academy trust, even if they have delegated some of their executive functions to senior staff. They are expected to safeguard academy assets and reserves through the implementation of appropriate systems of control. The auditor of an academy trust is responsible for forming an opinion as to whether financial statements show a true and fair view and to this end the auditor plans, performs and evaluates audit work in order to have a reasonable expectation of detecting material misstatements in the financial statements arising from error or fraud.

Academy trusts receive funds which have restrictions placed upon them. These funds are held on trust and must be applied to the purpose for which they were given. The misappropriation of funds constitutes a breach of trust or duty, whether it was intentional or accidental. In planning, performing and evaluating the audit work the auditor considers the risk of material misstatement arising from such breaches of trust. Auditors also need to consider the impact of any such breaches of trust on the regularity assurance engagement and their reporting accountant's report. The requirements of the regularity assurance engagement are detailed in section 4.3 of these guidance notes.

The auditor considers the possibility that the academy's records of income to which it is legally entitled may be incomplete as a result of fraud. A common type of fraud against academy trusts is the diversion of donations. Sources of audit evidence as to whether income from appeals and other 'non-routine' sources have been fully recorded can involve the assessment and testing of internal controls, and comparison of donations actually received by the academy trust to past results for similar appeals, to budgets and to statistics for response rates for charities in general. A further example is where an academy recognises income that it may never receive, for instance on the back of an informal pledge for which there is no formal agreement or payment plan, to provide assurance that the pledged monies will be forthcoming.

Certain features of charities may increase the risk of fraud. These include:

- limited involvement of trustees in key decision-making or monitoring transactions and limited engagement with academy staff;
- a wide geographical spread of constituent academies in a multi-academy trust, where income is received at a local level;
- reliance on volunteers and staff with limited management or supervision and a lack of segregation and rotation of duties;
- transactions (income and expenditure) often undertaken in cash;
- unpredictable patterns of giving (in cash, by cheque, and through donations in kind) by members of the public, both in terms of timing and point of donation; and
- diversion of grants payable.

Reviewing the minutes of meetings of the board of trustees, finance committee and audit committee helps the auditor evaluate whether one or more fraud risk factors are present.

A particular difficulty in applying analytical procedures to the audit of academies is that certain items in the financial statements can be very difficult to predict. The usefulness of individual procedures depends on the scale and nature of activities undertaken, but examples of measures that can be adopted include:

- comparison of actual income and expenditure to prior years' figures and trends;
- comparison of actual to budgeted results;
- comparison of actual income to successful bids, legacy notifications and potential legacies reported in the minutes;
- comparison of actual expenditure to the auditor's own estimate of the expenditure that would be reasonable for the particular transaction under review; and
- analysis of efficiency ratios such as staff or administration costs as a percentage of benefits delivered or grants made, or the ratio of operating costs to income (in this respect, care needs to be taken to compare the results of academy trusts of similar sizes, since larger trusts tend to benefit from economies of scale).

When using analytical procedures as main of the audit evidence, the requirements of ISA (UK) 520 must be applied. Section D of your audit programmes highlights those requirements.

4.2.2.8 Communication with the client

Another aspect of the ISAs (UK) is that a distinction is drawn between 'management' and 'those charged with governance'. For many audits, they are one and the same people. However, on academy audits there is a clear distinction between the management of the academy trust and the overall board of trustees.

The exact governance structure will differ dependent upon the type of academy. The board of governors may delegate certain of their functions to sub-committees, such as an audit committee or individual school governing bodies. It will be necessary to identify and understand the governance structure of the academy at the earliest opportunity in order that communication with those charged with governance in addition to management can be made as appropriate.

Under ISAs (UK), the auditor is required to discuss various matters, including:

- the management's / trustees' arrangements for assessing, identifying and responding to fraud risk;
- how, if at all, management / trustees communicate this to each other and to other staff and volunteers;
- any knowledge of actual, suspected or alleged fraud affecting the academy.

Practice Note 11 states that ISA (UK) 260 stresses the need for effective two-way communication between the auditor and those charged with governance. Communication from the auditor need to be understandable and clear and written for an audience of volunteer trustees who may have difference skills and experience than those found in a commercial board of directors.

Prompts of items requiring communication are included within B21~~–1/2~~ at the planning stage and A52-1/2 at the completion stage.

It is unlikely to be the case that all those charged with governance are involved in the management of the academy, as such communication is likely to be required with both parties.

The Accounts Direction notes that the auditor's written communication should usually contain:

- approach to the audit;
- the areas covered by the audit;
- findings, including any significant concerns, if arising including ratings of the importance/risk, e.g. high/medium/low;
- audit recommendations for the period;
- the trust's response to the auditor's recommendations including timescale for action;
- status of any audit recommendations from the previous year.

A copy of the management letter (the 'audit findings report') is submitted to the ESFA with the audited financial statements.

Section 4.3 of these guidance notes also highlight management letter reporting in the context of the regularity reporting engagement.

4.2.2.9 The FRC Ethical Standard

In December 2019, the FRC published the FRC Revised Ethical Standard (2019) which became effective from 15 March 2020. The firms detailed ethical policies and procedures should always be adhered to.

The requirements of the FRC Ethical Standard is effective for audits of academy financial statements in the same way as it is for private limited companies. It is structured as follows:

Part A:

- Overarching Principals and Supporting Ethical Provisions

Part B:

- Section 1: General Requirements and Guidance
- Section 2: Financial, Business, Employment and Personal Relationships
- Section 3: Long Association with Engagements and with Entities Relevant to Engagements
- Section 4: Fees, Remuneration and Evaluation Policies, Gifts and Hospitality, Litigation
- Section 5: Non-audit / Additional Services
- Section 6: Provisions Available for Audits of Small Entities (PAASE) - see below for criteria

The FRC Ethical Standard imposes ethical requirements on firms of auditors and applies to all academy audits undertaken in accordance with the ISAs (UK). Section 5 - Non-audit / Additional Services is likely to have the main impact on academy audit assignments. In addition, Section 6 - Provisions Available for Audits of Small Entities (PAASE) is also likely to be of relevance, as it provides alternative provisions for auditors of smaller clients. Remember, where advantage is taken of PAASE, this is sometimes disclosable in the audit report, with certain disclosures also required in the financial statements.

Ethical threats

Whilst all ethical threats must be identified and described, particular attention may need to be paid to the management and self-review threats in an academy trust. Problems may specifically arise as a result of accounting services and the lack of 'informed management'.

The ES states that unless there is 'informed management' and there are appropriate safeguards there is a risk of the auditor taking a management role. Auditors of academies should therefore record clearly on file who they believe is 'informed management' within the academy where such threats arise. Where problems exist the provisions available for smaller entities may be useful.

Provisions Available for Audits of Small Entities (PAASE)

To qualify for PAASE, an academy must be a 'small entity'. To be a 'small entity', an academy's income must be less than the turnover threshold applicable to small companies in s382 of the Companies Act 2006 (currently £10.2m) and qualify as a small company under s382 of the Companies Act 2006.

Alternative provision

For academies that qualify to apply PAASE, auditors are not required to apply safeguards to address a self-review threat, provided:

- the client has "informed management"; and
- the audit firm extends the cyclical inspection of completed engagements that is performed for quality management purposes, to include some PAASE clients.

It should be noted that if advantage is being taken of the alternative provision, no disclosure of this is needed in the audit report or notes to the accounts.

Exemption

Where advantage has been taken of the exemption against the management threat in the provision of non-audit services, the Responsible Individual should ensure that:

- the audit report discloses this fact; and
- either the financial statements or the auditor's report discloses the type of non-audit services provided.

The sample wording offered to include in the audit report is:

"We are independent of the academy trust in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and the provisions available for small entities, in the circumstances set out in note [X] to the financial statements, and we have fulfilled our other ethical responsibilities in accordance with these requirements."

Sample wording that can be used to include in the note is:

"In common with many other academies of our size and nature we use our auditors to prepare and submit returns to the tax authorities and assist with the preparation of the financial statements."

Other PAASE exemptions are also available - see your firm's audit procedures manual or section 6 of the FRC Ethical Standard for details.

Other services provided to academy trusts

Key ethical threats relating to other services provided to an academy include the following:

Regularity assurance engagement

The work required to provide the additional conclusion on regularity is an 'audit related services' as defined in the ES. These are services closely related to the work performed in the audit and the threats to auditor independence are clearly insignificant. As a consequence, safeguards need not be applied.

Teachers Pensions assurance

Work performed in respect of the EOYC would only be considered as an 'audit related service' for the purpose of the ES if it is integrated with the work performed in the audit, performed largely by the existing audit team and performed on the same principal terms and conditions as the audit. Further detail is provided within the EOYC part of this section of these guidance notes.

Internal Audit services

The revised Ethical Standard, effective for audits of financial statements with periods commencing on or after 15 March 2020, places an outright prohibition on the provision of internal audit services to an audit client.

VAT and tax services

It is unlikely that there be no informed management within the academy. Therefore, to a large extent management threats (in addition to the self review threats which may arise through the provision of many of the usual tax services provided to academies) can be adequately safeguarded.

There is a prohibition against providing tax services that would result in acting as an advocate of an audit client in the resolution of an issue which is material to the financial statements or dependent on a future contemporary audit judgment.

Accounting services

Accounting services provided to academies may include payroll, the preparation of the statutory accounts or other financial returns.

The ES suggests that in order to carry out both the audit and a non-audit service, the client must have informed management and the auditors must include safeguards, which could include:

- accounting services provided by the audit firm are performed by partners and staff who have no involvement in the external audit of the financial statements;
- accounting services are reviewed by a partner or staff member who is not part of audit team;
- the audit of the financial statements is reviewed by an audit partner who is not involved in the audit engagement to ensure that the accounting services performed have been properly and effectively assessed in the context of the audit of the financial statements.

Governance role

Given the need for finance expertise within many academies, employees of firms, persons closely associated with them, or close family members may be approached to sit on governing bodies or sub-committees within the academy.

The ES notes that a partner or member of staff cannot perform a role as an officer, a member of the board or a member of any sub-committee of that board of an audit client. Restrictions also apply where persons closely associated or close family members of covered persons or other staff (including partners) hold similar positions.

4.2.2.10 Opening balances

For initial engagements, we consider whether sufficient appropriate evidence can be obtained to confirm the client's opening balances. Specifically, we confirm:

- opening balances do not contain material misstatement affecting the current year's figures;
- appropriate accounting policies have been consistently applied or, when changed, have been properly accounted for and presented.

If we become auditors of a previously audited academy then there is no responsibility to re-audit the financial statements of the preceding period. The sufficiency and appropriateness of the audit evidence regarding opening balances required by us as incoming auditors depends on such matters as:

- the accounting policies followed by the academy;
- whether the preceding period's financial statements were audited and, if so, whether the auditors' report was qualified;
- the nature of the opening balances, including the risk of their misstatement; and
- the materiality of the opening balances relative to the current period's financial statements.

As incoming auditors normally the audit work on the current period provides evidence regarding opening balances. Other procedures which incoming auditors might perform include the following:

- requesting information from the predecessor auditor;
- consultations with management and review of records, working papers and accounting and control procedures for the preceding period; and
- substantive testing of any opening balances in respect of which the results of other procedures are considered unsatisfactory. Particular emphasis may need to be given to such testing where the previous financial statements were unaudited, although this is unlikely to occur in the academy sector due to the requirement for all academies to be audited.

4.2.2.11 Materiality

Materiality is calculated on the materiality form in the planning section of the manual. See Appendix 1 to these guidance notes for further guidance on completion of the Materiality form.

ISA (UK) 320 suggests that an appropriate benchmark for not for profit entities might be total income with Practice Note 11 also noting expenditure or net assets as being relevant benchmarks. For example, where income fluctuates then a benchmark based on expenditure which may remain stable could be considered. These suggestion are not prescriptive and income may, for example, be adjusted for one-off receipts such as transfers of new academies into a multi-academy trust. Practice Note 11 states that it is relatively rare to use net result for the year as a sole benchmark when determining materiality.

It should also be considered that different benchmarks may be appropriate for different disclosures.

4.2.2.12 Accounting estimates and work of experts

Whilst often unavoidable, the use of accounting estimates in the preparation of the accounts gives rise to increased risk of material misstatement. Accounting estimates are identified and assessed on the permanent file (form **PF1-8** *in Background information*).

ISA (UK) 540 lists a number of examples of situations where accounting estimates, other than fair value accounting estimates, may be required.

One area that is central to academies is the use of estimates for allocating income and expenditure both between different SoFA headings and between different types of funds. Therefore, if it wasn't already highlighted as a key area, classification of income and expenditure may well be a significant area.

Further examples of accounting estimates may include:

- allocation of income / expenditure between SoFA headings (as noted above);
- provision for doubtful debts;
- allowance of costs between funds;
- stock provisions;
- depreciation method / asset life;
- valuation of defined benefit pension schemes;
- valuation of investments;
- valuation of fixed assets (including heritage);
- valuation of income (including donated goods, services and facilities);
- outcomes of litigation;
- outcomes of long term contracts.

During risk assessment procedures, the auditor must gain sufficient understanding of the client's use of accounting estimates. The focus is on estimates with a high level of estimation uncertainty. Examples of situations where there is relatively low estimation uncertainty include non-complex operations, routine transactions, simple methods of estimation or well established models used to make the estimation.

The auditor should also assess the degree to which assumptions may be biased by managers / trustees' of the academy.

An expert is an individual or organisation with expertise in a field other than auditing. In order to comply with ISA (UK) 500 Audit Evidence to the extent necessary, taking into account the significance of the expert's work for the purposes of the audit, the auditor shall:

- obtain an understanding of the work performed;
- evaluate their competence, capabilities and objectivity; and
- evaluate the appropriateness of the work in relation to the relevant audit assertion.

This information and evaluation is recorded on **PF1-7** *in Background information* and appending schedules, as part of work performed to understand the entity and its environment driven from the completion of **PF1-1** and **PF1-2** *both in Background information*.

The work of a management's expert (ie. engaged by the client) will be used principally in two areas in respect of academies; actuarial valuations and property valuation.

Actuarial valuations

An understanding and assessment of key assumptions used by the actuary is required. In the context of LGPS, the scheme actuary may issue standard information for auditors to support actuarial assumptions which can go some way towards providing a basis for assessing the appropriateness of the work. Where this is not the case, communication will be required to ascertain the competence, capabilities and objectivity of the actuary and of the appropriateness of the valuation. Where appropriate, the holders of the pension scheme assets should also be assessed in respect of whether an AAF 01/06 service organisation auditor report is required.

Procedures in respect of the audit of the LGPS surplus / deficit are also included within the Wages, Salaries and Pensions section of the manual.

Property Valuation

Where the academy has procured its own valuation, or chooses to use an ESFA procured valuation in its own accounts, the assessment of competence, capabilities and objectivity should be performed in addition to assessment of the results of the valuer's work. Again, an understanding and assessment of key assumptions is required so as to ensure that the asset valuation as disclosed within the financial statements is appropriate.

For each individual key accounting estimate that is identified using **PF1-8** (in Background information) at the planning stage, we also complete a supporting Key Accounting Estimates Summary to document the risk assessment process specific to that estimate, along with the proposed audit procedures to be performed in response to the assertion risks that are identified. We replace the 'X' in the reference with a corresponding page number, eg. if there are three key accounting estimates, then we will complete three separate forms. (*Key accounting estimates can be recorded using the Key accounting estimates database, or the Q program and template)*

To complete our risk assessment at the planning stage, we detail whether the key accounting estimate poses a significant risk of material misstatement. If so, the risk will also need to be documented on the Risk Assessment.

Having identified the key areas of risk, we determine what our audit approach will be in response. The planned approach will be documented in full on the key accounting estimates audit plan and the **Q audit programme** must be tailored for each key accounting estimate and completed during the fieldwork stage of the audit *or the Key accounting estimates database used*. More detailed guidance on the use of these forms to document the audit approach is provided in Appendix 2a and 2b to these guidance notes. The **Q audit programme** on key accounting estimates is designed to ensure that the detailed requirements of ISA 540 are being complied and that sufficient appropriate audit evidence has been obtained that enables us to be able to draw a conclusion on the reasonableness of the key accounting estimate, regardless of the approach that is being followed to test the accounting estimate.

We then consolidate all our individual accounting estimate work to formulate an overall conclusion for accounting estimates on **A44**.

See ISA s (UK) 500, 540 and 620 and the firm's audit procedures manual for further guidance. Guidance on completing the substantive sampling form can be found within Appendix 3.

4.2.2.13 Going concern

An understanding of the entity and its environment in relation to going concern is considered on **PF1-10** (in Background information) and then an initial risk assessment is made at the planning stage, although we should always be alert to additional events or conditions which may cast significant doubt on the entity's ability to continue as a going concern throughout the audit. An audit plan is included and an audit programme is included for Section **R** along with update and evaluation procedures at the completion stage at **A42**.

See ISA 570 and your firm's Audit Procedures Manual for further details.

4.2.2.14 Subsequent events

In addition to the going concern audit programme within fieldwork, a subsequent events audit plan is included within planning and a subsequent events audit programme (**S audit programme**) has been added to fieldwork to give the same level of prominence. An update and subsequent evaluation of the work is recorded at **A41**.

See ISA 560 and your firm's Audit Procedures Manual for further details.

4.2.2.15 Planning the audit approach

Having assessed risks using the risk assessment forms, materiality and considered the use of analytical procedures etc. auditors should prepare an overall plan, and then tailor the audit programmes to the academy.

More detailed guidance on the use of these forms to document the audit approach is provided in the appendices to these guidance notes.

Often Service Organisations provide services to an academy that are part of the entity's information systems and are significant to financial reporting (eg. a payroll bureau or outsourced accounting function). Where relevant, the auditor is required to consider how the entity's use of a service organisation will affect the audit. In particular, they consider the following:

- the entity and environment (eg. the nature and significance of the services provided);
- where sufficiently significant, details of the background including controls and how they can confirm their design and implementation so that risk can be assessed;
- the audit approach including whether a Type 1 or Type 2 service organisation audit report (per AAF 01/06) is to be used;
- ultimately, whether sufficient appropriate evidence on the related assertions is available from the records held at the client or, if not, how further evidence is to be obtained.

Form **PF1-6** (in Background information) provides detailed guidance on what needs to be recorded. Where the auditor is unable to obtain sufficient appropriate evidence regarding the services provided by a service organisation, they will modify the audit report. Unmodified reports should not refer to the work of the service organisation.

4.2.2.16 Using audit data analytics (ADA) and other technology

Use of technology

The variety of technology and automated tools which are available for use on an audit engagement is incredibly diverse, ranging from relative routine analysis within a spreadsheet, to the use of sophisticated applications which apply algorithms and machine learning, to the use of drones or online applications. Throughout this manual, audit data analytics (ADA) is referred to as a specific category of technology and automated tools. For the purposes of this manual ADA is defined as data analysis techniques (eg. the filtering and sorting of data to identify outliers, anomalies, deviations and other inconsistencies or detection and evaluation of trends and patterns within a data set) which can be used to perform risk assessment procedures, both controls and substantive testing and completion activities. In most cases, audit teams performing such analysis will have the ability to directly control the parameters used within this analysis, although certain applications may draw on the use of algorithms, artificial intelligence and machine learning to aid users with this analysis. Guidance on the additional considerations needed when planning the use of algorithms, artificial intelligence and machine learning is set out below.

The Audit data analytics assessment form within planning should be used to record how ADA and other technology is intended to be utilised on an engagement and how its use has been considered appropriate. Whilst not an exhaustive list, areas where ADA and other technology could be considered are:

- As part of the risk assessment (eg. for its use of part of the preliminary analytical review)
- Highlighting high risk transactions for testing (see below)
- Stratification of populations for sampling (see below).

The use other technology which does not meet the definition of ADA should be recorded on the respective Audit plan form within planning when setting out the audit plan for each area (for example, use of a drone or video technology to physically verify a fixed asset would be recorded on the fixed asset audit plan).

Appraising the use of technology on engagements

The use of technology on engagements can take various forms and each engagement team will need to appraise the use of technology on each engagement. Considerations are recorded on the Audit data analytics assessment form within planning.

Applicability and potential uses of ADA on an engagement

The use of technology is evaluated on a client by client basis and is not deployed as a blanket approach to all engagements. While it is expected certain technologies and in particular ADA will be appropriate to use on the majority of engagements, certain complexities for particular clients may mean its use is not appropriate (such as unusual general ledger posting processes or complex business model meaning common algorithms are less applicable to them etc). Balanced consideration of these factors is recorded on the Audit data analytics assessment form within planning whether ADA or technology is applicable for use.

For clients where the use of ADA is considered applicable, how it is intended to be used is considered. While not an exhaustive list, areas where its use could be considered are:

- As part of the risk assessment (eg. for its use for the preliminary analytical review);
- Highlighting high risk transactions for testing (see below); and
- Stratification of populations for sampling (see below).

Where the use of ADA in other areas is planned, (eg. to gather audit evidence), this should be recorded on the Audit data analytics assessment form within planning and if applicable, on the Audit plan form within planning to confirm the audit plan has been suitable tailored to reflect its use.

Evaluation of the application being used

Before using ADA or other data analysis applications, the system being used needs to be understood and evaluated. Such applications may have been developed either internally or sourced from an external provider, but in either case, individual engagement files need to record how it was deemed appropriate for use. As a minimum this needs to evaluate the integrity of the application being used and the knowledge, expertise, and competence of the developers (whether internal or external to the firm). While the extent of evaluation needed requires an element of judgement in each case, as a general rule the more complex / sophisticated the application being used is, the extent of evaluation required increases.

The evaluation of the independence and expertise of the application developer needs to be considered, much in the same way auditors assess an expert. The application itself needs to have its integrity evaluated, in the same way an internally developed application would. Where the application being used is hosted by a third party, this should be discussed with the client to confirm they understand the role of the third party and respective responsibilities for data handling have been acknowledged and agreed.

Where the use of ADA purely involves analysing data within a spreadsheet, using relatively routine functionality that can be understood and reviewed by most individuals with basic spreadsheet training, this would generally involve explaining which functionality / formula(s) is being used and why they are considered appropriate.

Where a more bespoke ADA application is utilised (eg. one which automates the running of analytical tools based upon parameters within the application), this evaluation needs to be expanded to demonstrate an understanding of the automation within the application, how this has been assessed as reliable and as such is appropriate for use (eg. via user acceptance testing).

For larger firms, some efficiencies may be gained by a central team of experts within the firm undertaking the required testing and evaluation of the ADA application being used, which individual engagement teams then look to draw on when completing the Audit data analytics assessment form within planning, rather than the underlying evaluation of the application being performed by each individual audit team. Where teams use a centrally approved ADA application/functionality, they need to ensure the appropriate version is used on their engagement (i.e. not rolling forward an old version which is now out of date or accelerating the use of a new version prior to it being approved). Where individual engagement teams use a version of an ADA application that has not been tested and approved central, they should document why they are comfortable in using an unapproved version and how it is deemed appropriate for use.

Where an application utilises and relies on an algorithm (eg. use of machine learning or artificial intelligence), it is essential that development of any algorithms used is tracked, along with an audit trail to show how that algorithm has been tested and confirmed as being appropriate for use. It is expected that such testing (and approval for use) will be undertaken by a central team within the firm and that once approved any applications which utilise algorithms will be deployed and used consistently for a fixed amount of time (eg. 1 audit cycle) across all engagements, as this will help to ensure a consistent understanding of the application is in place across the firm. Individual teams looking to use such applications/algorithms with be responsible for confirming and documenting on each file that the version being used is appropriate, referencing where the testing of the version being used can be found and appraising why its use is considered appropriate for that specific engagement (eg there are no specific factors for that particular client which means it would not be reliable).

Evaluating the data to be used for ADA and other technology

Where applicable, each file should record details of the data set being analysed by ADA or other technological applications. In most cases this will be general ledger data, but could vary from audit to audit, with some analysing multiple data sets, from various sources (eg sales ledger, purchase ledger or inventory records from client systems).

Procedures to confirm the application has a complete and accurate data set(s) to be analysed will be performed. For general ledger data, this will generally be done by using the data set for all general ledger transactions during a period to reconcile the opening trial balance to the closing trial balance. The integrity of the data being used is evaluated, in particular considering controls around data extraction and the prevention of the data set being manipulated post extraction and also considering if wider audit procedures indicate any issues with the data set being used (eg. the results the preliminary analytical review) or if audit procedures need to be planned to test the validity of a data set (eg. where sales ledger data is being used, have audit procedures been planned to confirm this is complete and accurate).

Where teams are unable to validate the integrity of the data, then use of ADA is unlikely to be appropriate.

Preparing data for use in an application

In most cases where the application is using general ledger data, the chart of accounts will need to be mapped to the financial statements (eg. which general ledger accounts make up sales, cost of sales etc). While the account mapping will generally be rolled forward from one year to the next (with documentation also being rolled forward), any new accounts will need to be mapped in the first period they are used and an annual review should be performed to confirm if any accounts need to be remapped (eg. as a result of an accounting policy change).

For some uses, the application may also require the different document / transaction types within the clients general ledger data to be defined (for example manual journals, automated subledger posting, reversing journal etc), as these will generally present different levels of risk. As the coding of the different document / transactions types will vary between client systems this will be done for each engagement (although retaining a central firm wide library of system codes may provide some efficiencies should multiple clients use the same accounting software), with particular attention being paid to any bespoke document/journal types used by the client.

Where non-general ledger data is being analysed, the definition of the key data fields used by the application for its analysis will be considered. For example where ADA is being used to analyse aging of debtors, it is likely that the data fields which contain invoice number (as a document identified), invoice date (to determine age) and invoice amount. Where necessary the data fields which need to be defined with any internal experts (or the application developer) are confirmed.

Where sufficient understanding of the parameters needed for the application to analyse the data appropriately cannot be obtained, then use of ADA is unlikely to be appropriate.

Use of audit data analytics (ADA) for identifying high risk journals / transactions

As noted above, ADA can be applied to identify transactions for testing on the basis of risk criteria, including journal entries. This allows testing to be focused more efficiently than it would be using manual sample selection. This could involve using ADA to generate a risk score for each general ledger transaction, which can either be based upon artificial intelligence / machine learning, criteria set manually by the audit team (which is tailored for each client), or a combination of these methods depending on the ADA system being used.

Automated risk scoring

Where transactions have been risk scored using an automated ADA application, the application will usually have preset parameters set by the developer. These need to be understood and evaluated for their use for each client, ensuring they are tailored as appropriate. Given the bespoke nature of such applications, a freeform working paper will be needed to record this assessment, and a prompt to reference this included on the Audit plan form (use of ADA) within planning. For larger firms, some efficiencies may be gained by a central team of experts within the firm undertaking the required evaluation of the preset system parameters, wand this is considered when completing the assessment. Consultation where relevant with the central teams of experts or the application developer to confirm the appropriateness of any tailoring made to these parameters should be recorded.

Manual risk scoring

Where risk criteria are manually applied to transactions (eg when analysing data in a spreadsheet), each of the criteria selected should be allocated a risk score on a scale of 1 to 5 (1 being used for criteria which is considered to be the lowest risk and 5 for criteria which is considered the highest risk). The risk posed by certain factors will vary from client to client, and is tailored based upon the knowledge and experience of each client.

There are various criteria that can be applied when manually evaluating the level of risk posed by a transaction. While not an exhaustive list, common criteria to apply are as follows:

Risk Condition	**Example of criteria that could be applied**
Large amounts	Greater than or equal to performance materiality
Round sum amounts	Amounts which end 000.00, 999.99, 999.00
Unusual description / key word search	Descriptions which include names / titles of key management, directors and other related parties or unusual words such as adjust, correct etc
Transactions posted at unusual times	Journals posted when the office is usually closed, such as weekends or between 7pm and 8am
Back dated transactions	Journals which post to a prior period (i.e. a journal raised in accounting period 3 which is shown in accounting period 2)
Transactions posted and reviewed by the same person	Where a system had a 'park and post' or 'maker/checker' function and these roles have been performed by the same person
Transactions posted by an unexpected person	Journal posted by a senior member of staff/non-finance staff who typically are not involved in day to day ledger posting
Unexpected account combinations	Journals which are posted to accounts which would not typically be linked, for example sales and fixed assets
Transactions which bypass the expected transaction flow	System entries which are usually automated/triggered from a sub-ledger but are posted manually

These risk conditions and examples are not exhaustive examples and teams should also use their judgement to consider additional criteria and tailoring which could be applied relevant to the client. The justification for the criteria selected should be documented on file, with a template within the Audit plan form (use of ADA) within planning being provided for this.

Risk enhancers

To further tailor the risk score, certain ADA applications (both automated and manual) may allow us to enhance the risk score of a transaction by applying a multiple. This may be linked to certain document / journal types or members of client staff considered to present a higher risk, the financial statement assertion risks (eg. a high risk area could receive a higher risk multiple) or certain accounts which are considered inherently riskier due to their susceptibility to fraud. Details of enhancers applied should be recorded on the Audit plan form (use of ADA) within planning.

Manually calculating a transactions risk score

A transaction risk score is calculated by taking the sum of any risk scores triggered by a specific risk condition, which is then multiplied by any applicable risk enhancers (where no enhancer is applicable to a particular transaction, this will be assumed to be a multiplier of 1).

Example risk score calculation

Extract example of a manually applied risk criteria:

Risk condition	**Specific definition for this client**	**Risk score applied**
Large Value	£100,000 (performance materiality)	3
Round sum amount or transaction ending in '999'	Amount ending '000.00'	2
Transaction posted at unusual time	Any posting between before 7.30am and after 8.00pm Monday to Friday and at any time on a weekend	5

Extract example of a risk enhancer:

Risk enhancer	**Multiple to be applied**
Any transactions posted to Revenue	3

Example extract transaction data and scores calculation:

Description	Transaction ID	Account Dr	Account Cr	Value (£)	Time and Date	Risk score
Correction to accrued income	1234	Accrued income	Sales	200,000.00	11pm Friday dd/mm/yyyy	30 [(3+2+5)x3]
Monthly depreciation charge for Motor Vehicles	1235	P&L depreciation (Motor Vehicles)	Accumulated depreciation (Motor Vehicles)	105,000.00	2pm Monday dd/mm/yyyy	5 [(3+2)x1]

Items to be selected for testing

The final element of tailoring is setting the criteria which highlight the transaction to be tested. A risk score is set and any transactions which score equal or greater than this will be selected for testing. Consideration of other specific risk factors which may trigger a transaction to be tested or why it can be excluded from testing (eg. the value of the transaction is trivial or a reversing journals where it can be confirmed the net impact in the period is nil) and the rationale for using is recorded on the Audit plan form (use of ADA) within planning.

Where teams are relying on an algorithm (eg. in which risk scoring is done via machine learning or artificial intelligence), the understanding and evaluation of the appropriateness of the algorithm being used should be recorded on the Audit data analytics assessment form within planning.

Use of ADA for testing and responding to assessed risks

Evaluating the results of testing obtained from ADA

Where we undertake testing utilising ADA, this will generally involve us using the application to develop an expectation for the population being tested. This will draw on our understanding of the entity and ensure the application being used is appropriate for the specific circumstances of the entity.

Upon reviewing the results we may find these are generally in-line with our expectations, with some exceptions that require further testing. However in some circumstances we may find the results do not match our expectations, with a significant number of outliers within the population meaning further analysis is needed before we can begin to test exceptions.

Outliers which cause a deviation to our expectation can arise through one or a multiple of the following factors:

1. Our understanding of the entity was not sufficient to appropriately calibrate and set the parameters within the ADA application.
2. The data may not be of sufficient quality to facilitate the use of the ADA.
3. Our initial evaluation of the appropriateness of the use of ADA for this entity may be inappropriate.

Point two may be overcome through data cleansing activity or discussion with the client to evaluate if a more refined data set is available. Where this is the case we will need to ensure our evaluation on the Audit data analytics assessment form within planning is updated accordingly. Where this is not possible we will need to modify our planned approach accordingly.

The third point will also mean we will need to modify our planned approach accordingly.

For the first point above we may be able to recalibrate the parameters upon revising our understanding of the entity. Should we look to do this, the following points are areas to consider:

- Undertaking careful analysis of the outliers in order to assess which of the parameters used within the ADA require refinement and how this needs to be done. This includes revisiting our understanding of the entity and its environment to determine if parameters can be refined in order to reduce the number of outliers or identify those which are truly exceptions and therefore warrant further investigation as exceptions.
- Discussion with management, in a similar fashion to how we would when refining an expectation when undertaking analytical procedures in line with ISA 520, to understand the underlying data and potential relationships better.

When redefining the parameters used when applying ADA we need to be mindful to not adjust these for inappropriate reasons which include:

- Artificially reducing the amount of work required which ultimately results in obtaining insufficient appropriate audit evidence.
- Attempting to generate the same number of outliers / exceptions as seen in previous periods.
- Adjusting the parameters to compensate for data quality issues.

Once we are comfortable that the ADA application has been configured appropriately such that there are no outliers and any deviations from our expectation are due to true exceptions, we begin substantively testing these.

When testing the exceptions we will first need to consider if the population is homogenous, in which case sampling these can be considered. Where we determine the population is not homogenous we will need to consider if there is scope to stratify the population of exceptions into homogenous sub-populations before beginning sampling and substantive testing of these discrete groups. Where we do stratify the population of exceptions we need to take care that when sampling based on sub-populations, the untested population in a single financial statement line item does not exceed materiality.

Guidance on considerations to make when stratifying populations is given in your firm's Audit Procedures Manual.

For the remaining population (i.e. that which falls in-line with our expectation), we may be able to leverage testing undertaken elsewhere in the audit file in order to gain comfort over the non-exception population. Where this is not the case we will need to consider what additional procedures are needed.

The use of ADA and other technology and ethics

The use of certain ADA applications and / or other technology may allow us to communicate more detailed and meaningful insights to management. However, this does not extend beyond feedback that would be seen as being the normal by product of the audit, into wider commentary and analysis that could be seen as offering business advice that could be used in a managerial decision making process.

4.2.3 Auditor's reports

Example audit reports can be found in FRC Bulletin 'Compendium of illustrative auditor's reports on United Kingdom private sector financial statements (March 2020)', which are prepared in accordance with the requirements of ISA (UK) 700 (Revised November 2019) and ISA (UK) 570 (Revised September 2019). The Bulletin can be found at www.frc.org.uk/auditors/audit-assurance/standards-and-guidance/bulletins. ~~The only example reports included are for companies.~~

Revised ISA 700 requires auditors to explain in the auditor's report to what extent the audit was considered capable of detecting irregularities, including fraud. The Audit and Assurance Faculty of the ICAEW have published two guides for auditors on reporting on irregularities, including fraud and can be found at: https://www.icaew.com/insights/viewpoints-on-the-news/2020/oct-2020/guide-for-auditors-on-reporting-on-irregularities-including-fraud. and https://www.icaew.com/technical/audit-and-assurance/audit/reporting-and-completion/how-to-report-on-irregularities-guide-for-auditors-reporting-for-the-first-time. A29 is completed in order to help auditors and the RI demonstrate the approval of this wording.

Under revised ISA 570, where the auditor concludes the going concern basis is appropriate and no material uncertainty exists, a positive conclusion regarding going concern is now required under 'Conclusions related to going concern' or other appropriate heading.

An academy audit report is required to identify the financial reporting framework that the accounts have been prepared under, which will include specific reference to the Academies Accounts Direction 2022 to 2023 issued by the ESFA.

~~Example audit reports for academies have been updated in accordance with this and can be found in the example reports section of this manual.~~

4.2.3.1 Responsibilities in connection with the trustees' report

ISA (UK) 720 requires that the auditor reads 'other information' included in the annual report (eg. the trustees report) and, in doing so, considers whether it is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit, or otherwise appears to be materially misstated. If material inconsistencies or apparent material misstatements are identified, the auditor must determine whether there is a material misstatement in the financial statements or a material misstatement of the 'other information'. If based on the work performed, it is concluded that there is a material misstatement of 'other information', this fact is reported.

Work undertaken on the trustees' report to satisfy the requirements of ISA (UK) 720 includes evaluation with consistency, comparison of selected amounts with financial statement information and considering whether, in the context of audit evidence obtained and conclusions reached in the audit, there is a material inconsistency with knowledge obtained in the audit.

ISA (UK) 720 includes requirements to understand the requirements for 'statutory other information', how the entity complies with those requirements and perform such procedures as necessary to comply with the relevant legislative reporting requirements.

The auditor reports in accordance with relevant law and regulation and the requirements of ISA (UK) 720 paragraph 22.

In addition to the above, company law requires the auditor to state an opinion based on the work undertaken in the course of the audit as to whether the information given in the directors report and strategic report (if applicable) is consistent with the financial statements and that these narrative reports have been prepared in accordance with the applicable legal requirements.

It is also a requirement to separately state whether in light of the auditor's knowledge and understanding of the academy and its environment obtained during the course of the audit, they have identified material misstatements in the directors report and strategic report (if applicable). The quality of information within these narrative reports will therefore be considered. Members of the team have the skill and experience to use professional judgement to interpret the requirements of legislation in order to be able to assess these opinions.

For academy trusts, the auditor reports in accordance with relevant law and regulation and the requirements of ISA (UK) 720 paragraphs 22 to 22D-1.

~~The relevant example audit reports are included in the example reports section of this manual include these requirements.~~

4.2.4 Ceasing as auditor

As academy trusts are audited under the Companies Act 2006, the auditor cessation requirements of that Act will apply.

In addition, an auditor who ceases to hold office, for any reason, is required 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. The trust must send a copy of the auditor's statement to the ESFA in line with the requirements of the Academy Trust Handbook.

4.3 Regularity assurance

4.3.1 The requirement to report on regularity

The Accounts Direction requires a separate report to be issued, with addressees including the ESFA, to provide a limited assurance conclusion on regularity.

Regularity is the requirement that income received and expenditure disbursed has been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

The ESFA has included guidance on regularity reporting within Part 4 of the Framework and guide for external auditors and reporting accountants of academy trusts.

The approach outlined in the following sections of these guidance notes **must** be read in conjunction with the Accounts Direction and other relevant guidance and auditor instructions.

4.3.2 The Accounting Officer's Statement on Regularity, Propriety and Compliance

A formal signed declaration of the Accounting Officer's responsibilities is required as part of the annual accounts. Though this does not expand their responsibilities in any way, it forms part of the direct assurances provided to the ESFA and DfE that they in turn rely upon for their own audit purposes. An example statement is included in the Reports section of this manual.

The statement confirms the Accounting Officer's and governing body's ability to identify any material irregular or improper use of funds by the academy trust (with monetary amounts if known), or material non-compliance with the terms and conditions of funding under the academy trust's funding agreement and the Academy Trust Handbook. Further, it confirms whether any instances have been discovered and notified to the governing body and ESFA. Fraud, by its inherent nature is irregular and improper, and therefore needs to be included in the Accounting Officer's statement.

The Accounting Officer should also have due regard for, and include in their statement, any items included in the reporting accountants report on regularity.

Where there is a change of Accounting Officer during the period, the new Accounting Officer has to be satisfied that they can support their signing of the statement.

An accounting officer will need to consider the basis upon which they are making assertions within the Statement and also assertions made in the Governance Statement. This should be the starting point for the regularity assurance engagement.

4.3.3 Engaging as the regularity reporting accountant

The ESFA has published its standardised terms of engagement for the regularity reporting engagement within the Accounts Direction. The terms form the basis of engagement between the academy, the reporting accountant and the ESFA. Paragraphs are included within the engagement letter schedule on regularity in Example letters section of the manual, which refers to the terms of engagement available on the DfE website and includes the standard paragraph that is required by the Accounts Direction.

Once the reporting accountant's report is submitted to the ESFA in accordance with the terms, the ESFA will accept that an agreement is formed between the parties. By issuing standardised terms of engagement, the ESFA is not required to sign separate terms of engagement for all academies.

It is strongly recommended that firms undertaking academy audit and regularity engagements consider whether the level of professional indemnity cover held is adequate in light of terms regarding limitation of liability capping for these engagements.

4.3.4 Recording the regularity assurance engagement

The standardised terms of engagement do not refer to ESFA right of access to engagement working papers. As such, though the approach and evidence supporting the regularity conclusion should be clear, the work **can** be performed on the same file. Where testing performed as part of the audit is relied upon to inform the regularity assurance conclusion (dual purpose testing) the test objective(s) and separate conclusions relating to audit and regularity engagements should be clearly documented.

It should be clear from the file which evidence supports the separate regularity assurance conclusion as although much of the evidence will be drawn from existing audit procedures, this is technically a separate engagement.

The Academies SAM includes the following documents to aid the completion of the regularity assurance engagement:

- Regularity Planning Checklist;
- Regularity Risk Analysis;
- Regularity Risk Assessment; and
- Regularity Review and Conclusion.

The audit plans also incorporate prompts to tests which may be used to provide assurance relevant to the regularity assurance engagement.

It is strongly recommended that the "-R" forms are used and audit plans are referred to even where the audit planning has commenced at the time of publication of this SAM. It is also recommended that they are used where a 'freeform' planning approach is being taken. The following sections outline the use of the above documents in conjunction with other audit documentation.

4.3.5 Regularity assurance engagement risk assessment

The regularity assurance engagement requires that an understanding of the framework of authorities which govern transactions is obtained, such that an assessment of risk may be performed to enable evidence to be obtained sufficient to inform a negative form of conclusion.

Within the Academies SAM, the planning process for the regularity assurance engagement is driven by the Regularity Planning Checklist. To aid efficiency, it is preferable for this checklist to be completed at the same time as the audit planning.

Where it is believed there is an issue with a specific academy trust, ESFA communication requests for any relevant information considered necessary to the planning and subsequent delivery of the regularity assurance engagement may be made via the ESFA enquiry form. The ESFA's standardised terms of engagement provide further details.

Risks relevant to the regularity assurance engagement and the planned approach to the engagement are outlined on Regularity Risk Assessment. The risk of material irregularity, impropriety and non-compliance is also concluded on within this form.

Non-compliance in the context of the regularity assurance engagement relates to transactions not conforming to the authorities which govern them and has wider scope than just compliance with the funding agreement and Academies Financial Handbook. This is discussed further below.

Sources of information which may inform the risk assessment may include a number of existing audit planning and permanent file documents including, but not limited to:

Understanding the entity and its environment

As part of the audit documentation, there ought to be relevant consideration of the activities of the academy which may in themselves increase the risk of irregularity. Information such as the length of time that the academy has been in existence, the experience of key management and accounting personnel, the number of locations that the academy operates over (hence affecting oversight) will all be factors to consider in assessing the risk of irregularity.

Significant laws and regulations

ISA (UK) 250A requires that a general understanding is obtained of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework. Auditors must obtain a sufficient understanding of laws and regulations to identify and assess risk. It is not the auditors responsibility to prevent non-compliance with laws and regulations and auditors are not expected to detect non-compliance with all laws and regulation. Auditors should be chiefly concerned with areas that:

- directly affect amounts / disclosures in the financial statements;
- may have a fundamental effect on operations of the academy.

The understanding of the framework of authorities should include an understanding of the articles of association (and charitable objects), funding agreement and Academy Trust Handbook which are the authorities which govern a majority of transactions within an academy. Depending upon the activities of the academy, however, the understanding may also extend to laws and regulations specific to other activities and terms attaching to other sources of income.

Beyond the risk assessment procedures, auditors must maintain professional scepticism and remain alert for the possibility of non-compliance or suspected non-compliance during the fieldwork and completion stages of the audit. Certain procedures on significant laws and regulations are included on **K** section audit programmes (in this context, 'Significant' means those laws and regulations where non-compliance may have a material effect on the financial statements). Written representations from the client are obtained and confirm that they have disclosed all known or suspected instances of non-compliance with laws and regulations.

Beyond this however, in the absence of identified or suspected non-compliance, auditors are not required to perform any further procedures.

Further information pertaining to understanding the framework of authorities as relevant to the regularity assurance engagement is provided in the Accounts Direction.

Internal controls

Where controls in a particular area appear weak or have been in operation for only part of the period then the risk associated with potential irregularity may be increased. An understanding of the oversight affected by the accounting officer and those charged with governance and the quality of policies and procedures in place to ensure compliance will often inform the assessment of risk. Key internal controls identified are also likely to be subject to testing as part of the regularity assurance engagement.

Internal audit / internal scrutiny function

The internal audit department or internal scrutiny function in place throughout the period will have reported on a regular basis. Issues reported may impact on the assessment of risk of irregularity. Also, specific discussion pertaining to fraud will have been performed as part of the audit which would directly impact upon the assessment of risk.

Consideration should be given as to 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 performed in forming the assurance conclusion on regularity and to minimise any duplication of work.

In such cases, the independence, objectivity and competence of the function and the nature, scope and subjectivity of the work performed, should be assessed. Where the work is used, the reporting accountant may evaluate and perform testing on that work to determine its adequacy for regularity reporting. The regularity 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.

Overall, fraud, group and regularity risk factors

Specific consideration of issues which may indicate an increased risk of misstatement or irregularity will be prompted through the completion of the above checklists.

The regularity risk analysis should be used to help identify indicators of increased risk relating to irregularity, impropriety and non-compliance in the period. Risks highlighted may also affect procedures performed as part of the audit engagement. The form may also help to evidence review of the Accounting Officer's own assessment of compliance with funding agreement and Academy Trust Handbook terms, as referenced risk indicators are also requirements of the Handbook.

There will be a risk of irregularity, impropriety and non-compliance within all academies. This risk may be reduced by the absence of some indicators of risk, however, to inform professional judgement in the level of procedures required, the regularity reporting accountant will need to be aware of information relevant to that particular client obtained through informed discussion and assessment with the Accounting Officer, management and potentially governors. It may also be possible that a preliminary analytical review as part of the audit has identified an increased risk of activities being performed which are not in accordance with the framework of authorities.

4.3.6 The planned approach

The approach outlined within the planning section relevant to the regularity assurance engagement should be reflected within individual audit area plans (or freeform planning memorandum). Prompts to tests which may provide assurance as part of the regularity assurance engagement are included on individual area audit plans. Materiality at the planning stage will likely be the same as for the audit engagement though it is important to consider that issues identified may be considered material by nature. Further guidance on the application of materiality is provided within the ESFA guidance.

It should be noted that a number of the tests which are likely to be planned as part of audit procedures may provide assurance as part of this separate regularity reporting engagement, however some additional testing will be required.

Accounts Direction includes example procedures to aid focus of the regularity approach in the following areas:

- Delegated authorities;
- Transactions with connected parties;
- Governance;
- Internal controls;
- Procurement; and
- Income.

The type and extent of testing is entirely dependent upon the assessed risk of material irregularity, impropriety and non-compliance. The example tests provided in the Accounts Direction are incorporated in the regularity risk assessment, the untailored work programmes and highlighted on individual area audit plans as being relevant to the regularity engagement.

4.3.7 Completion and reporting

Steps relevant to the completion stage of the regularity assurance engagement are prompted on **A21-R**. This form is also used to document the reporting accountant's overall conclusion on the engagement.

Where potential irregularities are identified, they should be discussed with the accounting officer and the governing body as appropriate and consideration should be given to modification of the Accounting Officer's own Statement and the regularity assurance report. Where appropriate, a reassessment of risk and additional procedures may be required. Regularity matters will also be reported through the report to management.

A separate representation letter is required which should be obtained from the Accounting Officer. An example letter is included in the Example Letters section of this manual. Representations from the governors (trustees) are included within the example audit representation letter.

The file ought to clearly document how the conclusion has been drawn specifically in relation to the regularity reporting engagement and be clear on the work performed to inform this conclusion. A summary of the work performed should be included either on the audit summary memorandum or on a separate schedule.

Example wording for the reporting accountant's assurance report on regularity is included in the Example Reports section of this manual. Example engagement terms and an example letter of representation for this engagement are also included in this section.

The audit management letter should include matters in relation to the regularity engagement in the following form:

- Issue (including a rating of risk / importance and financial impact).
- Implications / consequence.
- Recommendation;
- Management response (including timescale for change).

Further guidance on materiality and reporting issues is also included within the ESFA guidance.

5 Other reporting requirements

5.1 Reporting To The Regulator

5.1.1 Introduction

Section 156 of the Charities Act 2011 places a duty on the auditors of charities appointed under Sections 144-146 of the Act to report matters of material significance to the Charity Commission. Section 159 of the Act then extends the duty to the auditor of a charitable company appointed under Chapter 2 of Part 16 of the Companies Act, which includes academy auditors. Section 160 of the Act places a requirement on auditors of unincorporated exempt charities to report matters of material significance to the charity's principal regulator rather than the Charity Commission.

Guidance issued by the Charity Commission on reporting Matters of Material Significance notes the following:

"Nothing in the Act disapplies section 159 from exempt charities and so the Companies Act Auditor of an exempt charitable company also has a duty to report any concerns. This duty is modified by section 160 so that the report must be made to the principal regulator rather than the Commission."

Whilst the underlying legislation is unclear in this respect, the above guidance sets out that the Charity Commission would not expect to receive reports in connection with academies. Matters should instead be reported to the principal regulator being the Secretary of State for Education through the ESFA.

The Charity Commission guidance is available at https://www.gov.uk/government/publications/guidance-for-auditors-and-independent-examiners-of-charities and was reissued in April 2020. Further guidance on auditors reporting to the regulator is also included in PN11 and in the Framework and guide for external auditors and reporting accountants of academy trusts, issued by the ESFA.

In the first instance of identifying matters of 'material significance' the reporting accountant is to contact ESFA via its enquiry form.

It is recommended that the audit engagement letter should include appropriate reference to this duty to report matters of material significance to the Secretary of State for Education through the ESFA.

5.1.2 What must be reported?

The duty to report arises where the auditor, in the course of their audit, identifies a matter, which relates to the activities or affairs of the academy or of any connected institution or body, and which they have reasonable cause to believe is likely to be of material significance for the purposes of the exercise by the regulator of its functions.

Auditors are only required to communicate matters described as being of material significance in the context of the regulator's functions. These functions are set out under sections 46, 47 and 50 (inquiries) and 76 and 79 to 82 (power to act for protection of charities) of the Charities Act 2011 (CA11).

Determining whether a matter is reportable involves consideration both of 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 regulator. The regulations do not require auditors 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 academy. However, in circumstances where they identify that a reportable matter may exist, they should carry out such extra work, as considered necessary, to determine whether the facts and circumstances give them 'reasonable cause to believe' that the matter does in fact exist. It should be noted that the work done does not need to prove that the reportable matter exists.

In charity law the term 'material significance' is used to determine which matters should be reported to the regulator. Auditors must report any matters of material significance which they become aware of during their appointment. It should be noted that in this context materiality is not only financial materiality. It includes all matters which would be of material significance to a regulator in carrying out their function such as a safeguarding issue affecting beneficiaries or an issue that could impact on the charitable status of an organisation.

The determination of whether a matter is, or is likely to be, of material significance to the regulator inevitably requires auditors to exercise their judgement. In forming such judgements, 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.

In order to recognise whether a situation is likely to be of material significance to a regulator's function an understanding is needed of those matters which either due to their nature or potential financial impact are likely to require evaluation and, where appropriate, investigation by the regulator.

The CC and hence ESFA will always consider the following to be of material significance and hence reportable where identified during the course of an audit:

- matters suggesting dishonesty or fraud involving a significant loss of, or a major risk to, charitable funds or assets;
- failure(s) of internal controls, including failure(s) in academy governance, that resulted in, or could give rise to, a significance loss or misappropriation of charitable funds, or which leads to significant charitable funds being put at major risk;
- knowledge or suspicion that the academy or charitable funds, including its bank accounts, have been used for money laundering or such funds are the proceeds of serious organised crime or that the academy is a conduit for criminal activity;
- matters leading to the knowledge or suspicion that the academy, its trustees, employees or assets, have been involved in or used to support terrorism or proscribed organisations in the UK or outside the UK (with the exception of matters relating to a qualifying offence as defined by Section 3(7) of the Northern Ireland (Sentences) Act 1998);
- evidence suggesting that in the way the academy carries out its work relating to the care and welfare of beneficiaries, the academy's beneficiaries have been or were put at significance risk of abuse or mistreatment;
- single or recurring breach(es) of either a legislative requirement or of the academy's trusts leading to material charitable funds being misapplied;
- evidence suggesting a deliberate or significant breach of an order or direction made by a regulator under statutory powers including suspending a trustee, prohibiting a particular transaction or activity or granting consent on particular terms involving significant charitable assets or liabilities;
- on making a modified audit opinion, emphasis of matter or material uncertainty related to going concern, notification of the nature of the modification / 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; and
- evidence suggesting that conflicts of interest have not been managed by the trustees in accordance with guidance issued by the regulator and / or related party transactions have not been fully disclosed in all respects required by the Charities SORP, or applicable Regulations.

A whistle blowing checklist is included in this manual which may be completed to help identify possible reportable matters.

5.1.3 Timing of report

In reaching their conclusion as to whether a report is required, auditors may wish to take appropriate advice and consult with colleagues, a professional body or lawyers.

Unless the matter casts doubt on the integrity of the trustees this should not preclude discussion of the matter with trustees and seeking such further advice as is necessary, so that a decision can be made on whether or not a duty to report exists. Such consultations and discussions are however undertaken on a timely basis to enable auditors to conclude on the matter without undue delay.

The regulators expect a report to be made in accordance with the following timescales:

- as soon as possible on becoming aware of an immediate risk to charitable funds, a material loss due to fraud, or doubts as to the integrity of trustees or key management personnel; or
- in instances where the auditor or examiner concludes that the trustees and / or key management personnel are uncooperative, deliberately unresponsive, or unreasonably slow in responding to the auditor or examiner seeking to discuss a reportable matter, then the report is made as soon as possible and in such cases the auditor should include reference to this behaviour in their report; or
- on signing or making a modified audit opinion, an audit opinion with an emphasis of matter or material uncertainty regarding going concern; or
- for those accounts that must be tabled before a Parliament or a Governmental Assembly, once the tabling process has been completed; or
- for other circumstances not listed above, reporting is done as soon as possible following on from any discussion(s) had with trustees.

5.1.4 Contents of a report to the regulator

The Charity Commission has issued guidance on how to report and this is supplemented by further information within the Accounts Direction. Reports should be made to ESFA via the enquiry form.

The auditor should include in his / her report:

- a header 'Matter(s) of material significance reported';
- the auditor's name and contact address, telephone number and / or e-mail address;
- the academy's name;
- a statement that the report is made in accordance with section 156 of the Charities Act 2011;
- under which of the nine headings of reportable matters the report is being made;
- describe the matter giving rise to concern and the information available on the matter reported and, where possible, provide an estimate of the financial implications;
- where the trustees are attempting to deal with the situation, a brief description of any steps being taken by trustees of which the auditor has been made aware;
- if the report concerns terrorist, money laundering or other criminal activity whether you have notified the National Crime Agency and / or Police as appropriate;
- if the report concerns the abuse of vulnerable beneficiaries whether you have informed the Police and / or social services.

Auditors are not relieved of their duty to make a report where an oral report has been previously made or by any informal discussions of the issue. Similarly, they are not relieved of their duty to report on the basis that any other party has provided relevant information, whether written or oral.

5.1.5 Reporting to the National Crime Agency (NCA) and to the Regulator

It should be noted that the submission of a report to NCA under the Anti-Money Laundering Regulations does not relieve an auditor of a duty to report that matter to the Regulator where the information is of material significance to the Regulator's function.

5.1.6 What may be reported?

A separate statutory right (as opposed to a duty) to report to the appropriate regulator also exists and may be used by auditors. Auditors may become aware of circumstances which in their opinion does not give rise to a duty to report to the regulator but which should nonetheless be brought to their attention. Such matters should be considered in conjunction with ISA (UK) 250 'Consideration of law and regulations', and where any report is made auditors rely on the protection afforded by general law.

In May 2019, the guidance on reporting of matters of interest to UK charity regulators was updated. The guidance provides examples of the types of matters that the regulators consider to be relevant. The guidance is available at:

https://www.gov.uk/government/publications/reporting-relevant-matters-of-interest-to-uk-charity-regulators

5.2 Reporting on potential irregularities and non-compliance

Reporting accountants of academies have additional responsibilities in relation to reporting irregularities and non-compliance identified in the course of the regularity assurance engagement.

Issues identified by the reporting accountant should be raised initially with the academy trust's accounting officer and chief financial officer, who 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 accounting officer.

When the reporting accountant concludes that there are matters of material irregularity, this will lead to a modified conclusion of the regularity report, including full disclosure of those matters with the report with monetary amounts if known.

In cases where a modified regularity assurance report is to be issued, the reporting accountant must, as soon as they become aware, notify ESFA using the enquiry form and NAO, via email at academy.returns@nao.gov.uk.

The issues should be fully discussed with the trustees before notifying ESFA and NAO, unless the reporting accountant deems this to be inappropriate due to the nature of the matter(s) identified.

5.3 Submission of audit findings reports to the ESFA

The requirement for academies to submit a copy of their audit findings report to the ESFA does not remove the duty of auditors to make reports of material significance or relating to modified irregularity reports.

The audit findings report includes significant matters arising from the audit of the financial statements and regularity assurance assignment.

Regularity issues should be documented in the audit findings report as follows:

- issue (including a rating of the risk / importance and financial impact);
- implication / consequence;
- recommendation; and
- management response (including timescale for change).

5.4 Teachers' Pensions EOYC reporting requirements

Each year, Teachers' Pensions publish reporting accountants' guidance for its End of Year Certificate certification exercise (TP05). This engagement is an agreed upon procedures engagement and results in the reporting accountant issuing a report of factual findings. Standardised tripartite engagement terms for this engagement are included within TP05, along with the procedures required and guidance on test completion and report submission.

Reporting accountants must be familiar with the requirements and guidance within TP05 prior to commencing the EOYC reporting engagement using the documentation within this manual.

The programmes, example letter and report in *the templates* ~~this manual~~ are based on TP05 (2021/22 Version 1).

6 Other

6.1 Other Sources Of Information

The Education and Skills Funding Agency (ESFA):

- The Education and Skills Funding Agency, Ministerial and Public Communications Division, Department for Education, Piccadilly Gate, Store Street, Manchester, M1 2WD (address for general enquiries)
- Website: www.gov.uk/government/organisations/education-and-skills-funding-agency
- Enquiry form: form.education.gov.uk

HM Revenue & Customs:

- Charities, Savings and International 2, HM Revenue and Customs, BX9 1BU
- Telephone: 0300 123 1073
- Website: www.hmrc.gov.uk/charities
- E-mail: charities@hmrc.gov.uk

Charity Commission:

- Charity Commission, PO Box 211, Liverpool. L20 7YX
- Central telephone help line: 0300 066 9197
- Website: www.gov.uk/government/organisations/charity-commission
- General enquiries form: https://forms.charitycommission.gov.uk/charity-commission-enquiry-form/

Footnote

This manual reflects existing legislation and current best practice. However the sector has seen an increasing rate of change, and the professional adviser needs to keep up to date with relevant developments.

Appendix 1: Notes for completion of planning form B25 - Materiality

Materiality – Notes for completion
The objective of the materiality form is to determine materiality and performance materiality.

Materiality B25

Objective: To determine materiality and performance materiality

For guidance on materiality, refer to Appendix 4 of the guidance notes in this manual. NB. Shaded areas to be completed at the completion stage of the audit.

		Expected Current Year £'000	Actual Current Year £'000
Benchmarks			
Income			
Adjustments for unusual transactions or items			
Adjusted income			
Surplus			
Assets (state "net" or "gross")			
Other			
Basis for determining materiality			
Adjusted income	%		
Surplus	%		
Assets (state "net" or "gross")	%		
Other (specify ____________________)	%		
Justification for materiality level:			
Materiality for the financial statements as a whole			
Justification for performance materiality level:			
Performance materiality			
Amount below which misstatements are clearly trivial			
Audit areas requiring other levels of materiality and performance materiality (e.g. trustees' / directors' transactions / restricted funds):			

Other could include total expenditure or total funds.

State which benchmark from above and the percentage or level to be adopted. ISA (UK) 320 suggests 5% of unadjusted profit may be used for a profit-orientated entity in a manufacturing industry or 1% of income for a non-for-profit entity but other benchmarks and higher or lower percentages may be appropriate.

Materiality on the financial statements as a whole relates to the level at which misstatements (including omissions) individually or in the aggregate would affect the decisions of users of the financial statements. Materiality is not affected directly by audit risk but some of the factors in determining materiality may also lead to increased audit risk.

Conclusions

Planning materiality

The planned levels of materiality are appropriate for this audit.

Prepared by		Dated:	
Reviewed by		Dated:	

Final materiality

The final level of materiality is appropriate for this audit

Prepared by		Dated:	
Reviewed by		Dated:	

Performance materiality is the working level of materiality used throughout the fieldwork as a guide as to which balances and transactions need to be tested.

It is the amount set at less than materiality (ie. for the financial statements as a whole) to reduce to an acceptably low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

Performance materiality may be set at an amount or a percentage of materiality on the financial statements as a whole. This percentage is a matter of judgement but is affected by the auditor's understanding of the entity, updated during the risk assessment procedures, and the expectation of misstatements. For example, where the overall risks are low the auditor may set performance materiality at 90% of materiality. Where the risk of misstatement is higher, the auditor should use a lower percentage of materiality.

Clearly trivial refers to matters which are clearly inconsequential and is of a wholly different (smaller) magnitude than performance materiality (for example the auditor may use up to 5% of materiality). Where there is uncertainty as to whether something is clearly trivial, it should be assumed that it is not.

State the area and the level of materiality and performance materiality.

Revisit the levels of materiality and performance materiality at the closing stages of the audit, and consider if / how this impacts the audit.

Appendix 2: Notes for completion of planning form B40 - Audit plan

Audit plan – Notes for completion
The objective of the Audit plan is to record the risk and approach for the individual areas of the audit. This can be achieved by completing the individual area audit plans on **B40/X2.** Alternatively, you may prepare a free-form audit plan setting out the risks (including the risks in relation to internal control) and the planned approach.

Choice of filing at **B40** or **X2** (eg. for taxation, this example is C2, and for bank and cash, this would be **I2**.

Audit plan - Taxation (including VAT) B40/C2

Objective: To record the risk and the planned audit approach for this individual area of the audit.

For guidance on completing the audit plan, refer to Appendix 5 of the guidance notes in this manual.

Risks identified

Note factors which affect risk (including fraud risk). Refer to specific audit assertions.

Note any factors which affect risk (including fraud risk) and state whether there are any significant risks identified in each area. The risk factors and risks identified should be considered at the specific audit assertion level.

Audit approach

Current / deferred tax
Occurrence, Completeness, Accuracy, Cut-off

Audit programme(s):	Tests of control ☐	Non-audit procedures ☐	Analytical procedures ☐	Other substantive procedures ☐

VAT
Occurrence, Completeness, Accuracy, Cut-off

Audit programme(s):	Tests of control ☐	Non-audit procedures ☐	Analytical procedures ☐	Other substantive procedures ☐

Where tests of control or other substantive procedures require sampling then documentation regarding the sample sizes is required. If a sampling plan is used, a cross reference to the relevant plan is required. Where judgement is used then justification of the determined sample size would be stated. Justifications may relate to size of population, risk, performance materiality, other work performed etc. Further guidance on sampling is provided in Appendix 1.

Sampling

Cross refer to sampling plan(s) or if judgemental, document justification of planned sample sizes.

Prepared by		Dated:	
Reviewed by		Dated:	

The audit approach is split into relevant areas (ie. for taxation, split between current and deferred tax) and the key assertions for those areas identified. The team should document the justification for audit tests to be performed in order to address the identified key assertions.

The audit tests documented will help to decide which audit programmes are to be used (eg. non-audit procedures and other substantive procedures). The relevant boxes are then ticked.

When tailoring the detailed programmes form the audit plan, section A should always be required as it contains general and mandatory procedures such as confirming the design and implementation of systems, agreeing the financial statements to the underlying accounting records and other mandatory ISA testing.

The audit programmes generally include test of controls in section B, non-audit procedures in section C, analytical procedures in section D and other substantive procedures in section E. Either E (blank programme) is used to record any additional tests for objectives not achieved by other testing or the full F test bank is used. Tests should be tailored / deleted as appropriate.

Accounting estimates (Q), going concern (R), and subsequent events (S) only include section A (general and mandatory tests) and do not include the audit programme(s) tick boxes.

A plan for each key accounting estimate (as included on the **B32Xs**) is required on **B40/Q2**.

Appendix 2.1: Notes for completion of planning form B40

Audit plan - Trial balance (use of ADA)

Audit plan - Trial balance (use of ADA) – Notes for completion
The objective of Audit plan - Trail balance (use of audit data analytics) is to tailor the use of ADA when being used to identify journals/significant unusual transactions for testing. This form is only necessary where audit data analytics (ADA) is planned to identify high risk transactions for testing.

To confirm if an automated or manual ADA application is being used to risk score transactions, including an indication of where the parameters used for the risk assessment are set out and have been assessed. For automated, it may be easiest to reference to a printed schedule from the application alongside clear justifications on the parameters.

For manual scoring, indicate if a particular criterion is considered relevant or not (Y/N). NB. the list of risk conditions is not exhaustive and customised risk conditions should be added where relevant.

The specific criteria to be applied to should be defined (eg. what is considered to be a 'large value').

A risk score to be applied should be noted (1 being for the lowest risk and 5 being for the highest risk).

Any risk enhancers should be defined (eg. what particular risk criteria exist which means the risk score for certain transactions should be enhanced by a multiple).

The risk multiple should be recorded.

Audit plan - Trial balance (use of ADA) B40/N2(ADA)

Objective: To record the use of audit data analytics (ADA) when being used to identify journals / significant unusual transactions for testing.

For guidance on completing this audit plan, refer to Appendix 5.1 of the guidance notes in this manual.

B21 must be completed to appraise the use of ADA.

Risk criteria to identify high risk journals / transactions

Transactions have been risk scored using an automated ADA application. The parameters used by the system (including details of any tailoring specific to this client), with justification for why these are considered appropriate are set out on sch______.[1]	☐
Transaction risk criteria is being applied manually[2]. Tailoring of the risk criteria for this client is detailed below or on sch ____.	☐

Risk criteria to be applied manually:[3]

Risk condition	Relevant for this engagement (Y/N)	Specific definition	Risk score applied	Justification
Large value				
Round sum amounts or transactions ending '999'				
Unusual description / key word search				
Transactions posted at an unusual time				
Back dated transactions				
Transactions posted and reviewed by the same person				
Transactions posted by an unexpected person				
Unexpected account combination(s)				
Other (describe):				

Risk enhancers

If applicable, risk enhancer multiply to be applied[4]:

Risk enhancer	Multiple to be applied	Justification

Items to be selected for testing

Criteria to select or exclude transactions for testing[5]:

	Criteria	Justification
Transactions with a risk score[6] equal or greater than:		
De minimis threshold below which journal values can be excluded from testing:		
Other criteria specifically triggering a journal to be tested:		
Other criteria specifically triggering a journal to be excluded from testing:		

Prepared by		Dated:	
Reviewed by		Dated:	

1. The assessment of automated risk scoring is likely to require a freeform assessment. See Section 7 of the guidance notes in this manual.

2. Manual risk scoring is likely to be done in a spreadsheet or similar. See Section 7 of the guidance notes in this manual.

3. Example risk criteria is given in chapter 7 of the guidance notes in this manual.

4. For guidance on the use of risk enhancers to emphasise risk factors for a transaction by applying a multiple to the risk score, see Section 7 of the guidance notes in this manual.

5. Judgement is required when determining the criteria to select transactions for testing., see Section 7 of the guidance notes in this manual.

6. An example risk score calculation is given in Section 7 of the guidance notes in this manual.

The criteria to trigger a transaction to be considered high risk and which should be tested should be recorded (eg. high risk score). Any criteria which would mean a transaction could be excluded from testing should also be recorded here (eg. below a trivial value).

Appendix 3: Notes for completion of substantive sampling forms (p/c on or after 15 Dec 21)

ISA or ES para

Substantive sampling approach

General information

Introduction

This methodology includes two different sampling approaches. One is for judgemental sampling (and incorporates a sample cap), the other is a statistical sampling approach (which does not incorporate a sample cap). Whilst a different approach may be used on different audits, it would be difficult to justify mixing and matching the different approaches on the same audit. For many audits, particularly where populations are smaller, the judgemental sampling approach will be appropriate, however it is not suitable for use on the audits of PIEs or other audits where the populations are very large. The firm's policy should also be consulted, as some firms may mandate the use of the statistical sampling approach in all cases.

A sample size calculated using either of the substantive sampling approaches is derived on the basis that little error is expected in the population being tested. If this is not be the case and a number of errors are likely, then the form is not appropriate and the level of testing should be set judgementally at a level considered to be sufficient to provide adequate audit assurance. In these cases testing levels are likely to be considerably in excess of the numbers calculated using either of the approaches.

The substantive sampling forms require the documentation of a number of qualities of the test being performed and population being tested in order to evidence due consideration of those factors. The forms encourage the extraction of significant and other key items which would be tested in addition to the calculated sample size for the residual population. This sample size for the residual population is determined by reference to the assessed risk in the population, the planned reliance on other procedures and the size of the residual population. Key factors to consider when completing the substantive sampling forms are highlighted below.

Definition and expectation of error

Errors should be defined when designing the sample. The definition of an error is important because the errors found in a sample will be projected (extrapolated) across the population being sampled.

As noted above, where the expectation of an error occurring is more than low, we should set the sample size judgementally at a level considered to be sufficient to provide adequate audit assurance.

Stratification

Where appropriate, we should divide a population into discrete sub-populations which have an identifying characteristic, this process is termed stratification.

The objective of stratification is to reduce the variability of items within each sub-population (stratum) and therefore allow a reduced sample size to be taken without increasing sampling risk. If revenue is generated in a number of different ways by the entity, it is likely to be appropriate to split each type of revenue into a different stratum, for example. *530.5, 530 App. 1*

Where there is little variation in the population stratification may not be required. For example, if testing debtors for membership fees, stratification may not be necessary as there is little or no variability in the population.

Consideration should be given to increasing the sample size if the population contains sufficient variability to warrant stratification, but a decision is taken not to stratify.

When performing substantive tests of details, the population may be stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement.

Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

If values are not known (eg. unpriced stock), then the population may be stratified in some other way, for example by quantity or by type.

If a class of transactions or an account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

The value of residual population to sample

There may be certain items in the population that we wish to test specifically. This may be due to either their value or some qualitative characteristic (eg intra-group items, transactions or balances with related parties, etc.). We will remove these items from the population and test them separately.

When designing a sample, we determine a level of tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality to a particular sampling procedure and may be the same amount or an amount lower than performance materiality. *530.5*

All items greater than tolerable misstatement should normally be treated as individually significant items. These, along with other key items, are extracted from the population and examined separately. The residual population is then sampled.

Method of selection to use

Once the sample size has been determined we will use one of the following methods to select the sample: *530 App 4*

- random selection;
- systematic selection (ie. every "nth" item);
- monetary unit sampling (items with greater monetary value have a proportionally greater chance of being sampled); or
- haphazard selection (not generally recommended but may be necessary where documents are filed alphabetically).

Whichever method is chosen, the following criteria need to be observed:

- items chosen must be selected in such a way that we can reasonably expect them to represent the whole population;
- each item in the population must have a chance of being selected; and
- conscious bias must be avoided.

Some form of systematic selection is frequently used to arrive at the items to be sampled, although random selection can also be used.

Example: Systematic selection of a sample

c. A sample of 30 items is required from a population of 4,000 items. The sampling interval would be 4,000 / 30 = 133. A random start should be taken from within the first 133 items with every 133rd item chosen thereafter.

d. A sample of 20 items is required from a day book of 50 pages. A random start point somewhere between pages 1 - 10 would be chosen then an item would be sampled from every 2nd page. Depending on the number of entries per page a random number calculator could be used to select a line on each of the pages to be sampled.

Accounting estimates

Sampling techniques are unlikely to be utilised when testing accounting estimates, however certain accounting estimates such as depreciation / amortisation calculations may utilise a sampling approach. Care is needed here regarding clarity over the assertion(s) being tested.

Sample size calculation - Judgemental sampling

When determining the sample size for the residual population in a substantive test of detail the initial sample size will be 60 items. Note that where there are different income or expense streams, that have different systems, each of these should be treated as a separate population – i.e. the each stream will need to be sampled separately, with each stream having an initial sample size of 60. This number can be reduced based on various deduction factors that are dependent upon the following:

- the risk of material misstatement associated with the population being tested;
- the planned level of reliance placed on the operating effectiveness of controls;
- the strength of analytical and other related substantive procedures; and
- the size of the residual population (adjusted via a 'materiality factor').

The following table highlights the level of deduction available in each instance. This is followed by guidance on the application of judgement in taking deductions available.

Assessed inherent risk in population		**Planned reliance on internal controls**		**Analytical and other related substantive procedures**		**Materiality factor**	
Level	No.	Level	No.	Strength of evidence	No.	Value	No.
1	20	High	20	Strong	20	Under 15	20
2	15	Medium	10	Moderate	10	15-27	10
3	10	None	0	Weak	0	Over 27	0
4	5						
5	0						

Assessed inherent risk in the population

The assessed inherent risk in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

This assessed inherent risk in the population will depend on the audit area and the particular assertion being tested. For example, it may be deemed within a population of stock that the existence assertion is at a lower risk of material misstatement than the valuation assertion. This could be due to the stock existence being easily verifiable whereas the valuation within the population could be subject to complex accounting estimates. Therefore we may deem it appropriate to calculate separate samples for the existence and valuation testing.

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, eg, valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

Planned reliance on internal controls

Where we only evaluate whether relevant controls are designed effectively and determine whether they have been implemented, we cannot reduce the substantive test sample size for any reliance on controls - this can only be done where we have tested their operating effectiveness.

Tests of operating effectiveness of internal controls are often designed to provide either a high or moderate level of reliance and therefore risk reduction.

- A high level of reliance (low level of risk remaining) applies where the primary evidence is coming from tests of controls.
- A medium level of reliance (medium level of risk remaining) applies where the tests of controls will be combined with other substantive procedures to address a particular assertion.

The type of controls being tested may influence the level of reliance to be placed on them. For example, a control applied to all items in the population is likely to provide a sounder basis for reliance than one only applied to certain types or sizes of transactions.

The extent to which we test controls for the planned level of reliance is a matter of professional judgement; however, in ascertaining an appropriate sample size for tests of controls we may use the tests of controls sampling form.

Analytical and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg. sales or debtors, or the population could be disaggregated into its component parts, eg. different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may “take credit” for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

Materiality factor

The materiality factor is calculated as follows:

total value of population / materiality = materiality factor

The lower the resulting figure for the materiality factor the greater the reduction in sample size. Thus, not surprisingly, the larger the value of the residual population relative to materiality the greater the value of the materiality factor and the larger the final sample size will be.

Where a different specific audit area materiality is set on the **B25** then this materiality rather than the overall materiality should be used to calculate any sample sizes for that particular area.

Minimum sample size

Small samples have an increased risk of being unrepresentative and unreliable. If the total population comprises a relatively small number of items, say fewer than 50 items, then alternative procedures should be considered in place of sampling. For example, this might include analytical procedures or a review for unusual items.

When the calculated sample results in a sample size of 15 items or fewer, then alternative audit procedures should be considered as outlined above. If these are not appropriate, then the minimum sample size should be 15 items.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

Justification

Since this is a judgemental sampling approach, it is necessary to justify the sample size used. The substantive sampling form includes appropriate space to document this justification. It is not acceptable to simply state that that it is appropriate because that is what was calculated by the approach – this is simply an indicative guide to be used as a starting point.

Example: Transaction tests on income

We have established the following:

Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Assessed inherent risk in population	= 1
Planned reliance on internal controls	= High
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor	= 30

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(20)
Planned reliance on internal controls	(20)
Analytical and other related substantive procedures	(10)
Materiality factor	(0)
Total sample size	**10**

However, the sample size will still be 15 (ie. the minimum sample size) which would therefore require 15 items to be tested substantively.

Alternatively, we may choose not to place any reliance on internal controls and therefore not test the operating effectiveness of controls. The resulting substantive sample size would be 30 items, with no tests of control being necessary. This, in practice, may be a more cost effective approach.

Example: Testing existence of debtor balances

We have established the following:

Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Assessed inherent risk in population	= 3
Planned reliance on internal controls	= None
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor (Residual population value / materiality)	= 250,000 / 10,000 = 25

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(10)
Planned reliance on internal controls	(0)
Analytical and other related substantive procedures	(10)
Materiality factor	(10)
Total sample size	**30**

Example: Testing valuation of stock lines

We have established the following:

Total population value	= £200,000
Monetary value of items over tolerable misstatement	= £130,000
Number of items over tolerable misstatement	= 7
Number of other key items	= 0
Residual population to be sampled	= £70,000
Assessed inherent risk in population	= 5
Planned reliance on internal controls	= Moderate
Reliance on analytical and other related substantive procedures	= Moderate
Materiality factor (Residual population value / materiality)	= 70,000 / 7,000 = 10

Therefore substantive sample size:

Initial sample	60
Less deductions for:	
Assessed inherent risk in population	(0)
Planned reliance on internal controls	(10)
Analytical and other related substantive procedures	(10)
Materiality factor	(20)
Total sample size	**20**

Therefore, the total number of items to examine will be 27 items (20 sample items + 7 individually significant items).

Sample size calculation - Statistical sampling

When determining the sample size for the residual population in a substantive test of detail the sample size will be based on:

- the risk of material misstatement associated with the population being tested;
- the strength of analytical and other related substantive procedures;
- the tolerable misstatement; and
- the size of the residual population.

Tolerable misstatement is defined in ISA 530 as 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. The tolerable misstatement cannot exceed performance materiality.

Risk of material misstatement

The assessed risk of material misstatement inherent in the population relates to the susceptibility of a relevant assertion (or assertions) within the population to a misstatement that could be material, either individually or when aggregated with other misstatements. It should have been assessed as part of the risk assessment process.

This assessed risk in the population will depend on the audit area and the particular assertion being tested. For example, it may be deemed within a population of stock that the existence assertion is at a lower risk of material misstatement than the valuation assertion. This could be due to the stock existence being easily verifiable whereas the valuation within the population could be subject to complex accounting estimates. Therefore we may deem it appropriate to calculate separate samples for the existence and valuation testing.

Examples of factors which may affect the risk assessment include:

- misstatements identified by the audit team in prior audits;
- unexplained relationships identified at the preliminary analytical review stage;
- complex financial reporting which requires specialised skills, e.g. valuations;
- the involvement of significant judgements or estimates;
- significant related party transactions;
- the potential for fraud or misappropriation;
- recent changes in the related accounting system; and
- the expected and tolerable misstatement within the population.

The risk of material misstatement will also be affected by the control risk. Where a controls based approach is taken to the audit, and it is possible to place reliance on relevant controls (the operating effectiveness of which will be tested as part of controls testing), this may serve to reduce the risk of material misstatement – see *Identified risks* **B30**.

Analytical and other related substantive procedures

The level of reliance which can be placed on analytical and other related substantive procedures is specific to each situation and so is an area where we will need to apply professional judgement.

The degree of reliance on analytical procedures will generally depend upon:

- **The predictability of the relationships relevant to the assertion** – in general, predictability tends to be greater for profit and loss account items than for balance sheet items.
- **The level of detail of the analytical procedure** – for example, analytical procedures may be applied to the overall population, eg. sales or debtors, or the population could be disaggregated into its component parts, eg. different types of sales or classes of debtors.

Care should be taken that undue reliance is not placed upon analytical procedures which provide little assurance.

The extent of sample size reductions based on analytical procedures should have a direct link to the effectiveness of the analytical procedure in detecting the same errors as the test being performed on the sample items.

The reference to "other related substantive procedures" does not solely refer to analytical procedures, but includes other tests of details within the same cycle that provide evidence regarding the monetary correctness of a financial statement assertion. For example, if subsequent cash receipts are examined in conjunction with the determination of the reasonableness of the valuation assertion for debtors, the audit team may "take credit" for the fact that this procedure also provides evidence as to the existence of debtors – the same assertion being tested by the debtors sample.

Although evidence from other substantive procedures can be obtained from any procedure within the same cycle, it is important to remember that the procedure has to provide evidence in respect of the assertion being tested.

The strength of analytical and other related substantive procedures is ultimately a matter of professional judgement, however the following should be considered:

- Weak analytical and other related substantive procedures would generally be where no such procedures were undertaken, or would include simple variance analysis, or other limited procedures which do not confirm to the requirements of ISA 520 Analytical Procedures.
- Moderate analytical and other related substantive procedures would generally include analytical procedures in conformity with the requirements of ISA 520 Analytical Procedures in addition to at least some other substantive work.
- Strong analytical and other related substantive procedures would generally include detailed analytical procedures in conformity with the requirements of ISA 520 Analytical Procedures and extensive further substantive procedures over the population in addition to the testing to be performed on the sample.

Total number of items to be examined

The total number of items to be examined is equal to:

- the number of items over tolerable misstatement; plus
- the number of other key items; plus
- the sample size for the residual population.

Note that in some cases it's not possible to calculate a sample size using the statistical approach. This occurs where the analytical and other related substantial procedures are strong and the risk of material misstatement is very low, low or medium; or where the analytical and other related substantial procedures are moderate and the risk of material misstatement is very low. In such cases, statistically, the planned test of details may not be necessary unless specified by regulation or other standards.

Example: Transaction tests on income

We have established the following:

Total population value	= £6,100,000
Tolerable misstatement	= £75,000
Number of items over tolerable misstatement	= 0
Number of other key items	= 0
Risk of material misstatement	= High (4)
Analytical and other related substantive procedures	= Weak

The high risk of material misstatement, coupled with the weak analytical and other substantive procedures would result in a confidence factor of 2.30. The substantive sample size would therefore be (£6,100,000 x 2.30) / £75,000 = 188. This would also be the number of items to be tested in this case.

If stronger work was undertaken on analytical and other related substantive procedures, this can significantly reduce the sample size. For example, if instead the analytical and other related substantive procedures were Strong, the confidence factor would instead be 0.41 and the sample size would only be 34 items.

Of course, in order to change the strength of analytical and other related substantive procedures, additional such procedures would need to be undertaken.

Example: Testing valuation of stock lines

We have established the following:

Total population value	= £200,000
Tolerable misstatement	= £7,000
Number of items over tolerable misstatement	= 7
Monetary value of items over tolerable misstatement	= £130,000
Number of other key items	= 0
Risk of material misstatement	= Very High (5)
Analytical and other related substantive procedures	=Moderate

The very high risk of material misstatement, coupled with the moderate analytical and other related substantive procedures would result in a confidence factor of 2.08. The substantive sample size would therefore be (£70,000 x 2.08) / £7,000 = 21. The total number of items to be tested would therefore be 28 (21 + 7).

22.3 Getting started for new manual users

Introduction

This 'Getting started' guidance will help you to use the Mercia Academies Manual. You may be a regular user of our products or this may be the first time that you have used such a manual. Either way these notes will help you understand the Mercia approach and how to maximise the benefits of the package.

Guidance

You will find the following documents in this section of the Academies Manual:

- a contents page;
- guidance notes on the academies sector
- this getting started guidance for new manual users; and
- What's Changed, which provides a summary of the changes made to the manual in the most recent updates.

Audit approach

The Mercia approach encourages you to adopt a thinking rather than a form filling approach. This is achieved in two main ways:

- Through the use of permanent information. If something that you record is unlikely to change significantly from one year to the next, we believe it is better that this is recorded properly once and then rolled forward (updating where necessary) each year.
- By encouraging those completing audit work not to file surplus copy documentation thus generating the need to sign off, date and evidence as reviewed the excess paperwork. Where additional paperwork is considered necessary, the system encourages you to file these on a non-audit section of the file.

The planning approach (the Permanent File Documents and section B within the Current File Documents)

The key to an effective audit is effective planning. The various steps to be undertaken at the planning stage (such as updating your knowledge of the client, calculating materiality, etc.) are driven by the planning checklist which is filed within the Current file documents planning documentation.

There are different approaches to completing the planning documentation. For more straightforward assignments, as an alternative to completing many of the standard current planning forms, you may choose to adopt a 'free-form' planning memorandum.

In such cases, you may opt for the Mercia proforma free-form memorandum which must also be completed alongside the free-form memorandum planning checklist and the other documents provided within this section, where required, to ensure you have covered all necessary matters.

Whilst completing the memorandum, you should read guidance provided on what is required in certain areas.

It is for the firm to decide the criteria as to when the free-form planning memorandum should be used to replace other standard forms. We recommend that such criteria include:

- the client has been audited by the firm for at least the immediate preceding period;

- there has been no history of controversial issues arising from the previous audits;
- the client qualifies as small as per company law or contains characteristics indicative of a simple business as set out below.

The following characteristics may be indicative of a simple business:

- ownership is concentrated in a small number of individuals (sometimes a single individual) who are actively involved in managing the business; and
- the operations are uncomplicated with few sources of income and activities; and
- business processes and accounting systems are simple; and
- internal controls are relatively few and may be informal.

Such entities are likely to include companies which are exempt from audit, but which choose nonetheless to have a voluntary audit, small subsidiary companies, as well as larger entities that are also relatively simple.

The fieldwork approach (sections C onwards within the Current File Documents)

Once the audit plan has been formed and tailored audit programmes have been produced (see the section named 'The structure of each audit section' within these notes), the audit evidence should be obtained in accordance with these programmes.

To assist in the recording of the detailed procedures at the fieldwork stage, you may find it useful to use some or all of the proforma working papers included in the manual.

The completion approach (section A within the Current File Documents)

At the completion stage, the planning must be reviewed alongside the evidence obtained and all matters need to be drawn together and concluded upon. Completion of the appropriate forms on this section (including a full record of review points, notes of discussions with the client and evidence of clearance of all of these points) will help to achieve the required objectives.

The current file

The current audit file provides the documentary record of the audit and constitutes the evidence of what was done and why. In conjunction with the permanent file, it supports the report on the financial statements.

The report not only consists of the opinion but also contains a statement that the audit has been carried out in accordance with auditing standards, thus the two files must demonstrate compliance with the International Standards on Auditing (ISA) (UK), the Ethical Standard and any other regulatory requirements.

The principal objectives of the current audit file are to provide:

- evidence of the planning process (including the risk assessment procedures) and any changes from the original plan;
- a record of the nature, timing and extent of auditing procedures undertaken, the results of such procedures and conclusions drawn;
- a record of the figures included in the financial statements, and evidence supporting these figures;
- evidence of control and review;

- a record of problems encountered, weaknesses discovered, and any contentious issues raised and how they were resolved;
- a record of communications with the client relevant to the audit; and
- evidence of the opinion formed.

The permanent file

The principal purpose of the permanent file is to improve the efficiency of the assignment by providing a good understanding of the organisation. It is an intrinsic part of the audit assignment. Therefore, the permanent file must be comprehensive and up to date. Each year the permanent file should be reviewed, updated and signed to evidence that this has been done.

The permanent file contains information of a permanent and semi-permanent nature, being information, which will be of continuing importance to assignments over a number of years.

Although there is a standard index to the file, as with all aspects of an audit, the file should only contain mandatory information required to comply with auditing standards and other legislation and regulation along with information which will aid the efficiency of the audit. The content and form of the file is therefore likely to be different for each client and must be decided upon by the Responsible Individual and manager.

However, a permanent file will normally include the following information:

- information concerning the legal and organisational structure of the organisation, including information regarding related parties and any group structure;
- extracts of important legal documents and agreements;
- any sector specific data;
- details of the accounting systems and internal control environment;
- an appraisal of those systems;
- a summary of key ratios and figures over a period of years; and
- accounts information of ongoing value.

The Mercia approach also encourages users to develop tailored audit programmes which can be held on the permanent file. If held on the permanent file, in future years these must be reviewed and, if necessary, updated as appropriate.

The structure of each audit section

Divider cards (see Current file indexes within the Current File Documents)

The divider cards include recommended standard references for working papers as well as the conclusions for each section of the audit file.

The audit conclusions should be signed by the person completing the work and should then be signed by the reviewer.

Audit plan

Where individual audit sections have been planned separately using the standard individual area audit plans, a copy of the working paper can be placed on the planning section, the permanent file and / or the front of each section of the audit file (where it is filed behind the relevant lead schedule, as this helps to ensure that the section is audited in accordance with the plan).

The use of the individual area audit plan schedules also helps to focus the selection of appropriate audit programmes.

Audit programmes

The audit programme is very flexible and must be carefully tailored for each audit area at the planning stage.

We generally have a choice of sections as follows:

- A General and mandatory tests
- B Tests of controls
- C Non-audit services
- D Analytical procedures
- E Tests of detail (blank programme), or
- F Tests of detail (tailorable programme)

The only sections where this choice is not available are the Accounting Estimates (Q), Going Concern (R) and Subsequent Events (S) audit programmes. In programmes R and S, only the A section is available. For programme Q, this is a supplementary form which must be used where there are key accounting estimates. A separate Q programme is used for each individual key accounting estimate. For example, if there are three key accounting estimates documented in planning, then there would be three Q programmes. The Q programmes can either be filed in the Q section or with the relevant fieldwork for that key accounting estimates (eg. for a stock provision, it could be filed either at Q or in the G Stocks section).

Section A (General and mandatory tests)

This section is nearly always applicable, as this deals with general file completion issues, in addition to mandatory ISA testing. Selecting section A will ensure that each programme generated has the correct heading and objectives at the top.

Also included in this section, where applicable, are:

- a prompt to record the risk assessment procedure confirming the design and implementation of key controls; and
- certain procedures mandated by the ISAs.

Section B (Tests of controls)

This section is a prompt to the tests required when assurance is to be placed on the effective operation, throughout the period, of one or more control procedures, as established on the individual area audit plans.

Section C (Non-audit services)

This section is useful when non-audit procedures (such as involvement in the compiling of numbers for the financial statements) are to be carried out and used as part of the audit evidence.

Section D (Analytical procedures)

This section is a menu of possible procedures that could be utilised to achieve the objectives.

Section E (Tests of detail (blank programme))

This section is a page highlighting the key audit assertions for the individual audit area. It should be used either:

- to record any additional tests for objectives not achieved by sections A to D above, or;
- on a very low risk area, to record all the tests required for the section.

Section F (Tests of detail (tailorable programme))

This section can be used:

- to record the additional procedures for objectives not achieved by sections A to D above, or;
- as the main audit programme for the individual audit area.

NB. If this section is selected, it is very likely that it will need to be tailored, with a number of the procedures crossed through or deleted.

Each individual section of the audit file has its own audit programme. The tailoring process takes place in two stages. Firstly, you should select which of the standard pages are appropriate. Once this decision has been made, further tailoring on a line by line basis is required to select / design the appropriate tests.

The four main areas are referenced consistently for each individual section. Using the sales / income and debtors section as an illustrative example:

- **H3 General and mandatory tests and tests of controls**
  This must be selected for nearly all audits as it ensures general and mandatory ISA tests are performed. The controls - operating effectiveness programme should be selected when some or all of the evidence is to be obtained from testing some or all of the operating effectiveness of controls.

- **H3 Non-audit services programme**
  This is the programme to select when some or all of the evidence is to be obtained from non-audit services, such as financial statements compilation.

- **H3 Analytical procedures**
  This is the programme to select when some or all of the evidence is to be obtained from analytical procedures.

- **H4 Blank additional programme**
  The programme to select either:

  - to record any further tests on objectives not met by work planned on the above tests at H3; or
  - to record all the tests required in a low risk area, when H3 tests are not selected.

These pages could be used in every section of a very low risk assignment.

- **H5 Bank of 'tests of detail'**
  This programme can be used in a variety of ways, for example:

  - as the main programme; or
  - as a reference document to select tests for recording on H4; or
  - as an additional programme to H3.

Selecting appropriate audit programmes for each section is the answer to eliminating over auditing and improving efficiency.

Regardless of which audit programmes are selected as the starting point, individual tests must be added or deleted depending on the specific knowledge of the client.

All combinations and permutations of programmes are acceptable. It is extremely unlikely that all of the tests on any of the programmes will be necessary. This is particularly true of the 'bank of tests of detail' programme (H5).

22.4 What's changed

Update - June 2023

What's changed

We are pleased to issue updates to your Mercia Academies Manual (dated 06/23).

The principal technical changes in this update include:

- Changes in relation to the issue of the *Academies Accounts Direction 2022 to 2023*, *Academies model accounts 2022 to 2023* and *Framework and guide for external auditors and reporting accountants of academy trusts*;
- Changes in relation to the requirements of the *Academy Trust Handbook (effective 1 September 2022)* (also known as the *Academies Financial Handbook*);
- Changes in relation to the *Teachers' Pensions Reporting Accountant Guidance TP05 for 2022/23*, pertaining to the reporting requirements of the Teachers' Pensions End of Year Certificate (EOYC);
- The introduction of documentation to support group audits involving component auditors;
- The introduction of a new (optional) statistical sampling approach; and
- The restructuring of the guidance notes.

In addition a number of other minor improvements and amendments have been made to the manual.

See below for a full list of changes.

The issue of the *Academies Accounts Direction 2022 to 2023*, *Academies model accounts 2022 to 2023* **and** *Framework and guide for external auditors and reporting accounts of academy trusts*

The Education & Skills Funding Agency issued its Accounts Direction 2022 to 2023, model set of academy accounts and framework and guide for auditors and reporting accountants in April 2023. This Accounts Direction and the related documents must be used by academy trusts preparing annual reports to 31 August 2023. We have updated the pro-forma accounts, accounts disclosure checklist and other relevant forms and guidance to reflect changes made to the 2023 reporting requirements.

The requirements of the *Academy Trust Handbook (effective 1 September 2022)* **(also known as the Academies Financial Handbook)**

Relevant forms and guidance on regularity reporting within the Academies Manual have also been updated to reflect the Academies Financial Handbook 2022, which became effective on 1 September 2022.

Teachers Pensions Reporting Accountant Guidance TP05 for 2022/23, **pertaining to the reporting requirements of the Teachers' Pensions End of Year Certificate (EOYC)**

Teachers' Pensions have published Reporting Accountant Guidance TP05 for 2022/23 which contains information on reporting requirements pertaining to the Teachers' Pensions End of Year Certificate (EOYC). Documentation and guidance for this engagement have been updated in the manual to reflect the updated requirements. The EOYC reporting engagement has a filing deadline of 30 September 2023.

New (optional) statistical sampling approach

A new (optional) statistical sampling approach has been added to sit alongside the extant judgemental sampling approach. For many audits the extant judgemental approach, particularly where populations are smaller, will remain appropriate, however it is not suitable for use on audits where populations are very large. As such a new statistical sampling approach which does not include a sample size cap has been added to the methodology for use on audits where the judgemental approach is not considered appropriate.

Guidance notes

The guidance notes have been restructured to make them more user-friendly and to ensure a consistent approach to guidance notes across Mercia's suite of products.

Contact us

We are always pleased to receive feedback on our manuals, including any improvements that you would like to see incorporated. Please contact me if you have any comments to make.

Andy Holton

June 2023

June 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
Guidance	

Contents	• Updated for addition of the Group audit instruction letter and Group audit questionnaire to the Example letters section. • Updated to remove references to the documents relevant for audit of periods commencing before 15 December 2021, which have been removed as no longer relevant to the audit of academies for the year ending 31 August 2023.
Guidance notes	• The guidance notes have been restructured to make them more user friendly and to ensure a more consistent approach across the suite. • Guidance notes have been updated to reflect the requirements of the Academies Accounts Direction 2022 to 2023 and the Academy Trust Handbook 2022. • ESFA, HMRC and Charity Commission postal addresses have been updated in Section 6. • Appendices 1b, 2b, 2.1b and 3b have been removed as they related to documents relevant for audit of periods commencing before 15 December 2021, which have been removed from this edition. • Appendices 1a, 2a, 2.1a and 3a have been renumbered as 1, 2, 2.1 and 3. • Appendix 3 to the guidance notes includes guidance on the new statistical sampling approach.
Getting started for new manual users	• The Accessing the manual section has been removed - guidance on accessing manuals is available on the website.
What's changed	• A copy of this What's changed notice has been added to the manual.

Example letters

4 Schedule of professional services - Teachers' Pensions	• Tripartite appendix updated for minor changes in TP05 2022/23 (Version 1). • Updated to refer to TP05 2022/23 (Version 1) relevant for Teachers' Pensions assurance assignments for the year ended 31 March 2023.
5 Schedule of professional services - Accounts Return	• Updated reference dates for the 2023 return.
7.2 Letter of representation - regularity assurance	• Updated references to the Academy Trust Handbook 2022.
7.3 Letter of representation - Teachers' Pensions	• Updates period end date to 31 March 2023.
8 Group audit instruction letter	• New form added to support group audits involving component auditors.
9 Group audit questionnaire	• New form added to support group audits involving component auditors.

Example reports

Audit report (individual entity)	• Year/period end date of 31 August 2023 added as all academies report to the same date. • Updated references to Academies Accounts Direction 2022 to 2023. • Minor updates and amendments to reflect latest guidance.
Audit report (group)	• Year/period end date of 31 August 2023 added as all academies report to the same date. • Updated references to Academies Accounts Direction 2022 to 2023. • Minor updates and amendments to reflect latest guidance.
Teachers' Pensions report	• Updated to refer to TP05 2022/23 (Version 1) relevant for Teachers' Pensions assurance assignments for the year ended 31 March 2023.
Statement of trustees' responsibilities	• Updated reference to Academies Accounts Direction 2022 to 2023.
Report to management	• Updated references to Academies Accounts Direction 2022 to 2023. • Minor editorial amendments.

Statement on regularity, propriety and compliance	• Detail added to reflect the requirement to refer to responsibilities relating to estates safety and management. • Updated references to the Academy Trust Handbook 2022.
Assurance report on regularity	• Updated references to Academies Accounts Direction 2022 to 2023. • Updated references to Academy Trust Handbook 2022.
Example accounts	• Updated references to Academies Accounts Direction 2022 to 2023. • Dates throughout rolled forward to reflect 2023 as the current year and 2022 as the prior year. • ~~Hyperlink to Academies Accounts Direction 2022 to 2023 added to front cover.~~ • References to periods commencing before 1 January 2021 removed as not longer relevant. • Governance statement: detail added to prompt for consideration of how the trust has effectively used relevant funding to ensure the trust's estate is safe, well-maintained, and complies with relevant regulations. • Balance sheet: pension asset caption added. • Note 4: guidance added in response to ESFA clarification that material ESFA/DfE grants should be separately listed in the note. • Note 31: text added to reflect minor edit in the AAD confirming the DfE has reaffirmed its commitment to the LGPS guarantee.
Accounts disclosure checklist	• Updated references to Academies Accounts Direction 2022 to 2023. • Financial review: detail added to risks and uncertainties to reflect requirement to consider estates safety and management risk. • Organisational structure: detail added to reflect requirement to refer to organisational structure of subsidiaries, joint ventures and associates of the academy trust. • Governance statement: detail added to clarify that governance structure information should be provided in respect of the audit and risk committee in addition to the Board. • Governance statement: detail added to clarify that descriptions of processes to manage conflicts of interest should extend beyond requiring declarations of interest. • Governance statement: detail added to clarify that the value for money statement should include up to three examples and consider demonstrating how the trust has effectively used relevant funding to ensure the trust's estate is safe, well-maintained, and complies with relevant regulations. • Statement on regularity, propriety and compliance: detail added to reflect the requirement to refer specifically to estates safety and management. • Staff costs: detail added to clarify that teaching assistants should be included in 'administration and support' in the headcount disclosure.
Current file documents	
Periods commencing before 15 December 2021	• Documents relevant for audits of periods commencing before 15 December 2021 have been removed as no longer relevant to the audit of academies for the year ending 31 August 2023.
~~Current file indices~~	• ~~References to A53 and B26 added to the completion and planning indices respectively.~~
~~A22 Overall review of the group financial statements~~	• ~~Text added to point 8 to clarify that uncorrected misstatements should include those identified by component auditors, where they are involved.~~
~~A29 Reporting on irregularities, including fraud in the auditor's report (individual and group)~~	• ~~An additional column has been added to enable comments to be cross referenced back to where the underlying work has been performed.~~
~~A31 Group audit completion checklist~~	• ~~An additional section has been added to the form for considerations where component auditors are involved.~~
~~A41 Group subsequent events update and evaluation~~	• ~~Point 2 inserted for consideration where component auditors are involved.~~

~~A52-1 Communication with group management checklist~~	• ~~Bullet point added to point 3 for consideration where component auditors are involved.~~
~~A52-2 Communication with those charged with governance of the group checklist~~	• ~~Point 8 added for consideration where component auditors are involved.~~
~~A53 Component auditors~~	• ~~New form added to support group audits involving component auditors.~~
~~B01 Group planning checklist~~	• ~~Shaded text added to each section for consideration where component auditors are involved.~~
~~B20 Information gathering summary~~	• ~~Section added for key matters arising from communication with component auditors and component risk assessment.~~
~~B22-1 Communication with group management~~	• ~~Shaded bullet point added to 'Nature of assignment' section for consideration where component auditors are involved.~~
~~B22-2 Communication with those charged with governance~~	• ~~Shaded bullet point added to 'Nature of assignment' section for consideration where component auditors are involved.~~
~~B26 Component auditors~~	• ~~New form added to support group audits involving component auditors.~~
~~B35 Group audit team discussion~~	• ~~Shaded bullet added under 'Fraud risk' section for consideration where component auditors are involved.~~
~~B40 Audit plans (individual and group)~~	• ~~Guidance in sampling section updated to refer to sampling plan(s) / sampling form(s) as appropriate.~~
~~B40/P2 Group audit plan - Intra group balances, transactions and consolidations~~	• ~~Sections to plan the approach to consolidation and group components have been added.~~
CSF Controls sampling form (individual, freeform and group)	• Updated to new format (no substantive technical changes).
SSF Substantive sampling form - Judgemental (individual, freeform and group)	• Updated to new format including more space to justify sample sizes.
SSF Substantive sampling form - Statistical (individual, freeform and group)	• New form for use with the new statistical sampling approach.
M work programme	• Test C3 updated to reflect clarification that teaching assistants should be included in 'administration and support' in the headcount disclosure. • Test F17 updated to refer to special severance payments and update detail of exit packages requiring prior ESFA approval.
TP-1 Teachers' pensions work programme	• Updated to refer to TP05 2022/23 (Version 1) relevant for Teachers' Pensions assurance assignments for the year ended 31 March 2023. • Minor amendments for consistency with TP05 2022/23. • Minor editorial amendments.
Permanent file documents	
Periods commencing before 15 December 2021	• Documents relevant for audits of periods commencing before 15 December 2021 have been removed as no longer relevant to the audit of academies for the year ending 31 August 2023.
Permanent file indices	• Reference to PF1-9 added.
PF1-7 Using the work of an expert	• Auditor's expert section expanded.
~~PF1-9 Component auditors~~	• ~~New form added to support group audits involving component auditors.~~
Supplementary forms	
File review checklist	• A copy of the cold file review checklist has been added to the file.

Update - March 2023

What's changed

We are pleased to issue updates to your Mercia Academies Manual (dated 03/23).

The principal technical changes in this update include the removal of content relating to the now superseded ISQCs and consequential amendments arising as a result of this. The Academies Manual, together with the Audit Procedures Manual, address engagement level quality management, with the Quality Management Manual addressing firm wide requirements.

In addition a number of minor amendments / improvements have been made to other sections of the Academies Manual, including updating engagement letters to reflect latest guidance.

See below for a full list of changes.

Contact us

We are always pleased to receive feedback on our manuals, including any improvements that you would like to see incorporated. Please contact me if you have any comments to make.

Andy Holton

March 2023

March 2023 - Detailed list of changes

The below table provides a detailed list of changes within the manual. In addition to the items listed below, minor changes have been made for formatting, grammar, and other editorial amendments.

Updated area	Main reason for change
Guidance	
What's changed	• A copy of this What's changed notice has been added to the manual.
Example letters	
1 Engagement – Covering letter	• Updated the 'professional services provided' section to include a new paragraph which confirms whether disbursements are expected to be incurred. • A new section detailing how communication will be maintained throughout the engagement has been added. • Updated the 'agreement of terms' section to include reference to the firm's privacy notice on their website and reference to the standard terms of business in relation to instances of variation or termination of the engagement.
2.1 Engagement – Schedule of professional services - Audit	• Moved the paragraph highlighted the client's responsibility towards publishing electronic information from the 'Scope of audit' section to the 'Your responsibilities' section. • Added an optional paragraph in the 'Our responsibilities' section highlighting that the auditors have a statutory requirement to communicate with the group auditor. • Included a paragraph in 'Our responsibilities' confirming that the client is to be informed should matters or significant facts arise that may raise ethical concerns. • A paragraph was added to the 'Scope of audit' section explaining that the auditors may also use analytical tools in their work.
2.2 Engagement – Schedule of professional services – Audit (Group)	• Moved the paragraph highlighted the client's responsibility towards publishing electronic information from the 'Scope of audit' section to the 'Your responsibilities' section. • Included a paragraph in 'Our responsibilities' confirming that the client is to be informed should matters or significant facts arise that may raise ethical concerns. • A paragraph was added to the 'Scope of audit' section explaining that the auditors may also use analytical tools in their work.
3 Engagement - Schedule of professional services - Regularity assurance	• Added a section on 'Your responsibilities' and included a paragraph confirming the client acknowledges and agrees to the responsibilities of the academy trust, as set out in the Framework and guidance for external auditors and reporting accountants of academy trusts.

4 Engagement - Schedule of professional services - Teachers Pensions	• Added a section on 'Your responsibilities' and included a paragraph confirming the client acknowledged and agreed to the responsibilities of the employer set out in the pre-agreed standardised terms of engagement included within the TP05 guidance.
6 Engagement - Standard terms of business	• Updated paragraphs in the 'Fees and payment terms' section clarifying the use of insurance policies to cover fees, circumstances where clients are unable to pay fees and the rights of the firm to exercise a lien over all funds have also been added. • Added a new section detailing standard business terms in relation to confidentiality. • Clarification of potentials actions of the firm, should a dispute arise between parties within the engagement.
Example reports	
Statement of trustees' responsibilities	• Clarified that the reference to material departures is only required where there are such departures.
Current file documents	
Current file indices (both p/c before and on or after 15 Dec 21)	• Updated to more accurately reflect naming of A21-1, A21-2, A21-3 and B03/B14.
A21-2 Engagement quality review checklist (individual and group) (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
A21-2 Engagement quality review checklist (individual and group) (p/c before 15 Dec 21)	• Updated to ISQM version of form.
A21-3 Consultation review (individual and group) (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
A21-3 Consultation review (individual and group) (p/c before 15 Dec 21)	• Updated to ISQM version of form.
A22 Overall review of the financial statements (individual and group) (p/c on or after 15 Dec 21)	• Additional bullet 'requirements for and of a statement of cash flows' added to Q23.
A31 Audit completion checklist (individual and group) (p/c on or after 15 Dec 21)	• References to ISA (UK) 240 updated to reflect the FRC's reissued ISA which includes corrected numbering aligned to the international version.
A46 Fraud update and evaluation (individual and group) (p/c on or after 15 Dec 21)	• References to ISA (UK) 240 updated to reflect the FRC's reissued ISA which includes corrected numbering aligned to the international version.
B03 Preliminary engagement quality review (individual and group) (p/c on or after 15 Dec 21)	• ISQC version of form removed. • ISQM version retained but renamed to remove reference to ISQM as this is now the only version.
~~B10 Engagement review (individual and group) (p/c on or after 15 Dec 21)~~	~~• Under the 'New client checklist' heading, the wording has been updated from "We have completed B13..." to "We have completed / reviewed B13..." to reflect the fact that relevant matters should also be identified in future years when the client is not new.~~
B14 Preliminary engagement quality review (individual and group) (p/c before 15 Dec 21)	• Updated to ISQM version of form.
B32A-E Key accounting estimate (individual, freeform and group) (p/c on or after 15 Dec 21)	• Updated wording of the key assertions relevant to the accounting estimate which may be selected for clarity.
Permanent file documents	
PF1-2 The applicable financial reporting framework	• Additional bullet 'Requirements for a statement of cash flows' added.
PF5 Permanent audit planning documentation (both p/c before and on or after 15 Dec 21)	• Additional table added to list engagement team members each year if desired.

Chart of account	• The chart of accounts has been updated to reflect the changes made in CCH Accounts production.