

# Changes in financial reporting

## The only way is ethics

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Auditor independence and ethics in the context of non-audit services is an area where regulators and our own audit compliance review team continue to identify issues. The implementation of new UK GAAP is likely to test the boundaries of auditor independence further. In [Changes to financial reporting: The time to act is now](#), we provided an overview of the considerations that you need to think about now. In this commentary we look at some common situations that auditors will need to be wary of if they are to remain independent enough to continue as the auditor of their clients.

### New UK GAAP implementation issues for auditors

With significant changes to the UK financial reporting framework ahead, auditors will need to be careful not to overstep the advisory line and impair their independence if they are to continue to act in the capacity as auditor.

Issues are likely to arise as clients implement a financial reporting regime with which they are unfamiliar. Assisting audit clients in their transition to the new UK GAAP will increase the likelihood of Ethical Standards threats arising due to the provision of non-audit services (Ethical Standard 5). Auditors will need to be aware that the provision of valuation, accountancy and tax advisory services in relation to transition could present significant issues and in some cases an outright prohibition from acting as auditor.

Another factor to consider will be the requirement that non-audit services can normally only be provided where there is informed management. Though intended to be a low hurdle, the ability to make an independent management decision and choice based on information supplied will be affected by the size and nature of changes.

Application of Provisions Available to Small Entities may also require consideration as small entities transition to FRS 102.

The following scenarios highlight just a few of the areas where auditors will need to consider compliance with Ethical Standards and the impact services offered have on the ability to remain independent. As always with issues of independence, however, direct reference to the Standards will be the safest way of ensuring compliance.

#### Scenario 1

##### Frankie Ethics Limited

Frankie Ethics Limited is a medium-sized owner managed business. As part of the November 2015 final audit communication document, you include a short summary of areas where FRS 102 is likely to impact on the company in future period financial statements.

##### Scenario 1: Ethical considerations

The communication of potential accounting issues will not necessarily cause independence problems and may actually help to promote the discussion of potential future implications.

Further, this communication may aid the development of informed management where other non-audit services are also proposed.

However, care would need to be taken in the way that the analysis is presented. For example, the client should not be under the impression that a factual analysis of current policies and FRS 102 impact is tantamount to assurance work over the subject matter.

Any factual analysis would normally also be accompanied by clarification of responsibilities to highlight that assessment of the impact, making accounting policy choices and application of the new standards is the responsibility of the client.



## Scenario 2

### Don Ethics Limited

Don Ethics, the FD of Don Ethics Limited, has asked the firm to assist in the valuation of shares of a significant private company investment required to be held at fair value for the first time under FRS 102. Don Ethics limited is a medium-sized entity and Don is considered to be 'informed management'.

#### Scenario 2: Ethical considerations

Regardless of the presence of informed management, Ethical Standard 5 prohibits the undertaking of valuation work where the valuation would both involve a significant degree of subjective judgement and have a material effect on the financial statements either separately or in aggregate with other valuations provided.

As the investment appears significant and a valuation of this type is likely to be highly subjective, this appears to fall within the outright prohibition and the client will need to receive valuation advice from elsewhere if the audit is to be retained.

There are numerous areas where the application of FRS 102 will require valuations to be undertaken. As such when assessing the threats to independence an 'act first, think later' approach has the potential to cause some significant ongoing issues for audit firms.

## Scenario 3

### Joey Ethics Limited

Joey Ethics Limited is a medium-sized owner managed business. They have asked your firm to assist in the transition to FRS 102 and help prepare the first statutory accounts under the new formats.

#### Scenario 3: Ethical considerations

For non-small entities, the provision of non-audit services to an audit client may only be undertaken where informed management is present. Assuming this to be the case (which is no guarantee, and a separate issue in itself) the provision of accounting services to assist in preparing the FRS 102 accounts will give rise to a management and self-review threat. Dependent on just how much work is being undertaken, the fees arising could give rise to a self-interest threat also.

The precise scope of the engagement will determine the level of threats present. As noted in scenario 2, there are certain services that cannot be provided due to the level of threat. Once the level of threat has been assessed, appropriate safeguards will need to be put in place.

A common safeguard will be to separate the accounting service and audit engagement teams. Some firms will be going down the route of outsourcing the accounting work to a 'friendly firm'.

Where threats are at the lower end of the spectrum, a file review may be the tonic for a loss of independence.

In providing accounting services to the client, the respective engagement team must ensure that they are not taking the role of management. The role and responsibilities of management will need to be clear from the outset.

Arguably, the more involved the conversion exercise becomes; the more likely it is that you need to dust off Ethical Standard 5 and work out whether you are overstepping the line. However, in many cases threats will be able to be suitably safeguarded.



## Scenario 4

### Joey Ethics Jnr Limited

Joey Ethics Jnr Limited is a small owner-managed business. They have asked your firm to assist in the transition to FRS 102 and help prepare the first statutory accounts under the new formats.

#### Scenario 4: Ethical considerations

The ethical considerations are similar to those discussed in scenario 3 although there are certain provisions and exemptions available to your small clients in terms of the self-review and management threats.

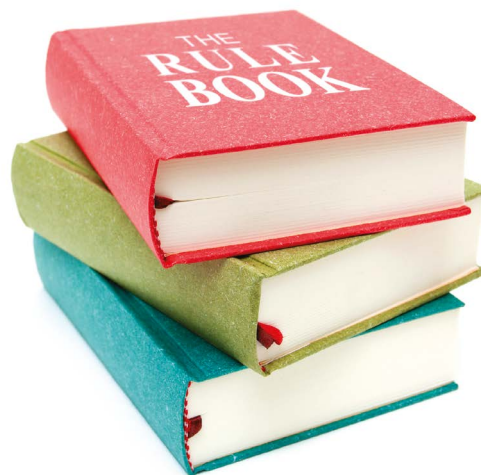
Where your small entity clients have informed management, the alternative provisions in Ethical Standard, Provisions Available for Small Entities (ES-PASE) may be used instead of safeguarding the self-review threat. Conditions of the exemption include extending audit file reviews to include a random selection of engagements where non-audit services have been provided.

For your clients that do not have informed management, exemptions are available in ES-PASE that allow the provision of certain non-audit services that would involve the firm undertaking part of the role of management. Conditions for the exemption include making relevant audit report disclosures and the accounts or the audit report disclosing the type of non-audit services provided to the client. This exemption does not extend to the valuation services discussed in scenario 2.

## Clearly documented compliance

Some safeguards will need to be applied prospectively as retrospective action may provide less than the required level of protection against the threats present.

The examples above are intended only to provide an overview of some issues arising on adoption of FRS 102. As always when it comes to Ethical Standards compliance, documentation of your application of judgement will be critical and consultation with the main Standards will be essential.



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- [client letters](#)
- [newswire](#)
- [blogs](#)
- [e-learning library](#)

You can rest assured that we will continue to keep you up to date using all of these channels in the months ahead. You will find details of everything that we do on our website at [www.mercia-group.co.uk](http://www.mercia-group.co.uk) and a subscription to our free monthly newswire is a great way of keeping yourself up to date with these.

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