

July 2018

Consultation Paper and Impact Assessment

Proposal to revise ISA (UK) 540
(Revised June 2016) Auditing
Accounting Estimates, Including Fair
Value Accounting Estimates, and
Related Disclosures

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8th Floor, 125 London Wall, London EC2Y 5AS

CONSULTATION PAPER AND IMPACT ASSESSMENT

Proposal to revise ISA (UK) 540 (Revised June 2016) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

Objective

The Financial Reporting Council (FRC) proposes, subject to consultation, to issue a revised version of International Standard on Auditing (UK) (ISA (UK)) 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, to reflect recent revisions to the international standards on auditing issued by the International Auditing and Assurance Standards Board (IAASB¹). The revisions made by the IAASB are designed to address issues arising from evolving financial reporting frameworks and concerns expressed by regulators and other stakeholders that have developed since the current standard was originally issued in 2009. The revised ISA 540 approved by the IAASB is subject to approval in due course by the Public Interest Oversight Board (PIOB) but we do not expect this to not be forthcoming.

The FRC is not proposing to add any new UK requirements to the changes made at the international level, as we are satisfied that the revised standard has been amended in a way that addresses concerns raised by the FRC in its comment letter² on the IAASB's Exposure Draft. As a result, we are able to confirm in the attached impact assessment that no additional work effort, beyond that which may be required by changes in the international standard, is expected to result from regulatory decisions taken by the FRC. In issuing the revised standard for consultation, the FRC has carried over additional material added to ISA (UK) 540 in June 2016, to comply with requirements in the EU Audit Regulation and Directive, but has not changed that material.

Invitation to comment

The FRC is requesting comments on this Consultation Paper by 5pm on Friday 21 September 2018. Comments are invited in writing on all aspects of the Consultation Paper. In particular, comments are sought in relation to questions 1-3 as discussed below.

Comments on the Consultation Paper should be sent to:

Keith Billing
Project Director
Financial Reporting Council
E-mail: AAT@frc.org.uk

¹ IAASB is a committee of the International Federation of Accountants (IFAC). The IAASB's constitution and due process is described in its 'Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements'.

² <https://www.frc.org.uk/getattachment/6767fea2-6d62-4801-a357-64aa31b277dc/UK-FRC-ED-540-COMMENT-LETTER-20-July-2017.pdf>

Introduction

1. The Financial Reporting Council (FRC) is committed to acting as a proportionate and principles-based regulator, and balances the need to minimise the impact of regulatory requirements on business, while working to support the delivery of high-quality audit and assurance work, to maintain investor and wider stakeholder confidence in audit.
2. The ISAs (UK) are based on the corresponding international standards issued by the IAASB. Where necessary, the international standards have been augmented with additional requirements to address specific UK legal and regulatory requirements; and additional guidance that is appropriate in the UK national legislative, cultural and business context.
3. On 22 June 2018, the IAASB approved ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* and related conforming amendments to other ISAs. This is subject to approval by the Public Interest Oversight Board (PIOB) in September 2018 to confirm that due process has been followed with proper regard to the public interest. The effective date of the revised and amended standards is for audits of financial statements for accounting periods beginning on or after 15 December 2019.
4. The FRC supports this revision and related amendments, noting their importance in supporting an enhanced focus by auditors on management estimates and disclosures. Revisions to International Financial Reporting Standards mean the importance of estimates in corporate reporting will increase still further, for example in the areas of: financial instruments; revenue recognition from contracts; and insurance contracts. The FRC believes that they represent an improvement to the current standards and they are also designed to address concerns expressed by regulators and other stakeholders. The revision includes:
 - Enhanced requirements and application material for risk assessment procedures and the auditor's work effort in responding to the assessed risks of material misstatement. These include, in addition to addressing risks related to estimation uncertainty, specific attention to other risk factors in making accounting estimates such as complexity and subjectivity.
 - Enhanced work effort requirements based on one or more of:
 - (a) Considering events occurring up to the date of the auditor's report;
 - (b) Testing how management made the accounting estimate; or
 - (c) Developing an auditor's point estimate or range.If the auditor develops an auditor's range, the auditor is specifically required to determine that the range includes only amounts that are supported by sufficient appropriate audit evidence.
 - Amending the objective and the requirements to the effect that audit procedures address whether both the accounting estimates and the related disclosures are "reasonable" in the context of the applicable financial reporting framework (the current ISA addresses whether disclosures are "adequate").
 - Enhancements to reinforce the application of professional scepticism. These include using wording to drive questioning or challenging management where appropriate; more focus on identifying indicators of possible management bias; requiring further

audit procedures to be designed and performed in a manner that is not biased toward obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory; and an enhanced retrospective review and an overall evaluation based on procedures performed.

- Emphasising the importance of the need to consider internal control, with improved cross references to ISAs 315 and 330 (those standards being more specific to the consideration of internal control).
- A new requirement to remind auditors of their responsibilities to communicate certain matters to those charged with governance and to consider the matters to communicate regarding accounting estimates, taking into account the reasons given to the risks of material misstatement.
- Enhanced documentation requirements.

The revised standard is applicable to all estimates. It has been designed to be scalable, recognising that some estimates may not require significant judgments and the processes for making them may not be complex.

5. Conforming amendments are being made by the IAASB to:

ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing - including identifying in the application material that ISA 540 (Revised) requires a separate assessment of inherent risk and control risk.

ISA 230, Audit Documentation - including identifying in the application material that documentation providing evidence of the auditor's exercise of professional scepticism may include documenting how the auditor evaluated evidence obtained that both corroborates and contradicts management's assertions. It also identifies that examples of documentation of significant professional judgments include the basis for the auditor's evaluation of whether an accounting estimate and related disclosures are reasonable in the context of the applicable financial reporting framework.

ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements - amending the application material to be clear that a retrospective review is not necessarily restricted to the prior period.

ISA 260 (Revised), Communication with Those Charged with Governance - including identifying in the application material that those charged with governance may be interested in the auditor's views on the degree to which complexity, subjectivity or other inherent risk factors affect the selection or application of the methods, assumptions and data used in making a significant accounting estimate, as well as the auditor's evaluation of whether management's point estimate and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework; and, when applicable, whether a significant accounting practice of the entity relating to accounting estimates is considered by the auditor not to be most appropriate to the particular circumstances of the entity. The material on qualitative aspects of accounting estimates given in Appendix 2 is moved ISA 540 (Revised).

ISA 500, Audit Evidence, in relation to "external information sources" - including a definition; amending the requirement in paragraph 7 to clarify that the auditor needs to consider the relevance and reliability of information to be used as audit evidence

obtained from an external information source; and extensive additional application material.

ISA 580, *Written Representations*, - amending the illustrative representation letter to align with the changes in ISA 540 (Revised).

ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements* - amending the requirement in paragraph 13(c) to reflect that the auditor evaluates whether related disclosures, as well as the accounting estimates, made by management are reasonable.

ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* - editorial changes to the requirement in paragraph 9 and related application material, including to reflect ISA 540 (Revised) references to a high "degree of" estimation uncertainty.

6. The FRC responded to the IAASB's consultation on the revised standard, taking account of views of UK stakeholders obtained through outreach activities. The FRC response³ was supportive of the aims of the IAASB. It identified several proposals the FRC was particularly supportive of and would want to be retained in the final standard. The response did not raise any significant concerns, but it did identify areas where the FRC believed that the proposals could be further enhanced in a number of important respects. The FRC is satisfied that the changes made by the IAASB in finalising the revised standard are appropriate and that ISA (UK) 540 (Revised June 2016) can be revised to adopt it without the need for further FRC supplementary material. It is proposed to retain the small amount of supplementary material included in the current ISA (UK) 540 (Revised June 2016) as it relates to requirements of the EU Audit Regulation and Directive.
7. Consequently, the FRC proposes, subject to consultation, to issue a revised version of ISA (UK) 540 (Revised), adopting the changes made by the IAASB to ISA 540 and the conforming amendments to other ISAs. This will ensure that the UK auditing standards continue to be compliant with the ISAs and maintains the FRC's support for the international harmonisation of auditing standards based on ISAs.

Q1. Do you agree that ISA (UK) 540 (Revised June 2016) and other ISAs (UK) should be revised to adopt the revision to the underlying international standard and the related conforming amendments to other ISAs? If not, please give your reasons and explain what action, if any, that you believe should be taken to update the ISAs (UK) in relation to auditing accounting estimates.

Q2. If you agree that the ISAs (UK) should be revised to adopt the revised ISA 540 and conforming amendments, do you agree that the UK supplementary material can be limited to that shown in the exposure draft? If not, please give your reasons and explain what supplementary material, if any, you believe should be added.

Q3. Is the proposed effective date, which is consistent with the effective date of the IAASB's revised ISAs, appropriate? If not, please give reasons and indicate the effective date that you would consider appropriate.

³ <https://www.frc.org.uk/getattachment/6767fea2-6d62-4801-a357-64aa31b277dc/UK-FRC-ED-540-COMMENT-LETTER-20-July-2017.pdf>

Impact Assessment

As a matter of policy, the FRC's auditing standards are based on the corresponding international standards issued by the IAASB. Where necessary the international standards are augmented with additional requirements to address specific UK legal and regulatory requirements; and additional guidance that is appropriate in the UK national legislative, cultural and business context. We believe that ISA 540 (Revised) introduces changes compared to the current ISA 540 that are appropriate and proportionate to address issues that have been identified since the current standard was issued.

We propose to maintain the FRC's supplementary requirement in paragraph 21D-1 of current ISA (UK) 540 (Revised) as it reflects the explicit requirement in the EU Audit Directive for the auditor to maintain professional scepticism throughout the audit and, in particular, when reviewing management estimates relating to fair values, the impairment of assets, and provisions (paragraph 32D-1 in the proposed revision). An objective of the IAASB's revision of ISA 540 was to enhance professional scepticism and maintaining the FRC's supplementary requirement should not result in significant additional work effort.

We also propose to maintain the FRC's supplementary application material in paragraph A26-1 of current ISA (UK) 540 (Revised). This paragraph provides cross references to requirements in other ISAs (UK) that reflect requirements of the EU Audit Regulation pertaining to the auditor's assessment and communication of valuation methods (paragraph A37-1 in the proposed revision). This should not result in additional work effort.

The revised standard has been designed to be scalable. We believe that benefits in the public interest of enhancements to the quality of audit of accounting estimates and related disclosures, although not quantifiable, will outweigh the costs of changes that may be necessary to audit firms' methodologies.

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Financial Reporting Council

8th Floor
125 London Wall
London
EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk