

# CONSULTATION PAPER AND IMPACT ASSESSMENT

## Proposal to revise ISA (UK) 240 (Updated January 2020) *The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements*

### Objective

The Financial Reporting Council (FRC) proposes, subject to consultation, to issue a revised version of International Standard on Auditing (UK) (ISA (UK)) 240 (Updated January 2020) *The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements*.

ISA (UK) 240 is one of the key auditing standards that implemented the risk based approach to auditing in 2004. It has been over 16 years since the standard was last substantively revised, and stakeholder concerns persist about the ability of audit to detect fraud. Specific concerns about a lack of clarity in the standard as to the auditors obligations have been raised, including by Sir Donald Brydon's review of the quality and effectiveness of audit<sup>1</sup>.

We believe it is important to act now to address immediate concerns about the auditor's responsibilities in respect of fraud. At the same time, we will continue to contribute to the wider debate about the implementation of the Brydon review by government, including whether even more substantial changes to standards are required in due course, as well as developments at the International Auditing and Assurance Standards Board (IAASB).

In developing the proposed revisions to ISA (UK) 240, we have sought to maintain our support for the underlying international standards while introducing supplemental material to address concerns currently identified in the UK. We believe that the proposed revisions described below, clarifying the auditor's responsibilities in relation to fraud and promoting a more consistent and robust approach to those responsibilities, introduce benefits in the public interest.

### Invitation to comment

The FRC is requesting comments on this Consultation Paper by 5pm on Friday, 29 January 2021. Comments are invited in writing on all aspects of the Consultation Paper. In particular, comments are sought in relation to questions 1-11 as discussed below.

Comments on the Consultation Paper should be sent to:

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<sup>1</sup> Report of the Independent Review into the Quality and Effectiveness of Audit, Sir Donald Brydon CBE, December 2019. <https://www.gov.uk/government/publications/the-quality-and-effectiveness-of-audit-independent-review>

## 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. ISA (UK) 240 is one of the key auditing standards that implemented the risk based approach to auditing in 2004. It was adopted in the UK in 2004, with a small amount of supplementation, primarily to clarify who those charged with governance are in a UK context and to identify the reporting responsibilities under UK money laundering legislation. It was restructured in 2009 as part of the IAASB's project to clarify the standards. In 2016 two UK requirements were added to reflect requirements of the EU Audit Regulation:

41-1. For audits of financial statements of public interest entities, when an auditor suspects or has reasonable grounds to suspect that irregularities, including fraud with regard to the financial statements of the entity, may occur or has occurred, the auditor shall, unless prohibited by law or regulation, inform the entity and invite it to investigate the matter and take appropriate measures to deal with such irregularities and to prevent any recurrence of such irregularities in the future.

43-1. For audits of financial statements of public interest entities, where the entity does not investigate the matter referred to in paragraph 41-1, the auditor shall inform the authorities responsible for investigating such irregularities.

A small amount of application material was also added supporting those requirements. Some minor conforming edits in the application material were introduced by ISA (UK) 540 (Revised December 2018). Further minor conforming edits in the requirements and application material will be introduced by ISA (UK) 315 (Revised July 2020) when it becomes effective. Other than those limited changes, the standard has not been substantively revised since 2004.

4. When a major fraud comes to light after an audit has been signed off, the question is almost always raised as to "why didn't the auditor find it?" Concerns have been expressed that too much is made of the "inherent limitations of an audit" described in ISA (UK) 240 and that this may lead to auditors not planning and performing appropriate procedures to detect material misstatements due to fraud.
5. Most recently, Sir Donald Brydon's report identified that he "found the question of fraud and auditors' related responsibilities the most complex and most misunderstood in relation to auditors' duties". He commented that "ISA (UK) 240 appears to be a balancing act between managing, or possibly lowering, expectations whilst seeking to avoid going so far as to affect significantly users' perceptions as to the value of audit. The messaging in this standard is therefore somewhat ambiguous, in my view, contributing to a lack of clarity as to what exactly is expected of auditors in this area. Indeed, a number of respondents

called for auditors' responsibilities to be clarified, whether or not they believed there is or may be a case for increasing them."

6. Sir Donald made a number of recommendations including<sup>2</sup>:

14.1.5 - I recommend that ARGA amends ISA (UK) 240 to make clear that it is the obligation of an auditor to endeavour to detect material fraud in all reasonable ways.

14.2.2 - I recommend therefore that directors should report on the actions they have taken to fulfil their obligations to prevent and detect material fraud against the background of their fraud risk assessment.

14.3.5 - I recommend that the auditor's report state explicitly the work performed to conclude whether the directors' statement regarding the actions they have taken to prevent and detect material fraud is appropriate. Furthermore, the auditors should state what steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud.

The revisions we are proposing in this consultation include addressing recommendation 14.1.5 to clarify the obligations of auditors. We are also proposing further supplemental requirements and guidance to enhance the auditors procedures to identify and assess risks of material misstatement due to fraud and to plan and perform procedures responsive to those risks.

7. The FRC understands that BEIS is likely to consult on statutory requirements for directors to report on the actions they have taken to fulfil their obligations and for auditors to report in relation to such a director's statement (recommendations 14.2.2 and 14.3.5). We will address these recommendations in due course, taking account of the outcome of the BEIS consultation.

8. With regard to Sir Donald's recommendation in 14.3.5 that auditors should state what steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud, we intend to address that separately from this proposed revision of ISA (UK) 240. It relates to auditor reporting and we will consider it holistically with other recommendations in relation to the content of the auditor's report.

## **IAASB**

9. The IAASB is commencing its own review of ISA 240. We intend to support and contribute to that. However, if a project to revise the standard is commenced by IAASB it is possible that it could be several years from now before that revision is finalised. We believe it appropriate to proceed with a revision of the UK version of the standard now in light of the current concerns of stakeholders in the UK and to address Sir Donald's recommendations on a timely basis.

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<sup>2</sup> Sir Donald also made recommendations in relation to matters such as auditor training, registers of corporate frauds and investigations into auditor failure. These are not addressed in ISA (UK) 240.

## **Explanation of Proposed Key Changes**

10. ISA (UK) 240 contains a significant number of requirements, with related application material, designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement. However, as explained above, there is ongoing concern 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 obligation to plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud. Reasonable assurance is a high, but not absolute, level of assurance.
11. The FRC is proposing revisions to address these concerns. These include providing increased clarity as to the auditors obligations together with enhancements of the requirements for the identification and assessment of risk of material misstatement due to fraud and the procedures to respond to those risks.
12. FRC text in ISAs (UK) that supplements the text of the underlying international standards is highlighted with grey shading. Comparing this to the limited amount of FRC text in the current standard can identify the proposed revisions. Given the timing of this consultation, the exposure draft also incorporates the IAASB's conforming changes being introduced by ISA (UK) 315 (Revised July 2020), which are identified in mark-up.
13. The FRC's proposed revisions include:

### ***Introduction to the ISA (UK)***

- Paragraph 3 has been supplemented to clarify that the evaluation of whether suspected or identified fraud is material takes into account the qualitative as well as quantitative characteristics of the fraud.
- New paragraph 7-1 has been added to clarify that while the risk of not detecting a material misstatement resulting from fraud may be higher than the risk of detecting one resulting from error, that does not diminish the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud. Reasonable assurance is a high, but not absolute, level of assurance.

### ***Objectives of the auditor***

- The lead in text in paragraph 10 has been supplemented to clarify and emphasise that the objectives of the auditor include to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud. This is consistent with the overall objectives of the auditor set out in ISA (UK) 200 which include to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement whether due to fraud or error<sup>3</sup>.

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<sup>3</sup> ISA (UK) 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)*, paragraph 11(a).

### ***Professional scepticism***

- New paragraph 12-1 has been added, requiring that the auditor shall undertake risk assessment procedures and design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. This is consistent with other recently revised ISAs (UK), including ISA (UK) 540 (Revised December 2018)<sup>4</sup> and ISA (UK) 315 (Revised July 2020)<sup>5</sup>. Professional scepticism assists the auditor in remaining unbiased and alert to both corroborative and contradictory audit evidence.
- New paragraph 13-1 has been added to clarify that the auditor shall remain alert for conditions that indicate a record or document may not be authentic. Extant paragraph 13 states that unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a record or document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. New paragraph 13-1 does not contradict this but emphasises the importance of staying alert to records or documents that may not be authentic. New supporting application material (paragraph A9-1) has been added giving examples of conditions that may indicate a physical or electronic document is not authentic or has been tampered with.
- Paragraph 14 has been revised, requiring the auditor shall, in addition to investigating inconsistent responses to inquiries, investigate responses to inquiries of management, those charged with governance or others in the entity that appear implausible.

### ***Discussion among the engagement team***

- New paragraphs 15-1 to 15-3 have been added specifying particular matters to cover in the discussion, including how management could perpetrate and conceal fraudulent financial reporting and how assets of the entity could be misappropriated; the susceptibility of a significant component in a group audit to material misstatement of the financial information of that component due to fraud; and how to investigate allegations of fraud that may have come to the auditor's attention. The application material (paragraph A11) has also been supplemented with some further examples of matters that may be discussed.
- New paragraph 15-4 has been added requiring that the engagement partner shall determine whether further discussion(s) among the engagement team be held at later stages in the audit to consider fraud risk factors that have been identified and the implications for the audit. Application material (paragraph A11-1) has been added giving examples of circumstances where it may be beneficial to have a further discussion.

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<sup>4</sup> ISA (UK) 540 (Revised December 2018), *Auditing Accounting Estimates and Related Disclosures*, paragraphs 18, 34.

<sup>5</sup> ISA (UK) 315 (Revised July 2020), *Identifying and assessing the Risks of Material Misstatement*, paragraphs 13, 35.

### ***Risk assessment procedures and related activities***

- Paragraph 16 has been supplemented to clarify that the understanding obtained by the auditor includes the fraud risk factors relevant to the entity that affect the susceptibility of assertions to material misstatement due to fraud.
- New paragraph 18-1 has been added requiring that persons within the entity the auditor makes inquiries of include those who are responsible for dealing with allegations of fraud raised by employees or other parties.
- New paragraph 21-1 has been added to emphasise that if the responses to inquiries of those charged with governance, or others within the entity, are inconsistent with the responses to the inquiries of management, the auditor shall determine the implications for the audit in accordance with ISA (UK) 500.
- New paragraphs 24-1 and 27-1 have been added requiring that the auditor shall determine whether the engagement team requires specialized skills or knowledge to perform particular procedures and, If the auditor identifies a misstatement due to fraud or suspected fraud, the auditor shall determine whether a forensic expert is needed to investigate further. Application material (paragraph A27-1) has been added giving examples of matters that may affect the auditor's determination of whether the engagement team requires specialized skills or knowledge.

### ***Responses to the assessed risks***

- New paragraph 32-1 has been added to emphasise that, in obtaining and evaluating audit evidence regarding possible management bias in making accounting estimates, the auditor shall also comply with the relevant requirements in ISA (UK) 540 (Revised December 2018).
- New paragraph 36-1 has been added to emphasise that in performing the stand-back and overall evaluation of the sufficiency and appropriateness of audit evidence obtained, the auditor shall, taking into account all relevant audit evidence obtained, whether corroborative or contradictory, evaluate whether:
  - (a) The assessments of the risks of material misstatement at the assertion level due to fraud remain appropriate;
  - (b) Sufficient appropriate audit evidence has been obtained regarding the assessed risks of material misstatement due to fraud, and shall conclude whether, the financial statements are materially misstated as a result of fraud.

### ***The auditor's report***

- New paragraph 39-1 has been added to emphasise that, as required by ISA (UK) 700, the auditor's report shall explain to what extent the audit was considered capable of detecting irregularities, including fraud<sup>6</sup>. To clarify that this is not intended to be 'boilerplate', it is required that this explanation shall be specific to the circumstances of the audited entity and take account of how the auditor planned and performed

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<sup>6</sup> ISA (UK) 700 (Revised November 2019), *Forming an Opinion and Reporting on Financial Statements*, paragraph 29-1.

procedures to address the identification and assessment of the risks of material misstatement.

### ***Communications to management and those charged with governance***

- Paragraph 42 has been supplemented to require that in communicating matters related to fraud, the auditor shall consider the matters, if any, to communicate regarding management's process for identifying and responding to the risks of fraud in the entity and the auditor's assessment of the risks of material misstatement due to fraud.

### ***Documentation***

- New paragraph 45-1 has been added emphasising that, as required by ISA (UK) 230, if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency.

### **Potential additional changes to ISA (UK) 240**

14. In the course of developing this exposure draft of the standard, we identified a small number of potential additional revisions to the standard which we would like to specifically consult on:

- A requirement for the auditor to have a specific discussion with Those Charged With Governance on the risks of material fraud in the audited entity, including those with business sector specific relevance. The purpose of this discussion would be to enhance risk assessment procedures related to material misstatement of the financial statements due to fraud.
- Interaction with ISA (UK) 250 Sections A and B: A matter that is often closely related to fraud is non-compliance with laws and regulations, particularly where that non-compliance is intentional as it is often also fraudulent in nature. The auditor's responsibilities to consider laws and regulations in an audit of financial statements is set out in ISA (UK) 250 Section A (Revised November 2019). The Appendix to that standard also sets out the auditor's additional responsibilities that arise as a result of money laundering, terrorist financing and proceeds of crime legislation in the UK. ISA (UK) 250 Section B sets out specific reporting requirements placed on the auditor of specific types of entity. It is important that these responsibilities and requirements are considered when complying with the requirements of ISA (UK) 240. The FRC would therefore like to hear the views of stakeholders about whether more could be done within the exposure draft to clarify these links.

### **Proposed effective date**

15. We are proposing an effective date of audits of financial statements for periods beginning on or after 15 December 2021, with early adoption permitted. This is the same effective date as for ISA (UK) 315 (Revised July 2020). We believe this is practicable given the nature of the revisions and also will enable firms to address both revised standards in a single update of their procedures rather two separate updates within a relatively short period of time.

## Request for Comments

16. We welcome comments in writing on all aspects of this proposed revision. In particular, comments are sought in relation to questions 1-10 below.

- Q1. Has ISA (UK) 240 been appropriately revised to give increased clarity as to the auditor's obligations relating to fraud in the audit of financial statements. If you do not consider this to be the case, please set out why and how you believe those obligations should be clarified.
- Q2. Have appropriate enhancements been made to the requirements for the identification and assessment of risk of material misstatement due to fraud, and the procedures to respond to those risks, to promote a more consistent and robust approach to the auditor's responsibilities in relation to fraud? If you do not consider this to be the case, please set out why and how you believe the requirements should be enhanced.
- Q3. Have appropriate enhancements been made to the application material? If you do not consider this to be the case, please set out why and how you believe the application material should be enhanced.
- Q4. Do the proposals sufficiently support the appropriate exercise of professional scepticism throughout the risk assessment procedures, the procedures to respond to those risks and the evaluation of audit evidence obtained? If you do not consider this to be the case, please give reasons and describe how you consider the exercise of professional scepticism could be better supported.
- Q5. ISA (UK) 240 establishes a rebuttable presumption that there are risks of fraud in revenue recognition (paragraph 26). Are there other account balances, transactions or disclosures for which such a rebuttable presumption should be established? If you consider there are, please identify them and set out why.
- Q6. ISA (UK) 240 specifies particular audit procedures responsive to risks related to management override of controls (paragraphs 31 – 33). Are there other audit procedures responsive to those risks, or any other risks of material misstatement due to fraud, that you believe should be required for all audits? If you consider there are, please describe them and set out why.
- Q7. In complying with the requirements of ISA (UK) 240 (Revised), the auditor may also need to consider whether there has been non-compliance with laws and regulations, and therefore that requirements in ISA (UK) 250 Sections A and B (Revised November 2019) also apply. Is it sufficiently clear in these ISAs (UK) of the interaction between them?
- Q8. Are the requirements and application material sufficiently scalable, including the ability to apply ISA (UK) 240 (Revised) to the audits of entities with a wide range of sizes, complexities and circumstances? If you do not consider this to be the case, please set out why and how you believe that could be addressed.
- Q9. References to 'computer assisted audit techniques' have been updated to 'automated tools and techniques' and we have identified that these may enable more extensive testing and assist in identifying unusual transactions or relationships (paragraphs A44, A48 and A50). Is there other guidance in relation to the use of automated tools and techniques that you believe could assist auditors in relation to their obligations with regard to fraud? If you consider there is, please give an explanation of it.



- Q10. Do you agree with the proposed effective date of audits of financial statements for periods beginning on or after 15 December 2021, with early adoption permitted, which is aligned with the effective date of ISA (UK) 315 (Revised July 2020)? If not, please give reasons and indicate the effective date that you would consider appropriate.
- Q11. Should an additional requirement be placed on auditors to have a specific discussion with those charged with governance on the risks of material fraud in the business, including those which are business sector specific, in order to further the risk assessment process in respect of the risk of material error in the financial statements relating to fraud?

## 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. In developing the proposed revisions to ISA (UK) 240, we have sought to maintain our support for the underlying international standards while introducing supplemental material to address concerns currently identified in the UK.

We recognise that some additional costs will be incurred by practitioners, including those relating to enhanced planning and performance, staff training, and familiarisation with the standards. The standard has been designed to be scalable. We believe that benefits in the public interest of clarifying the auditor's responsibilities in relation to fraud and promoting a more consistent and robust approach to those responsibilities, although not quantifiable, will outweigh the costs of changes that may be necessary to audit firms' methodologies.

Impact	Assumptions	Cost Impacts	Estimated Cost (hours)	Recurring (Y/N)
Familiarisation and training with revised standard	Updating guidance by technical managers/partners (90%/10%) 30 hours per firm. To note that audit firms update technical/methodology material on an annual basis.	Audit firm	30 per firm	N
Familiarisation and training with revised standards (ethical and auditing).	Familiarisation of audit practitioners with standards estimated at 5 hours per practitioner. To note that practitioners are required to maintain CPD, and an aspect of familiarisation with standards would have taken place anyway.	Audit firm	5 per practitioner	N
Enhanced planning and performance	Additional team discussions, inquiries of management, review and respective documentation to meet the requirements in the standard	Audit firm	10 hours per audit	Y

**Financial Reporting Council**

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