

October 2022

INTERNATIONAL STANDARD ON AUDITING ISA (UK) 540: POST IMPLEMENTATION REVIEW

Call for Feedback

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ISA (UK) 540 (Revised December 2018) - Post Implementation Review

Call for Feedback

Introduction

1. This Call for Feedback seeks feedback on the International Standard on Auditing (ISA) (UK) 540 (Revised December 2018) *Auditing Accounting Estimates and Related Disclosures*.

Background

2. The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The 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.
3. The ISAs (UK) are based on the corresponding international standards issued by the International Auditing and Assurance Standards Board (IAASB). Where necessary, the international standards have been augmented with additional requirements and guidance that is appropriate in the UK national legislative, cultural and business context.
4. ISA (UK) 540 (Revised December 2018) adopted ISA 540 (Revised) issued by the IAASB. It kept the FRC's supplementary requirement in the previous standard 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 32-1 in the revised standard). The supplementary requirement reflects a specific requirement of the auditor under UK legislation¹. An objective of the IAASB's revision of ISA 540 was to enhance professional scepticism and maintaining the FRC's supplementary requirement was not expected to result in significant additional work effort.
5. The revised standard also maintained the FRC's supplementary application material for audits of financial statements of public interest entities, providing cross references to requirements in other ISAs (UK) pertaining to the auditor's assessment and communication of valuation methods (paragraph A37-1 in the revised standard). This was not expected to result in additional work effort.
6. The revision of ISA 540 was designed primarily to address issues arising from evolving financial reporting frameworks and concerns expressed by regulators and other stakeholders that had developed since the previous standard was issued in 2009. These issues included:
 - Financial reporting frameworks require more complex accounting estimates with high estimation uncertainty and related disclosures (for example IFRS 9² and other financial reporting standards require greater use of forward looking information).
 - Complex accounting estimates becoming more prevalent and a fundamental part of financial statements for some entities, and increasingly developed by complex models and/or involving the use of experts.
 - Findings by audit inspectors raising concerns about audit quality for accounting estimates, including in relation to:
 - The performance of sufficient risk assessment procedures;

¹ The Statutory Auditors and Third Country Auditors Regulations 2016, Schedule 1, paragraph 2(b)(ii).

² International Financial Reporting Standard 9, *Financial Instruments*.

- The extent of the auditor's understanding and further consideration of the appropriateness of methodologies used by management;
 - Sufficiency of testing over the accuracy and completeness of data used and the reasonableness of assumptions adopted by management;
 - Consideration of contradictory or inconsistent evidence, where available; and
 - Application of an appropriately independent and challenging sceptical mindset.
7. While complex accounting estimates have become more prevalent, it was recognised that some entities, particularly many SMEs, may generally have fewer such complex accounting estimates.

The revised standard

8. The revision of ISA (UK) 540 included:
- 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 previous standard addressed 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 (UK) 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 is designed to be scalable, recognising that some estimates may not require significant judgments and the processes for making them may not be complex.

9. Conforming amendments were also made to other ISAs (UK). These included:

ISA (UK) 230 (Revised June 2016), *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 (UK) 260 (Revised June 2016), *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.

ISA (UK) 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 (UK) 700 (Revised June 2016), *Forming an Opinion and Reporting on Financial Statements* - amending the requirements to reflect that the auditor evaluates whether related disclosures, as well as the accounting estimates, made by management are reasonable.

Post implementation review

10. The FRC's principles for the development of codes, standards and guidance include that they will be kept under regular review and re-considered at least once every 5 years. ISA (UK) 540 became effective for audits of accounting periods beginning on or after 15 December 2019.

Invitation to comment

The FRC is requesting responses to this Call for Feedback by 13 January 2023. In particular, comments are sought in relation to questions 1-11 as presented below. While some questions are directed at particular stakeholders, respondents are welcome to comment on any matters they wish to.

Responses to the Call for Feedback should be sent to:

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

ISA (UK) 540 (Revised December 2018) - Post Implementation Review Questions

General

1. Has the 2018 revision of ISA (UK) 540 been effective in driving high quality audit of accounting estimates and related disclosures, addressing issues arising from evolving financial reporting frameworks that had developed since the previous standard was originally issued in 2009 (including for complex estimates such as certain expected credit loss estimates)? If not, what specific issues do you believe need more attention and why?
2. Are there any further steps that the FRC should consider as part of this review to ensure the high quality audit of accounting estimates and related disclosures?

For practitioners

3. Are the requirements and application material sufficiently clear? If not, please explain the issues that are of concern and how you believe they could be resolved.
4. Has the standard provided for sufficient proportionality and scalability, especially for accounting estimates with low uncertainty, complexity and subjectivity? If not, please explain the issues that are of concern and how you believe they could be resolved.
5. Are you aware of and, if so, have you used the IAASB's ISA 540 implementation support materials³? Do you believe it would be helpful for the FRC to promote these materials?
6. What other difficulties, if any, have you encountered in complying with the revised standard? Is there anything the FRC could do to help alleviate these (e.g. further supporting guidance)?

For those charged with governance, including audit committees

7. Has the auditor's communications with you about their views on aspects of the entity's accounting practices relating to accounting estimates and related disclosures been relevant and helpful to you in discharging your responsibilities for oversight of the financial reporting process? What aspects have you found it particularly helpful to discuss with the auditor? What further aspects, if any, would you benefit from communication by the auditor?
8. Are new or enhanced disclosures about accounting estimates being given as a result of enhanced auditor attention to them since ISA (UK) 540 was revised?

³ The IAASB makes available the following ISA 540 (Revised) Implementation Support materials:

- [Flow Charts and Diagram](#)
- [Audit Client Briefing](#)
- [Illustrative Examples for Auditing Simple and Complex Accounting Estimates](#)
- [Illustrative Examples for Auditing Expected Credit Loss Accounting Estimates](#)

The IFAC 'Knowledge Gateway' gives links to the IAASB materials and has also issued an ISA 540 (Revised) [Implementation Tool](#)

For users of audited financial statements

9. When an entity includes robust disclosure about accounting estimates, has the auditor where appropriate drawn attention to the disclosure of key assumptions, the disclosure of the range of possible outcomes, and other qualitative and quantitative disclosures relating to key sources of estimation uncertainty or critical accounting estimates, as part of addressing why the matter was one of most significance in the audit (a key audit matter) and how the matter was addressed in the audit?
10. Where relevant do the key audit matters covered in the auditor's report sufficiently address the significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that are subject to a high degree of estimation uncertainty? If not, what more information would you find helpful and why?
11. What more information, if any, do you believe the auditor should give in the auditor's report about accounting estimates and related disclosures?



Financial Reporting Council

8th Floor
125 London Wall
London
EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk