Feedback Statement and Impact Assessment

ISA (UK) 240 (Revised May 2021) The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Financial Reporting Council

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 International Auditing and Assurance Standards Board (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. In October 2020 the FRC issued a public consultation on the proposal to revise ISA (UK) 240 (Updated 2020), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*. The consultation closed on 29 January 2021. The FRC has considered the responses received together with views expressed by stakeholders in webinar outreach events. The FRC is now issuing the final revised standard which, as proposed in the consultation, is effective for audits of periods commencing on or after 15 December 2021 with early adoption permitted. This is the same effective date as for ISA (UK) 315 (Revised July 2020*) Identifying and Assessing the Risks of Material Misstatement*. A small number of changes have been made to address matters raised in the consultation, which are explained below. These changes do not introduce any substantive new requirements to those proposed in the consultation.

Background

4. 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 had not been substantively revised since 2004.

5. 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.

6. 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."

7. Sir Donald made a number of recommendations including[1]:

   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.

[1] 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.

The revisions we consulted on included addressing recommendation 14.1.5 to clarify the obligations of auditors. We also proposed 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.

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 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.

Responsibilities of management and those charged with governance

9. It is important for users of financial statements to be aware that while the audit may assist the prevention and detection of material fraud, it cannot provide absolute assurance that all fraud is detected. As is identified in ISA (UK) 240, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention and deterrence. This was recognised by Sir Donald and underpins his recommendation "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."

10. The Department for Business, Energy and Industrial Strategy (BEIS) is currently consulting [2] on proposals to restore trust in audit and corporate governance, including 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.

IAASB project

11. The IAASB is undertaking its own review of ISA 240. We intend to support and contribute to that. However, it is possible that it could be several years from now before a revision of ISA 240 is finalised by the IAASB and becomes effective. 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.

[2] Restoring trust in audit and corporate governance
https://www.gov.uk/government/consultations/restoring-trust-in-audit-and-corporate-governance-proposals-on-reforms

Explanation of Key Changes

12. 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.

13. The FRC has revised ISA (UK) 240 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.

14. The FRC's 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 not 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[3].

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)[4] and ISA (UK) 315 (Revised July 2020)[5]. 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. 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.

[3] 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).
[4] ISA (UK) 540 (Revised December 2018), *Auditing Accounting Estimates and Related Disclosures*, paragraphs 18, 34.
[5] ISA (UK) 315 (Revised July 2020), Identifying and assessing the Risks of Material Misstatement, paragraphs 13, 35.

New supporting application material (paragraph A9-1) has been added giving examples of conditions that may indicate a 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 members of the engagement team be held at later stages in the audit to consider fraud risk factors that have been identified during the course of the audit 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.

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 deal with allegations, if any, of fraud raised by employees or other parties.

- New paragraph 21-1 has been added requiring that when obtaining an understanding and making inquiries of those charged with governance in accordance with paragraphs 20 and 21, the auditor shall discuss with those charged with governance the risks of material fraud in the entity, including those that are specific to the entity's business sector. Supporting application material is provided in paragraph A20-1.

- New paragraph 21-2 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 33-1 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 specialized skills or knowledge are needed to investigate further for the purpose of the audit. Application material (paragraphs A27-1 and A48-1) 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[6]. 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 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.

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

Effective date

15. The revised standard is effective for audits of financial statements for periods commencing 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.

Responses to the consultation

16. The FRC's consultation closed on 29 January 2021. We received 25 responses[7] but not all respondents answered all 11 questions asked in the consultation document. A list of the respondents is included in the Appendix to this Feedback Statement.

17. The distribution of responses is as follows:

Type of respondent	Number
Audit Firm (AF)	10
Professional Body (PB)	4
National Audit Agency (NAA)	1
Investors and Analysts (INV)	3
Industry Groups and Companies (IG)	3
Individuals (IND)	3
Other (OTH)	1
Total	**25**

Other outreach

The FRC hosted a public webinar[8] on the ISA (UK) 240 consultation and held further outreach events with investors and audit committee members.

18. A summary of the responses received to the specific questions asked in the consultation, and the FRC's responses, are set out 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.

Summary of responses

Sixteen respondents (AF 7; PB 3; NAA 1; INV 3; IG 1; OTH 1) agreed or generally agreed that ISA (UK) 240 is being revised to give increased clarity as to the auditor's obligations relating to fraud in the audit of the financial statements. However, some of those respondents identified matters where they believed the clarity of particular requirements and guidance could be further clarified or enhanced. Four respondents (AF 3; PB 1) did not give a direct answer but gave

[7] Copies of the responses can be seen at: https://www.frc.org.uk/consultation-list/2020/consultation-on-revised-auditing-standard-(isa-(uk

[8] A recording of the webinar can be accessed at: https://vimeo.com/510206666/e8268ffd28

comments on some particular matters. Three respondents (IG 1; IND 2) said that they did not believe the standard was being appropriately revised. Two respondents (IG 1; IND 1) did not answer the question.

Comments on specific requirements and guidance were expanded on in the responses to questions 2 and 3.

The auditor's objective

With regard specifically to the clarity of the auditor's obligations, only three respondents challenged the proposed revisions to the wording that describes the objective of the auditor. An audit firm suggested that it should be made clear what an auditor cannot do and at a minimum state that the objective is "not to obtain absolute assurance". Another audit firm suggested that the revisions do not address aspects of the expectation gap that may be contributed to by potential misunderstanding of terms such as 'reasonable assurance', 'taken as whole' and 'material misstatement'. It was also suggested that reasonable assurance may be less for fraud than for error.

Alternatively, two respondents (AF 1; PB 1) did not object to the revised wording of the objective but suggested the changes were not adding anything new and five respondents (AF 3; INV 2) explicitly supported the proposed revisions.

Materiality

Ten respondents expressed concern with the revision to paragraph 3 of the Introduction text that stated that "judgements about whether a misstatement is material involves both qualitative and quantitative considerations" and the example that "a fraud or suspected fraud by a key member of management may be considered material even if the potential misstatement is less than materiality determined in quantitative terms." In particular there was concern that this may be taken to mean that an audit should be planned to detect any qualitatively material fraud or, for example, to check all management expense claims and treat any small error in them as a potential fraud.

Wider necessary reforms

Thirteen respondents (AF 7; PB 2; INV 2; IND 1; OTH 1), either in answer to question 1 or elsewhere in their responses, commented on matters such as the proposed revisions being relatively limited and that for a significant step change in the prevention and detection of fraud wider reforms would be necessary. These include in particular addressing the responsibilities of directors in respect of fraud, for example Sir Donald Brydon's recommendation that directors should report on the actions they have taken to fulfil their obligations to prevent and detect material fraud. Some respondents also commented on a need for auditors to receive fraud awareness training, which was also recommended by Sir Donald Brydon.

FRC response

As described in the Consultation Paper, the revisions proposed in the exposure draft address Sir Donald Brydon's recommendation to clarify the obligations of auditors, together with some 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. We believe it is important to act now to clarify the auditor's current responsibilities given the level of misunderstanding referred to by Sir Donald.

We share the views that even more might be done but believe it is best to wait so as to take account of other ongoing developments. The consultation by BEIS, *Restoring trust and confidence in audit*, includes proposed statutory requirements for directors to report on the actions they have taken to fulfil their obligations to prevent and detect fraud, for auditors to report in relation to such a director's statement, and the auditor to state what steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud (covering Sir Donald's recommendations 14.2.2 and 14.3.5). Those proposals need to be considered holistically together with other proposals in the BEIS consultation (e.g. relating to matters such directors' accountability for internal controls and auditor reporting). We will address those recommendations in due course, taking account of the outcome of the BEIS consultation. However, the outcome of the consultation and the timing of any new statutory responsibilities is not known, and we consider it important that it does not delay clarifying the auditor's current responsibilities.

With regard to a more fundamental review and revision of the standard, as we noted in the Consultation Paper, we intend to support and contribute to the project that has been commenced by the IAASB. We believe that is a more appropriate approach than starting a separate grass roots review and revision, and maintains our support for the underlying international standards. However, it is possible that it could be several years from now before a revision of the underlying international standard is finalised.

In finalising this revision of ISA (UK) 240, we have considered the concerns described above. We have amended paragraph 3 to clarify that judgments about whether an "identified" misstatement is material involves both qualitative and quantitative considerations. That is consistent with ISA (UK) 450, *Evaluation of Misstatements Identified During the Audit*. The evaluation of whether a misstatement arising from an identified or suspected fraud by a key member of management is material to the financial statements, even if the potential misstatement is less than materiality determined in quantitative terms for the financial statements as a whole, depends on the circumstances (e.g. where it gives rise to concerns about the integrity of management responsible for internal controls or the preparation of the financial statements).

We do not agree that reasonable assurance for fraud should be treated as a lower level than reasonable assurance for error. As set out in ISA (UK) 200, reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

Reasonable assurance is not an absolute level of assurance, because of the inherent limitations of an audit. ISA (UK) 200 and ISA (UK) 240 explain that due to the inherent limitations of an audit, the risk of not detecting a material misstatement resulting from fraud may be higher than the risk of not detecting one resulting from error, particularly where fraud may have involved sophisticated and carefully organized schemes designed to conceal it.

However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Accordingly, the greater the risks of material misstatement the auditor believes exists, the more persuasive the audit evidence required by the auditor.

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.

Summary of responses

Sixteen respondents (AF 7; PB 3; NAA 1; INV 3; IND 1; OTH 1) were supportive of the enhancements. However, thirteen of those identified some areas where clarity could be enhanced or, in a few cases, some additional procedures could be considered. Five respondents (AF 3; PB 1; IND 1) did not answer the question explicitly but commented that some of the requirements needed further clarification. Two respondents (IG 1, IND1) said they did not believe the requirement had been appropriately revised; and two respondents (IG 1, IND 1) did not answer the question.

While respondents raised some concerns about the clarity of some of the proposed revised and new requirements, in many cases other respondents supported those requirements as worded. One area where there was a more general consistency of concern (although not shared by all respondents) was the proposed new requirement that "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". Concerns included: what is actually meant by a "forensic expert"; whether all firms would be able to source such an expert if needed; and is this moving responsibility for investigating a suspected fraud to the auditor when it should be the responsibility of the entity.

Possible additional procedures that some individual respondents suggested included a requirement for the auditor to assess the complexity of the entity's business model; and a requirement for the auditor to have wider discussions with other parties, including the entity's available shareholders, about fraud risks.

For the two respondents who stated that the requirements had not been appropriately revised, one suggested that more attention needed to be given to other fraud risk factors, in particular assessing management integrity and motives to commit fraud; and the other believes the requirements are too generic and not sufficiently scalable for differing levels of complexity of audited entities.

FRC response

We have considered respondents' comments and do not believe that fundamental changes need be made to the proposed new and enhanced requirements. However, in finalising the revised standard we have made some edits to address the concern related to the reference to 'forensic experts' and to enhance clarity in some other requirements.

Paragraph 27-1 in the exposure draft, which required the auditor to determine whether a forensic expert is needed, has been repositioned to be paragraph 33-1 in the section on evaluation of audit evidence, and has been amended to require that "If the auditor identifies a misstatement due to fraud or suspected fraud, the auditor shall determine whether specialised skills or knowledge are needed to investigate further for the purposes of the audit." We have also added supporting application material in paragraph A48-1, which includes identifying that in some circumstances the auditor may consider it appropriate to use the specialist skills and knowledge of a forensic accountant.

Considerations for understanding the entity and its business model are addressed in ISA (UK) 315 (Revised July 2020).

We do not believe it would be appropriate to mandate wider discussion about fraud risks with other parties outside the entity, including available shareholders. The practicalities of identifying and contacting "available shareholders" could be difficult and it is unclear the that the benefits would outweigh the overall costs. There could also be issues of confidentiality and a need to ensure that market sensitive information is not disclosed to fewer than all shareholders. However, shareholders who have particular concerns could inform appropriate members of those charged with governance of the entity, with whom the auditor would have discussions as required by the standard, or inform the auditor directly.

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.

Summary of responses

Fifteen respondents (AF 7; PB 3; NAA 1; INV 3; IG 1) were supportive of the enhancements of which ten identified some areas where clarity could be enhanced or further guidance added. Five respondents (AF 3; PB 1; OTH 1) did not answer the question explicitly but commented that some of application material needed further clarification or amendment. Two respondents (IG 1, IND1) said they did not believe the application material had been appropriately revised; and three respondents (IG 1, IND 2 did not answer the question.

Five respondents (AF 4, PB1) raised a concern that the proposed new application material in paragraph A10-1 that indicated that "all" members of the engagement team, including specialists, participate in the discussion [about the susceptibility of the entity's financial statements to material misstatement due to fraud]. They identified that on many large audits, and in particular group audits and international audits, this would be impractical. It was also observed that it is inconsistent with the requirement for the team discussion that is established in ISA (UK) 315 that requires the involvement of "key" members of the engagement team.

Helpful comments and observations were made by various respondents about other elements of the application material, but there were no particular areas for which a number of consistent concerns were raised.

FRC response

We have considered respondents' comments and do not believe that fundamental changes need be made to the proposed new and enhanced application material. However, in finalising the revised standard we have made some edits to address the concern related to the members of the engagement team participating in the team discussion and to enhance clarity in some other application material. A small amount of new application material has also been added as described in the responses to other questions.

The main intent of paragraph A10-1 was to identify that members of the engagement team involved in the team discussion may include specialists, not necessarily all members of the engagement team. It has been reworded to "Members of the engagement team involved in the discussion may include specialists participating in the audit who have relevant knowledge and experience."

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.

Summary of responses

Fifteen respondents (AF 8; PB 2; NAA 1; INV 3; IG 1) agreed that the proposals supported the appropriate exercise of professional scepticism. Five of those respondents suggested that further guidance for auditors on a variety of different matters would be helpful, including how to demonstrate and document the exercise of scepticism, and that further guidance should be given to stakeholders on "reasonable assurance", emphasising that it is not absolute assurance. Five respondents (AF 2; PB 1; IG 1; OTH 1) indicated that they did not believe the proposals would have a significant effect and indicated some areas where more enhancements or guidance would be helpful, including a requirement for auditors to validate parties responding to confirmation requests and more focus on fraud in revenue recognition facilitated by collusion. The importance of auditor training and experience was also highlighted. Three respondents (PB 1; IG; IND 1) stated that the proposals did not sufficiently support the exercise of professional scepticism and sought more guidance on matters such as how to exercise and demonstrate scepticism. One of those respondents emphasised a need for education and training rather than experience and also suggested that "critical thinking" needs to be introduced to the definition of professional scepticism. Two respondents (IDV 2) did not answer the question.

FRC response

We believe that it is important for ISA (UK) 240 to reinforce the application of professional scepticism when addressing the risks of material misstatement due to fraud. For example, through requirements such as the auditor undertaking risk assessment procedures and designing and performing 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 (paragraph 12-1); clarifying that the auditor remains alert for conditions that indicate a record or document may not be authentic (paragraph 13-1); investigating responses to inquiries of management, those charged with governance or others in the entity that appear implausible (paragraph 14); and the “stand back” requirement when evaluating audit evidence obtained to into account all relevant audit evidence, whether corroborative or contradictory (paragraph 36-1).

The ISAs (UK) are principles based. We expect auditors to be able to determine how to demonstrate and document that they have applied professional scepticism when they have done so. It is not practicable to give detailed guidance on how to exercise scepticism in all circumstances.

We agree that education and training are important and will consider how this can be further addressed outside of the standards.

Requirements for undertaking confirmation requests are established in ISA (UK) 505, *External Confirmations*. If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor is required to obtain further audit evidence to resolve those doubts. It would not be proportionate to require that the auditor perform further procedures to specifically validate all parties responding in all circumstances.

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.

Summary of responses

Fourteen respondents (AF 10; PB 3; OTH 1) said that it was not was not necessary to add further rebuttable presumptions. Reasons included that fraud risks vary in different businesses and that it is important for auditors to undertake an assessment of the risks based on the facts and circumstances specific to the entity; and rebuttable presumptions may cause an inappropriate focus on particular risks. Two respondents (PB1, NAA 1) suggested that rebuttable presumption of fraud risk could be extended to 'expenditure' for some types of business such as service based businesses and owner-managed businesses. Expenditure is already a presumed fraud risk in the public sector. Five respondents (INV 3; IG 2) suggested a rebuttable presumption of fraud risk in relation to cash balances and transactions. One respondent (IND 1) identified some areas of risk, including assets, expenses and disclosures but did not suggest there should be a rebuttable presumption. Three respondents (IG 1; IND 2) did not answer the question.

FRC response

Having considered the responses to the consultation, we are not including further rebuttable presumptions in this revision of ISA (UK) 240. We will make the IAASB aware of the comments sent to us so that it can take them into consideration when performing it's more fundamental review and revision of the underlying international standard.

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?

Summary of responses

Fourteen respondents (AF 7; PB 2; NAA 1; INV 1; IG 2; IND 1) said the interaction between the standards was sufficiently clear, although one suggested more guidance outside the standards could be helpful and one suggested the standards identify all laws and regulations that need to be considered. One respondent (PB) suggested the boundaries between the standards was blurred and they could be merged. Seven respondents (AF 3; PB1; INV 2; OTH 1) said the interaction was not clear. Suggestions from those respondents included introducing a specific requirement, when a fraud is suspected or identified, to address whether the fraud also represented non-compliance with law or regulations; clarifying circumstances under which non-compliance with law or regulations would be a fraud; improving the cross references to Section B as well as Section A of ISA (UK) 250; and giving examples of exceptional circumstances that might cause the auditor to withdraw from the engagement. Three respondents (IG 1; IND 2) did not answer the question.

FRC response

We have now included reference to ISA (UK) 250 Section B for completeness. ISA (UK) 250 Section A makes clear that where the auditor determines that the identified or suspected non-compliance with laws and regulations is intentional, the requirements in ISA (UK) 240 apply. Paragraph 8a of ISA (UK) 240 highlights that the auditor may have additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's non-compliance with laws and regulations; and paragraph 43 specifically requires, if the auditor has identified or suspects a fraud, that the auditor determine whether law, regulation or relevant ethical requirements require the auditor to report to an appropriate authority outside the entity.

Both ISAs (UK) 240 and 250 Section A make clear that withdrawal from the engagement by the auditor is a step of last resort and include an example of when that may be appropriate.

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.

Summary of responses

Eleven respondents (AF 4; PB 1; NAA 1; INV 2; IG 1; IND 1; OTH 1) said the requirements and application material were sufficiently scalable. Six respondents (AF 4; PB 2) reiterated concerns expressed in answers to Q2 and Q3 regarding the requirement to consider the use of a forensic expert and the guidance to involve all team members in the team discussion. Three respondents (AF 2; PB 1) expressed other concerns, including that the requirements relating to management override of controls do not distinguish between the different management structures in small and large entities; the requirement to make inquiries of the person responsible for dealing with allegation of fraud when in a smaller entity there may not be someone with that responsibility; and the differences in the complexity related to IT in smaller and larger entities. One respondent (IG) simply said the standard was not scalable. Four respondents (INV 1; IG 1: IND 2) did not answer the question.

FRC response

As noted under Q2 and Q3, we have addressed the concerns relating to the use of a forensic expert and the team members to be involved in the team discussion. We have reviewed the requirements relating to management override of controls and continue to believe they can be applied appropriately in small and large entities with different management structures. We are following the IAASB's ongoing projects to look at audits of less complex entities and address challenges relating to complexity, understandability, scalability and proportionality of ISAs. The outcomes of those projects may in time help address the more general concerns relating to the scalability of auditing standards.

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.

Summary of responses

Twenty respondents (AF 10; PB 3; NAA 1; INV 1; IG 3; IND 1; OTH 1) said that more could be made of automated tools and techniques and that specific guidance could be helpful, but did not necessarily need to be delivered now for this revision. The most common suggestions were for analysis of data to identify themes, trends, unusual transactions and outliers, particularly in risk assessment; and for greater coverage of populations in procedures responsive to assessed risks. Other suggestions included use in the confirmations process and validating respondents, and using metadata to validate electronic documents. The importance of training was also referred to by some respondents. Five respondents (PB 1; INV 2; IND 2) either did not answer the questions or said they had nothing to suggest.

FRC response

As noted under Q6, we agree that more consideration should be given to the impact of technology, both in relation to how frauds are committed, how entities can prevent and detect fraud, and the methods available to auditors to detect material frauds. Many respondents support this view but noted that this matter did not necessarily need to be addressed in this revision. We believe it is important that this is also considered at the level of the underlying international standard and we will be encouraging the IAASB do so as part of its review and revision of ISA 240. We are supportive of the IAASB's ongoing project to explore emerging developments in the effective and appropriate use of technology, including data analytics, to enhance audit quality.

We have added an additional application material paragraph (A43-1) to indicate that when automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of automated techniques. This reflects guidance given in ISA (UK) 315 (Revised July 2020).

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.

Summary of responses

Seventeen respondents (AF 8; PB 3; NAA 1; INV 2; IG 2; IND1) agreed with the proposed effective date. One of those respondents (AF) suggested finalising the changes to the requirement on auditor reporting should be delayed until the outcome is know of expected consultation on directors' reporting and the auditor's reporting thereon. One respondent (AF) said the FRDC should wait and work the IAASB on its project to revise the international standard but, if the FRC did not wish to do that, agreed the proposed effective date. One respondent (OTH) said the effective date should be sooner as the revisions are relatively minor. Three respondents ((AF 1; PB 1; INV 1) said they had no comment on the effective date. Three respondents (IG 1; IND 2) did not answer the question.

FRC response

Having considered the responses to the consultation, we are implementing the proposed effective date of audits of financial statements for periods beginning on or after 15 December 2021, with early adoption permitted. As noted above, this is the same effective date as for ISA (UK) 315 (Revised July 2020). We believe this is practicable given the targeted 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. Mandating an earlier effective date could create issues for some audit firms in updating their methodologies and developing and delivering training for their partners and staff within the set time frame.

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?

Summary of responses

Seventeen respondents (AF 9; PB 4; INV 2; IG 2 IND 1) supported an additional requirement. Three of those respondents (AF 2; IG1) said it should be conditional as it may not be needed in all circumstances. Four respondents

(AF 1; NAA 1; IG 1; OTH 1) said that an additional requirement was not needed as existing requirements were adequate and this consideration could be addressed in application material. Four respondents (INV 1; IG 1; IND 2) explicitly said they had no comment to make or did not answer the question.

FRC response

Having considered the responses and the general support at the outreach events we held, we have introduced a requirement (paragraph 21-1) that "When obtaining an understanding and making inquiries of those charged with governance in accordance with paragraphs 20 and 21, the auditor shall discuss with those charged with governance the risks of fraud in the entity, including those that are specific to the entity's business sector." We have also added some supporting application material. By virtue of the links to the other requirements, this requirement will in effect apply unless all of those charged with governance are involved in managing the entity. There are existing separate requirements for inquiries of management.

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 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

May 2021

Appendix

Respondents to the FRC Consultation on its proposal to revise ISA (UK) 240

ACCA

Audit Scotland

BDO LLP

Chartered Accountants Ireland

Confirmation (part of Thomson Reuters)

Corporate Reporting Users' Forum (CRUF)

Deloitte LLP

Dr Rasha Kassem

Duncan & Toplis Ltd

EY LLP

Fraud Advisory Panel

Grant Thornton UK LLP

ICAEW

ICAS

Inflo

Jon Grant

KPMG LLP

Mark Bellamy

MHA MacIntyre Hudson

PwC

Quoted Companies Alliance

Roliscon Limited

RSM UK Audit LLP

Saffery Champness LLP

ShareSoc and UKSA

Financial Reporting Council

Financial
Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk