

December 2018

Feedback Statement and Impact Assessment

ISA (UK) 540 (Revised December 2018) Auditing Accounting Estimates and Related Disclosures

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FEEDBACK STATEMENT AND IMPACT ASSESSMENT

ISA (UK) 540 (Revised December 2018) *Auditing Accounting Estimates and Related Disclosures*

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 Board¹ (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 June 2018, the IAASB approved ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* and related conforming amendments to other ISAs. This was subsequently approved by the Public Interest Oversight Board (PIOB) in September 2018 to confirm that due process has been followed with proper regard to the public interest. The effective date of the revised and amended standards is for audits of financial statements for accounting periods beginning on or after 15 December 2019.
4. The FRC supports this revision and related amendments, noting their importance in supporting an enhanced focus by auditors on management estimates and disclosures. Revisions to International Financial Reporting Standards mean the importance of estimates in corporate reporting will increase still further, for example in the areas of: financial instruments; revenue recognition from contracts; and insurance contracts. The FRC believes that they represent an improvement to the current standards and they are also designed to address concerns expressed by regulators and other stakeholders.
5. The FRC had responded to the IAASB's consultation on the revised standard, taking account of views of UK stakeholders obtained through outreach activities. The FRC response² was supportive of the aims of the IAASB. It identified several proposals the FRC was particularly supportive of and would want to be retained in the final standard. The response did not raise any significant concerns, but it did identify areas where the FRC believed that the proposals could be further enhanced in a number of important respects. The FRC is satisfied that the changes made by the IAASB in finalising the revised standard are appropriate and that ISA (UK) 540 (Revised June 2016) can be revised to adopt the new international standard without the need for further FRC supplementary material beyond the small amount in the current ISA (UK) 540 (Revised June 2016) which relates to requirements of the EU Audit Regulation and Directive³.

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

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

³ These requirements are expected to remain relevant after Brexit as they are reflected in UK law.

6. In July 2018 the FRC issued a public consultation on the proposal to revise ISA (UK) 540 (Revised June 2016) to adopt the revised international standard, retaining the small amount of current FRC supplementary material, and to make the related conforming amendments to other ISAs (UK). Our proposals ensure that the UK auditing standards continue to be compliant with the ISAs and this maintains the FRC's support for the global harmonisation of auditing standards based on ISAs.

7. The revision of ISA (UK) 540 includes:

- Enhanced requirements and application material for risk assessment procedures and the auditor's work effort in responding to the assessed risks of material misstatement. These include, in addition to addressing risks related to estimation uncertainty, specific attention to other risk factors in making accounting estimates such as complexity and subjectivity;
- Enhanced work effort requirements based on one or more of:
 - (a) Considering events occurring up to the date of the auditor's report;
 - (b) Testing how management made the accounting estimate; or
 - (c) Developing an auditor's point estimate or range.

If the auditor develops an auditor's range, the auditor is specifically required to determine that the range includes only amounts that are supported by sufficient appropriate audit evidence;

- Amending the objective and the requirements to the effect that audit procedures address whether both the accounting estimates and the related disclosures are "reasonable" in the context of the applicable financial reporting framework (the current standard addresses whether disclosures are "adequate");
- Enhancements to reinforce the application of professional scepticism. These include using wording to drive questioning or challenging management where appropriate; more focus on identifying indicators of possible management bias; requiring further audit procedures to be designed and performed in a manner that is not biased toward obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory; and an enhanced retrospective review and an overall evaluation based on procedures performed;
- Emphasising the importance of the need to consider internal control, with improved cross references to ISAs (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; and
- Enhanced documentation requirements.

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

8. The other ISAs (UK) which are revised for the conforming amendments are:

ISA (UK) 200 (Revised June 2016), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing* - including identifying in the application material that ISA (UK) 540 (Revised December 2018) requires a separate assessment of inherent risk and control risk.

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) 240 (Revised June 2016), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* - amending the application material to be clear that a retrospective review is not necessarily restricted to the prior period.

ISA (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. The material on qualitative aspects of accounting estimates given in Appendix 2 is moved to ISA (UK) 540 (Revised December 2018).

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) 580, *Written Representations*, - amending the illustrative representation letter to align with the changes in ISA (UK) 540 (Revised December 2018).

ISA (UK) 700 (Revised June 2016), *Forming an Opinion and Reporting on Financial Statements* - amending the requirement in paragraph 13(c) to reflect that the auditor evaluates whether related disclosures, as well as the accounting estimates, made by management are reasonable.

ISA (UK) 701, *Communicating Key Audit Matters in the Independent Auditor's Report* - editorial changes to the requirement in paragraph 9 and related application material, including to reflect ISA (UK) 540 (Revised December 2018) references to a high "degree of" estimation uncertainty.

9. The FRC's consultation closed on 21 September 2018. We received six responses – two from professional bodies and four from audit firms, which are listed in the Appendix to this

statement⁴. Our expectation was that comments would be limited given the existing general support for FRC's long standing position on ensuring UK auditing standards are compliant with the ISAs; and that the FRC was not proposing substantive modifications to the requirements and application material in the revised international standard nor proposing further FRC supplementary material other than to maintain the current material which relates to requirements of the EU Audit Regulation and Directive.

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

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

Summary of Responses

All respondents broadly supported the proposal to revise ISA (UK) 540 (Revised June 2016) and make the conforming amendments to other ISAs (UK) to adopt the revisions to the underlying international standards.

One respondent (professional body) expressed some concern over scalability for smaller and less complex entities. However, they did not oppose adoption but recommend that FRC give consideration to producing additional materials to help address scalability, similar to those they understand the IAASB is considering producing.

FRC Response

The revised standard has been designed to be scalable, recognising that some estimates may not require significant judgments and the processes for making them may not be complex. The FRC does not propose to make further changes to the standard in relation to scalability, we intend, however, to support the IAASB's development of additional materials to contribute to an effective implementation of the revised standard, through participation in the IAASB's Implementation Working Group.

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

Summary of Responses

All respondents agreed that the UK supplementary material could be limited to that shown in the exposure draft.

One respondent (audit firm) recommended consideration of providing practical examples of certain requirements (not specified).

⁴ Copies of the responses can be seen at: [https://www.frc.org.uk/consultation-list/2018/consultation-revision-of-isa-\(uk\)-540](https://www.frc.org.uk/consultation-list/2018/consultation-revision-of-isa-(uk)-540)

FRC Response

The FRC does not propose to add any further UK supplementary material within the final standard. However, as noted above, the FRC intends to support the IAASB's development of additional materials to contribute to an effective implementation of the revised standard.

Given the impact the revised standard will have on bank audits, the FRC has also undertaken a project to revise Practice Note 19 – *The Audit of Banks and Building Societies in the United Kingdom*. This provides additional application guidance for one of the sectors which will be most affected by the new standard.

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

Summary of Responses

Five respondents supported the proposed effective date. One respondent (audit firm) commented that "any divergence between effective dates [with that of the international standard] would be unhelpful when dealing with, for example, group audits where components are based in different jurisdictions where standards had been revised at different times."

One respondent (audit firm) expressed the view that the proposed effective date is not appropriate and a delay would be warranted. Their reasoning, in summary, is that a number of the concepts in the revised standard may be affected by the IAASB's current project to revise ISA 315, which addresses identifying and assessing the risks of material misstatement, and that stakeholders should have the opportunity to comment on those proposals which may result in further conforming changes to ISA 540 (Revised). They were also concerned that audit firms will have to modify their methodologies twice in a relatively short space of time to implement the revision of ISA (UK) 540 and then subsequent conforming changes related to a revision of ISA (UK) 315. The IAASB has proposed an effective date for the proposed revised ISA 315 of audits of financial statements for periods beginning on or after 15 December 2020.

FRC Response

The FRC does not propose to change the effective date of the revised ISA (UK) 540. The key concepts in the standard that are also reflected in the IAASB's proposed revision of ISA 315 were covered in the exposure draft for the revision of ISA 540, giving stakeholders the opportunity to comment on them at that time (which they did). The IAASB's exposure of ISA 315 (Revised) does include some conforming amendments to ISA 540 (Revised), and finalisation of ISA 315 (Revised) may result in some changes to those, but they are not expected to be problematic for audit firms in updating their methodologies in due course.

The revision of ISA (UK) 540 includes changes to enhance the quality of audit of accounting estimates and the FRC believes it would not be in the public interest to defer its adoption. The FRC also agrees that a deferral of the effective date could give rise to an inconsistency of application internationally and would be unhelpful.

Conclusion

Following the consultation and having regard to the responses received, the FRC is adopting ISA (UK) 540 (Revised December 2018) and the conforming changes to other ISAs (UK) as proposed. The effective date is for audits of financial statements for periods beginning on or after 15 December 2019, consistent with the international standard.

Impact Assessment

As a matter of policy, the FRC's auditing standards are based on the corresponding international standards issued by the IAASB. Where necessary the international standards are augmented with additional requirements to address specific UK legal and regulatory requirements; and additional guidance that is appropriate in the UK national legislative, cultural and business context. We believe that ISA (UK) 540 (Revised December 2018) introduces changes compared to the current ISA (UK) 540 that are appropriate and proportionate to address issues that have been identified since the current standard was issued.

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

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

The revised standard has been designed to be scalable. We believe that benefits in the public interest of enhancements to the quality of audit of accounting estimates and related disclosures, although not quantifiable, will outweigh the costs of changes that may be necessary to audit firms' methodologies. Those costs are not attributable to regulatory decisions taken by the FRC, but rather due to decisions taken by the IAASB, and for the supplementary requirements carried over from the 2016 standard, by the European Commission.

Financial Reporting Council

December 2018

**Respondents to the July 2018 FRC consultation on the proposed revision of ISA (UK)
540 (Revised June 2016)**

Professional Bodies

Institute of Chartered Accountants in England and Wales (ICAEW)

Institute of Chartered Accountants of Scotland

Audit Firms

Deloitte LLP

Ernst & Young LLP

Grant Thornton UK LLP

Moore Stephens LLP



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