

# TECHNICAL BULLETIN

**AUDIT SPECIAL  
ISSUE NO. 167  
OCTOBER 2022**

## FRC QUALITY MANAGEMENT STANDARDS

In September 2020, the International Auditing and Assurance Standards Board (IAASB) strengthened an audit firm's approach to quality management with the issue of three new and revised quality management standards.

In July 2021, the Financial Reporting Council (FRC), published the revised quality management standards applicable in the UK following a consultation on the adoption of the IAASB's revised standards, with a small number of additional requirements and guidance to address specific UK legal and regulatory requirements.

International Standard on Quality Management (UK) 1 (ISQM (UK) 1) and International Standard on Quality Management (UK) 2 (ISQM (UK) 2) will replace the current International Standard on Quality Control (UK) 1 (ISQC (UK) 1) for audits of financial statements for periods beginning on or after 15 December 2022. International Standard on Auditing (UK) 220 (Revised July 2021) (ISA (UK) 220), Quality Management for an Audit of Financial Statements, also becomes effective from that date.

The three standards provide a holistic improved quality management package. It is crucial that implementation of the quality management standards should not be seen as a compliance exercise. There is real benefit to a firm in ensuring that it is performing quality engagements. Adopting such a mindset and approach will help to ensure that the firm gets the most out of this project. Focusing on quality will help to maintain the reputation of the firm and reduce the risk of its personnel ever being subject to investigation and potential disciplinary action.

### CONTENTS

FRC QUALITY MANAGEMENT STANDARDS .....	1
ISA (UK) 315 (REVISED JULY 2020) – IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISTATEMENT.....	10
ISA (UK) 240 'THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS' (REVISED MAY 2021) UPDATED MAY 2022 .....	15
SME THRESHOLDS.....	18

### Benefits

The new ISQM 1 'risk-based' approach is expected to generate multiple benefits for firms' systems of quality management that support the consistent performance of quality engagements, including:

- A system that is tailored for the nature and circumstances of the firm and the engagements it performs, thereby improving the robustness and effectiveness of activities undertaken by the firm to address engagement quality. A tailored system of quality management may also result in improved utilisation of firm resources.
- Facilitating a proactive response by the firm to changing circumstances and proactively managing or mitigating risks, and promoting continual improvement and responsiveness. This new approach will also aid in keeping the system fit for purpose and adaptable to a changing environment.
- Increased emphasis on monitoring the system as a whole and timely and effective remediation, to promote ongoing improvement and consideration of the appropriateness of the system, including whether it is effective in supporting engagement quality.
- Improved integration of the components of the system, thereby promoting an ongoing process of improvement, and consideration of the effect of

decisions across the system. In addition, this approach is intended to be adaptable to the size and nature of a firm or the services it provides.

## Scope

ISQM 1 applies to firms that perform engagements undertaken in compliance with performance standards issued by the FRC which comprise:

- a) Audits of financial statements undertaken in compliance with International Standards on Auditing (UK);
- b) Reporting accountants acting in connection with an investment circular;
- c) Reviews of interim financial information by the independent auditor of the entity (International Standard on Review Engagements (UK) 2410 (Revised May 2021));
- d) Engagements to provide assurance on client assets to the Financial Conduct Authority; and
- e) Assurance engagements specified by the FRC as 'public interest assurance engagements' performed in accordance with International Standard on Assurance Engagements (UK) (ISAE (UK)) 3000 (July 2020).

There is, therefore, no change in the scope of the FRC's quality management standard from the existing position with ISQC (UK) 1.

## About the new quality management standards

As with any system of internal control, a firm's System of Quality Management (SOQM) needs to have a purpose to help ensure its effective design and allow for determination of whether the system is effective in fulfilling that purpose. In this regard the objective of the firm is to design, implement and operate a SOQM to manage the quality of engagements performed by the firm.

The objective of the SOQM is to provide the firm with reasonable assurance that:

- The firm and its personnel fulfil their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and
- Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.

Where a firm performs other types of engagements that are not engagements performed under the scope of ISQM (UK) 1 (e.g., tax or consulting services), ISQM

1 does not require that the SOQM is extended to cover such engagements. However, ISQM (UK) 1 may affect operational areas of the firm (e.g., IT and human resources), other engagements, or personnel in the firm who are not involved in performing engagements under the FRC's performance standards. This is because ISQM (UK) 1 adopts a holistic approach and does not view quality management as a separate function of the firm. Rather, in order to enhance the effectiveness of quality management, ISQM (UK) 1 promotes integrating quality management into the culture of the firm, the firm's strategy, operational activities and business processes. Additionally, in order to fulfil law, regulation or relevant ethical requirements, the firm's SOQM may need to address other areas of the firm.

A firm is responsible for its system of quality management. This is so, even where the firm:

- i. is part of a network, and the firm complies with network requirements or uses network services in the system of quality management or in the performance of engagements; or
- ii. uses resources from a service provider in the system of quality management or in the performance of engagements.

## Where do you start?

There was an [Ask ICAS webinar](#) held on 29 September 2022 in which Graham Marjoribanks, Audit Partner and Head of Audit & Assurance, Johnston Carmichael and Keith Macpherson, Audit Partner, Henderson Loggie, shared their respective insights on how their respective firms had gone about this project and provided useful pointers for other firms to consider.

## Responsibilities

A firm is required to assign various responsibilities including operational responsibility for the system. As per the IAASB's standard ultimate responsibility and accountability for the system of quality management must be assigned to the firm's chief executive officer or the firm's managing partner (or equivalent). A UK plus to the standard is required for firms performing audits of financial statements, which requires that the firm shall ensure that at least one individual who is eligible (see sections 1212 to 1225 of the Companies Act 2006) for appointment as a statutory auditor is assigned:

- a) Ultimate responsibility and accountability for the system of quality management; and

- b) Operational responsibility for the system of quality management.

Where an audit firm's CEO or managing partner is not eligible for appointment as a statutory auditor this would potentially not meet the requirements of ISQM (UK) 1. In this situation, ultimate responsibility and accountability for the system of quality management would need to be assigned to the firm's managing board of partners, of which at least one of those individuals would need to be eligible for appointment as a statutory auditor.

The individual(s) assigned ultimate responsibility and accountability for the firm's system of quality management, and the individual(s) assigned operational responsibility for the firm's system need to have an understanding of ISQM (UK) 1, including the application and other explanatory material, to understand the objective of ISQM (UK) 1 and to apply its requirements properly.

## Components of Quality Management System

ISQM 1 focuses on addressing the following eight components of a system of quality management that operate in an iterative and integrated manner:

1. Governance and leadership – This covers matters such as the firm's culture, leadership responsibility and accountability, the firm's organisational structure, assignment of roles and responsibilities and resource planning and allocation.
2. Firm's risk assessment process – This consists of establishing quality objectives, identifying and assessing quality risks to the achievement of the quality objectives and designing and implementing responses to address the assessed quality risks.
3. Relevant ethical requirements – This covers fulfilling relevant ethical requirements by the firm and its personnel; and relevant ethical requirements to the extent that they apply to others external to the firm.
4. Acceptance and continuance – This deals with the firm's judgements about whether to accept or continue a client relationship or specific engagement.
5. Engagement performance -This covers the firm's actions to promote and support the consistent performance of quality engagements, including through direction, supervision and review, consultation and differences of opinion. This includes how the firm supports engagement teams in exercising professional judgement and professional scepticism.

6. Resources - Deals with obtaining, developing, using, maintaining, allocating and assigning resources in a timely manner to enable the design, implementation and operation of the SOQM. This includes technological, intellectual and human resources, and also addresses the use of service providers.
7. Information and communication – Deals with obtaining, generating or using information regarding the SOQM, and communicating information within the firm and to external parties on a timely basis to enable the design, implementation and operation of the SOQM.
8. Monitoring and remediation process - The process that: provides the firm with relevant, reliable and timely information about the design, implementation and operation of the SOQM; and addresses taking appropriate actions to respond to deficiencies such that deficiencies are remediated on a timely basis.

Other requirements, comprising the roles and responsibilities for the system, leadership's overall evaluation of the system, network requirements or network services and documentation are also dealt with in the standard.

The components addressed in ISQM 1 are aligned to the six components in extant ISQC 1 but as seen above include two new components:

- The firm's risk assessment process; and
- Information and communication.

A firm is required to meet all of the requirements within ISQM 1, including the requirements in the components. However, a firm is not required to organise its SOQM according to the eight components and may choose to use different terminology or frameworks to describe the components of the SOQM.

## Risk-based approach

ISQM (UK) 1 introduces a new risk-based approach to quality management at the firm level. It requires the firm to design and implement a risk assessment process that sets quality objectives; identifies and assesses quality risks; and implements responses to address those quality risks. Unlike extant ISQC (UK) 1, the new approach requires a firm to customise the design, implementation and operation of its system of quality management based on the nature and circumstances of the firm and the engagements it performs. The new approach also requires the firm to transition from policies and procedures that address standalone elements, as required by extant ISQC (UK) 1, to an integrated approach that reflects upon the

system as a whole. This is absolutely key to ISQM (UK) 1 and a conceptually different approach to that adopted in ISQC (UK) 1, although of course elements of a firm’s existing system may still form a key part of its enhanced quality management system under ISQM (UK) 1.

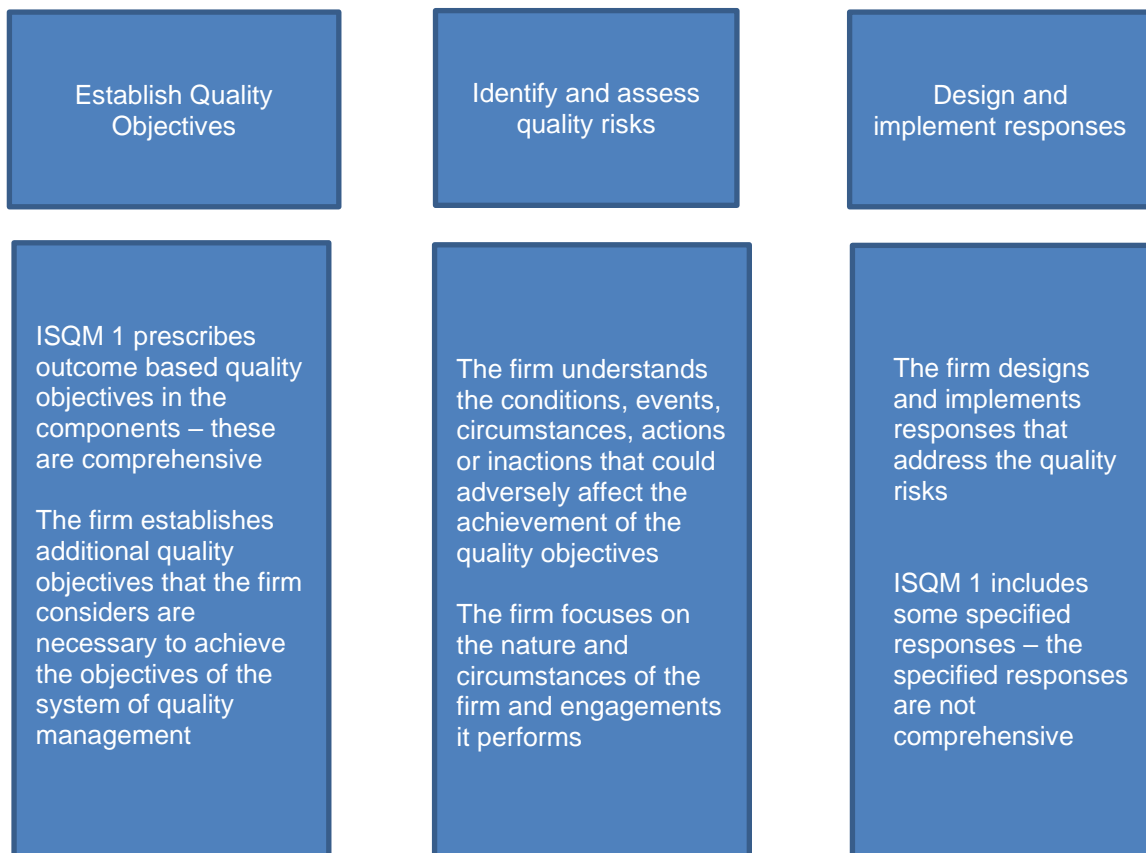
The risk-based approach is embedded in the requirements of ISQM (UK) 1 through:

- a) Establishing quality objectives. The quality objectives established by the firm consist of objectives in relation to the components of the system of quality management that are to be achieved by the firm. A firm is required to establish the quality objectives specified by ISQM (UK) 1 and any additional quality objectives considered

necessary for the firm to achieve the objectives of the system of quality management.

- b) Identifying and assessing risks to the achievement of the quality objectives (quality risks). A firm is required to identify and assess quality risks to provide a basis for the design and implementation of responses.
- c) Designing and implementing responses to address the quality risks. The nature, timing and extent of a firm’s responses to address the quality risks are based on, and are responsive to, the reasons for the assessments given to the quality risks.

The standard details the quality objectives that need to be met for the different areas. Of course, depending on the firm’s circumstances there may be additional quality objectives that require to be considered.



## Quality Objectives

The standard requires specific quality objectives to be established. These are the desired outcomes in relation to the components of the system of quality management to be achieved by the firm.

These are established in the following areas and set out in detail in paragraphs 28 to 33 of the standard:

### i. Governance and leadership

There are enhanced requirements to address firm governance and leadership, including increased leadership responsibilities. These establish the environment that supports the system of quality management and include that:

- a) The firm demonstrates a commitment to quality through a culture that exists throughout the firm.
- b) Leadership is responsible and accountable for quality.
- c) Leadership demonstrates a commitment to quality through their actions and behaviours.
- d) The organisational structure and assignment of roles, responsibilities and authority is appropriate to enable the design, implementation and operation of the firm's system of quality management.
- e) Resource needs, including financial resources, are planned for and resources are obtained, allocated or assigned in a manner that is consistent with the firm's commitment to quality.

### ii. Relevant ethical requirements

- The firm and its personnel understand the relevant ethical requirements to which the firm and the firm's engagements are subject, and fulfil their responsibilities in respect of these.
- Others, including the network, network firms, individuals in the network or network firms, or service providers who are subject to the relevant ethical requirements to which the firm and the firm's engagements are subject, understand the relevant ethical requirements that apply to them and fulfil their responsibilities in relation to the relevant ethical requirements that apply to them.

### iii. Acceptance and Continuance of Client Relationships and Specific Engagements

Judgements by the firm about whether to accept or continue a client relationship or specific engagement are appropriate and that the financial and operational priorities of the firm do not lead to inappropriate judgements about whether to accept or continue a client relationship or specific engagement.

### iv. Engagement Performance

- Engagement teams understand and fulfil their responsibilities in connection with the engagements.
- The nature, timing and extent of direction and supervision of engagement teams and review of the work performed is appropriate.
- Engagement teams exercise appropriate professional judgement and professional scepticism.
- Consultation on difficult or contentious matters is undertaken and the conclusions agreed are implemented.
- Differences of opinion within the engagement team, or between the engagement team and the engagement quality reviewer or individuals performing activities within the firm's system of quality management are brought to the attention of the firm and resolved.
- Engagement documentation is assembled on a timely basis after the date of the engagement report, and is appropriately maintained and retained to meet the needs of the firm and comply with law, regulation, relevant ethical requirements, or professional standards.

### v. Resources

These quality objectives address appropriately obtaining, developing, using, maintaining, allocating and assigning resources in a timely manner to enable the design, implementation and operation of the system of quality management. They cover human, intellectual and technological resources as well as the use of service providers.

### vi. Information and Communication

These address obtaining, generating or using information regarding the system of quality management, and communicating information within the firm and to external parties on a timely basis to enable the design, implementation and operation of the system of quality management. There is a focus here on relevant and reliable information.

## Quality Risks

A quality risk is one that has a reasonable possibility of:

- a) Occurring; and
- b) Individually, or in combination with other risks, adversely affecting the achievement of one or more quality objectives.



A firm is required to identify and assess quality risks to provide a basis for the design and implementation of responses to those risks. This involves obtaining an understanding of the conditions, events, circumstances, actions or inactions that may adversely affect the achievement of the quality objectives.

This involves consideration of both those relating to:

- i. the nature and circumstances of the firm, which will include matters such as the complexity and operating characteristics of the firm; strategic and operational decisions and actions, business processes and business model of the firm; characteristics and management style of leadership; resources, including those provided by service providers; and
- ii. the nature and circumstances of the engagements performed by the firm, those relating to the types of engagements performed by the firm and the reports to be issued and types of entities for which such engagements are undertaken.

The firm is also required to take into account how, and the extent to which, the conditions, events, circumstances, actions or inactions of such matters (listed in (i.) and (ii.) immediately above may adversely affect the achievement of the quality objectives.

Properly assessing the quality risks is crucial in this exercise. Consideration also needs to be given on an ongoing basis as to whether any new such risks have emerged and need to be mitigated or indeed whether any previous risks are no longer so.

Consideration should be given to holding an internal meeting of appropriate personnel to seek to give a holistic consideration to risk identification and assessment. Those attending should be asked for their views on the risk that they perceive to the quality objectives that the firm has established. Where a service provider has produced a risk assessment template this may be used to assist in this process or the matters listed in paragraph 25 of ISQM 1 may also provide a useful springboard for generating discussion.

In addition to risk identification, consideration also needs to be given to assessing the risks to facilitate a determination of the level of response required. There is therefore merit in considering both the significance and likelihood of the risks concerned at the same time.

## Responses to quality risks

These are a firm's responses and will be reflected by policies or procedures designed and implemented by the firm to address one or more quality risks. Policies are statements of what should, or should not, be done

to address a quality risk(s). Such statements may be documented, explicitly stated in communications or implied through actions and decisions; and procedures are the actions to implement these policies.

A mapping exercise is therefore useful to assess whether any of the quality risks identified are already mitigated by existing responses that form part of the firm's system of quality control established to ensure compliance with ISQC 1. In some situations, a series of quality risks might be mitigated by a single specific response. Likewise, certain risks may be mitigated by a series of responses. Professional judgement needs to be applied in this regard.

A firm has to design and implement responses to address the quality risks in a manner that is based on, and responsive to, the reasons for the assessments given to the quality risks. Where a service provider is being used, consideration can be given to which of their suggested responses might be appropriate in the circumstances, whether individually or in combination with other responses. There may also be a need to specifically tailor the provider's suggestion to the specific risk(s) concerned.

Where a firm does not undertake complex engagements and therefore has straightforward objectives and risks, the required responses will likely reflect that lack of complexity.

In terms of determining responses, at least in certain circumstances and depending on a firm's existing system, adjusting, re-purposing or expanding existing procedures might mitigate the identified risks. This of course is dependent on the nature and circumstances of the firm and the engagements that it undertakes.

## Monitoring and remediation

The monitoring and remediation process is the process that:

- provides the firm with relevant, reliable and timely information about the design, implementation and operation of the SOQM; and
- addresses taking appropriate actions to respond to deficiencies to ensure that they are remediated on a timely basis, which facilitates the proactive and continual improvement of engagement quality and the SOQM. Identifying and remediating deficiencies is constructive and is an essential part of an effective SOQM.

This process has been extensively enhanced from extant ISQC 1 and is intended to be a non-linear process that operates in a dynamic and iterative manner. It includes:

- A new focus on monitoring the SOQM as a whole;
- A new framework for evaluating findings and identifying deficiencies, and evaluating identified deficiencies; and
- More robust remediation.

The monitoring and remediation process can be broken down into four aspects:

- i. Design and perform monitoring activities to provide a basis for the identification of deficiencies.
- ii. Evaluate findings and identify deficiencies and evaluate identified deficiencies. A firm is required to evaluate the severity and pervasiveness of identified deficiencies by identifying their root cause(s) and to evaluate their effect, individually and aggregate on the SOQM.
- iii. Respond to identified deficiencies.
- iv. Communicate activities performed, findings and remedial actions.

The firm monitors the SOQM as a whole. This may include monitoring:

- How responsibilities are assigned to leadership and whether the requirements of ISQM 1 have been met.
- The design and operation of the firm's risk assessment process, i.e., how the firm goes about establishing quality objectives, identifying and assessing quality risks, designing and implementing responses, and identifying information related to changes in the nature and circumstances of the firm and engagements it performs that may impact the quality objectives, quality risks or responses.
- The implementation and operation of the responses, including whether they properly operate according to how they have been designed and whether the responses effectively address the related quality risks.
- Whether the firm's monitoring and remediation process is achieving its intended purpose.
- How, where applicable, the firm has addressed network requirements or network services and whether it complies with the requirements of ISQM 1.
- Leadership's evaluation of the SOQM and whether it has met the requirements of ISQM 1.

#### *Types of monitoring activities*

These include the following:

- Inspections of completed engagements. These are one of the monitoring activities required to be

performed by ISQM 1. Inspections of completed engagements, although focused on engagements, provide information to the firm about the SOQM e.g. are there quality risks that have not been identified by the firm, or whether the assessment of quality risks may need to be modified?

- Inspections of in-process engagements.
- Interviewing firm personnel, or undertaking formal surveys, to assess firm culture.
- Considering the consistency of leadership's communications and messaging, and whether they reflect the firm's values and focus appropriately on quality.
- Checking and evaluating IT applications used for functions related to the SOQM.
- Inspecting documentation and contracts supporting engaging service providers, to determine whether proper consideration was given to whether the service provider was appropriate for use.
- Checking CPD records.
- Inspecting time records for number of hours spent by engagement partners and other senior personnel and assessing the sufficiency of such hours.

As the monitoring and remediation process plays a key role in the effectiveness of the system, it is important that the firm monitors this process to determine whether it is achieving its intended purpose, i.e.:

- Providing relevant, reliable and timely information about the design, implementation and operation of the SOQM; and
- Taking appropriate actions to respond to identified deficiencies such that deficiencies are remediated on a timely basis.

In small and less complex firms, the firm may have readily available information about whether the monitoring and remediation process is achieving its intended purpose through leadership's knowledge (i.e., in a small firm, leadership is likely to have frequent interaction with the SOQM). In such cases, oversight of the monitoring and remediation process may be simple.

The SOQM will continue to evolve over time and feedback generated from the monitoring and remediation process will help to ensure that the system continues to improve over time.

#### **Evaluation**

The individual assigned ultimate responsibility and accountability for the system of quality management

is required to evaluate the system of quality management at a point in time at least annually. Based on this evaluation they are required to conclude either:

- a) The system of quality management provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved; or
- b) Except for matters related to identified deficiencies that have a severe but not pervasive effect on the design, implementation and operation of the system of quality management, the system of quality management provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved; or
- c) The system of quality management does not provide the firm with reasonable assurance that the objectives of the system of quality management are being achieved.

Where the conclusion is either (b) or (c) then prompt and appropriate action requires to be taken and be communicated to:

- i. Engagement teams and other individuals assigned activities within the system of quality management to the extent that it is relevant to their responsibilities; and (Ref: Para. A197)
- ii. External parties in accordance with the firm's policies or procedures.

Additionally, the firm is also required to undertake periodic performance evaluations of the individual(s) assigned ultimate responsibility and accountability for the system of quality management, and the individual(s) assigned operational responsibility for the system of quality management.

## Documentation

A firm is required to prepare documentation of its system of quality management that is sufficient to:

- a) Support a consistent understanding of the system by personnel, including an understanding of their roles and responsibilities with respect to the system and the performance of engagements;
- b) Support the consistent implementation and operation of the responses; and
- c) Provide evidence of the design, implementation and operation of the responses, to support the evaluation of the system by the individual(s) assigned ultimate responsibility and accountability for the system of quality management.

To enable this, the firm is required to document various matters including:

- a) The identification of the individual(s) assigned ultimate responsibility and accountability for the system of quality management and operational responsibility for the system of quality management.
- b) The firm's quality objectives and quality risks.
- c) A description of the responses and how the firm's responses address the quality risks.
- d) Evidence of the monitoring activities performed, including the evaluation of findings, and identified deficiencies and their related root cause(s); and remedial actions taken to address identified deficiencies and the evaluation of the design and implementation of such remedial actions; and communications about monitoring and remediation.
- e) The basis for the conclusion on whether the system of quality management provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved.
- f) Independence and objectivity requirements as set out in the relevant ethical requirements.
- g) Information on audited entities.
- h) Records of complaints, breaches of professional standards and applicable legal and regulatory requirements (unless minor) etc.

## Retention of Documentation

A firm is required to establish a time period for the retention of documentation for the system of quality management that is sufficient to enable the firm to monitor the design, implementation and operation of the firm's system of quality management, or for a longer period if required by law or regulation.

For audits of financial statements, a firm is required to establish policies and procedures that require retention of audit documentation for a period that is not less than any period necessary to satisfy the requirements of any applicable laws or regulation relating to data protection and to meet the requirements for any applicable administrative and judicial proceedings, and that is in any case not less than six years from the date of the auditor's report.

## Service Providers

Service providers will be used by a number of firms. However, it is important to note that a firm remains responsible for its SOQM irrespective of whether the resources are provided directly through the firm or



through a service provider. Consideration of the extent of which service providers are utilised as part of a firm's SOQM needs to be given as well as an assessment of the related quality risks. Given the tailored nature of the SOQM required it is unlikely that a standard solution without customisation to the specific circumstances would enable compliance with the requirements of ISQM 1.

## **ISQM (UK) 2 - Engagement Quality Reviews**

ISQM (UK) 1 deals with the firm's responsibility to establish policies or procedures addressing engagements that are required to be subject to engagement quality reviews. ISQM (UK) 2 is a new standard which contains the detailed requirements and related application material for engagement quality reviews that were previously located in ISA (UK) 220. It enhances the existing criteria around the appointment and eligibility of an engagement quality reviewer and their related responsibilities.

## **ISA (UK) 220 (Revised July 2021) - Quality Management for an Audit of Financial Statements**

ISA 220 was significantly revised by the IAASB, relocating the requirements relating to engagement quality reviews, resulting in a clear delineation of the responsibilities of the engagement partner and engagement team in relation to managing and achieving quality at the engagement level. There is also increased focus on taking into account the nature and circumstances of the audit engagement in managing quality at the engagement level.

## **Links to the new and revised UK quality management standards**

### **Effective Date**

The firm is required to have the system of quality management (SOQM) designed and implemented in compliance with ISQM 1 by 15 December 2022. The evaluation of the SOQM required by paragraphs 53–54 of ISQM 1 is required to be performed within one year of that date. This means that by 15 December 2022, the firm is expected to:

- a) Establish the quality objectives, identify and assess the quality risks and design and implement the responses; and
- b) Design and implement the monitoring activities.

The operation of the responses and monitoring activities is only required to commence from 15 December 2022 onwards.

[ISQM \(UK\) 1](#)

[ISQM \(UK\) 2](#)

[ISA \(UK\) 220 \(Revised July 2021\)](#)

[FRC Feedback Statement and Impact Assessment](#)

### **IAASB resources**

The IAASB has created a suite of resources and material to support audit firms in the transition to the new quality management approach.

First time implementation Guide - [ISQM 1](#)

First time Implementation Guide - [ISQM 2](#)

First time Implementation Guide - [ISA 220 \(revised\)](#)

[Quality management Webinar series](#)

[Article by IAASB Chair, Tom Seidenstein](#)

[Quality management videos – introducing the quality management standards](#)

## ISA (UK) 315 (REVISED JULY 2020) – IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISTATEMENT

### Introduction

On 19 December 2019, the International Auditing and Assurance Standards Board (IAASB) issued International Standard on Auditing (ISA) 315 (Revised 2019), 'Identifying and Assessing the Risks of Material Misstatement and related conforming amendments to other ISAs'. The Financial Reporting Council (FRC) subsequently consulted on the proposed standard and in July 2020 issued its finalised version: ISA (UK) 315 (Revised July 2020) ['Identifying and Assessing the Risks of Material Misstatement'](#). This becomes effective for accounting periods commencing on or after 15 December 2021. Therefore, in most situations this will first apply to audits of financial statement for years ended 31 December 2022. The FRC adopted the standard without the need for further FRC supplementary material beyond the small amount currently included in the extant standard i.e. two footnotes, which clarify who are 'those charged with governance' in a UK context and that they are the appropriate persons to provide critical written representations in line with ISA (UK) 580 (Updated May 2022), 'Written Representations'.

### Why was the standard revised by the IAASB?

Experience of how the extant standard had been implemented in various jurisdictions revealed:

- Inconsistencies in the nature and number of significant risks identified in practice.
- Obtaining an understanding of the system of internal control was difficult to apply in practice.
- Information Technology (IT) risks were not sufficiently addressed in the standard.
- Challenges applying the standard when auditing small-and medium-sized entities (SMEs).

The IAASB responded by undertaking a rigorous review evidenced by the length of the standard increasing from 50 to 181 pages. The result is an enhanced standard forming a stronger foundation for the audit, in particular better quality risk identification and assessment is expected to enhance the procedures required by other standards such as ISA 330 'The Auditor's Responses to Assessed Risks' and ISA 540 (Revised) 'Auditing Accounting Estimates and Related Disclosures'. Additionally, conforming and

consequential amendments were also made to a number of other ISAs resulting from the changes made to ISA 315 (Revised), including ISA 330, ISA 240 'The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements' and ISA 540 (Revised). The FRC has also made these conforming amendments to its UK ISAs (see below).

The revised standard focuses on complexity rather than size (i.e. 'less complex entities' rather than 'smaller entities' in line with the IAASB's approach to such entities). Scalability has been illustrated through the use of contrasting examples throughout the standard i.e., illustrating both ends of the complexity spectrum rather than only focusing on 'smaller entities'. Where appropriate, the content has also been updated to reflect unique public sector considerations.

### Inherent risk, control risk, detection risk

The concepts of inherent risk, control risk and detection risk as described in ISA (UK) 200 (Revised June 2016 - Updated May 2022) 'Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)' have not changed. However, a separate assessment of inherent risk and control risk is now required by ISA (UK) 315 (Revised July 2020) for the identified risks of material misstatement at the assertion level.

The concept of the spectrum of inherent risk has been introduced to assist with the assessment of inherent risk. The spectrum of inherent risk assists the auditor in making a judgment, based on the likelihood and magnitude of a possible misstatement, on a range from lower to higher risk, for the purpose of assessing risks of material misstatement. Inherent risk factors have been introduced to help auditors consider risks of material misstatement on the spectrum of inherent risk. These are defined as characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be qualitative or quantitative, and include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.

Although the definition of the risk of material misstatement has not changed, in the application material to ISA (UK) 200 (Revised June 2016 - Updated May 2022), the 'threshold' for the identification of a possible misstatement has been clarified and explained. By including this clarification in ISA (UK) 200 (Revised June 2016 - Updated May 2022) rather than ISA (UK) 315 (Revised July 2020)), it supports the definition of risk of material misstatement in ISA (UK) 200 (Revised June 2016 - Updated May 2022). The clarification explained in the application material to ISA (UK) 200 (Revised June 2016 - Updated May 2022), is that a risk of material misstatement exists where there is a reasonable possibility of both a misstatement occurring (i.e., its likelihood), and being material if it were to occur (i.e. its magnitude) - reference should be made to the new paragraph A15a in ISA (UK) 200 (Revised June 2016 - Updated May 2022). Based on this clarification in ISA (UK) 200, the term 'reasonably possible' is used within ISA 315 (UK) (Revised July 2020) as it relates to the threshold for identifying risks of material misstatement.

## Identifying Risks of Material Misstatement

The audit risk model has not changed. The auditor is still required to identify risks of material misstatement at both the financial statement and assertion levels. The identification of risks of material misstatement continues to be performed before the consideration of any related controls (i.e., the inherent risk) (see paragraph A186 in ISA (UK) 315 (Revised July 2020)). The assertions remain the same, and the auditor may still use different assertions as long as all aspects of the assertions set out in the standard have been covered (see paragraphs A189–A191 in ISA (UK) 315 (Revised July 2020)).

Key changes to ISA (UK) 315 (Revised July 2020):

- It has been modernised and updated to better reflect for an evolving business environment. This includes requiring:
  - the auditor to understand the entity's use of Information Technology (IT) in its business;
  - the related risks; and
  - the entity's system of internal control addressing such risks.

The related application material has also been significantly enhanced. There is a clearer delineation between the respective work efforts for understanding the IT environment, including information processing activities, as part of obtaining the understanding of the information system, and the requirements to identify and

address risks of material misstatement arising from the use of IT related to the IT applications and other aspects of the IT environment.

- Although there are no specific requirements to use automated tools and techniques the revised standard takes into account their increasing use by some audit firms. It does so by reflecting that they are ways that procedures may be carried out but are not necessarily the only way. New specific application material has been added to give examples of where and how they may be used (e.g. paragraphs A137 and A161 of the standard).
- Provisions designed to enhance the use of professional scepticism throughout the risk assessment process, including:
  - Emphasising in the introductory paragraphs the importance of applying professional scepticism.
  - Emphasising the need to not bias the auditor's work toward obtaining evidence that is corroborative or excluding evidence that is contradictory.
  - A new requirement for the auditor, towards the end of the risk assessment process, to consider all audit evidence obtained from performing risk assessment procedures, whether corroborative or contradictory the purpose of which is to evaluate whether the audit evidence obtained from the risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement. (Paragraph 35, ISA (UK) 315 (Revised July 2020)).
- Clarifying that the purpose of performing risk assessment procedures is to obtain audit evidence that provides an appropriate basis for the identification and assessment of the risks of material misstatement and the design of further audit procedures in accordance with ISA (UK) 330 (Revised July 2017 - Updated May 2022) 'The Auditor's responses to Assessed Risks'.
- Restructuring the requirement that focuses on the understanding of the entity and its environment, including to elevate the importance of understanding the applicable financial reporting framework.
- Including the concept of 'inherent risk factors' to assist the auditor in identifying events or conditions that may affect the susceptibility of assertions about classes of transactions, account balances or disclosures to misstatement.
- Enhancing and clarifying the requirements and application material pertaining to the auditor

obtaining an understanding of the entity's system of internal control, including clarifying the controls for which the design is required to be evaluated and implementation determined. To aid Understandability, the required understanding for each element of the system of internal control is presented in a tabular format.

- Enhancing and clarifying the requirements and application material pertaining to identifying and assessing the risks of material misstatement, including introducing new concepts and/or definitions for:
  - Inherent risk factors (see above).
  - Relevant assertions - when the assertion about a class of transactions, account balance or disclosure has an identified risk of material misstatement.
  - Significant classes of transactions, account balances or disclosures – those for which there is one or more relevant assertions.
  - Spectrum of inherent risk – the degree to which inherent risk varies. Application material explains how this should be operationalised.
  - Significant risk – Rather than focusing on the responses to risks (as the definition in the current ISA (UK) 315 does), this definition has been revised to focus on an identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or that is to be treated as a significant risk in accordance with the requirements of other ISAs. Paragraph A221 in ISA 315 (UK) (Revised July 2020) provides some examples of those matters where significant risks may be more prevalent e.g. accounting estimates that have high estimation uncertainty or complex models.
- Explaining how control risk is assessed when the auditor does not plan to test the operating effectiveness of controls. Any plans to test the operating effectiveness of controls is based on an expectation that controls are operating effectively, and this forms the basis of the auditor's assessment of control risk. Accordingly, if, based on the work undertaken in the control activities

component, the auditor does not plan to test the operating effectiveness of controls, the assessment of control risk is such that the assessment of the risks of material misstatement is the same as the assessment of inherent risk (i.e., control risk is 'maximum'). Therefore, if the auditor plans to undertake a primarily substantive approach to the audit, once the understanding of the components of the system of internal control has been obtained and the relevant work done for that purpose (as required by paragraphs 21 – 27 of ISA 315 UK (Revised July 2020)), there is no need for further testing of controls.

- Introducing a stand-back requirement to drive the completeness of the identification of the risks of material misstatement by evaluating the completeness of the significant classes of transactions, account balances and disclosures identified by the auditor. This is done by focusing on those classes of transactions, account balances and disclosures that are material (either quantitatively or qualitatively) but have not been identified as significant (i.e., no identified risks of material misstatement and therefore no relevant assertions).
- Enhanced documentation requirements for the auditor's work in evaluating the design of controls and determining whether those controls have been implemented.
- Enhanced application material giving examples of areas that may be documented to help demonstrate the exercise of professional scepticism.

ISA (UK) 315 (Revised July 2020) also places focus on explaining why certain procedures are required (these "why" paragraphs can be found within the application material) and are intended to address the rationale for certain requirements where there may have been misunderstanding, misapplication or inconsistent application of the requirements. In particular, these have been added to explain why the understanding of the various components of the entity's system of internal control is required, particularly in circumstances where it is intended that a primarily substantive approach to the audit will be undertaken.

## Other Matters

The revised standard is applicable to all audits and is designed to be scalable.

The conforming amendments are contained in the following ISAs (UK):

- i. ISA (UK) 200 (Revised June 2016 - Updated May 2022), 'Overall objectives of the Independent



- Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing'. Enhanced application material is included in relation to risks of material misstatement, including reference to inherent risk factors and the spectrum of inherent risk. References to considerations in relation to scalability and automated tools and tools and techniques have also been added.
- ii. ISA (UK) 210 (Revised June 2016 - Updated May 2022), 'Agreeing the Terms of Audit Engagements'. Minor conforming edits have been included in the application material.
  - iii. ISA (UK) 230 (Revised June 2016 - Updated May 2022), 'Audit Documentation'. This clarifies that examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control.
  - iv. ISA (UK) 240 (Revised May 2021 - Updated May 2022), 'The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements'. This identifies that ISA (UK) 315 (Revised 2020) requires understanding of the applicable financial reporting framework and the system of internal control. It requires that the auditor evaluate the design of controls that address risks of material misstatement due to fraud and determines whether they have been implemented. It requires documentation of identified controls in the control activities component that addresses assessed risks of material misstatement due to fraud. There is also enhanced and edited application material, including for fraud risk factors.
  - v. ISA (UK) 250 Section A (Revised November 2019 - Updated May 2022), 'Consideration of Laws and Regulations in an Audit of Financial Statements'. This contains minor conforming edits in the application material.
  - vi. ISA (UK) 260 (Revised November 2019 - Updated May 2022), 'Communication with Those Charged with Governance'. There are minor conforming edits in the application material, including to conform references to matters that were determined to be 'significant risks' and to the entity's system of internal control.
  - vii. ISA (UK) 265 (Updated May 2022), 'Communicating Deficiencies in Internal Control to Those Charged with Governance'. There are minor conforming edits, including to conform references to the entity's system of internal control.
  - viii. ISA (UK) 300 (Revised June 2016 - Updated May 2022), 'Planning an Audit of Financial Statements'. There are minor conforming edits in the application material.
  - ix. ISA (UK) 330 (Revised July 2017 - Updated May 2022), 'The Auditor's responses to Assessed Risks'. There are conforming edits and enhancements to the requirements and application material. These include clarifying that the auditor need not design and perform further audit procedures where the assessment of the risk of material misstatement is below the acceptably low level; enhanced application material in relation to general IT controls; and enhanced application material in relation to when substantive procedures are required to be designed and performed.
  - x. ISA (UK) 402 (Updated May 2022), 'Audit Considerations Relating to an Entity Using a Service Organization'. This contains an enhanced and clarified description of the scope of the standard and enhanced and clarified objective. There are conformed references to controls, and requirements that the auditor evaluate the design of controls in the controls activities component and determine whether they have been implemented. Conforming edits to the application material.
  - xi. ISA (UK) 500 (Updated May 2022), 'Audit Evidence'. There are minor conforming edits in the application material.
  - xii. ISA (UK) 501 (Updated May 2022), 'Audit Evidence—Special Considerations for Selected Items'. There are minor conforming edits in the application material.
  - xiii. ISA (UK) 530 (Updated May 2022), 'Audit Documentation'. There are minor conforming edits in the application material.
  - xiv. ISA (UK) 540 (Revised December 2018 - Updated May 2022), 'Auditing Accounting Estimates and Related Disclosures'. This includes conforming edits in the requirements and application material, including in relation to references to the applicable financial reporting framework, inherent risk factors, the entity's information system, controls and IT applications.

- xv. ISA (UK) 550, 'Related Parties' (Updated May 2022). There are minor conforming edits in the application material.
- xvi. ISA (UK) 600 (Revised November 2019 - Updated May 2022), 'Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)'. There are minor conforming edits in the requirements and application material, including to refer to understanding the applicable financial reporting framework and system of internal control.
- xvii. ISA (UK) 610 (Revised June 2013 - Updated May 2022), 'Using the Work of Internal Auditors'. There are minor conforming edits, including to refer to understanding the applicable financial reporting framework and system of internal control and identifying that significant risks are risks assessed close to the upper end of the spectrum of inherent risk.
- xviii. ISA (UK) 620 (Revised November 2019 - Updated May 2022), 'Using the Work of an Auditor's Expert'. There are minor conforming edits in the application material.
- xix. ISA (UK) 701 (Revised November 2019 - Updated May 2022), 'Communicating Key Audit Matters in the Independent Auditor's Report'. There is a conforming edit in the application material to identify that a significant risk is an identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which the inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur.
- xx. ISA (UK) 720 (Revised November 2019 - Updated May 2022), 'The Auditor's Responsibilities Relating to Other Information'. There are minor conforming edits in the application material relating to matters the auditor obtains an understanding of in line with ISA (UK) 315 (Revised July 2020).

#### **Guidance**

The IAASB has produced the following useful guidance for auditors:

- ['ISA 315 First time implementation guide for auditors'](#).
- [Introduction to ISA 315.](#)

## ISA (UK) 240 ‘THE AUDITOR’S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS’ (REVISED MAY 2021) UPDATED MAY 2022

### Introduction

In his December 2019 report into the [quality and effectiveness of audit](#), Sir Donald Brydon made a number of recommendations, which included the following in relation to fraud:

- the Audit Reporting Governance Authority (ARGA) should amend International Standard on Auditing (ISA) (UK) 240 to make clear that it is the obligation of an auditor to endeavour to detect material fraud in all reasonable ways.
- 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.
- the auditor’s report should state explicitly the work they 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.

In response, the FRC decided to address the first recommendation above to seek to address the expectation gap between what the public feels an auditor does or should do in relation to fraud, and what the auditor’s obligations actually are in this area.

The FRC 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. In relation to the last bullet above, the FRC decided not to address this when revising ISA (UK) 240 but rather to consider it holistically with other recommendations in relation to the content of the auditor’s report (ISA (UK) 700 and potential future revisions thereon).

Whilst the International Auditing and Assurance Standards Board (IAASB) is undertaking its own review of ISA 240, given the lengthy timescale before a revised IAASB standard is likely to be issued, the FRC believed it appropriate to proceed with revising the UK standard in the interim period.

Following consulting on proposed changes, in May 2021 the FRC issued a finalised revised International ISA (UK) 240 ‘The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements.’ This standard was subsequently updated in May 2022 as one of a number of standards to incorporate conforming amendments made as a result of the revision of ISA (UK) 315 ‘[Identifying and Assessing the Risks of Material Misstatement \(Revised July 2020\)](#)’.

[ISA \(UK\) 240 \(Revised May 2021\) Updated May 2022](#) has an effective date for audits of periods commencing on or after 15 December 2021 with early adoption permitted which is the same as for ISA (UK) 315 (Revised July 2020). It therefore supersedes ISA (UK) 240 (Revised June 2016) Updated January 2020.

### Key Changes

There remains 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.

The FRC’s May 2021 revisions to ISA (UK) 240 are intended to address these concerns as explained below:

1. Introduction to the ISA (UK) 240 (Revised May 2021)
  - *Evaluation of qualitative and quantitative characteristics*

Paragraph 3 of the standard 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.

- *Auditor’s responsibility not diminished*

A new paragraph 7-1 has been added to the standard 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.

## 2. Objectives of the auditor

### - *Reasonable assurance*

The lead in text in paragraph 11 of the standard 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 'Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)', 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

In line with the revisions to ISA (UK) 315, the revised ISA 240 places greater focus on professional scepticism as highlighted below:

### - *Mitigation of bias*

A new paragraph 13-1 has been added. This requires that the auditor 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) Updated May 2022 and ISA (UK) 315 (Revised July 2020). Professional scepticism assists the auditor in remaining unbiased and alert to both corroborative and contradictory audit evidence.

### - *Authenticity of records/documents*

A new paragraph 14-1 has been added to the standard to clarify that the auditor shall remain alert for conditions that indicate a record or document may not be authentic. Paragraph 14 of the standard 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. Paragraph 14-1 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 A10-1) has been added to the standard giving examples of conditions that may indicate a document is not authentic or has been tampered with.

### - *Inconsistent responses/implausibility*

Paragraph 15 of the standard has been revised, requiring the auditor, in addition to investigating inconsistent responses to inquiries, to investigate responses to inquiries of management, those charged with governance or others in the entity that appear implausible.

## 4. Related parties

Given the potential risks associated with related parties, a new paragraph 15-1 serves as a reminder to the auditor that in obtaining audit evidence regarding the risks of material misstatement due to fraud they also have to comply with the relevant requirements in [ISA \(UK\) 550 'Related parties' Updated May 2022](#).

## 5. Discussion among engagement team

New paragraphs 16-1 to 16-3 have been added to the standard 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 A12 of the standard) has also been supplemented with some further examples of matters that may be discussed.

A new paragraph 16-4 has also been added to the standard 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 A12-1 of the standard) has been added giving examples of circumstances where it may be beneficial to have a further discussion.

## 6. Risk assessment procedures and related activities

Many of the new requirements come at the risk assessment stage. These are:

### - *Clarification of understanding required*



Paragraph 17 of the standard 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.

- *Inquiry of those who deal with fraud allegations*

A new paragraph 19-1 has been added to the standard 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.

- *Discussion with those charged with governance*

A new paragraph 22-1 has been added to the standard requiring that when obtaining an understanding and making inquiries of those charged with governance in accordance with paragraphs 21 and 22, 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 A21-1 of the standard.

- *Inconsistent responses from TCWG and management*

A new paragraph 22-2 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.

- *Engagement team – specialised skills*

New paragraphs 25-1 and 34-1 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 A28-1 and A49-1) has been added giving examples of matters that may affect the auditor's determination of whether the engagement team requires specialized skills or knowledge.

7. Responses to the assessed risks

- *Accounting estimates*

A new paragraph 33-1 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) Updated May 2022 [‘Auditing Accounting Estimates and Related Disclosures’](#).

- *Stand-back*

A new paragraph 37-1 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.

8. The auditor's report

- *Extent to which audit was considered capable of detecting irregularities*

A new paragraph 40-1 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. 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.

9. Communications to management and those charged with governance

- *Management's risk identification process and auditor's assessment of fraud risks*

Paragraph 43 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.

10. Documentation

- *Addressing inconsistencies*

A new paragraph 46-1 has been added emphasising that, as required by [ISA \(UK\) 230 ‘Audit](#)

[Documentation' Updated May 2022](#), 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.

## SME THRESHOLDS

Currently, small businesses are presumed to be exempt from certain regulations. However, many medium sized businesses – those with between 50 and 249 employees - still report that they are spending over 22 staff days per month on average dealing with regulation.

To seek to address this, on 3 October 2022 the previous Prime Minister announced plans to widen the definition of an SME to those with fewer than 500 employees for the purposes of future and reviewed regulations. This change applies prospectively and therefore does not impact extant financial reporting and auditing requirements but could in the future.

It is intended that the exemption will be applied in a proportionate way to ensure workers' rights and other standards will be protected, while at the same time reducing the burden for growing businesses. Regulatory exemptions are often granted for SMEs, which the EU defines at below 250 employees. Having left the EU the UK is free to take its own approach and

### 11. Effective date

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).

exempt more businesses and has thus increased this to those with under 500 employees.

The revised threshold came into force on Monday 3 October 2022 and applies to all new regulations under development as well as those under current and future review, including retained EU laws. The government also intends to look at plans to consult in the future on potentially extending the threshold to businesses with 1,000 employees, once the impact on the current extension is known.

These are not blanket exemptions, and they can be overridden in appropriate cases as a result of the policy development process including any consultations that may be undertaken if there is a justifiable reason for doing so.

Whether there will be any change to the above policy following the appointment of the new Prime Minister and new Business Secretary remains to be seen.

# TECHNICAL BULLETIN

**AUDIT SPECIAL  
ISSUE NO. 167  
OCTOBER 2022**

## EDITORIAL BOARD

James Barbour	Director, Policy Leadership, Accounting & Auditing ICAS
John Cairns	Partner, French Duncan LLP
Jeremy Clarke	Assistant Director, Practice Support, ICAS
Kate Neilson	Practice Support Specialist, ICAS
Elaine Dyer	Partner, Martin Aitken & Co Ltd
Justine Riccomini	Head of Taxation (Scottish Taxes, Employment & ICAS Tax Community), ICAS
Guy Smith	Tax Director, Goringe
Ron Weatherup	Director, Lugo
Liz Smith	Business Development Director, Lugo
Lynn Gemmell	Director, Gemmell McGee VAT Solutions
Chris Campbell	Head of Taxation (Tax Practice & Owner Managed Business Taxes)



### Contact us

CA House, 21 Haymarket Yards, Edinburgh, UK, EH12 5BH  
+44 (0) 131 347 0100  
[connect@icas.com](mailto:connect@icas.com) | [icas.com](http://icas.com)

 @ICASaccounting  ICAS – The Professional Body of CAs

Although care has been taken in the production of this Technical Bulletin, it is a summary only of the topics discussed. Any views expressed by contributors within this publication are their personal views and not necessarily the views of ICAS. Neither ICAS nor the members of the editorial board shall be liable for negligence in the preparation, presentation or publishing of the material contained herein, nor for the correctness or accuracy of that material, nor for actions, failures to act, or negligence on the part of those to whom the material is disseminated, which results in any liability, loss, claim or proceedings whatsoever and howsoever caused by, on behalf of, or against any person.

© Copyright 2020 ICAS. It is understood that reproduction of the contents of this Technical Bulletin as purchased by a firm shall not constitute an infringement of the Institute's copyright provided always that such reproduction shall be limited for the purpose of training and administration within the firm or the private study of partners or employees thereof and for no other purpose whatsoever.