Audit News – Winter 2022/23

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Audit Monitoring update

Audit News is back

With our Audit and Practice Monitoring team now back to full strength, we are resuming Audit News for our registered audit firms. During 2023, we plan to issue regular news on audit regulatory developments.

ISQM (UK) 1: Are you ready? ICAS issues guidance to support firms

Firms are reminded of the implementation deadline of 15 December 2022 for the implementation of the new quality management standard, International Standard on Quality Management (ISQM) (UK) 1 ' Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagement.'

ISQM (UK) 1 is by far the biggest change in the quality management suite of standards (explained in the next article) and ICAS has issued two videos and implementation guidance to assist audit firms to design and implement a System of Quality Management. The videos feature Lesley Byrne CA, who has recently returned to the role of Director of Regulatory Monitoring and James Barbour CA, Director, Policy Leadership.

The video '**ISQM (UK) 1 Unwrapped'** covers a short summary of the main changes from ISQC (UK) 1 and the main requirements in the new standard and can be accessed here.

The video **'ISQM (UK) 1: How to get started'** shares practical tips on setting up a System of Quality Management and can be accessed here.

The implementation guidance which can be accessed here is intended to highlight certain key elements of ISQM (UK) 1 and provide tips on how to implement the standard, including useful examples.

Further videos and implementation guidance can be found on the Quality Management page of icas.com here and an ICAS webinar sharing the tips from two ICAS firms on how to go about implementing ISQM (UK) 1 is available here.

Monitoring of compliance with the new standard will commence in early 2023 and, as advised in the videos, Audit & Practice Monitoring expect firms to have set up their System of Quality Management, albeit the firm may have identified gaps that it remediates during 2023.

Quality Management Standards ISQM (UK) 1, 2 and ISA 220: A reminder of the changes

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 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.

About the new quality management standards

ISQM (UK) 1 - Quality Management For Firms That Perform Audits Or Reviews Of Financial Statements, Or Other Assurance Or Related Services Engagements
ISQM (UK) 1 introduces a new risk-based approach to quality management at the firm level, called the System of Quality Management (SOQM') that is scalable to deal with differences in the size of firms and nature of the services they provide. 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.

The firm is required to have the SOQM designed and implemented in compliance with ISQM (UK) 1 by the 15 December 2022 deadline. The evaluation of the SOQM required by paragraphs 53–54 of ISQM (UK) 1 is required to be performed within one year of that date.

This means that by 15 December 2022, the firm is expected to:
- Establish the quality objectives, identify and assess the quality risks and design and implement the responses; and
- Design and implement the monitoring activities. The operation of the responses and monitoring activities is only required to commence from 15 December 2022 onwards.

The requirements are explained in the ICAS videos and implementation guidance referred to in the previous article.

ISQM (UK) 2 - 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

[ISQM (UK) 1]

[ISQM (UK) 2]

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

[Conforming amendments to other ISAs and related materials (as introduced by the IAASB)]

[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 guides:

[ISQM 1]

[ISQM 2]

[ISA 220 (revised)]

[Webinar series]

[Article by IAASB Chair, Tom Seidenstein]

[Quality management videos]

Mandatory audit quality course: Keeping Audit on the Right Track

Audit and Practice Monitoring have currently suspended access to this webinar and a new webinar is under development to reflect the implications of ISQM (UK) 1. We will notify all audit firms via Audit News when the new webinar is made available during 2023.

Changes to the joint UK Audit Regulations 2022: Effective date 5 December 2022

General Amendments to the joint UK Audit Regulations ('JAR') will be considered by the ICAS Council on 2 December and are expected to go live on 5 December 2022.

These amendments address changes in the audit environment during 2021 and the first half of 2022 and can be summarised as:

- The registration regulations have been modified to recognise the additional registration process now required by the FRC in respect of firms that carry out the audits of Public Interest Entities (PIEs).
- The rules around ownership and control of firms have been clarified to address some of the issues arising from complex firm structures and Brexit legislation.
- The period allowed for the exercise of dispensations has been clarified.
- The replacement of ISQC (UK) 1 by ISQM (UK) 1 for quality management.
- Some terminology has been amended to reflect changes in the disciplinary framework.

These amendments do not include proposed changes under the government's proposed audit reforms issued in June 2022 but do include the modification of registration arrangements for PIE auditors as a consequence of an initiative outside government.

It should be noted that regulations in respect of audit in Ireland are now contained in a separate document which was issued by CAI in April 2022.

The revised Audit Regulations, once approved, can be accessed here.

ISA (UK) 315 (Revised July 2020) - Identifying and Assessing the Risks of Material Misstatement

As audit firms will shortly be conducting year-end audits under ISA (UK) 315 (Revised) for the first time, we have therefore issued a special edition article on implementing this standard written by James Barbour CA, Director, Policy Leadership.

Introduction
Following on from the work of the International Auditing and Assurance Standards Board (IAASB) the Financial Reporting Council (FRC) issued its finalised version of 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 statements 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?
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 revised standard is considerably longer but provides 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 (UK) 330 'The Auditor's Responses to Assessed Risks' and ISA (UK) 540 (Revised) 'Auditing Accounting Estimates and Related Disclosures'. Additionally, conforming and consequential amendments were also made to a number of other ISAs (UK).

The focus of the revised standard is 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 judgement, 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)

- This 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.

Guidance
The IAASB has produced the following useful guidance for auditors:

i. ‘ISA 315 First time implementation guide for auditors’.
ii. ‘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.

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 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)’ (as explained in the previous article).

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 (UK) 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.

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).

UK Government issues feedback paper to its 2021 'Restoring trust in audit and corporate governance' white paper.

On 31st May, the UK Government published its plans to revamp the UK's corporate reporting and audit regime through a new regulator, greater accountability for big business and by addressing the high level of concentration in the public interest entity audit market.

Firstly, the reforms are focused on Public Interest Entities (PIEs) with a number of the proposals restricted to larger PIEs. Some of the key points are set out below.

ARGA – New Regulatory Body
The Financial Reporting Council (FRC) will be replaced by a new, stronger regulator – the Audit, Reporting and Governance Authority (ARGA) – with tougher enforcement powers and funded by a levy on industry. Work on this has already begun, with the Business Secretary already acting to enable the regulator to ban failing auditors from reviewing large companies' accounts.

Widening of PIE definition
For the first time, it is intended that the largest private companies, those with over 750 employees and with over £750m annual turnover, will come under the scope of the regulator, reflecting the impact they have on the wider economy. Companies traded on the Alternative Investment Market (AIM) or other multilateral trading facilities, Limited Liability Partnerships and third sector entities will also be PIEs if they meet this 750:750 test.

Breach of directors' duties
It is intended that directors at the biggest companies who breach their legal duties to be open with auditors, or lie about the state of their firm's finances, will face sanctions such as fines, and the Government will act to address 'rewards for failure'.

Internal controls
The Government has invited the FRC to consult on strengthening the internal control provisions in the UK Corporate Governance Code to provide for an explicit statement from the board about their view of the effectiveness of the internal control systems (financial, operational and compliance systems) and the basis for that assessment. This matter remains under consideration by the FRC.

Distributable profits
The Government intends to require qualifying companies or, in the case of a UK group, the parent company only, to disclose their distributable reserves, or a "not less than" figure if determining an exact figure would be impracticable or involve disproportionate effort.

ARGA will issue guidance on what should be treated as 'realised' profits and losses. The Government is not legislating to require parent companies to provide an estimate of the dividend-paying capacity of the group as a whole. Such disclosures are to be encouraged rather than be a required element of reporting.

Managed Shared Audit
To reduce the level of concentration in the FTSE 350 audit market, the proposal was that FTSE 350 companies would be required to have a 'meaningful proportion' of their audit conducted by a challenger firm. The Government stated its intention to legislate to give ARGA the power to set this percentage. However, recent adverse media coverage indicates that the cost of such a new regime to business will be £1bn and therefore the current status of this reform is unclear.

Operational Separation
The new regulator, ARGA, will also be given the power to make big audit firms keep their audit and non-audit functions operationally separate and to enforce a market cap if the state of the market doesn't improve. The FRC has already taken this forward with the largest firms on a voluntary basis.

Code of Ethics
The Government recognises the concerns raised regarding its proposal for ARGA to set and enforce a code of ethics. Accordingly, the Government intends that ARGA will instead use the IESBA International Code of Ethics for Professional Accountants as the basis for enforcement action. The Government believes that this will allow the professional bodies to retain autonomy to set their own ethical standards while ensuring that there is a single set of standards, consistent with those of the professional bodies, as the basis for enforcement action by ARGA. The same code could also be applied to non-member accountants, should the scope of the regime need to be expanded in the future e.g. for non-professional accountants providing assurance on sustainability-related information.

Next Steps
The Government has previously confirmed its commitment to publish a draft Bill to revamp the UK's audit and corporate reporting regime this parliamentary session. It remains to be seen how quickly the audit and corporate governance reform bill will be taken forward.

FRS 102 – The Way Ahead

The Financial Reporting Council (FRC) intends to issue a consultation on proposed revisions to Financial Reporting Standard (FRS) 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland' towards the end of this year or possibly early in 2023.

The main matters being considered by the FRC are whether to bring in the approaches that have been adopted by the International Accounting Standards Board (IASB) in the following International Financial Reporting Standards (IFRS):

(i) IFRS 15 'Revenue from Contracts with Customers'
(ii) IFRS 16 'Leases
(iii) IFRS 9 'Financial Instruments'.

ICAS View
In response to the FRC's periodic review of FRS 102 consultation in 2021, ICAS commented as follows on the possibility of adopting the approaches set out in these standards in FRS 102:

IFRS 15
"IFRS 15, if simplified, was perceived as a valuable addition to FRS 102 as the five-step model would introduce a more structured and consistent methodology for revenue recognition.

Nonetheless, it was highlighted that, while IFRS 15 applies to revenue from contracts with customers, the definition of 'contract' can sometimes be a grey area. Anecdotally, many owner-managed businesses do apply the principles of IFRS 15 when accounting for revenue from contracts so alignment of the two reporting frameworks would have the benefit of regularising what is already happening. However, it is noted that the information required to allow for proper interpretation of the standard may not exist in some smaller entities and, whilst it would be beneficial for these entities to react by enhancing/formalising their internal systems, it may result in the standard being inappropriately applied. Therefore, some accompanying guidance may be required."

IFRS 16

"The introduction of elements of IFRS 16 was perceived as a potential valuable addition to FRS 102 to reduce elements of quasi "off balance sheet" disclosures bringing right of use assets onto the balance sheet.

We also suggest the FRC considers an exemption from IFRS 16 for intra-group leases, e.g. of property between a parent and subsidiary, in much the same way as such leased assets have an exemption from the definition of investment properties in the lessor's accounts. Without such an exemption, those wishing to avoid accounting for such leases will simply redraft leases or let them lapse."

IFRS 9

"Although our outreach highlighted that greater harmonisation with IFRS standards would enable greater comparability and consistency, there were specific concerns raised about greater harmonisation with IFRS 9.

Based on its complexity and extent of reporting, IFRS 9 would have the most significant impact on FRS 102 reporters and assurance providers as almost all balance sheet asset classes would require assessment under the standard. Preparers would be required to prepare assessments to either estimate lifetime losses on assets (where relevant) or defend attestations that the impact of adoption is not material. For private entities, the main challenges would be:

- Where receivables are held with 3rd parties, assessing counterparty credit risk over the lifetime of the instrument and determining an estimate of loss given default, even if the outcome is immaterial. Assessment and challenge by audit teams would be required where applicable.
- A simplified approach can be taken for trade, contract and lease receivables; however, this would likely require upskilling within finance functions reporting under UK GAAP.
- While practical expedients are available (i.e. low credit risk), an assessment would still be required to substantiate this."

What happens next?

The feedback from the FRC's 2021 consultation would suggest that revisions will be taken forward with respect to incorporating the IFRS 15 and IFRS 16 approaches in a simplified manner in FRS 102 but that consideration of whether to incorporate the IFRS 9 approach, including the expected credit loss (ECL) model, may be deferred to a separate later consultation. The approach to be adopted by the IASB may also have an impact. At present the IASB is debating requiring the ECL model but exempting trade receivables and contract assets from its application.

The IASB recently published an exposure draft of its proposed revisions to the IFRS for Small and Medium Sized Entities (IFRS for SMEs) on which FRS 102 is substantively based. The FRC is currently finalising its own consultation, which may be issued before the end of 2022.

The finalised changes to FRS 102 will not become applicable before accounting periods commencing on or after 1 January 2025.

FRC Issues Guidance on Professional Judgement

The Financial Reporting Council (FRC) has published professional judgement guidance for auditors to improve how they exercise professional judgement. The new guidance includes a framework for making professional judgements and a series of illustrative examples. The guidance will be of particular use for auditors and central technical teams but will also have wider interest for those interested in audit quality, such as audit committee members and investors. The guidance is non-authoritative; it is intended to be persuasive rather than prescriptive, encapsulating good practice. However, practitioners who chose not to use or consider this guidance will need to be prepared to explain how they have complied with the relevant engagement standards.

Firms who already have a professional judgement framework are not required to adopt the FRC's. However, the FRC would expect those firms to analyse and understand the FRC's Framework and identify and remedy any areas where their own frameworks could be enhanced. The FRC would also encourage those firms to assess how and in what circumstances they apply their frameworks. They believe that the process for implementing the new Quality Management Standards (ISQM (UK) 1, ISQM (UK) 2 and ISA (UK) 220) represents a significant opportunity to ensure that any professional judgement framework that is being applied helps address risks to audit quality within the firm. The FRC also encourages those firms who do not yet have their own professional judgement framework to consider the merits of developing one, or applying the FRC's. Crucially, it is not simply the existence of a framework which is important, but how effectively it is utilised in the specific circumstances of a firm, or of an engagement.

The framework, when applied by individual practitioners, is intended to enhance the quality and consistency of the exercise of professional judgement in two ways:

- Understanding the nature of a more structured approach can help individuals and teams improve their more intuitive judgement-making, for example by deepening their understanding of areas where they may be most susceptible to biases and other judgement traps.
- Where a more structured approach is appropriate, the framework can help auditors take account of all relevant considerations and achieve a high quality of judgement.

The framework consists of four main components which are broken down into a series of sub-components as follows:

1 Mindset
An appropriate mindset for auditors exercising professional judgement.

Sub-components
(i) Appreciation of the purpose of audit and its public interest benefits.
(ii) Professional Scepticism.
(iii) Understanding of biases and other relevant psychological factors.
(iv) Sensitivity to uncertainty.
(v) Commitment to quality.

2 Professional Judgement Trigger and Process
A suggested professional judgement process, together with a reminder to remain alert to situations which may require professional judgement.

Sub-components
(i) Remain alert to situations which require the exercise of professional judgement.
(ii) Consider who is the right person to make this judgement.
(iii) Appropriately frame the issue.
(iv) Marshal your information.
(v) Carry out the analysis.
(vi) Stand-back, and conclude.

(vii) Document, communicate and reflect

3 Consultation
Effective communication with a range of relevant parties.

4 Environmental Factors
Factors that may be present in the environment of those making a judgement, that can impact on how challenging it is to exercise professional judgement in an appropriate manner.

Sub-components
(i) Audit firm: culture, resources, training and processes.
(ii) Quantity and quality of relevant information available.
(iii) Time and resources available.
(iv) Audited entity: management and those charged with governance.

The framework and illustrative examples are also available as standalone documents. The illustrative examples illustrate application of the framework in a range of scenarios.

The FRC has also published an expectations paper which outlines its expectations in relation to the guidance. This highlights that as stated above the Framework is intended to have the status of non-prescriptive guidance which is consistent with a range of other guidance (Practice Notes for example) which:

"are persuasive rather than prescriptive and are indicative of good practice…. Auditors should be aware of and consider Practice Notes applicable to the engagement. Auditors who do not consider and apply the guidance included in a relevant Practice Note should be prepared to explain how the engagement standards have been complied with."

Practitioners are therefore expected to be aware of guidance that the FRC issues, and to consider its relevance to audit and assurance engagements. The FRC's intent is that:

- It can be applied at a firm-wide level, and potentially incorporated into the firm's methodology;
- It may be an important consideration in the development of a Quality Management System in accordance with ISQM (UK) 1;
- It can also be applied in the circumstances of an individual audit engagement as a stand-alone guide to the application of professional judgement;
- It can be used by individual practitioners at any level of seniority in the conduct of an audit or assurance engagement, and provides high level principles and a benchmark for the application of professional judgement.

The Framework sets out principles that can be applied to help deliver high quality professional judgement, an indicative process to follow, risks and mindset traps, and illustrative examples. Any of these aspects of the material can be applied in a variety of circumstances – and indeed prescription might be impracticable or have outcomes which are inconsistent with the FRC's objectives. The FRC's intent is not to create unnecessary process or documentation, but to enable better and more consistent professional judgement. The FRC highlights that it is important to note that although the Framework itself is non-prescriptive, the application of professional judgement in the conduct of audits (and other assurance engagements) is a requirement of the auditing standards.

In terms of applying a Professional Judgement Framework in practice there is currently divergent practice with some firms focussing on central methodology and/or training applications, and others focussing instead on more complex and subjective professional judgements made at the engagement level. The FRC believes that it is a matter for audit firms to decide which approach will be more effective in their individual circumstances. It is that assessment of how a framework can drive better and more consistent professional judgements that is critical, and how it can (or could) help manage risks to quality management. Audit firms will therefore need to understand what additional opportunities there are to ensure that a professional judgement framework is understood and socialised within the firm, and that appropriate expectations are set for how it can be used.

UK Endorsement Board adopts IFRS 17 – first major standard

The UK Endorsement Board (UKEB) has announced that it has approved the adoption of the International Accounting Standards Board's (IASB) International Financial Reporting Standard (IFRS) 17 Insurance Contracts for use by UK companies. It is the first major standard adopted by the UKEB since the UKEB received delegated powers from the Business Secretary on 22 May 2021.

IFRS 17 is a significant new accounting standard for the insurance sector and is the result of many years of work by the IASB, with extensive input from a wide range of international stakeholders. IFRS 17 represents the first comprehensive international accounting standard that can be applied to all types of insurance contracts, aiming to ensure that entities provide relevant information that faithfully represents those contracts.

It replaces IFRS 4 Insurance Contracts, an interim standard, which permitted insurers largely to continue to apply their existing (local) accounting practices. This has meant that insurers may have applied different accounting policies to measure similar insurance contracts written in different countries.

The objective of IFRS 17 is to provide more transparent and useful information about insurance contracts. IFRS 17 introduces consistent principles, improving international comparability. Insurers must use updated estimates and assumptions that reflect the timing of cash flows and any uncertainty relating to insurance contracts. Profits are only recognised as the company delivers services and companies must provide information about insurance contract profits they expect to recognise in the future.

IFRS 17 is effective for annual periods beginning on or after 1 January 2023, with early application permitted for entities that apply IFRS 9 Financial Instruments on or before the date of initial application of IFRS 17.

The standard can be viewed on the ifrs.org website. Please note that registration is required but that access to the standard itself is free.