



## AUDIT AND BREXIT PART 3: AUDITING STANDARDS CONSIDERATIONS

27 November 2018

This guide is part of a series intended to help auditors of SMEs deal with current Brexit-related uncertainties associated with a potential no-deal exit as they affect 31 December 2018 and 31 March 2019 audits. The series does not deal with the longer-term potential opportunities or risks associated with Brexit more widely.

### ***ISQC 1 and ISA 220: Quality control***

Some firms have determined that Brexit issues are to be considered for inclusion as a 'mandatory' issue to be addressed during the audit. Firms are encouraging internal consultation on the technical aspects of Brexit as part of their quality control procedures.

Brexit considerations may be taken into account when selecting files for any sort of review, including hot reviews, cold reviews, engagement quality control reviews under ISQC 1 and any other reviews a firm may conduct.

### ***ISA 570: Going concern***

Issues that might, of themselves, give rise to uncertainties about going concern include the following:

- the availability of grant and commercial funding, particularly where entities currently rely on EU funding. Expectations relating to interest rates are relevant to commercial funding. Evidence regarding the availability of either continued EU funding or alternative sources will need to be adequate where appropriate;
- the availability of staff in sectors heavily dependent on EU labour;
- the cumulative impact of increases in import and export tariffs and duties and delays at ports on entities involved in just-in-time supply chains. Additional working capital requirements may result in increased borrowing costs;
- entities that are, in addition to being exposed to Brexit-related risks, already operating close to their borrowing limits, or in danger of breaching covenants, or relying on future refinancing to remain viable, for example. Such entities will need to provide more evidence to auditors, as well as financiers, and may need particularly careful handling.

It seems likely that auditors will need to pay special attention to cash flow forecasts more generally this reporting season and, in particular, at whether management has taken a 'sensible look' at potential downsides. Engagement partners will be paying particular attention to the extent to which all of these issues impact banking covenants, and the reporting and other implications where covenants seem likely to be breached.

## **Mitigating factors**

Some clients may have the option of addressing the risk of the potential loss of overseas customers and suppliers by focusing on other markets. Management will need to provide good quality support for this type of approach.

Hedging strategies might be used to manage potential adverse currency fluctuations.

Some entities - particularly those in the financial services sector - may be considering or planning opening offices in the EU, or moving operations, centres of administration or head offices there to manage the risks associated with retaining the principal place of business in the UK. The quality of management plans in such cases will be relevant to the going concern risk assessment, as will uncertainty over tax considerations.

## **Disclosures**

Disclosures of Brexit-related issues generally, and of going concern issues in particular, are likely to be the most contentious issue between auditors and clients. Clients may resist the need for anything other than high-level generalised disclosures and auditors will need to challenge this.

## **Reporting**

Three types of illustrative audit report are provided in ISA 570 where there is a material uncertainty regarding going concern:

- unmodified opinion: material uncertainty exists and is adequately disclosed in the financial statements;
- qualified opinion: material uncertainty exists and there is inadequate disclosure concerning that material uncertainty;
- adverse opinion: when a material uncertainty exists and is not disclosed in the financial statements.

### ***ISA 560: subsequent events***

Auditors reporting on 31 December 2018 year-ends cannot reasonably be expected to wait and see if a deal is struck, assuming no deal is struck before then.

Where reporting timetables permit, and where the audit report is normally signed on or around the end of March, auditors may use their judgment when considering how to address the implications of Brexit when preparing their audit report and considering its timing. Some auditors have suggested that they may consider delaying signing the report until after 29 March 2019 if it seems highly likely that a deal will be finalised very close to that time. However, others seem to be taking the view that even if a deal seems likely, its resolution should not be treated as an adjusting event. Others again take the view that the subsequent events review should be concluded earlier wherever possible to minimise uncertainty, and to avoid potential risks to the firm arising from the use of hindsight. Where auditing an entity incorporated in an EU Member State, third country auditor registration will be required from 29 March 2019 and it might therefore be beneficial to sign off before that date in some circumstances.

In practice this is an issue for entities rather than auditors. For unlisted entities, there can be a delay between the date of approval by the directors and the date of the audit report (firm methodologies may take a position on this) but this is not appropriate for listed entities.

Auditors may wish to determine in advance what they consider to be an adjusting or non-adjusting event in this context including, for example, the immediate economic effects of Brexit after 29 March 2019, and the nature of and/or uncertainty associated with any deal agreed on before or

during the period immediately following 29 March 2019. Any material going concern uncertainty, is treated as an adjusting event as by definition, the assessment covers 12 months from the approval of the financial statements.

UK listed entities have in theory, 4 months to report which extends beyond 29 March 2019 but many (and their components) report considerably earlier.

## **ISA 600: group audits**

### **UK auditor responses to requests from auditors in the EU**

Where UK firms report on subsidiary undertakings of EU parent entities, the group engagement team often seek assurances about the component auditor's compliance with local (EU) auditing standards and/or ISAs issued by the IAASB, and about the audited entity's compliance with IFRS as adopted in the EU. While firm responses are likely to be the same immediately post-Brexit, some EU group engagement teams may seek additional or different assurances from UK auditors, particularly in relation to IFRS, on the grounds that it can no longer be assumed that IFRSs as adopted in the UK are exactly the same as those in the EU.

In the short term, provided IFRS as issued by the IASB and IFRS as adopted by the EU remain closely aligned, firms may in such circumstances in their audit opinions refer to compliance with both IFRS as issued by the IASB and IFRS as adopted by the EU – some firms already do this for US Foreign Private Issuers. However, some take the view that as a third country, UK entities listed on EU regulated markets would be expected to prepare accounts in accordance with IFRS as issued by the IASB and for auditors to report accordingly.

Similar considerations apply to ISAs. ISAs (UK) contain more than ISAs as issued by the IAASB to deal with UK-specific issues and the requirements of EU Regulations and Directives. The FRC has not indicated any plans to amend ISAs (UK) in the immediate future. ISAs have not been adopted directly by the EU. Responses to requests for confirmation of compliance with local (EU) auditing standards from EU auditors sometimes involve UK auditors simply striking out wording referring to the local auditing standards and replacing it with wording referring to ISAs (UK) and/or ISAs issued by the IAASB.

The FRC's June 2016 *Scope and Authority of Audit and Assurance Pronouncements* at paragraph 5 states that:

*'ISAs (UK) are consistent with International Standards on Auditing as issued by the IAASB and the requirements of ISAs (UK) do not conflict with the requirements in ISAs. An audit conducted in accordance with ISAs (UK) does not therefore preclude the auditor from being able to assert compliance with International Standards on Auditing issued by the IAASB.'*<sup>1</sup>

### **EU auditor responses to requests from UK auditors**

Auditors of UK parent entities preparing the consolidated financial statements of groups with EU subsidiaries may need to think about whether the General Data Protection Regulation (GDPR)

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<sup>1</sup> The full text of paragraph 5 is as follows:

*The ISAs (UK) and ISQC (UK) 1 are based on the corresponding international standards issued by the International Auditing and Assurance Standards Board<sup>3</sup> (IAASB). Where necessary, the international standards have been augmented with additional requirements to address specific UK legal and regulatory requirements; and additional guidance that is appropriate in the UK national legislative, cultural and business context. This additional material is clearly differentiated from the original text of the international standards by the use of grey shading. Requirements derived from the European Audit Regulation<sup>4</sup> and Directive<sup>5</sup> are designated by the letter "R" or "D" respectively<sup>6</sup>. ISAs (UK) are consistent with International Standards on Auditing as issued by the IAASB and the requirements of ISAs (UK) do not conflict with the requirements in ISAs. An audit conducted in accordance with ISAs (UK) does not therefore preclude the auditor from being able to assert compliance with International Standards on Auditing issued by the IAASB.*

might impair their ability to obtain audit evidence relating to the group financial statements. The position here, as in so many areas, is far from clear.

Under the GDPR, as before, any country outside the EEA (a third country) to which the personal data of EU data subjects is transferred, must have in place a data protection regime deemed 'equivalent' by the EC - by means of an 'adequacy decision' - to EU legislation. There are a number of other GDPR compliant ways to transfer data from the EU to countries outside the EU if no adequacy decision is in place and there are some exceptions, subject to appropriate safeguards, but all of these represent very high hurdles.

If entities in the EU refuse to permit the transfer of information to UK auditors, including remote access, it may become necessary to visit the relevant jurisdiction. China refuses to allow the transfer of data and many firms already have experience of this issue which adds to cost and time budgets. In the short term, this will hopefully not be an issue because UK law incorporates the GDPR, however, EU entities may take the view that as of 29 March 2019, assumptions can no longer be made about UK law.

Approaches will depend on whether the information requested for audit purposes constitutes or contains 'personal' data. The standard example is data within detailed payroll or debtor records, however, such detail is rarely required by group auditors reviewing component auditor work, but there is always a risk that other accounting records might contain or refer to the sort of personal data caught by the GDPR. Some firms in the EU may take a more cautious approach than others.

After 29 March 2019, the UK will be a 'third country' for these purposes. Government has suggested that obtaining an adequacy decision will be a formality because the Data Protection Act 2018 (DPA 2018) is equivalent to the GDPR, but this remains to be seen. An adequacy decision seems likely to take time and the process cannot be started before the UK leaves the EU.<sup>2</sup>

For UK listed entities, with 31 December 2018 year-ends, reviews of component auditor work are likely to take place before 29 March 2019, however this may not be the case for unlisted entities.

### ***ISAs 700, 701, 705, and 706: Auditor Reporting, KAM, Modifications, Emphases of matter***

For 31 December 2018 year-ends, auditors need to assess whether clients have appropriately assessed, concluded and, where appropriate, disclosed relevant risks and uncertainties. The interaction of KAM and EoM may not be straightforward and each situation will need to be judged on the specific client circumstances. While very few entities seem likely to be wholly unaffected by Brexit, the impact of Brexit on many smaller entities seems likely to be limited. Where that is the case, there will be no need to refer to the issue in the auditor's report. However, it seems equally likely that Brexit will have a significant impact on some smaller entities.

In addition to reporting on going concern issues under ISA 570 noted above, Brexit-related issues may in some cases give rise to key need for auditors to report key audit matters (KAM) or emphases of matter (EoM).

EoM under ISA 706 draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users'

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<sup>2</sup> For data transfers in the opposite direction (from the UK to the EU, there will be no change, the DPA 2018 will continue to apply, at least for the time being. Sanctions for breach of the DPA 2018 include fines of the higher of €20 million or 4% of the company's global annual turnover.

understanding of the financial statements. It seems possible that Brexit-related issues will be 'fundamental' to users' understanding in some cases.

If a qualification is required because of an inadequately disclosed material uncertainty relating to going concern, neither an EoM nor a KAM should be used either in conjunction with or as a substitute for that qualification.

Auditors might appropriately draw attention to significant but properly disclosed uncertainties over the timing and amount of future costs arising from border checks in an EoM, although auditors should remember that the 'fundamental' (to users' understanding) test is a high hurdle. An entity may only be able to withstand a certain level of increased lead time and production costs before it cannot raise its own selling prices any more. Management may make reasonable assumptions about this in their reviews. As the level of sensitivity to reasonably possible changes in assumptions increases, especially where assumptions are subject to a high level of uncertainty, the potential impact thereof increases and might in some cases be deemed to be 'fundamental', or become a material uncertainty relating to going concern

'Other matter' paragraphs in the audit report cover matters 'other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.' While it seems possible that Brexit-related issues that are not presented or disclosed are nevertheless relevant to users' understanding of the audit - where an entity might be expected to be affected by Brexit but is not, for example - such situations seem likely to be few and far between.

It seems unlikely that firms will determine that Brexit issues are always to be covered in the audit report but where firms are likely to have many clients with Brexit-related disclosures, they may determine that it is necessary to develop criteria for determining when and how to refer to Brexit-related issues in the audit report.

The FRC (see above) has already indicated that blanket or boilerplate disclosures in the financial statements, or in the auditor's report are to be avoided (as with any other sort of 'mandatory' KAM) and it seems likely that ICAEW's QAD will highlight the FRC's stance in its dealings with firms.

As with many other issues, questions should not arise as to whether an issue should be reported as a qualification to the audit report or as a KAM or EoM as they are fundamentally different issues.

### ***ISA 720: other information***

Auditors may encounter situations in which Brexit-related issues (a) are dealt with differently, or with a different focus in the financial statements and the other information, such as where Brexit-related risks are disclosed in the financial statement but not in the Strategic Report, or (b) come to the auditors' attention during the audit and are materially inconsistent with the other information. Both require the issue to be resolved or a reference made to the matter in the audit report.

### ***Other ISAs***

#### **ISA 260: communications with those charged with governance**

Even if Brexit-related issues are not deemed to be significant to the audit, Brexit-related communications may be caught under the requirement to communicate any 'other' significant

matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

Brexit-related communications also seem likely to be caught, to the extent that they are not already caught by other requirements in ISA 260, by UK 'pluses'. These are principally communications for entities that report on the application of the UK Corporate Governance Code, and PIEs. They relate to, for example, valuations of material assets and liabilities and related disclosures, systems of control, the robustness of the directors' assessment of the principal risks, including those that would threaten the business model, future performance, solvency or liquidity ratios, and directors' explanations of how they have assessed the entity's prospects and over what period.

There is also a requirement to report and explain judgments about events or conditions identified in the course of the audit that may cast significant doubt on the entity's ability to continue as a going concern and whether they constitute a material uncertainty, and to provide a summary of all guarantees, comfort letters, undertakings of public intervention and other support measures that have been taken into account when making a going concern assessment.

### **ISA 505: external confirmations**

UK auditors may consider it more important to obtain confirmations where, for example, Brexit-related issues lead to disputes related to goods incorrectly labelled, spoiled in transit or regarding who pays the tariffs, for example.

### **ISA 520: analytical procedures**

Substantive analytical procedures involve the prediction of likely results. To the extent that Brexit creates uncertainty and the past may be less likely to be predictive of the future than usual, those predictions may be harder to make going forward or auditors may be less confident in them. Expectations regarding changes in costs, new markets or sources of supply will need to be factored in where appropriate. A variety of responses is possible: auditors may choose to perform alternative substantive procedures, to require more rigorous supporting evidence around substantive analytical procedures (by performing more detailed follow ups, for example), or they may simply rely less on or abandon substantive analytical procedures.

### **ISA 540: accounting estimates**

Extant ISA 540 permits four basic approaches to the audit of estimates: reviewing management's process for developing the estimate, testing the operational effectiveness of controls over that process, developing an auditor point estimate or range, or reviewing subsequent events. Where auditors review management's process for the development of estimates impacted by Brexit, such as impairments and asset valuations, they need, as always, to exercise professional scepticism by, for example, ensuring that appropriate downside sensitivities have been considered. Auditors will also need to focus on the disclosure of assumptions supporting such estimates.

### **ISA 580: written representations**

Written representations seem most likely to relate to management intentions with regard to the planned mitigation of any potential adverse effects of Brexit, or management assumptions. In such cases, as always, auditors will need to consider the entity's past history in carrying out its stated intention, its reasons for choosing a particular course of action and its ability to pursue that course. If management assumptions do not appear reasonable, or assumptions are not adequately supported, written representations may not be appropriate, and a qualified audit report may be necessary.

If management's assessment of Brexit-related risks and sensitivities was insufficiently robust or accurate, or the conclusions drawn were inappropriate, or if there were residual risks arising from the analysis that management had not addressed, written representations will not compensate.

### ***Further reading***

Further resources are available on [icaew.com/brexit](https://www.icaew.com/brexit).

## CONTACT US

[brexitsupport@icaew.com](mailto:brexitsupport@icaew.com)

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