

Clarity in Detail

Presented by

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ISA 540 AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES

Introduction

Some financial statement items cannot be measured precisely, but can only be estimated. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias.

It might be thought that accounting estimates are only a problem for larger entities but this is not the case. Situations where accounting estimates may be required for entities of all sizes include:

- Provision for doubtful debts.
- Stock write-downs.
- Warranty obligations.
- Depreciation.
- Outcome of long term contracts.

A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Objective

ISA 540 tells us that the objective of the auditor is to obtain sufficient appropriate audit evidence about whether:

(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and

(b) related disclosures in the financial statements are adequate,

in the context of the applicable financial reporting framework.

Definitions

(a) Accounting estimate - An approximation of a monetary amount in the absence of a precise means of measurement.

(b) Auditor's point estimate or auditor's range - The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

(c) Estimation uncertainty - The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

(d) Management bias - A lack of neutrality by management in the preparation of information.

(e) Management's point estimate - The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

(f) Outcome of an accounting estimate - The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

Requirements

Risk assessment

Paragraph 8 is concerned with the auditor's knowledge of the business. This is required to include an understanding of the following:

1. The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Note that, IFRS requires estimation techniques to be selected so as to fairly present the accounts. Disclosure is required of estimation techniques that are significant. In this context, significant means that the range of reasonable monetary estimates is so large that the use of a different amount within that range could materially affect the view shown by the financial statements. The description of a significant estimation technique will include details of those underlying assumptions to which the monetary amount is particularly sensitive.)
2. How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or

disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

3. How management makes the accounting estimates, and an understanding of the data on which they are based, including:
 - The method, including where applicable the model, used in making the accounting estimate;
 - Relevant controls;
 - Whether management has used an expert;
 - The assumptions underlying the accounting estimates;
 - Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
 - Whether and, if so, how management has assessed the effect of estimation uncertainty.

Paragraph 9 requires the auditor to review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at the time.

It is to be expected that the outcome of accounting estimates will differ from the original estimates. This does not necessarily mean that the financial statements were misstated. The review will, however, provide information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process. It will also provide the auditor with information about estimation uncertainty and possible management bias.

ISA 240 also requires a retrospective review of management judgments and assumptions related to significant accounting estimates. That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls.

The Application Material tells us that the auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates

that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

Paragraph 10 requires the auditor to evaluate the degree of estimation uncertainty associated with an accounting estimate. This will assist the auditor in identifying and assessing the risks of material misstatement.

The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as the extent to which judgement is required; the sensitivity of the estimate to changes in assumptions; the existence of recognised measurement techniques; and the availability of reliable data from external sources.

The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias.

Matters relevant to the assessment of the risks of material misstatement may also include the amount of the estimate; the difference between management's point estimate and the auditor's estimate; whether management has used an expert in making the accounting estimate; and the outcome of the review of prior period accounting estimates.

Paragraph 11 requires the auditor to determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

This is likely to be the case if accounting estimates:

- are highly dependent upon judgment,
- are not calculated using recognised measurement techniques.
- performed in the past show a substantial difference between the original estimate and the actual outcome.

Note that the size of the amount recognised or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty. In other words, an apparently immaterial estimate can contain a material misstatement.

Recall that, in the situation where the auditor assesses a risk to be significant, Paragraph 29 of ISA 315 requires the auditor to obtain an understanding of the entity's controls, including control activities.

Response to risk

Bearing in mind the assessment of risk, the auditor is required by paragraph 12 to determine whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate. In addition, the auditor should determine whether the methods for making the

accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.

Paragraph 13 contains detailed requirements for audit procedures based on the risk assessment. The auditor is required to undertake one or more of the following, as appropriate in the circumstances:

- Determine whether events after the balance sheet date (and up to the date of the auditor's report) provide audit evidence regarding the accounting estimate. This method may be appropriate for matters such as the estimate of a provision for doubtful debts.
- Test the method used by management and the reliability of the data on which it is based. In doing so, the auditor must evaluate whether the method is appropriate in the circumstances and the assumptions are reasonable. This method may be appropriate if the method had been used consistently in the past and has been found to give a reasonable estimate of actual outcomes.
- Test the operating effectiveness of the controls together with appropriate substantive procedures. This method is likely to be effective if the accounting estimates are made frequently (eg for management accounting purposes) and therefore the estimate is derived from the routine processing of data by the entity's accounting system. Further, because of the repetitive nature of such estimates, there is a process to ensure management approval of the models used.
- Develop a point estimate or a range to evaluate management's point estimate. This method is likely to be used when an accounting estimate is not derived from the routine processing of data by the accounting system and the auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective. It may be that the auditor's knowledge of the industry suggests the use of a model that has been used at other entities.

When developing a point or range estimate, the auditor must obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. Further, if the auditor concludes that it is appropriate to use a range, the auditor must narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

Following on from the requirements in Paragraphs 12 and 13 above, Paragraph 14 requires the auditor to consider whether specialised skills or knowledge are required in order to obtain sufficient appropriate audit evidence concerning accounting estimates.

Response to significant risks

For accounting estimates that give rise to significant risks, Paragraph 15 requires the auditor to perform additional procedures by evaluating the following:

- How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

The Application Material suggests that sensitivity analysis might be an appropriate technique for this purpose. This does not mean that such a technique is compulsory and the auditors of small entities may well be able to assist management by discussing estimation uncertainty with them`

- Whether the significant assumptions used by management are reasonable.

An assumption is deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.

- Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

If, as a result of the evaluation described above concerning significant risks, the auditor concludes that management has not adequately addressed the effects of estimation uncertainty, Paragraph 16 requires the auditor to consider whether it is necessary to develop a range with which to evaluate the reasonableness of the accounting estimate.

Paragraph 17 requires the auditor to consider the applicable financial reporting framework and obtain sufficient appropriate evidence about whether accounting estimates (where risk is significant) have been properly recognised (or not) in the financial statements and whether they have been measured using an appropriate basis. For these same accounting estimates, Paragraph 20 requires the auditor to evaluate the adequacy of the disclosure of estimation uncertainty in the notes to the accounts

Conclusions and disclosures

The auditor must state a conclusion as to whether the accounting estimates in the financial statements are either reasonable or are misstated. (Paragraph 18)

A misstatement should be dealt with in accordance with ISA 450 but the Application Material in ISA 540 adds some helpful comments.

Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has used a range then the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

A change in the method of making an accounting estimate may be seen as an indicator of possible management bias – see Paragraph 21 below.

Paragraph 19 deals with disclosures of accounting estimates in the accounts and requires the auditor to obtain sufficient appropriate audit evidence about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

Paragraph 21 requires the auditor to consider whether there are indicators of possible management bias. Such indicators do not necessarily mean that individual accounting estimates are misstated.

Management bias might be indicated if:

- Methods for making accounting estimates have changed.
- The assumptions used in making estimates are inconsistent with observable marketplace assumptions.
- Assumptions are being selected which give estimates favourable for management objectives.
- The auditor's opinion of misstatements in estimates show a pattern of over- or under-optimism.

On a practical level, this suggests that the auditor might find it helpful to prepare a schedule which summarises all accounting estimates along with the auditor's conclusion as to their reasonableness – both individually and in aggregate.

Paragraph 22 requires the auditor to obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

Paragraphs A126 and A127 in ISA 540 provide examples of the contents of representation letters.

There is a specific documentation requirement in Paragraph 23 which is reproduced in full below.

23. The auditor shall include in the audit documentation:

- (a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
- (b) Indicators of possible management bias, if any.

Recall that, the absence of other specific requirements for documentation does not mean that there are no other documentation requirements. The auditor will, for example, need to evidence audit work performed on all material accounting estimates not just those that are significant.

So what?

In their research into the cost of adopting the new clarity ISAs, the APB stated that the two standards which would cause most extra expense were ISA 540 and ISA 550.

The list of changes in ISA 540 provided in the APB's staff paper repeats a large part of the standard covered above.

In my view, we need to address the following:

1. Notes in the permanent file (or section of the current file which deals with knowledge of the business) probably need to be expanded to meet the requirements of Paragraph 8. This will include the process used by management to identify the need for accounting estimates and the methods used to calculate estimates. The permanent file may also be a good place to record estimation uncertainty (Paragraph 10) and the existence of significant risks (Paragraph 11). The vital thing is that any risks identified are picked up when the audit is planned.
2. The need to address the outcome of prior-year estimates could again be dealt with in the permanent file – indeed this may be an appropriate place to record the history of such estimates (their amounts and outcome). However, it is probably more reliable to include the response to this requirement (Paragraph 9) in the current file. The auditor needs to be aware that it is necessary to consider these issues when auditing any accounting estimate.
3. Auditors have a choice of procedures (Paragraph 13). It is true to say that many firms do not give accounting estimates the attention they deserve. Staff are too willing to accept consistency with the prior year as an acceptable explanation.

4. It has been well-documented that some auditors are weak at identifying significant risks. Many accounting estimates will give rise to significant risks and this means that we need to obtain an understanding of the entity's controls, including control activities, over the accounting estimates. (Paragraphs 15 to 17)
5. As mentioned earlier, I think the auditor should prepare a schedule which lists all accounting estimates so that management bias can be considered both individually and in aggregate. (Paragraph 21).

ISA 550 RELATED PARTIES

Introduction

The nature of related party relationships and transactions may give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. This might be because of complexity, lack of information in the accounting system or because related party transactions may not be conducted at arm's length.

The auditor will be concerned with the impact of related party relationships in two ways:

- Are disclosures in accordance with IAS 21 or equivalent
- Are there any fraud risk indicators since fraud may be more easily committed through related parties.

The auditor needs to be alert for previously undisclosed related party relationships and to exercise professional scepticism throughout the audit.

Objectives

ISA 550 tells us that the objectives of the auditor are:

(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:

(i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and

(ii) To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:

a. Achieve fair presentation (for fair presentation frameworks); or

b. Are not misleading (for compliance frameworks); and

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

Requirements

Paragraphs 12- 17 require the auditor to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions. This is seen as part of the risk assessment procedures and related activities required by ISA 315 and ISA 240.

Paragraph 12 requires the engagement team discussion to include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. The guidance material gives some assistance in this area.

It says that matters that may be addressed in the discussion among the engagement team include:

- The nature and extent of the entity's relationships and transactions with related parties.
- An emphasis on the importance of maintaining professional scepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor.
- The records or documents that may indicate the existence of related party relationships or transactions.
- The attitude of management and those charged with governance to the accounting for, and disclosure of related party relationships and transactions and the related risk of management override of relevant controls.

In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud.

Paragraph 13 requires the auditor to make inquiries of management concerning the identity of the entity's related parties; the nature of the relationships; and whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

There is a specific documentation requirement in Paragraph 28 for the auditor to include in the audit documentation the names of the identified related parties and the nature of the related party relationships. Recall that, the absence of other specific requirements for documentation does not mean that there are no other documentation requirements. The auditor will, for example, need to evidence that the discussion among the engagement team took place and dealt with the issues in Paragraph 12.

Paragraph 14 requires the auditor to obtain an understanding of the controls, if any, established by management in respect of related party relationships and transactions and their authorisation and approval including significant transactions and arrangements outside the normal course of business. A consideration of the control environment may be relevant in mitigating risks arising from related party relationships.

The Application Material points out that controls over related party relationships and transactions within some entities may be deficient or non-existent. In this case, the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions.

Specific guidance is given for the audit of smaller entities where control activities are likely to be less formal. The regular involvement of an owner-manager may mitigate or increase risks arising from related party relationships. The auditor's understanding of related party relationships and transactions, and any relevant controls will come from inquiry of management combined with other procedures, such as observation and inspection.

Paragraph 15 contains the requirement for the auditor to be alert!

It does however provide some assistance in this requirement by specifying when this state of alertness is required. Paragraph 15 is reproduced in full below.

15. During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank and legal confirmations obtained as part of the auditor's procedures;
- (b) Minutes of meetings of shareholders and of those charged with governance; and
- (c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

Where the auditor identifies significant transactions outside the entity's normal course of business, Paragraph 16 requires the auditor to inquire of management about the nature of these transactions; and whether related parties could be involved.

Paragraph 17 requires the auditor to share relevant information obtained about the entity's related parties with the other members of the engagement team.

Paragraph 18 includes the requirement that the auditor identifies and assesses the risks of material misstatement associated with related party relationships and transactions and determines whether any of those risks are significant risks. A significant related party transactions outside the entity's normal course of business automatically is treated as a significant risk.

Recall that Paragraph 29 of ISA 315 contains the particular requirement when the auditor is faced with a significant risk that the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk.

Fraud risk factors identified by the auditor when performing procedures in connection with related parties should be considered when identifying and assessing the risks of material misstatement due to fraud. (Paragraph 19)

When responding to risks associated with related party relationships and transactions, Paragraph 20 requires that the auditor's procedures include:

- Confirmation that previously unidentified related party relationships actually exist (Paragraph 21).
- Prompt communication of the relevant information to the other members of the engagement team.
- A request of management to identify all transactions with the newly identified related parties for the auditor's further evaluation.
- Inquiry of management as to why the entity's controls failed to identify or disclose the related party relationships or transactions.
- Performance of appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions.

- Reconsideration of the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary.
- Evaluation of the implications for the audit if the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud) (Paragraph 22)

Paragraph 23 requires that the auditor's response to significant related party transactions outside the entity's normal course of business should include inspection of underlying contracts or agreements to evaluate whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. Further, are terms of the transactions consistent with management's explanations and are they appropriately accounted for and disclosed. The auditor should also obtain audit evidence that the transactions have been appropriately authorised and approved.

In evaluating the business rationale of a significant related party transaction outside the entity's normal course of business, the auditor may consider matters such as the complexity of the transaction; whether the terms of trade are unusual; lack of logic; the involvement of previously unidentified related parties; unusual processing; or emphasis on a particular accounting treatment rather than giving due regard to the underlying economics of the transaction.

International Accounting Standards make the assumption that related party transactions are not usually at arm's length. Therefore, if appropriate, the accounts will contain explicit disclosure of management's assertion that a related party transaction was conducted on arm's length terms. In this case Paragraph 24 requires the auditor to obtain sufficient appropriate audit evidence about the assertion.

Paragraph 25 requires the auditor to evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed.

Paragraph 26 requires the auditor to obtain written representations from management and, where appropriate, those charged with governance that they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and that they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

The auditor may also decide to obtain written representations regarding specific assertions that management may have made, such as a representation that specific related party transactions do not involve undisclosed side agreements.

An entity may require its management and those charged with governance to sign individual declarations in relation to related party matters. In other cases, the auditor may wish to obtain written representations directly from each of those charged with governance and from members of management.

Unless all of those charged with governance are involved in managing the entity, Paragraph 27 requires the auditor to communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

So what?

This is the other new clarity ISA where the APB expects the auditor's costs to increase considerably. The revised ISA is written on the risk based approach and, again, there are many new requirements.

To provide a quick checklist of the major issues might not be appropriate since the auditor must have an understanding of the entire text of the ISA . However, I see the following as the practical impacts:

1. The auditor needs to document an improved knowledge of the business identifying the names of the related parties and the nature of the relationship. (Paragraph 28) This must extend to an understanding of internal controls. (Paragraph 14)
2. The file needs to document that related parties were included in the engagement team discussion at the planning stage. (Paragraph 12)
3. Significant risks arising from related party relationships need to be considered and a response to risk documented. (Paragraph 18). This will include the response to the identification of related parties or significant related party transactions not previously disclosed to the auditor. (Paragraph 22) Similarly, the auditor needs to respond appropriately if significant related party transactions are identified which are outside the normal course of business. (Paragraph 23)

ISA 600: SPECIAL CONSIDERATIONS - AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS)

Introduction

ISA 600 is the most changed of all the Auditing Standards. In the UK Auditing Practices Board research, it was considered that this standard alone would add 3% to the cost of the audit of large and listed entities. From this it might be interpreted that there is no great impact on the auditors of smaller entities. However, many audit firms of all sizes have clients with subsidiaries abroad and, in this case, there will be some significant changes in how they conduct their work.

Objectives and definitions

The objectives of the auditor are:

- a. To determine whether to act as the auditor of the group financial statements; and
- b. If acting as the auditor of the group financial statements:
 - (i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and
 - (ii) To obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

A “component” is defined as an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

Component materiality is the materiality for a component determined by the group engagement team.

Other definitions are self-explanatory or dealt with in the text below.

Overall responsibility of the group auditor

The new Clarity ISA 600 is based on the key requirement that the group auditor has overall responsibility for the group audit engagement. This means that the group engagement partner is responsible for the direction, supervision and performance of the group audit engagement and for the appropriateness of the group audit opinion (ISA 600.11).

Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatements. In a group audit, this includes the risk that the component auditor may not detect a misstatement in the financial information of the component that could cause a material misstatement of the group financial statements, and the risk that the group engagement team may not detect this misstatement.

The new Standard sets out what the group auditor considers when determining the nature, timing and extent of its involvement in the risk assessment procedures and further audit procedures performed by component auditors (ISA 600.6).

Core concepts

The following sum up the core concepts that need to be understood and applied by the group auditor:

- Scoping decisions
- Materiality considerations
- Understanding the component auditor
- Involvement in the component auditor's work

Scoping decisions

The first thing that the group auditor has to do is identify the entities that form "components" of the group. The group auditor is then required to classify the components in order to determine what audit procedures should be planned.

A significant component is a component identified by the group engagement team that is either of individual financial significance to the group, or that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements

A financially significant component can be identified using benchmarks like group assets, group liabilities, cash flows, profit and turnover

Whilst the standard does not specify a percentage that indicates an individually financially significant component, the application material gives an example of 15%. A possible interpretation of this is:

20% or greater	Probably financially significant
15% to 20%	May be financially significant
15% or smaller	Probably not financially significant

The standard includes a section entitled “Determining the type of work to be performed on the financial information of components”. This is summarised in the table below.

Individually financially significant components	Components which are significant because they are likely to include significant risks	Non-significant components
Audit of financial statements	Audit of financial statements or Audit of one or more accounts balances or disclosures relating to the significant risks or Specified audit procedures relating to the significant risks (ISA 600.27)	Perform analytical procedures at group level (ISA 600.28) If sufficient evidence not obtained for group opinion, then additional work will be performed on non-significant components as follows: Audit of financial statements or audit of one or more account balances or disclosure or review or specified audit procedures (ISA 600.29)

Materiality considerations

The group auditor will determine materiality for the group financial statements as a whole. As usual, this may involve setting lower materiality levels for particular classes of transactions, account balances or disclosures.

In addition to determining group materiality, the group auditor is also required to determine component materiality for those components where component auditors will perform an audit or review for purposes of the group audit. Component materiality has to be smaller than group level materiality.

The group auditor will also set the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

The component auditors will set performance materiality at the component level but the group auditor must evaluate whether the level set is appropriate.

If a component is subject to audit in its own right, and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team shall determine whether materiality for the component financial statements as a whole; and performance materiality at the component level meet the requirements of the ISA.

Understanding the component auditor

Where the group auditor is also the component auditor this is relatively straightforward, especially if the same engagement team is performing both audits under the same quality control procedures.

The group auditor is required to understand the following in relation to the component auditor:

- Compliance with relevant ethical requirements including independence,
- Professional competence and
- Regulatory environment

The group auditor must also be satisfied that the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.

The practical implications of this are:

- ISA 600 induces a strong link between the understanding of a component auditor and the extent of the involvement in the component auditor's work,
- A lower level of understanding of a component auditor has direct repercussions on the nature, timing and extent of audit procedures to be performed by the group engagement team on the financial information of the component and on the work performed by the component auditor.
- ISA 600 induces a strong incentive to try to obtain a good understanding of all component auditors relevant for a group audit.

Alternatively, it is being suggested by some commentators that it might be more cost-effective for the group auditors to audit significant components themselves (using group materiality) rather than seek to rely on component auditors.

Involvement in the work performed by component auditors

For significant components

Group auditors shall be involved in the component auditor's risk assessment. This involves at a minimum:

- Discussing business activities of significance to the group
- Discussing component's risks of material misstatements due to fraud or error and
- Reviewing the component auditor's documentation of identified significant risks of the group financial statements

The nature, timing and extent of this involvement are affected by the understanding of the component auditor.

For significant risks the group auditor shall evaluate the appropriateness of the further audit procedures to be performed to respond to those risks. In addition to this, based on the understanding of the component auditor, the group auditor shall determine whether it is necessary to be involved in the further audit procedures.

So what?

The new Clarity ISA 600 introduces a number of new group audit requirements, in the following areas:

- Performing a risk assessment and planning discussion
- Establishing a group audit strategy and a group audit plan
- Testing of group wide controls, including those on consolidation if the work to be performed on components is based on an expectation that those controls are operating effectively or if substantive procedures alone cannot provide sufficient appropriate audit evidence
- Extent of the communication between a group and a component auditor and the need for "two way communication"
- Determination of the nature, timing and extent of the involvement in the work of component auditors on non-significant components

- Performance of explicitly mentioned further audit procedures on the consolidation process
- Identification of subsequent events
- Evaluation of sufficiency and appropriateness of audit evidence obtained
- Documentation of:
 - An analysis of components, indicating those that are significant and the type of work performed on those
 - The nature, timing and extent of the involvement in the component auditor's work on significant components, including, where applicable, work paper reviews and conclusions and
 - Written communications with the component auditor on audit requirements.

FAQs on group audits

This question is taken from the ICAEW Audit & Assurance Faculty's newsletter Audit & Beyond.

Q1. My firm audits a group with a UK holding company. A substantial component of the group is an Australian trading company. A local audit firm performs an audit of that component. Currently as part of the group audit we communicate on a number of issues with the audit firm in Australia at the planning and completion stages of the audit. I understand that the new Clarity Standard on groups is more onerous than the present ISAs, what additional work might we need to do?

Because of the numerous issues raised by the Clarity Standard in this area, space in Audit & Beyond does not permit a full reply to this question but I will do my best!

The Clarity standards, which are mandatory for periods ending on or after 15 December 2010, do demand considerably more of the auditors of groups. Indeed there is as much change in this one Standard as the rest of the Clarity Standards put together.

Under Clarity ISA 600 Special considerations – audit of group financial statements your firm will be required to do more at the risk assessment stage of the audit. In particular you must assess whether the Australian component of the audit is a “significant component”. This may be because of its individual financial significance to the group or because of its specific nature or circumstances which might indicate significant risks of material misstatement of the group financial statements.

If it is a significant component then there are a number of obligations imposed on the group auditor, such as:

- establishing an understanding of the component auditor, including factors effecting their independence and competence,
- assessing component materiality to be used during the audit of the component,
- if the component is significant due to its individual financial significance then the component must be audited (under the Clarity Standards) using component materiality,
- communicating with the component auditor at various stages of the audit
- being involved in the risk assessment process
- reviewing the component auditor's documentation identifying significant risks of material misstatement of the group financial statements and
- assessing whether sufficient appropriate audit evidence has been obtained on the component.

This is by no means an exhaustive list of your obligations. In practice it is often difficult to satisfy the requirements of the new Clarity Standards without visiting the component auditor of a significant component and reviewing the audit documentation. More rarely, the group auditor might reach the view that they will need to obtain audit evidence directly rather than relying upon the component auditor. Either way, the group auditor, if based in the UK, may incur additional review and travel costs.

Even if the component is not a "significant component" as defined by the Standard then there may still be other onerous obligations placed upon the holding company auditor.

I hope that this answer points you in the right direction but more than ever it is important to read the Standard yourself. Also, there is Faculty guidance in this area (see below).

Q2. I audit a predominantly UK based group with a subsidiary in Italy. The Italian company is eligible for audit exemption and is not subject to audit. Nevertheless the Italian subsidiary is a significant part of the group. As the group auditor we sign the group audit report but we have been asked by the Directors to ignore the Italian component of the group because it is audit exempt. What should our approach be?

Just because the Italian subsidiary is audit exempt in Italy does not mean that it can be ignored for group purposes. If it is, as you say, a significant component of the group then it has to be subject to audit for group purposes. The answers to the

previous question highlight the numerous issues that need to be addressed in the new Clarity Standards.

You either have to insist on a local Italian auditor being appointed to audit the subsidiary or you are required to conduct audit work yourself on this component for the purposes of the group audit.

If the Directors refuse to allow you to undertake the audit work as you see fit then this is an enforced limitation of scope. As such you should consider withdrawing from the engagement.

ISA 200 OVERALL OBJECTIVES AND CONDUCT OF AN AUDIT

Overall Objectives of the Auditor and definitions

In conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) To report on the financial statements, and communicate as required by the ISAs , in accordance with the auditor's findings.

You will see reference above to the applicable financial reporting framework. The need to prepare auditing standards which can be used throughout the world leads to this rather inelegant form of words and you will see throughout the ISAs references to "fair presentation" frameworks and "compliance" frameworks.

The only definition which may be unusual to readers in some jurisdictions is the definition of "premise". This is the presumption that management and, where appropriate, those charged with governance, have acknowledged and understand their responsibilities that are fundamental to the conduct of an audit. That is, responsibility:

- For preparation of the financial statements
- For such internal control as they consider to be necessary;
- To provide the auditor with access to all information that is relevant to the preparation of the financial statements, any additional information that the auditor may request for the purpose of the audit, and unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

So important is the premise that the auditor is required by ISA 210 to obtain the agreement of management and, where appropriate, those charged with governance that they acknowledge and understand that they have the responsibilities set out above as a precondition for accepting the audit engagement.

Requirements

Professional requirements

Paragraph 14 requires the auditor to comply with relevant ethical requirements. The Application Material in ISA 200 requires compliance with the IFAC code

Paragraphs 15 and 16 require the auditor in planning and performing an audit to exercise:

- Professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated; and
- Professional judgment.

Professional scepticism includes being alert to contradictory audit evidence; the possibility that documents may be unreliable; and conditions that may indicate possible fraud. Professional scepticism protects against the risk that the auditor might make inappropriate assumptions or overlook unusual circumstances.

The Application Material tells us that the auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. However, the auditor is required to consider the reliability of information to be used as audit evidence and to consider the need for additional procedures if there is a doubt about the reliability of information or indications of possible fraud.

The Application Material goes on to acknowledge the auditor can take into account past experience of the honesty and integrity of the client but this does not relieve the auditor of the need to maintain professional scepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. This will be achieved by compliance with the requirement in ISA 230 to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

Obtaining reasonable assurance

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

It is in Paragraph 17 above that we get the simplest statement of what an audit involves. The Application Material in Paragraphs A 28 to A 52 give a fuller explanation of the basics of auditing including a discussion of the following matters:

- Sufficiency and appropriateness of audit evidence - whether sufficient appropriate audit evidence has been obtained is a matter of professional judgment.
- Audit risk - is a function of the risks of material misstatement and detection risk. Audit risk is defined as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Therefore the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not is not considered.
- Risks of material misstatement may exist at the overall financial statement level and the assertion level. Risks of material misstatement at the overall financial statement level may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud. They may derive in particular from a deficient control environment. For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.
- The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.
- The auditor must assess risks of material misstatement at the assertion level. The auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.
- For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. The greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.
- There are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. Therefore, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with ISAs . Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with ISAs .

These themes are developed in other ISAs including ISA 300 which covers planning, ISA 315 which deals with identifying and assessing risks of material misstatement

and ISA 330 which is called the auditor's responses to assessed risks. These ISAs will be the subject of future courses.

Conduct of an audit in accordance with ISAs

Paragraph 18 is the most frequently quoted paragraph from the standard.

18. The auditor shall comply with all ISAs relevant to the audit. An ISA is relevant to the audit when the ISA is in effect and the circumstances addressed by the ISA exist.

Close relative to this Paragraph is Paragraph 22.

22. Subject to paragraph 23, the auditor shall comply with each requirement of an ISA unless, in the circumstances of the audit:

- (a) The entire ISA is not relevant; or
- (b) The requirement is not relevant because it is conditional and the condition does not exist.

(Paragraph 23 permits the auditor, in exceptional circumstances, to depart from a relevant requirement in an ISA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. This situation is only expected to arise where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement.)

There are over 450 requirement paragraphs in the ISAs. This has led some to suggest that compliance with the clarity ISAs will require the completion of voluminous checklists. The IAASB and the APB are keen to play down such suggestions. The Application Material in ISA 200 ends with the comment:

“While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.”

I think it is reasonable to assume that this comment applies to requirements in the same way as it applies to objectives.

Paragraph 19 requires the auditor to have an understanding of the entire text of an ISA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

This paragraph places considerable training requirements on firms and individuals. Partners and staff involved in audit work should supplement their attendance at courses dealing with ISAs by private reading of the entire text of the documents.

The auditor's report should only state that the auditor complies with ISAs if the auditor has complied with the requirements of all ISAs relevant to the audit.

Whilst paragraph 22 above requires compliance with all of the requirements of ISAs , Paragraph 21 goes even further in requiring the auditor to use the objectives stated in relevant ISAs to determine whether any additional audit procedures are necessary in order to achieve the objectives stated in the ISAs ; and to evaluate whether sufficient appropriate audit evidence has been obtained.

Failure to achieve an objective in a relevant ISA, leads the auditor to evaluate whether the overall objectives can be achieved and whether there is a need to modify the auditor's opinion or withdraw from the engagement. Failure to achieve an objective represents a significant matter requiring documentation in accordance with ISA 230. (Paragraph 24)

Audit documentation that meets the requirements of ISA 230 and the specific documentation requirements of other relevant ISAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor.

So what?

In my opinion, the two biggest problems are the requirement in Paragraph 22 to comply with every requirement in ISAs and the demand in Paragraph 19 for the auditor to have an understanding of the entire text of all ISAs relevant to the audit.

Since ticking over 450 boxes is not required, the only answer to both problems is to ensure that partners and staff are trained to a very high level of competence.

In their staff paper which summarises the main changes introduced by the clarity ISAs, the APB identify Paragraph 21 as being of great importance.

If you recall, this requires the auditor to use the objectives stated in relevant ISAs to determine whether any additional audit procedures are necessary in order to achieve the objectives stated in the ISAs; and to evaluate whether sufficient appropriate audit evidence has been obtained.

Many audit systems are based heavily on lists of required procedures. It will be interesting to see how such systems are amended to reflect this new way of thinking. The response from the monitors from the professional will also be eagerly anticipated.

ISA 260 COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

Introduction

This ISA provides a framework for the two-way communication between auditors and those charged with governance. It also identifies some specific matters to be communicated to those charged with governance.

Additional matters to be communicated are identified in other ISAs (see below). In addition, ISA 265 establishes specific requirements regarding the communication of significant deficiencies in internal control the auditor has identified during the audit to both management and those charged with governance.

Objectives and definitions

The objectives of the auditor are:

- (a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
- (b) To obtain from those charged with governance information relevant to the audit;
- (c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
- (d) To promote effective two-way communication between the auditor and those charged with governance.

Those charged with governance - defined as the person(s) or organisation(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process.

Management – defined as the person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive

members of a governance board, or an owner-manager. Management will not normally include non-executive directors.

Requirements

Those charged with governance

Paragraph 11 requires the auditor to determine the appropriate person(s) within the entity's governance structure with whom to communicate.

If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, Paragraph 12 requires the auditor to determine whether it is necessary to communicate with the governing body.

If all of those charged with governance are involved in managing the entity, then if the matters noted in paragraph 16(c) below have been communicated to person(s) with management responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Paragraph 13)

Matters to be communicated

Paragraphs 14 to 17 require the auditor to communicate the following matters to those charged with governance

- The responsibilities of the auditor in relation to the financial statement audit – this includes that the auditor is responsible for forming and expressing an opinion on the financial statements and that the audit of the financial statements does not relieve management or those charged with governance of their responsibilities (Paragraph 14).
- An overview of the planned scope and timing of the audit (Paragraph 15).
- Significant findings from the audit (Paragraph 16) including
 - (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;
 - (b) Significant difficulties, if any, encountered during the audit;

(c) Unless all of those charged with governance are involved in managing the entity:

(i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and

(ii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

- In the case of listed entities, statements concerning compliance with relevant ethical requirements. This includes fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. It also includes the safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

The requirements to communicate above are usually achieved as follows:

Paragraph 14 – by an engagement letter.

Paragraphs 15 and 17 – by an audit arrangements (planning) letter. It is not necessary to repeat matters included in the engagement letter and it is not necessary to repeat matters which are unchanged from previous periods – in this case the auditor would inform those charged with governance that there are no new matters to communicate. The audit arrangements letter may cover matters such as the application of materiality and the auditor's approach to significant risks and internal controls. Care should be taken not to compromise the effectiveness of the audit by giving detailed information about the nature and timing of audit procedures.

Paragraph 16 – over the last few years, we have complied with this requirement by means of a letter of comment. This requirement arose as a result of a UK Plus – Paragraph 16-1 of ISA 260 said that the auditor should communicate in writing the significant findings from the audit. It is acceptable under the clarity ISA to make the report orally – although the auditor would need to document that oral communication had taken place. See Paragraph 19 below.

The communication process

Paragraph 18 requires the auditor to communicate with those charged with governance the form, timing and expected general content of communications.

This would normally be done in the engagement letter or the audit arrangements letter.

Paragraphs 19 and 20 require written communication in two circumstances:

1. regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Note that written communications need not include all matters that arose during the course of the audit.
2. regarding auditor independence when required by paragraph 17.

Paragraph 21 requires the auditor to communicate on a timely basis.

The application Material is not specific on this subject containing comments like “The appropriate timing for communications will vary with the circumstances of the engagement” and “Communications regarding planning matters may often be made early in the audit engagement...”

More helpful is the suggestion that it may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly helpful is the advice to consider prompt oral communication of significant deficiencies in internal control that the auditor has identified prior to communicating these in writing as required by ISA 265.

Paragraph 22 requires the auditor to evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor is required to evaluate the effect, if any, on their assessment of risks and their ability to obtain sufficient appropriate audit evidence.

Reassuringly, the Application Material says that the auditor need not design specific procedures to support the evaluation of the two-way communication; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes.

In my view, auditors should address this requirement by a specific statement on the file.

Documentation

Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

Finally, there is a clear requirement for documentation.

23. Where matters required by this ISA to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.

Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

In addition, there are many other ISAs that require communications with those charged with governance. The full list can be found in Appendix 1 to ISA 260.

So what?

Compliance with ISA 260 is a matter of setting up a robust methodology for dealing with audit assignments.

There are some important changes in ISA 260. The following matters were covered in substance in the guidance text in the old ISA 260 but are now explicit requirements:

- The requirement, when applicable, for the auditor to explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;
- Documenting matters communicated orally

And the following are new requirements:

- Significant difficulties, if any, encountered during the audit;
- Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management (unless all of those charged with governance are involved in managing the entity).

ISA 265 COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT

Introduction

The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. ISA 265 specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

Objective and Selected definitions

The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

A significant deficiency in internal control is defined as a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Issues that are likely to be particularly important in deciding whether deficiencies are significant are materiality and the risk of fraud.

Requirements

Paragraph 7 requires the auditor to determine whether deficiencies in internal control have been identified and Paragraph 8 requires the auditor to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.

Significant deficiencies must be communicate in writing to those charged with governance on a timely basis. (Paragraph 9)

Regardless of the timing of the written communication of significant deficiencies, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimise the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing, as this ISA requires.

The requirement in paragraph 9 applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

There is now in Paragraph 10 a requirement to communicate to management at an appropriate level of responsibility on a timely basis. The auditor will report significant deficiencies in writing - unless it would be inappropriate to communicate directly to management in the circumstances. This report can anticipate the report to those charged with governance or it can follow it.

The auditor will also report other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. These deficiencies can be reported orally or in writing. In contrast with the guidance above, if the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period.

Paragraph 11 tells us what should be included in the written communication of significant deficiencies in internal control:

- (a) A description of the deficiencies and an explanation of their potential effects; and
- (b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that:
 - (i) The purpose of the audit was for the auditor to express an opinion on the financial statements;
 - (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
 - (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Such a requirement is very reminiscent of the old-style "Management letter"!

So what?

ISA 265 is a new standard and therefore it might be thought that all of the requirements are entirely new. However, Paragraph 11 of the 2005 version of ISA

260 did contain a general catch-all requirement to communicate matters to those charged with governance and this included material weaknesses in internal control.

What we now have is a clear definition of “significant deficiencies” and requirements to report all significant deficiencies in writing to both those charged with governance and to management. In addition, there is the requirement to report other deficiencies to management – either orally or in writing.

Auditors of small companies should not be confused. Here, the directors will usually be involved in day-to-day management of the company and therefore all deficiencies (if worthy of mention) will be reported to the directors. In a charity, there may be a clear demarcation between communication with the trustees and communication with management.

ISA 265 is simply an extension Of ISA 260 and therefore the solution is to set up a robust methodology for reporting.

ISA 320 MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

The previous version of ISA 320 dealt with materiality at all stages of the audit. The clarity ISA 320 deals with materiality in planning and performing the audit. The new ISA 450 explains how materiality is applied in dealing with misstatements.

Materiality in the Context of an Audit

The introductory section of ISA 320 refers to the impact of the financial reporting framework. We have covered that issue earlier in these notes. The financial reporting framework provides a frame of reference for the auditor in determining materiality for the audit.

Paragraph 6 says that, in planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- (a) Determining the nature, timing and extent of risk assessment procedures;
- (b) Identifying and assessing the risks of material misstatement; and
- (c) Determining the nature, timing and extent of further audit procedures.

Paragraph 6 goes on to say that in some circumstances uncorrected misstatements which are (individually or in the aggregate) below materiality may still be evaluated as material by the auditor since the auditor considers not only the size but also the

nature of uncorrected misstatements, and the particular circumstances of their occurrence.

Objective

The ISA states that the objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

Materiality itself is not defined by the standard. Presumably, the thinking behind this is that materiality will be determined by the financial reporting framework and this may vary in different parts of the world.

There is a definition of “performance materiality” which is “the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.” The concept of performance materiality did not exist in the previous version of ISA 320. Previously performance materiality has traditionally been referred to as working materiality or tolerable error, although in fact both of these are not quite the same as performance materiality.

Note that there can be more than one figure for performance materiality and that the term can also refer to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Requirements

Determining materiality and performance materiality when planning

The fundamental requirement to set materiality is in Paragraph 10 of the standard:

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

Similarly Paragraph 11 requires the auditor to determine performance materiality for the purposes of assessing the risks of material misstatement and also for determining the nature, timing and extent of further audit procedures.

The requirements contained in these paragraphs may lead to a change in audit documentation for some firms.

The application material considers the use of benchmarks in determining materiality for the financial statements as a whole – although Paragraph A3 starts by stressing that the determination of materiality involves the exercise of professional judgment.

Paragraph A4 gives examples of benchmarks that may be appropriate, depending on circumstances. These include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax is often used but can be volatile in which case other benchmarks may be more appropriate,

In determining the amount to use for a benchmark, financial data from prior periods and budgets may be relevant as well as the data from the current period. Amounts may need to be adjusted for significant changes in the circumstances of the entity, the industry or the economic environment.

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. Different percentages will be appropriate for different benchmarks. For example, Paragraph A7 suggests that the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry. On the other hand, the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity.

For small entities, profit before tax might be an inappropriate benchmark if the owner takes much of the profit before tax in the form of remuneration. A benchmark such as profit before remuneration and tax may be more relevant.

The application material gives examples of situations where a misstatement below the overall materiality could reasonably be expected to influence the economic decisions of users. These include:

- Where measurement or disclosure of certain items is affected by law or regulations (for example, related party transactions or directors' remuneration).

- Key disclosures in the relevant industry (for example, research and development costs for a pharmaceutical company).
- Interest in a particular aspect of the entity's business (for example, a newly acquired subsidiary).

The views of management may be helpful in deciding whether such situations exist.

Paragraph A12 of the application material considers performance materiality. It uses what might be called a “margin of safety” argument. This recognises that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leave no margin for possible undetected misstatements.

The purpose of performance materiality is to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality. This principle applies both to the financial statements as a whole and also to any particular class of transactions, account balance or disclosure where a lower materiality level has been set.

The application material says that the determination of performance materiality is not a simple mechanical calculation but involves the exercise of professional judgment.

Revision as the Audit Progresses

As before the auditor must revise materiality if new information emerges as the audit progresses - for example, actual profit or turnover might be substantially different from the expectations used initially to determine materiality. If the revision to materiality results in a lower materiality than initially determined the auditor must consider whether it is necessary to revise performance materiality, and therefore whether additional audit procedures are required.

Documentation

The documentation requirements are in Paragraph 14 of the standard:

14. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:

(a) Materiality for the financial statements as a whole;

- (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures;

- (c) Performance materiality; and

- (d) Any revision of (a)-(c) as the audit progressed.

MATERIALITY – GUIDANCE PROVIDED BY PRACTICE NOTE 26: GUIDANCE ON SMALLER ENTITY AUDIT DOCUMENTATION

The APB have released an amended PN 26. This updates the example documentation to comply with the new clarity ISAs. One particular change is the introduction of an illustrative example for materiality.

As before, the APB give two examples of how audit documentation might be prepared. The first is a freeform approach. The auditor draws up a “free-form” audit strategy memorandum in which the subject of materiality is addressed.

ISA 450 EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

The previous version of ISA 320 dealt with materiality at all stages of the audit. The clarity ISA 320 deals with materiality in planning and performing the audit. The new ISA 450 explains how materiality is applied in dealing with misstatements.

Objective

The ISA states that the objective of the auditor is to evaluate:

- (a) The effect of identified misstatements on the audit; and

- (b) The effect of uncorrected misstatements, if any, on the financial statements.

Definitions

Misstatement is defined as a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in

accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

The application material explains that misstatements may result from an inaccuracy or omission. Misstatements also arise from incorrect accounting estimates (arising from overlooking, or clear misinterpretation of, facts) and judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

Examples of misstatements arising from fraud are provided in ISA 240.

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Uncorrected misstatements are defined as misstatements that the auditor has accumulated during the audit and that have not been corrected.

Requirements

Accumulation of identified misstatements

The fundamental requirement to accumulate misstatements is in Paragraph 5 of the standard:

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial.

"Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with ISA 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

The application material suggests that it might be useful to distinguish between:

- Factual misstatements which are misstatements about which there is no doubt.
- Judgmental misstatements which are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
- Projected misstatements which are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

Consideration of Identified Misstatements as the Audit Progresses

Paragraph 6 is concerned with the possible need to revise the overall audit strategy and/or the audit plan in two situations. Firstly, if the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material. The second situation is if the aggregate of misstatements accumulated during the audit is approaching materiality.

Paragraph 7 then requires the auditor to perform additional audit procedures in the circumstance where, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected. These additional procedures are intended to determine whether misstatements remain.

Communication and Correction of Misstatements

8. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.

9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

There is a tendency for management to reject proposed adjustments on the grounds of immateriality. However, as the application material points out, the correction by management of all misstatements enables them to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial

statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

Management's refusal to correct misstatements may be an indicator of possible bias in management's judgments. The auditor should consider this when obtaining an understanding of management's reasons for not making the corrections.

Evaluating the Effect of Uncorrected Misstatements

Following reassessment of the various measures of materiality, the auditor evaluates the effect of uncorrected misstatements as required by Paragraph 11.

11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

(a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and

(b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

The analysis required in Paragraph 11 is performed in each audit area where uncorrected misstatements exist. Note also that the existence of a number of immaterial misstatements within an audit area may lead the auditor to reassess the risk within that area.

Assessment of uncorrected misstatements requires the exercise of judgement. For example, an immaterial error in classification may be judged to be material because of its effect on ratios or covenants. Similarly, other misstatements which are lower than materiality for the financial statements as a whole, may be judged to be material because of eg regulatory requirements, the possible material effect on the results of future periods, the involvement of related parties or the impact on bonuses paid to management.

ISA 240 explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

Communication with Those Charged with Governance

Paragraph 12 requires the auditor, unless prohibited by law or regulation, to communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report. The auditor shall request that uncorrected misstatements be corrected.

Material uncorrected misstatements should be identified individually but where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement. The auditor is also required to communicate the effect on financial statements of the current period where there are uncorrected misstatements related to prior periods.

Written Representation

Paragraph 14 deals with the letter of representation and requires management/those charged with governance to indicate whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. Paragraph 14 also requires a summary of such items to be included in or attached to the written representation.

Documentation

The requirements concerning documentation are included in Paragraph 15:

15. The auditor shall include in the audit documentation:

- (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);
- (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5, 8 and 12); and
- (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion (paragraph 11).

The guidance notes indicate that the documentation of uncorrected misstatements may take into account:

- (a) The consideration of the aggregate effect of uncorrected misstatements;

(b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and

(c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

EVALUATION OF MISSTATEMENTS – GUIDANCE PROVIDED BY PRACTICE NOTE 26: GUIDANCE ON SMALLER ENTITY AUDIT DOCUMENTATION

The APB have released an exposure draft of an amended PN 26. This updates the example documentation to comply with the new clarity ISAs. One particular change is the introduction of illustrative material for evaluation of misstatements.

ISA 501 AUDIT EVIDENCE - SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

Objective

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

- (a) Existence and condition of inventory;
- (b) Completeness of litigation and claims involving the entity; and
- (c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Requirements

Inventory

4. If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- (a) Attendance at physical inventory counting, unless impracticable, to:
 - (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
 - (ii) Observe the performance of management's count procedures;

- (iii) Inspect the inventory; and
- (iv) Perform test counts; and
- (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

There are no surprises in the above requirement nor in the Application Material that expands on it. The Application Material is helpful in giving an outline of the work the auditor would perform during attendance at stocktake but this information is no more detailed than would exist in the work programme provided in the typical audit system.

What is interesting about the above is what it tells us about the clarity process. Under the 2005 version of ISAs auditors were left to their own devices in deciding what work needed to be performed in areas such as stock, debtors, cash etc. Now we have compulsory requirements covering stock-take attendance. Elsewhere in this standard we have requirements concerning certain liabilities; another standard covers external confirmations. How long will it be before auditing standards become a detailed audit programme – with the sting in the tail being that every procedure is compulsory?

Paragraph 5 deals with the situation where the stock-take is conducted at a date other than the date of the financial statements. This can occur either when the client is using continuous stock records to establish the year-end stock quantities or if the stock-take is the basis of the year-end quantities following adjustment for movements.

In either case, the expectation of ISA 501 is that the client will perform a physical count of stock at some point and the auditor should attend. In addition to the procedures required by paragraph 4, Paragraph 5 requires the auditor to perform procedures to obtain evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

Paragraph 6 says that if the auditor is unable to attend stock-take due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

There is no further explanation of this requirement but it would seem that the standard is assuming the existence of a continuous stock system. There would seem little point in counting stock otherwise – except in the circumstance where the auditor considers there is a need to examine the condition of stock.

Paragraph 7 considers the situation where attendance at stock-take is impracticable. (Impracticability does not include the excuse that it is inconvenient or costly to attend!) In such circumstances, the auditor is required to perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence

and condition of inventory. If this is not possible, the auditor is required to modify the opinion in the auditor's report.

8. If inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(b) Perform inspection or other audit procedures appropriate in the circumstances.

This situation arises quite frequently in practice and the requirement above is interesting because it combines (and confuses?) two different audit concepts.

Paragraph (a) is treating the third party as an independent party from whom an external confirmation can be obtained.

Paragraph (b) (as amplified by the Application Material) is treating the third party as a service organisation. In this case, their warehouse is considered to be an extension of the client's own warehouse. Either the auditor should attend the physical stock-take as would happen for the entity itself or the auditor can seek a report from the service entity auditor confirming the adequacy of the third party's controls over stock.

Litigation and Claims

Paragraph 9 requires the auditor to design and perform audit procedures in order to identify litigation and claims involving the entity that may give rise to a risk of material misstatement. These procedures include inquiry of management and, where applicable, others within the entity, including in-house legal counsel; review of minutes of meetings of directors/trustees and correspondence between the entity and its external legal counsel; and review of legal expense accounts.

Notice that there is no choice about these procedures. Even if the auditor has no reason to suspect that there are claims against the entity, it is still necessary to perform these procedures.

In the past, the auditor would have been alert for possible claims against the entity whilst performing other procedures such as review of minutes. Now, the work performed concerning completeness of litigation and claims should be recorded on file.

The auditor might consider that there is a risk of material misstatement regarding litigation or claims. In addition, the work performed under Paragraph 9 may identify claims against the entity which have not been evaluated by management. In either

case, Paragraph 10 requires the auditor, in addition to any other procedures, to communicate directly with the entity's external legal counsel. This is done by means of a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor.

This communication may be by means of a letter of general inquiry which requests the entity's external legal counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome, and an estimate of the financial implications, including costs involved.

In some jurisdictions, it is unlikely that the entity's external legal counsel will respond to a letter of general inquiry. In this case, the auditor may seek direct communication through a letter of specific inquiry. This would include a list of litigation and claims provided by management with management's assessment of the likely outcome. The external legal counsel is asked to provide confirmation that management's assessment is reasonable or to provide further information as appropriate.

In the event that it is not possible to communicate or meet with the entity's external legal counsel (either because management refuse permission or the external legal counsel refuses to respond or is prohibited from responding) then the auditor should seek to obtain sufficient appropriate audit evidence by performing alternative audit procedures.

If this is not possible, then Paragraph 11 requires the auditor to modify the opinion in the auditor's report.

Paragraph 12 requires the auditor to obtain a written representation from management and, where appropriate, those charged with governance, about the completeness of the disclosure in the financial statements of litigation and claims.

Segment information

Paragraph 13 requires the auditor to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information. Since many entities are not required to produce segmental disclosure, I have not covered this topic in detail.

So what?

Again a standard which is clarified but not revised. The procedures required for attendance at stock-take are not unusual and should not cause major problems. The requirements concerning litigation make no allowance for the client situation and this means that the subject will need to be addressed on every file.

ISA 505 EXTERNAL CONFIRMATIONS

Objective and definition

The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

External confirmation is defined as audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

Requirements

Paragraph 7 requires the auditor to maintain control over all aspects of the procedures involved in obtaining evidence from external confirmation requests. This includes:

- Determining the information to be confirmed or requested;
- Selecting the appropriate confirming party;
- Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
- Sending the requests, including follow-up requests when applicable, to the confirming party.

If management refuses to allow the auditor to send a confirmation request, the auditor is required by paragraph 8 to inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness. The auditor will also evaluate the implications for the assessment of risk, including the risk of fraud, and on the nature, timing and extent of other audit procedures. It is also necessary for the auditor to perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, then paragraph 9 requires the auditor to communicate with those charged with governance. The auditor shall also determine the implications for the audit and the auditor's opinion.

Results of the External Confirmation Procedures

If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts. (Paragraph 10)

The Application Material indicates that doubts may arise particularly because the response has not been sent directly to the auditor or appears to come from a party other than the expected confirming party. Further, replies by e-mail have not necessarily been sent by the party who is the named respondent. The auditor might deal with such a situation by telephoning the confirming party to determine whether the confirming party did in fact send the response.

It is in this part of the ISA that we are told that an oral response does not meet the definition of an external confirmation and does not therefore constitute sufficient evidence on its own.

If the auditor determines that a response to a confirmation request is not reliable, then paragraph 11 requires the auditor to evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. (Paragraph 12)

If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. In this case, paragraph 13 requires the auditor to determine the implications for the audit and the auditor's opinion.

Paragraph 14 requires the auditor to investigate exceptions to determine whether or not they are indicative of misstatements. For example, a disagreement on a balance may be indicative of a timing difference rather than an error.

Negative Confirmations are permitted by the standard but they provide less persuasive audit evidence than positive confirmations. Accordingly, paragraph 15 sets strict conditions that must apply if the auditor, in a given situation, wishes to use negative confirmation requests as the sole substantive audit procedure

These conditions are that risk is low; controls are operating effectively; the population subject to test comprises a large number of small, homogeneous items; a very low exception rate is expected; and the auditor is not aware of circumstances or

conditions that would cause recipients of negative confirmation requests to disregard such requests.

Finally, paragraph 16 requires the auditor to evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary.

So what?

The original version of ISA 505 (effective 2005) did not cause particular problems for firms and the clarified version does not add any complications.

ISA 520 ANALYTICAL PROCEDURES

Objectives and definition

The objectives of the auditor are:

- (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

The term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

The Application Material explains that analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.

- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Requirements

Substantive Analytical Procedures

5. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with ISA 330 the auditor shall:

(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7.

Paragraph 5 represents a significant difference from the old version of ISA 520. Whilst that standard contained guidance on the use of analytical procedures as substantive evidence, there were no bold-print paragraphs. Now we have definite requirements to meet if analytical procedures are to be used in that way.

Notice also, in passing, that ISA 520 no longer addresses the use of analytical procedures as risk assessment procedures.

The Application Material is very similar to the guidance in the old standard. It makes it clear that substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The use of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.

This means that, generally speaking, substantive analytical procedures will be more effective when auditing the P&L account. Indeed the three examples given in the ISA of the use of analytical procedures are all P&L applications namely:

- the estimate of total payroll costs based on a known number of employees at fixed rates of pay
- the use of widely recognised trade ratios (such as profit margins for different types of retail entities) – which the Application Material says provides evidence to support the reasonableness of recorded amounts.
- the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration,

By contrast with the prediction of rental income, the Application Material says that comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

Note that the only mention in the ISA of the use of analytical procedures in the balance sheet is in paragraph A10 where it states that particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

Perhaps we should not read too much into the nuances of the Application Material but I would propose the following conclusions:

- Different analytical tests give different levels of assurance. So, the test of rental income provides “persuasive evidence and may eliminate the need for further verification by means of tests of details” whereas the comparison of gross margin percentages “may provide useful corroboration if used in combination with other audit procedures”.

- Analytical procedures alone may provide sufficient evidence for P&L assertions but this is unlikely to be the case for the Balance Sheet. Although it has to be added that this is not stated clearly in the clarity ISA.

I mention these two issues because some auditors have a tendency to over-rely on substantive analytical review when, in my opinion, the procedures performed do not merit the degree of reliance placed.

Note that, when the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details (ISA 330 Paragraph 21).

The need to consider the reliability of data is familiar to us from the old standard but the explicit requirement to develop an expectation is new. This is an area where the monitors from the professional bodies have long been critical. In future, all analytical procedures which purport to provide substantive evidence should, as part of their design, set an expectation. This implies that the only acceptable form of analytical test is one that is framed as a “reasonableness test” or “proof in total”.

Paragraph 5(c) then requires an evaluation of whether the expectation is sufficiently precise. The Application Material lists matters relevant to this evaluation as follows:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor must also consider the reliability of the information as required by paragraph 5(b) above.

The auditor must also consider how accurate a test needs to be in order to provide the required level of assurance. In practice, a simplistic approach is often adopted – that is, as long as the difference between expected and actual is not material then the test is deemed to be a success.

The Application Material sees things in a rather more complicated way reminding us that ISA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence.

Analytical procedures that assist when forming an overall conclusion

Paragraph 6 requires the auditor to design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

This is very similar to the old bold print paragraph and should not cause any new problems. However, some auditors have always been uncertain as to what work should be recorded on file in order to satisfy this requirement.

Unfortunately, the ISA offers little help. Indeed the ISA contains only three short guidance paragraphs:

- The conclusions drawn from the results of final analytical procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.
- The results of final analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, the auditor should revise the risk assessment and modify the planned audit procedures accordingly.
- Final analytical procedures may be similar to those that would be used as risk assessment procedures.

Investigating Results of Analytical Procedures

If analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, then paragraph 7 requires the auditor to investigate such differences by inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and performing other audit procedures as necessary in the circumstances.

So what?

ISA 520 is clarified but not revised. However, the changes are dramatic in that, for the first time, we have compulsory procedures to perform if we wish to use analytical procedures as substantive procedures.

ISA 580 WRITTEN REPRESENTATIONS

Objectives

The objectives of the auditor are:

- (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations if determined necessary by the auditor or required by other ISAs ; and
- (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Definitions

For purposes of this ISA , references to "management" should be read as "management and, where appropriate, those charged with governance".

Requirements

Required representations

Paragraph 9 requires the auditor to request written representations from those responsible for the preparation of the financial statements. In the requirement itself, the term management is used but a UK plus in the Application Material points out that, in the UK and Ireland, those charged with governance are responsible for the preparation of the financial statements. Paragraph 9 goes on to refer to the need for those who provide representations to have knowledge of the matters concerned. Again this would imply that management are the correct providers of representations but, again, the UK Plus says that, if written representations are critical to obtaining sufficient appropriate audit evidence then, in view of their importance, these representations should be provided by those charged with governance rather than management

The problem of potential lack of knowledge is addressed in Paragraph A6 of the Application Material which says that the auditor may request that management include in the written representations confirmation that it has made such inquiries as it considered appropriate to place it in the position to be able to make the requested written representations.

Paragraphs 10 and 11 make it compulsory to obtain written representations that:

- Those charged with governance have fulfilled their responsibility for the preparation of the financial statements as set out in the terms of the audit engagement.
- Those charged with governance have provided the auditor with all relevant information and access as agreed in the terms of the audit engagement.
- All transactions have been recorded and are reflected in the financial statements.

Paragraph 12 requires that the responsibilities of those charged with governance should be described in the written representations in the same way that the responsibilities are described in the terms of the audit engagement.

Paragraph 13 identifies two other types of written representation:

- Representations required by other ISAs . For convenience, Appendix 1 of ISA 580 contains a list of such representations.
- Representations which the auditor determines are necessary to support other audit evidence. For example, these may include representations concerning the entity's plans or the existence of contingent liabilities.

In accordance with the requirement in Paragraph 14, the date of the written representations must be as near as practicable to, but not after, the date of the auditor's report on the financial statements. In a new requirement, Paragraph 14 goes on to say that the written representations must be for all financial statements and period(s) referred to in the auditor's report.

Paragraph 15 requires the written representations to be in the form of a representation letter addressed to the auditor. Appendix 2 to ISA 580 contains an example of such a letter. This includes the requirements of other ISAs.

Paragraph 15 also refers to the situation where law or regulation requires management or those charged with governance to make written public statements about their responsibilities. If the auditor determines that such statements provide some or all of the representations required by paragraphs 10 or 11, then the relevant matters covered by such statements need not be included in the representation letter.

Potential problem areas

Paragraphs 16 to 19 deal with problems that may arise in connection with written representations:

- Concerns about the competence, integrity, ethical values or diligence of those who provide the representations.
- Inconsistency with other audit evidence.
- Unreliability of the representations.
- Failure by the entity to provide one or more of the requested written representations.

Users of these notes should refer to ISA 580 for the correct response to these problems. Ultimately, Paragraph 20 requires the auditor to disclaim an opinion if the auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by paragraphs 10 and 11 are not reliable; or if management does not provide the written representations required by paragraphs 10 and 11.

So what?

According to the IAASB, the main reason for the revision of ISA 580 was to respond to concerns that auditors may be over relying on written representations. To address this concern, it is made clearer in the clarified ISA 580 that, although written representations provide necessary audit evidence, they support other audit evidence obtained and do not on their own provide sufficient appropriate audit evidence about any of the matters with which they deal.

Other changes include:

- Previously, the requirement was to obtain evidence that those charged with governance acknowledge their responsibility for the financial statements. Now there is a requirement for auditors to obtain written representations about management's responsibilities as shown in Paragraphs 10 and 11. Despite this change in the requirement, it is already common practice to include such matters in the letter of representation. However, there may well be minor changes to the wording of pro-forma letters so the key thing in practice is to make sure that the firm's own standard letters are updated.
- If management does not provide the written representations acknowledging its responsibilities the auditor is required to disclaim an opinion on the financial statements.