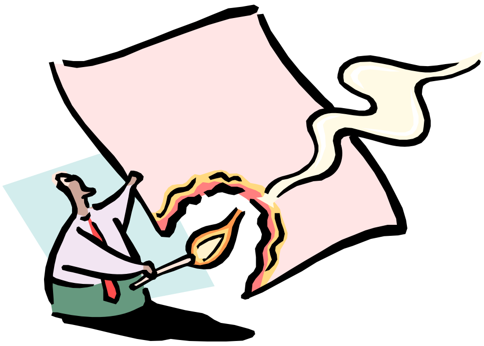
Auditing Update – Clarified ISAs

July 2011



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The IAASB Clarity Project

- In 2004, the IAASB of International Federation of Accountants also began a comprehensive programme to enhance the clarity of its ISAs (termed as the IAASB Clarity Project)
  - The programme involved the application of new drafting conventions to all ISAs, either as part of
    - a substantive revision, or
    - through a limited redrafting,

    to reflect the new conventions and matters of clarity generally.
- The IAASB clarity project was completed in March 2009.

The IAASB Clarity Project

- The final set of clarified standards comprises
  - 36 International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC) 1, including:
    - One new standard (ISA 265), addressing communication of deficiencies in internal control;
    - 16 standards containing new and revised requirements (these have been referred to as "revised and redrafted ISAs"); and
    - 20 standards that have been redrafted to apply the new conventions and reflect matters of general clarity only (these have been referred to as "redrafted ISAs and redrafted ISQC 1").
- Unless otherwise specified, the clarified pronouncements are effective for audits of financial statements for periods beginning on or after 15 December 2009.

Main Changes from Clarity Project

- All ISAs contain certain improvements arising from IAASB's Clarity Project including improvements in language and clarity of purpose.
- Broadly, these include:
  - Identifying the overall objectives of the auditor when conducting an audit in accordance with ISAs, setting an objective in each ISA, and establishing an obligation on the auditor in relation to those objectives;
  - Clarifying the obligations imposed on auditors by the requirements of the ISAs and the language used to communicate such requirements; and
  - Eliminating ambiguity about the requirements an auditor needs to fulfill.

Main Changes from Clarity Project

- The ISAs now have a new structure, in which information is presented in separate sections:
  - **Introduction**
    - Introductory material may include information regarding the purpose, scope, and subject matter of the ISA, in addition to the responsibilities of the auditors and others in the context in which the ISA is set.
  - **Objective**
    - Each ISA now contains a clear statement of the objective of the auditor in the audit area addressed by that ISA.
  - **Definitions**
  - **Requirements**
    - Each objective is supported by clearly stated requirements. Requirements are always expressed by the phrase "the auditor shall."
  - **Application and Other Explanatory Material**

16 Revised & Redrafted ISA

200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
260	Communication with Those Charged with Governance
320	Materiality in Planning and Performing an Audit
402	Audit Considerations Relating to an Entity Using a Service Organization
450	Evaluation of Misstatements Identified during the Audit
505	External Confirmations
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
550	Related Parties
580	Written Representations

16 Revised & Redrafted ISA

600	Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)
601	Using the Work of an Auditor's Expert
705	Modifications to the Opinion in the Independent Auditor's Report
706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
800	Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
805	Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
810	Engagements to Report on Summary Financial Statements

ISA 320 and 450

- In the clarity project of ISA, the consideration of materiality is divided into:
  a. Materiality in planning and performing an audit of financial statements in ISA 320 "*Materiality in Planning and Performing an Aud*it"; and
  b. Materiality in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements on the financial statements in ISA 450 "*Evaluation of Misstatements Identified during the Audit*".
- ISA 320 and ISA 450 issued in Hong Kong follow the same clarity result.

ISA 320 and 450

- The auditor applies the concept of materiality and audit risk throughout the audit and in:
  a. Planning and performing the audit; and
  b. Evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

ISA 320

- ISA 320 sets out that:
  – The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.
- The revised ISA 320 specifically requires an auditor to determine at least 2 types of materiality in planning an audit, namely:
  a. Materiality for the financial statements as a whole; and
  b. Performance materiality.

Materiality for the financial statements as a whole

Performance materiality

ISA 320

Audit Process

Planning	Preliminary engagement activities
	Planning activities
Risk assessment	Understanding the entity and its environment
	Identify and assess risks of material misstatements
Risk response	Design and implement auditor's responses to assessed risks
Reviewing and reporting	Overall reviewing
	Drawing conclusions and reporting

An audit is a cu ulative and i

Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

ISA 320

- Materiality for the financial statements as a whole must be determined when the auditor establishes the overall audit strategy.
- The auditor's assessment of materiality helps the auditor determine
  - what items to examine and
  - whether to use sampling and analytical procedures.

Materiality for the financial statements as a whole

ISA 320

- In addition to materiality for the financial statements as a whole,
  - an auditor must also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures
    - when, 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.

For particular classes of transactions, a/c balances or disclosures

Materiality for the financial statements as a whole

ISA 320

Example

- Practice Note 26 (revised) of UK APB sets out an example that:

  Materiality for the financial statements as a whole
  - Materiality for the financial statements as a whole has been set at £13,500.
    - This is based on 5% of an estimated profit before tax figure of £270,000, which is a consistent basis to that used in previous audits.
    - An unadjusted profit before tax figure is appropriate as there are no exceptional items affecting profit before tax and the levels of directors' remuneration are not abnormally high.

Materiality for the financial statements as a whole

ISA 320

Example

- Practice Note 26 (revised) of UK APB sets out an example that:
  Lower levels of materiality for specific items
  - Users of the accounts are the shareholders and the bank.
  - A lower level of materiality has been set in respect of the following classes of transactions, account balances and disclosures:
    - Transactions between the company and individual family owners (relevant to the non-family shareholders) £6,000

For particular classes of transactions, a/c balances or disclosures

Materiality for the financial statements as a whole

ISA 320

- Performance materiality:
  - means 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.
  - if applicable, also refers 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.

Performance materiality

ISA 320

- The auditor is required to determine performance materiality for purposes of:
  a. Assessing the risks of material misstatement and
  b. Determining the nature, timing and extent of further audit procedures.

Performance materiality

ISA 320

Example

- Practice Note 26 (revised) of UK APB sets out an example that:

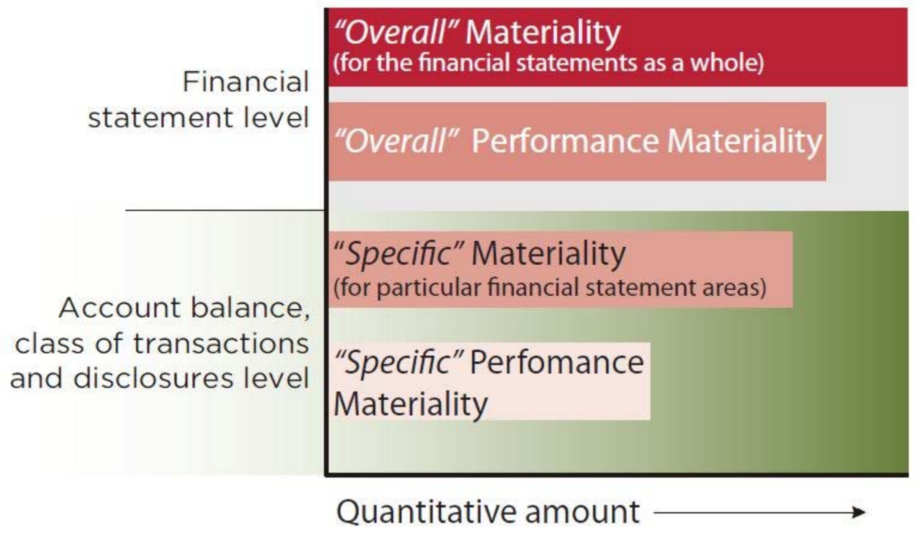
  Performance Materiality

  – In assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures performance materiality has been set
    - at £10,000
    - (and £5,000 for transactions between the company and individual family owners).

  – This is judged to be sufficient as, on the basis of past audit errors (which have been primarily of a cut-off nature), there is a low probability that the aggregate of uncorrected and undetected misstatements will exceed the overall materiality.

Performance materiality

ISA 320



Sourced from "Guide to Using ISA in the Audits of SMEs (2010) by IFA

ISA 320

- The auditor shall revise **materiality** for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures)
  - in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.
- If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate,
  - the auditor shall determine
    - whether it is necessary to revise **performance materiality**, and
    - whether the nature, timing and extent of the further audit procedures remain appropriate.

Materiality for the financial statements as a whole

Performance materiality

ISA 320

- 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 for the financial statements as a whole

Performance materiality

ISA 450

- ISA 450 *Evaluation of Misstatements Identified during the Audit*
  – deals with the auditor's responsibility to evaluate the effect
    - of identified misstatements on the audit and
    - of uncorrected misstatements, if any, on the financial statements.
- ISA 450 is a new standard that has been derived from the revision of ISA 320 on audit materiality.

ISA 450

Audit Process

Planning	Preliminary engagement activities → Planning activities
Risk assessment	Understanding the entity and its environment → Identify and assess risks of material misstatements
Risk response	Design and implement auditor's responses to assessed risks
Reviewing and reporting	Overall reviewing → Drawing conclusions and reporting

An audit is a cumulative and iterative process

Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

ISA 450

- ISA 450 sets out 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.
- ISA 450 specifically requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.
  – The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements.

Clearly Trivial

ISA 450

- "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.

Clearly Trivial

ISA 450

Example

- A firm sets the following benchmarks for the materiality in accordance with clarified ISAs:

According to their own materiality calculation plan, say Overall Materiality	Materiality for the financial statements as a whole
Performance Materiality = Overall Materiality x 80%	Performance materiality
Clearly Trivial Level = Overall Materiality x 5%	Clearly Trivial

ISA 450 – Consideration

- The auditor is required to determine whether the overall audit strategy and audit plan need to be revised if:
  a. 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; or
  b. The aggregate of misstatements accumulated during the audit approaches materiality determined, including
     - materiality for the financial statements as a while and
     - performance materiality,

     in accordance with ISA 320 as discussed above.

ISA 450 – Communication

- When misstatements are accumulated during the audit, the auditor is required to:
  a. Communicate all such accumulated misstatements with the appropriate level of management, unless prohibited by law or regulation; and
  b. Request management to correct those misstatements.
- If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor is required to:
  a. Obtain an understanding of management's reasons for not making the corrections and
  b. Take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

ISA 450 – Evaluation

- Before evaluating the effect of uncorrected misstatements,
  - the auditor must reassess materiality determined to confirm whether it remains appropriate in the context of the entity's actual financial results.
- Then, the auditor must determine whether uncorrected misstatements are material, individually or in aggregate.
- Uncorrected misstatements are defined
  - to be misstatements that the auditor has accumulated during the audit and that have not been corrected.

ISA 450 – Evaluation

- 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

ISA 450 – Evaluation

Example

- Circumstances that may affect the evaluation include the extent to which the misstatement:
  - Affects compliance with regulatory requirements;
  - Affects compliance with debt covenants or other contractual requirements;
  - Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
  - Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
  - Affects segment information presented in the financial statements;
  - Has the effect of increasing management compensation;
  - Affects other information that will be communicated in documents containing the audited financial statements that may reasonably be expected to influence the economic decisions of the users of the financial statements
    - For example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review"

ISA 450 – Evaluation

- Unless prohibited by law or regulation, the auditor must 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's communication must include:
  a. To identify material uncorrected misstatements individually and to request that uncorrected misstatements be corrected; and
  b. To communicate with those charged with governance 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.

ISA 450

- The auditor must request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.
- A summary of such items must be included in or attached to the written representation.

ISA 450

- In evaluating the identified misstatement, the auditor must include in the audit documentation:
  a. The amount below which misstatements would be regarded as clearly trivial;
  b. All misstatements accumulated during the audit and whether they have been corrected; and
  c. The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

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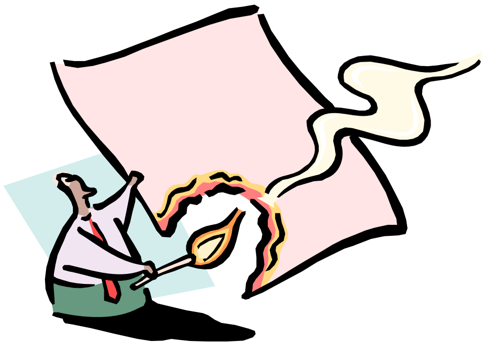

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