

Proposed Audit Risk ISAs and Amendment to ISA 200 – Significant Issues

Introduction

1. This issues paper summarizes the Joint Risk Assessments Task Force’s (task force) reaction to the significant issues raised by respondents to the audit risk exposure drafts. The audit risk proposals include:
 - (a) Proposed amendment to ISA 200, “Objective and General Principles Governing an Audit of Financial Statements” (ISA 200);
 - (b) Proposed ISA “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements” (ISA Assessing Risks);
 - (c) Proposed ISA “Auditor’s Procedures in Response to Assessed Risks” (ISA Auditor’s Procedures); and
 - (d) Proposed ISA “Audit Evidence” (ISA Audit Evidence).
2. A total of 40 responses from the following groups were received:
 - (a) 26 from representative bodies (IFAC member bodies, other national standards setters and other international representative bodies);
 - (b) 9 from audit firms;
 - (c) 2 from regulatory bodies; and
 - (d) 3 from other individuals and entities.
3. The respondents are detailed in Appendix 1. The task force also received comments from the SMP Task Force’s Rapid Response Team on drafts that are essentially equivalent to the exposure drafts. These comments have been considered in the same manner as the exposure draft comments received.
4. The respondents generally expressed support for the proposals. One respondent clearly expressed disagreement with the need for the proposals, primarily on the grounds that there was insufficient change from current standards and that the costs of change would be insufficient for the benefits obtained. The balance of the responses, however, was strongly in favour. Nevertheless, in most instances, the respondents highlighted significant areas where they believe additional guidance or consideration is required. Respondents also provided specific paragraph comments and useful suggestions for amending the proposals.

REPRESENTATIVE BODIES

5. Within representative bodies, certain constituents expressed stronger concern for some of the issues. The following issues were raised by many representative bodies, especially European representative bodies:
 - The nature and increase in the extent of bold statements;
 - The length and complexity of the proposals;
 - Implementation issues;
 - The cost and benefits of the increased emphasis on understanding internal control;

- The extent of documentation requirements; and
 - The application of the proposals to smaller entities.
6. As expected, more detailed comments and concerns on the application of the proposals to smaller entities were received from bodies with a greater representation of smaller practitioners. However, the task force also received supportive comments from the SMP's Rapid Response Task Force as well as suggestions for the areas where additional small entity consideration may be required. Similar suggestions were provided by other respondents and the task force will consider them in revising the drafts.

FIRMS

7. Inevitably, firms were concerned with matters of clarity and practicability. In particular, both larger and smaller firms thought the requirements on internal control could result in a broader and more extensive understanding than the task force may have intended. This was one of the most significant issues raised by respondents, and the task force gave it particular consideration.

REGULATORY BODIES

8. Regulatory bodies were generally supportive of the proposals including the emphasis on understanding internal control and the increase in bold statements related to essential procedures. However, they did suggest strengthening the language in some areas to clarify the expectations of the auditors.

Significant Issues and Other Key Comments

9. Significant issues were identified in reviewing the comment letters received and the compilation of comments prepared by IAASB Staff. Comments received by the U.S. ASB on the proposed SASs have also been considered where they have been relevant to the proposed ISAs. The significant issues discussed in this paper are:
- (a) General issues related to bold lettering, length of the proposals, effective date and implementation;
 - (b) Small entity audit related issues;
 - (c) Internal control including the use of COSO and the scope of understanding of internal control;
 - (d) Matters related to the auditor's use of tests of controls or substantive procedures, and a wholly substantive audit approach;
 - (e) The requirement to test controls every third audit and dual-purpose testing;
 - (f) The determination of significant risks;
 - (g) The nature and extent of documentation requirements;
 - (h) The categorization of assertions and
 - (i) Other key comments (these are addressed in Appendix 2 of this paper).
10. The paper is not intended to deal with all matters raised in comment letters, nor to deal with any specific comments in the way in which they were made. The other issues raised by respondents will be considered in the course of preparing the final ISAs.

General Issues

BOLD LETTER STATEMENTS

Issue

11. The nature and extent of the bold statements do not seem consistent with–

- The principles-based approach to ISA standard-setting;
- Bold statements in existing ISAs; or
- The proposals set out in the exposure draft “Operations Policy No. 1 – Bold Type Lettering”.

The bold statements require context and should be framed so that they describe not just the basic principle or essential procedures required but also the desired objective from applying the principle or procedure.

12. The above comments were received in particular from representative bodies and smaller audit firms. Regulatory bodies, however, were generally in agreement with the bold statements and made suggestions to strengthen language so as to make clearer what the auditor is expected to do in each audit.

Task Force Reaction

13. The increased number of bold statements reflects the basic principles and essential procedures considered necessary to implement enhancements to the audit risk model. In order to clarify the work effort and nature of procedures required in performing financial statement audits in the current audit environment, the increased bold statements place more emphasis on essential procedures.

14. One respondent provided recommendations to minimize the extent of bold statements by condensing some of the statements and by changing certain statements to grey letter guidance. The task force reviewed the recommendations but believed condensing and changing the bold statements would not convey the level of specificity in the basic principles and essential procedures necessary for the proposed requirement.

LENGTH OF PROPOSALS

Issue

15. A number of representative bodies and smaller audit firms commented that the proposals are too lengthy. Proposed ISA Assessing Risk in particular, contains too much grey letter guidance and is difficult to digest. The guidance on internal control is particularly lengthy and consideration should be given to deleting or moving some of this guidance into Appendix 2: Internal Control Components. In response to question 2 of the explanatory memorandum, respondents generally found Appendix 2 to be helpful.

Task Force Reaction

16. The comments were not unexpected, but the task force gave careful consideration to them. The problem is partly structural, deriving from the decision to put so much into the proposed ISA Assessing Risk. This was consciously done, and debated several times at task force and board level. The task force reaffirms its belief that it remains an important aspect of the revised standards to reinforce the elements of the audit that go towards risk assessment by

placing them in a single document. Dividing this standard into two or more standards (as suggested by a few respondents) would not in fact simplify what is said, and would only give the appearance of shorter individual standards.

17. The task force, however, recognizes the issue. The proposals will be thoroughly reviewed ('robustly edited' in the words of one respondent) to identify guidance that is repetitive or excessive in explaining the requirements and modified, deleted or moved into the relevant appendix as appropriate. In the course of this editing, the task force will take account of specific suggestions made by respondents, as well as instigating further possible deletions. In taking this decision, however, the task force is not intending to imply that substantial cuts will be made to the material; it is possible that the final view may be that there may be few.
18. The internal control guidance in particular will be reviewed to identify any guidance that is purely explanatory in nature and therefore appropriate to be moved into Appendix 2. Any guidance that is necessary to provide sufficient context to explain the relevant basic principles or essential procedures in the body of proposed ISA Assessing Risk will need to be retained in the main body.

EFFECTIVE DATE AND IMPLEMENTATION

Issue

19. Representative bodies in particular believe the proposals will require a significant amount of time and resources by their users to implement. Implementation activities may include modification of audit firm methodology and tools (software, audit programs), translation into national languages and training. An effective date of periods beginning on or after January 1, 2005 may not provide sufficient time for effective implementation.

Task Force Reaction

20. *Implementation:* The task force recognizes the proposals will require implementation activities and these activities may require more time and resources from some audit firms than others. The extent of changes required will depend on the extent to which existing methodology used by the auditor differs from the proposals. As with any new proposal, resources required may be expected to be greater in the initial period of application than in later periods.

Currently, the IAASB's resources are focused on the revision and development of ISAs and the development of audit risk implementation guidance is not included in its work program. In recognizing the need for guidance, some standards setters and firms may already be thinking about how to develop such guidance. The task force understands that one standard setter plans to work with some audit firms and universities in its country to develop implementation and education guidance. This may be an approach which others could follow.

21. *Effective Date:* The effective date will be influenced by when the proposals are finalized. However, the IAASB previously discussed an effective date of periods beginning on or after January 1, 2005 based on a timetable to approve the ISAs in the last quarter of 2003. The task force is working towards this timetable and would like to understand the IAASB's thoughts on what the effective date should be for both the proposed ISAs and the related conforming changes.

Small Entity Audit

Issue

22. Respondents were asked whether additional considerations are required for the audit of small entities. A number of smaller audit firms and representative bodies expressed concern about the length and complexity of the proposals; one in particular proposed that ISAs should be rewritten to deal with the issues of smaller entity audits first, with those relevant to larger entities being explained as special considerations. In general, respondents agree that ISAs should apply to entities of all sizes, and many constructive comments were received in that vein. The following key areas were noted as requiring additional consideration in the context of small entity audits:

- (a) The implementation time and costs to amend smaller firms' methodologies and the training required (see also the discussion above on implementation)
- (b) The effectiveness and efficiency of applying all the bold letter requirements in small entity audits, in particular those relating to internal control and documentation (see also the discussion above on bold statements);
- (c) The extent of understanding of internal control required given many small entities do not have formalized or reliable internal controls; and
- (d) Whether a wholly substantive approach is permitted.

Items (c) and (d) and the considerations regarding internal control and a wholly substantive audit approach are discussed in the relevant sections below.

Task Force Reaction

23. Small entity specific guidance is currently contained in IAPS 1005 "Special Audit Considerations in the Audit of Small Entities"¹. At its October 2002 meeting, the IAASB discussed a new approach of including small entity specific guidance into specific ISAs. The task force understands that this approach involves the inclusion of small entity guidance into ISAs as they are developed with the intention of deleting IAPS 1005 once all relevant guidance has been included into the relevant ISA. The task force is proceeding on that basis, but has assumed that general guidance such as the definition and characteristics of a small entity will be retained either in an IAPS or other ISA.

24. It is interesting to note that the response of one representative body, in the context of smaller audits, was enthusiastic about the introduction of an assessment of business risk into the audit, while recognizing that some further explanation might be needed. This is just an example of what the task force believes to be true, that all elements of the audit described in the exposure drafts are relevant to all audits. For small entity audits, the auditor often has regular and close contact with management, developing a deep understanding of the entity. As the proposed audit risk ISAs place emphasis on understanding the entity and its environment, this understanding will be helpful in applying the final proposals.

25. The task force believes that such an understanding will often be possessed by auditors of smaller entities; to the extent that it is not, it is difficult to see how a practitioner can conduct an effective audit. However, the scope of understanding, the required linkage of the assessed

¹ IAPS 1005 is being revised to incorporate additional guidance related to those ISAs issued since March 1999 by the IAASB. The proposed revisions have been exposed for comment with a comment period ending June 30, 2003.

risks to procedures in response to the risks and the documentation to support the audit opinion may represent new or additional requirements for small entity auditors (as indeed they do for others). The challenge for the task force will be to ensure that the final standards make clearer the extent to which the understanding of the business, and especially of internal controls, is to be taken. The task force is conscious of the need to avoid suggesting that any auditor (whether of a small or large enterprise) need carry out work which is not regarded as contributing to the audit opinion.

26. The question of how far to take the examination of internal control is discussed later in this paper, as it was a widely raised concern. The task force will deal with this important point, but the task force is satisfied that the auditor of a smaller entity does in fact have a view of controls and does take that into account in carrying out the audit.
27. Special considerations related to small entities currently included in the proposed IAPS 1005 will be reviewed and modified where appropriate for inclusion in ISA Assessing Risks. Where necessary, additional guidance will be included that takes account of the specific comments received.

Internal Controls

USE OF COSO

Issue

28. A few representative bodies thought that using COSO2, a national framework, as the basis to define internal control is not appropriate for an ISA. However, regulatory bodies seem encouraged by the use of COSO for the purposes of describing internal control. In addition, some firms thought some of the internal control descriptions, particularly those related to governance, seem outdated and this may be because it is based on COSO.

Task Force Reaction

29. As described in the guidance, the division of internal control into components provides a useful framework for the auditor in considering how different aspects of internal control may affect the audit. Using COSO also provides for some consistency between ISAs and developments in other regulatory requirements³.
30. Respondents' comments did not suggest they disagreed with the internal control characteristics set out by proposed ISA Assessing Risks. As far as the task force is aware, while different approaches to internal control may put emphasis on different aspects, the high level framework of components is capable of accommodating these different approaches. Accordingly, the internal control components as described in the proposals will be retained. However, the revision will–

² PricewaterhouseCoopers has been engaged by The Committee of Sponsoring Organisations of the Treadway Commission (COSO) to lead an extensive new study designed to provide additional guidance in managing risk. Once this study is completed, IAASB may wish to review the additional guidance and changes and determine whether a revision of ISA Assessing Risks will be helpful.

³ The recently issued U.S. SEC rule "Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports" also refers to COSO.

- Place greater emphasis on the guidance that entities and auditors may use different terminology or categorize individual internal components in different ways. This paragraph will also be moved up to introduce the guidance earlier; and
- Review the suggestions provided by respondents to reflect developments in internal control practices that have evolved since COSO was initially adopted and consider adding such guidance into the proposals. The examples provided focus on the role of management and governance.

SCOPE OF UNDERSTANDING REQUIRED

Issue

31. Representative bodies and firms (both smaller and larger audit firms) expressed concern about the scope of understanding of internal control required by the proposals. Regulators, however, generally seemed to agree with the way the requirements and guidance have been described. One regulator suggested that the auditor's understanding not be limited to controls the auditor intends to rely on.
32. Respondents expressing concern thought the way internal controls are described and discussed suggests the auditor is required to obtain a very broad understanding of internal control and of control procedures in particular. For example, the discussion of "controls relevant to the audit" and the bold statement requiring the auditor to obtain an understanding of those control procedures relevant to the audit may result in auditors believing that they need an understanding of most control procedures. For both small entities and larger entities, such an approach may not be efficient or necessary to assess risks of material misstatements of the financial statements.

In addition, respondents thought the definition of "understanding internal control" seems to suggest a level of understanding that is deeper than necessary and is more akin to testing the operating effectiveness of internal control.

Task Force Reaction

33. The task force recognizes the concern. It was not the intention to require a comprehensive understanding of all control procedures irrespective of the potential use the auditor may make of those control procedures. The task force intends to clarify the meaning of "controls relevant to the audit", in particular in the context of control procedures to make clear that these are only controls that contribute to the auditor's risk assessment.
34. The guidance will also be reviewed to ensure that the ISAs distinguish understanding internal control from testing the operating effectiveness. (Proposed ISA Auditor's Procedures provides this distinction; however, it may be helpful to repeat the thought in ISA Assessing Risks.) Part of the concern may be that respondents may have misunderstood the scope of the understanding required. If this is more clearly specified, the concerns should be alleviated.

Audit Approach

USE OF TESTS OF CONTROLS OR SUBSTANTIVE PROCEDURES

Issue

35. The interaction between using tests of controls and/or substantive procedures is unclear. Some representative bodies and smaller audit firms questioned whether the requirement to

understand internal control and the extent of understanding required suggests that a wholly substantive audit is not permitted.

Task Force Reaction: Tests of Controls or Substantive Procedures

36. Obtaining an understanding of the entity and its environment, including its internal control, assists the auditor in determining whether to perform tests of controls or substantive procedures to address the risks of material misstatements identified. The auditor's use of tests of controls and substantive procedures (extent, interaction) is ultimately a matter of the auditor's professional judgment and will depend on the circumstances of the audit and the audit evidence obtained during the course of the audit. For this reason, it is difficult within the context of the ISA to provide specific guidance on this issue.

37. For certain circumstances, the auditor is required to test the operating effectiveness of controls. For example:

- If the auditor considers the effect of internal controls in assessing whether there is a risk of material misstatement, the auditor is required to test the internal control as the auditor's assessment has placed reliance on the internal control;
- Where the nature of a risk of material misstatement at the assertion level is such that substantive procedures alone do not provide sufficient audit evidence, the auditor is required to test the related controls.

38. Similarly, there are occasions where the use of substantive procedures are mandated:

- For each material class of transaction, account balance and disclosure, the auditor is required to perform substantive procedures.
- For significant risks, the auditor is required to perform substantive procedures that are responsive to those risks.

Where the auditor plans to use audit evidence about the operating effectiveness of internal control obtained in a prior period (interim period, prior audit), ISA Auditor's Procedures also sets out specific considerations in the use of such audit evidence.

Task Force Reaction: Wholly Substantive Audit

39. In considering the characteristics of a small entity and the role management (owner-manager) in the day to day operations of the entity, the task force believes a small entity is rarely devoid of internal control.

40. IAPS 1005.15 states that "...for key areas, even in the very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls". The guidance also discusses the risk of management override given the lack of segregation of duties and the dominant position management may have in a small entity. However, the risk of such override depends on the control environment set by management. IAPS 1005.18 states: "The impact of the owner-manager and the potential for management override of internal controls on the audit depend to a great extent on the integrity, attitude, and motives of the owner-manager". The task force agrees with this guidance, especially management's role in setting the control environment and the importance the control environment has in other aspects of the entity including the other components of internal control. For small entity audits, the task force believes auditors may

already be implicitly obtaining an understanding of the internal control in understanding management's role in the business and the way management addresses risks related to the financial reporting, operations and compliance requirements of the entity.

41. Some respondents also indicated that small entities often use branded accounting software packages. As stated in IAPS 1005.14, "Many of these packages have been widely tested and accredited and can, if chosen and implemented with care, provide a reasonable basis for a reliable and cost-effective accounting system." Consequently, the use of such software may also provide a basis for relying on the entity's information system for financial reporting.
42. The combination of factors discussed above suggests it would be rare for an audit to be performed by substantive procedures alone without some understanding of internal control in assessing risks and influencing the auditor's decision about further audit procedures.

Tests of Controls

TESTING CONTROLS EVERY THIRD AUDIT

Issue

43. Question 3 in the Explanatory Memorandum asked respondents whether it is appropriate for ISA Auditor's Procedures to specify retesting of internal control at least every third audit. The responses included approximately—
 - (a) 18 respondents who did not agree with the bold letter requirement of every third audit. Many of these respondents did not believe this to be consistent with a principles based approach and considered that professional judgment for this is sufficient;
 - (b) 3 respondents who believed internal controls should generally be tested every year if they are to be relied on; and
 - (c) 11 respondents who agreed with the requirement.

Representative bodies in particular as well as some firms expressed disagreement with the requirement to test controls every third audit. Respondents who agreed with the requirement to test controls every third year included representative bodies, firms as well as regulators.

Task Force Reaction

44. The principle is clearly accepted. The IAASB debated the question whether to mandate a limit to the period allowed between testing, and views were finely balanced. The task force does not consider that any new arguments were advanced in the various submissions, and continues to think that it is appropriate for standards to place a limit on the auditor's judgment, particularly in the current audit environment. In discussing this issue at its June 5, 2003 meeting, the ASB strongly endorsed retaining a specific time limit.

CONCEPT OF "DUAL PURPOSE" TESTING

Issue

45. The concept of "dual purpose testing" needs further clarification and it is also described differently in the US ASB draft proposals. In particular, the statement "The absence of misstatement detected by a substantive procedure does not imply that controls related to the assertion being tested are effective" appears to contradict the guidance elsewhere (for example, the reference to "...the audit evidence about operating effectiveness that may result from the substantive procedures performed with regard to the remaining period..." in the

context of interim testing, and the guidance on the use of audit evidence about the operating effectiveness of controls obtained in prior audits).

Task Force Reaction

46. The drafting will be revised to eliminate the inconsistencies. For example, the following statement will be modified to be consistent with the US ASB equivalent exposure draft:

“The absence of misstatements from substantive procedures do not necessarily imply that controls related to the assertions being tested are provide any evidence as to the effectiveness of controls; however, misstatements that the auditor detects by performing substantive procedures are considered by the auditor when assessing the operating effectiveness of controls. “

The above guidance will be separately set out as a new paragraph to give it appropriate emphasis.

Significant Risks

Issue

47. Representative bodies and firms (smaller and larger audit firms) thought the definition and determination of significant risks requires clarification. Respondents were unclear how such risks relate to the risk of material misstatements and business risks; why significant risks should be subject to an evaluation of internal controls why substantive procedures alone are not sufficient; and why in assessing significant risks, internal control is not a consideration. In setting out the general requirement to assess risks of material misstatement, the supporting guidance provides that the auditor considers the entity and its environment, including the relevant controls that relate to the risks. However, in identifying significant risks, this determination excludes the auditor’s consideration of relevant controls. Respondents also noted that non-routine transactions and those that require significant judgment may not be subject to controls.

Task Force Reaction

48. Determining whether a risk is a significant risk is part of the auditor’s assessment of risks of material misstatement of the financial statements. Determining their significance is a matter of professional judgment; however, the proposals provide guidance to assist the auditor in identifying such risks (for example, significant non-routine transactions, the risk of fraud, and the degree of management judgment).
49. For significant risks, there are two requirements: first, the auditor should identify risks that are in his or her judgment significant such as to require special audit consideration; and secondly, to understand related control procedures to the extent that this has not yet been done. It is thought that it may be clearer to separate these two requirements as their juxtaposition may be causing confusion. The guidance will also be reviewed to describe significant risks more clearly as those that have a greater risk of material misstatement (before considering related internal control).
50. It is true that some significant risks (perhaps most) may not be thought to be susceptible to internal control, as some respondents suggest. But just because something is non-routine or subject to considerable judgment does not mean that this should be so; in fact, some such

risks are just the sort of thing that should be properly controlled (though not necessarily in standard ways), and it therefore seems right to suggest that the auditor look for such controls. If they are there, they may assist the audit; if they are not, they seem likely to be matters that should be reported to those charged with governance.

Documentation

Issue

51. In response to question 4 on whether the detailed documentation requirements are appropriate and the proposals practical, (approximately) 20 respondents agreed with the nature and extent of the documentation requirements. These respondents comprised primarily of representative bodies and smaller audit firms. The (approximately) 7 respondents who did not agree with the documentation requirements thought the requirements are too prescriptive, may lead to a tick-box mentality and may be seen as required to demonstrate compliance with the ISA. There was also concern about the philosophy behind the requirements, of driving auditor performance; it was suggested that this was inconsistent with the stated purpose of documentation in ISA 230, “Documentation”.

52. Issues identified by both groups of respondents include:

- Further clarification on the extent of documentation required is necessary as the proposals can be interpreted to mean very extensive requirements;
- The extent of requirements may be burdensome for smaller entity audits; and
- The requirements related to the audit team discussion should focus more on documenting the outcomes and not necessarily ‘how’ the discussion occurred.

Task Force Reaction

53. The task force accepts that the objectives and basic principles for documentation are governed by ISA 230. Specific documentation requirements are described within the relevant subject matter ISA. The guidance in ISA Assessing Risks reinforces some of the general guidance in ISA 230, in particular, use of professional judgment; the form and extent is influenced by the nature, size and complexity of the entity. However, a reference to ISA 230 will be added so that the auditor also considers the basic principles and guidance in that ISA.

54. Nevertheless, the task force does see a role for documentation requirements in improving the performance of audits, and does not see this objective of a documentation requirement as being inconsistent with ISA 230.

55. As most respondents agreed with the documentation requirements, the requirements will be retained with the following modification:

- Clarify the requirements relating to significant risks and risks for which substantive procedures alone are not sufficient by adding “the risks identified” in addition to the existing wording to document the controls evaluated as a result of paragraphs 104 of the assessing risk ISA (relating to significant risks) and 110 (risks for which substantive procedures alone are not sufficient); and
- Emphasize the linkage of the risk assessment to the auditor’s procedures in response to the risks as set out in ISA Auditor’s Procedures.

Assertions

Issue

56. Some respondents, particularly those from representative bodies and larger audit firms, commented that the categorization of assertions, as described in proposed ISA Audit Evidence, according to classes of transactions and events for the period under audit; account balances at period end; and presentation and disclosure is unnecessary (“over-engineered”). Most respondents did agree on the thought of extending the assertions to presentation and disclosure.
57. Respondents also provided suggestions for certain assertions to be moved between the categories or amendments to the way assertions are described. The assertion “transparency” is also noted as being different from the proposed ASB draft SAS which uses the term “understandability”.

Task Force Reaction

58. There were two reasons for changing the assertions. The first was to align the ISA and US assertions, which were previously different; and secondly, in doing this the opportunity was taken to reconsider how they were expressed in order to clarify them. Although the presentation of the assertions represents a significant change to extant ISA 500, the task force believes the categorization will be helpful in relating the auditor’s work to the assertions. The categorization proposed is intended to assist the auditor in relating the assessed risks and the procedures in response to the risks at the assertions level to the relevant class of transaction, account balance or disclosure. Some respondents to the proposed ASB SAS suggested a tabular format to present the assertions while retaining the proposed categories. The ASB was receptive to such an approach and the task force will consider it in revising the drafts.
59. It is important for users of the standards to understand that, although assertions are suggested in the draft ISAs, the categorization and terms used to describe the individual assertion are not intended to represent the only ways that management or the auditor categorizes and uses the assertions. The use of assertions to focus the risk assessments is mandatory but the form of those assertions may vary. The assertions need to be sufficiently detailed and complete to meet the auditor’s objectives of obtaining sufficient audit evidence. The guidance will be modified to recognize that in practice, different methodologies may express the assertions in a different manner. However, the assertions relevant to presentation and disclosure will be separately retained as respondents generally believed this to be important.
60. The proposed amendments will be reviewed and considered as the proposals are revised. Two changes that will be made are:
- The assertion “transparency” will be amended to “understandability”; and
 - The assertion “valuation” will be extended to “valuation and allocation” to capture the concept of depreciation / amortization.

Appendix 1: Respondents to the ARM Exposure Drafts

	Representative Bodies
1	Alberta Institute of Chartered Accountants (ICAA)
2	Association of Chartered Certified Accountants (ACCA)
3	Auditing Practice Board (APB UK)
4	Australasian Council of Auditors-General (ACAG)
5	Australian Accounting Research Foundation (AARF)
6	Canadian Institute of Chartered Accountants (CICA)
7	Den norske Revisorforening (Norway, DNR))
8	Federación Argentina de Consejos Profesionales de Ciencias Económicas (FACPCE)
9	Fédération des Experts Comptables Européens (FEE)
10	Foreningen af Statsautoriserede Revisorer (Denmark, FSR)
11	Hong Kong Society of Accountants (HKSA)
12	Information Systems Audit and Control Association (ISACA)
13	Institute for the Accountancy Profession Sweden (FAR)
14	Institute of Chartered Accountants in England & Wales (ICAEW)
15	Institute of Chartered Accountants in Ireland (ICAI)
16	Institute of Chartered Accountants of New Zealand (ICANZ)
17	Institute of Chartered Accountants of Scotland (ICAS)
18	Institute of Chartered Accountants Zimbabwe (ICAZ)
19	Instituto Nacional de Contadores Públicos de Colombia (INCP)
20	Institut der Wirtschaftsprüfer (Germany, IDW)
21	International Organization of Supreme Audit Institutions (INTOSAI)
22	Japanese Institute of Certified Public Accountants (JICPA)
23	Koninklijk Nederlands Instituut van Registeraccountants (Netherlands, NIVRA))
24	London Society of Chartered Accountants (LSCA)
25	Malaysian Institute of Accountants (MAI)
26	South African Institute of Chartered Accountants and Public Accountants and Auditors' Board (SAICA)
	Regulatory Bodies
27	Basel Committee on Banking Supervision Switzerland (BASLE)
28	International Organization of Securities Commissions (IOSCO)
	Firms
29	BDO International B.V. Accountants & Advisers (BDO)
30	Deloitte Touche Tohmatsu (DTT)
31	Ernst & Young Global Limited (E&Y)
32	Grant Thornton International (GTI)
33	KPMG
34	Mazars (UK)

35	Pitcher Partners (Australia)
36	PriceWaterhouseCoopers (International) (PWC)
37	Scarrow & Donald Chartered Accountants (Canada)
	Others
38	K P Rao
39	MarsOmegaΩ Ltd
40	Stephen N Rosenfeld

Appendix 2: Other Key Comments

ISA 200 Concept of Reasonable Assurance

Issue

1. Some representative bodies commented that ISA 200 should more clearly explain the concept of reasonable assurance and explicitly articulate the (inverse) relationship between audit risk and reasonable assurance.

Task Force Reaction

2. The task force agrees that the concept of reasonable assurance could be further explained. The task force will consider adding some language on the relationship between audit risk and reasonable assurance. However, a more detailed explanation is beyond the scope of the audit risk project. The task force understands the IAASB will begin a project on reasonable assurance and recommends the project task force considers this issue further.

Proposed ISA Assessing Risks

RISK ASSESSMENT PROCEDURES

Issue

3. Some representative bodies and smaller firms thought the procedures to obtain an understanding of the entity (inquiry, observation and inspection and analytical procedures) should not be a bold requirement.

Task Force Reaction

4. The task force believes it is necessary to specify the types of procedures as this assists in communicating the nature of the audit procedures required in obtaining an understanding of the entity and its environment, including its internal control.

DISCUSSION AMONG AUDIT TEAM

Issue

5. If a discussion among the audit team is required, the proposals need to further clarify the objective of the meeting, why the meeting is required, who should attend, the ongoing nature of such discussions, and the expected outcome. The guidance should emphasize that the discussion should be sufficient for team members to fulfill their role in the audit.
6. Small entity audits are often carried out by one or two auditors and such a discussion may not have the same relevance.

Task Force Reaction

7. As stated in ISA Assessing Risks, the overall purpose of the discussion focuses on the susceptibility of the entity to material misstatements of the financial statements. Further guidance is also provided to achieve this purpose including emphasizing the use of professional judgment to determine which members of the audit team are included.
8. The auditor's role in an audit includes various aspects such as those of an administrative nature and more importantly those related to the actual performance of audit procedures to assess risks of material misstatements and to obtain sufficient audit evidence. Because this

guidance intentionally focuses on the susceptibility of the entity to material misstatement, the last sentence of paragraph 19 does provide a link of the discussions to the specific areas assigned to the team members and how the results they perform may affect other aspects of the audit.

9. ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements” is currently under revision. The task force will consider proposed revisions related to the audit team discussion as the proposals may be relevant to proposed ISA Assessing Risks.

BUSINESS RISKS

Issue

10. The relationship between business risks and risk of material misstatement needs to be better articulated to emphasize that the auditor is ultimately concerned with risks that relate to the financial statements. In addition, the guidance needs to recognize that small entities may not have a formal risk assessment process or may not be as familiar with the concept of business risks.

Task Force Reaction

11. The task force believes the guidance is sufficiently clear that not all business risks are risks of material misstatements. Additional guidance specific to small entities will also be considered. It is recognized that smaller entities are unlikely to have formal risk assessment processes, but owner/managers are likely to be well aware of business risks and how they are managed or controlled.

ENTITY’S RISK ASSESSMENT PROCESS

Issue

12. The discussion of the entity’s risk assessment process diverts attention from the discussion of business risks. The entity’s risk assessment process should be moved to the internal controls section.

Task Force Reaction

13. The guidance related to the entity’s risk assessment process will be moved to the internal control section. A cross-reference to the relevant paragraphs will also be added.

MEASUREMENT AND REVIEW OF THE ENTITY’S PERFORMANCE

Issue

14. The discussion on measurement and review of the entity’s performance is really a component of internal control and should be moved to the guidance on control procedures.

Task Force Reaction

15. The objective of understanding the measurement and review of the entity’s performance is more clearly expressed in the later part of the guidance. That is, understanding the performance and review measures relevant to the entity assists the auditor in identifying risks such as inappropriate actions by management or deviations in expected performance of the entity.

16. The task force has always been aware of the close relationship between monitoring controls and measurement and review, and of possible confusion between the two. It does believe that they are appropriately positioned in the draft, but will review the drafting to ensure that the necessary clarity is achieved.

INFORMATION TECHNOLOGY

Issue

17. IT is treated as old-fashioned and not the norm and also the discussion on considerations for manual environments and manual controls needs to be articulated (some of the discussion on IT is equally relevant to manual controls).

Task Force Reaction

18. The key objective was to integrate IT aspects into the text to recognize that it is in widespread use today. The guidance will be reviewed to ensure that it reflects the current audit environment. The task force does not think, however, that it would be particularly useful to turn round all references to systems to deal with IT issues first and deal with issues specific to manual systems as the exception.

REVISION OF RISK ASSESSMENT

Issue

19. Consider making the following guidance a bold statement to emphasize the importance of revising the risk assessment: “In circumstances where the auditor obtains audit evidence from performing further audit procedures that tends to contradict the audit evidence on which the auditor originally based the assessment, the auditor revises the assessment and modifies the further planned audit procedures accordingly”.

Task Force Reaction

20. The bold letter requirement in proposed ISA Auditor’s Procedures paragraph 58 requires the auditor to evaluate whether the risk assessments at the assertion level remain appropriate. This paragraph will be cross-referenced to paragraph 114; paragraph will also be cross-referenced to ISA Auditor’s Procedures paragraph 58.

Proposed ISA Auditor’s Procedures

CONTROLS PREVIOUSLY TESTED

Issue

21. The extent of testing or reliance on controls previously tested for the ‘roll forward’ period needs to be clarified.

Task Force Reaction

22. The phrase “...the audit evidence about operating effectiveness that may result from the substantive procedures performed with regard to the remaining period...” in the first sentence of paragraph 34 will be deleted as it incorrectly suggests that substantive procedures are sufficient for testing the operating effectiveness of controls. Paragraph 35 will be expanded to clarify the nature and extent of testing the operating effectiveness of controls in the “roll forward” period, including the use of tests of details as tests of controls described in paragraph 30.

Proposed ISA Audit Evidence

INQUIRY

Issue

23. The nature and extent of guidance on inquiry is not appropriate to be included in an audit standard.

Task Force Reaction

24. Guidance that is too detailed for purposes of explaining the nature of “inquiry” as an audit procedure will be deleted.