

Illustration of Matters Contained in the Proposed Policy Statement

The purpose of this agenda item is to provide a preliminary illustration of how the drafting concepts described in proposed Policy Statement X might be applied to selected International Standards on Auditing (ISAs).

IMPORTANT NOTICE: The material included in the agenda item is provided only to assist the IAASB to further understand (and to visualize an application of) the proposed Policy Statement included in Agenda Item 7-A.

Accordingly, this material DOES NOT represent the actual changes that might arise from the application of the proposed drafting conventions to the selected ISAs, nor any form of authoritative material or final recommendation by the Task Force. The application of the proposed drafting conventions will require revision to an ISA in its entirety following the due process of the IAASB, which has not been applied in the examples presented.

Exhibit 1 contains paragraphs excerpted from ISA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Exhibit II contains paragraphs excerpted from ISA 580, *Management Representations*. Illustrative changes to these ISAs are marked or otherwise identified.

Exhibit I

EXTRACTED PARAGRAPHS 20-23 FROM ISA 315, *UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT*

Understanding the Entity and Its Environment, Including Its Internal Control

20. An audit conducted in accordance with ISAs includes obtaining an understanding of the entity and its environment, including its internal control. That understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing risks of material misstatement of the financial statements and responding to those risks throughout the audit.
21. The auditor shall obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.
22. The auditor's understanding of the entity and its environment should consist of an understanding of the following aspects:
- (a) Industry, regulatory, and other external factors, including the applicable financial reporting framework.
 - (b) Nature of the entity, including the entity's selection and application of accounting policies.
 - (c) Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.
 - (d) Measurement and review of the entity's financial performance.
 - (e) Internal control.

Appendix 1 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (a) through (d) above. Appendix 2 contains a detailed explanation of the internal control components.

23. The nature, timing, and extent of the risk assessment procedures performed depend on the circumstances of the engagement such as the size and complexity of the entity and the auditor's experience with it. The auditor should consider such matters as the size and complexity of the entity and the auditor's experience with it when determining the nature, timing and extent of the risk assessment to be performed. In addition, identifying significant changes in any of the above aspects of the entity from prior periods is particularly important in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

INDUSTRY, REGULATORY AND OTHER EXTERNAL FACTORS, INCLUDING THE APPLICABLE FINANCIAL REPORTING FRAMEWORK

242. The auditor should obtain an understanding of relevant industry, regulatory, and other external factors including the applicable financial reporting framework.¹ These factors might include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments; the regulatory environment encompassing, among other matters, the applicable financial reporting framework, the legal and political environment, and environmental requirements affecting the industry and the entity; and other external factors such as general economic conditions. See ISA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements” for additional requirements related to the legal and regulatory framework applicable to the entity and the industry.
253. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and costs that give rise to risks of material misstatement. In such cases, the auditor should consider whether the engagement team includes members with sufficient relevant knowledge and experience.

¹ The original sentence was presented in bold type.

EXTRACTED PARAGRAPHS 1-6 FROM ISA 580, *MANAGEMENT REPRESENTATIONS*

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations and the action to be taken if management refuses to provide appropriate representations.
2. An audit includes obtaining representations from management in a form appropriate to their significance.
3. The auditor ~~shall~~should obtain appropriate representations from management.²

Acknowledgment by Management of its Responsibility for the Financial Statements

4. The auditor should obtain evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the relevant financial reporting framework, and has approved the financial statements.³
5. The auditor ~~may~~can obtain evidence of management's acknowledgment of such responsibility and approval from relevant minutes of meetings of the board of directors or similar body or by obtaining a written representation from management or a signed copy of the financial statements.

Representations by Management as Audit Evidence

6. The auditor ~~shall~~should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.³
7. The possibility of misunderstandings between the auditor and management is reduced when oral representations are confirmed by management in writing. Matters which might be included in a letter from management or in a confirmatory letter to management are contained in the example of a management representation letter in the Appendix to this ISA.
- 5.8. Written representations requested from management may be limited to matters that are considered either individually or collectively material to the financial statements. Regarding certain items it may be necessary to inform management of the auditor's understanding of materiality.
- 6.9. During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific inquiries. When such representations relate to matters which are material to the financial statements, the auditor ~~should~~will need to:
 - (a) Seek corroborative audit evidence from sources inside or outside the entity;
 - (b) Evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and

² The original sentence was presented in bold type.

- (c) Consider whether the individuals making the representations can be expected to be well informed on the particular matters.

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