



International Federation of Accountants

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Agenda Item

6

Committee: IAASB

Meeting Location: Brussels

Meeting Date: July 10-13, 2006

Clarity – IAASB October 2005 Exposure Drafts

Objective of Agenda Item

1. To agree the following four revised Redrafted ISAs in light of comments received on exposure:
 - ISA 240 (Redrafted), “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements”;
 - ISA 300 (Redrafted), “Planning an Audit of Financial Statements”;
 - ISA 315 (Redrafted), “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement”; and
 - ISA 330 (Redrafted), “The Auditor’s Procedures in Response to Assessed Risks”.

Clarity Task Force Members

2. The members of the Clarity Task Force are as follows:

John Kellas (Chairman)

Paul Chan (IFAC SMP Committee)

Denise Esdon

John Fogarty

Jon Grant

Bodo Richardt

Jim Sylph (ex-officio)

Gérard Trémolière

Background

3. In October 2005, the IAASB exposed four ISAs redrafted in accordance with the IAASB’s proposed new drafting conventions. Forty-six comment letters were received in response.¹ Input was also received from the IFAC Small and Medium Practices (SMP) and Developing Nations Committees.
4. At the May IAASB meeting, the Task Force addressed with the IAASB significant issues of principle raised by respondents in relation to objectives. It was agreed that the task force should reconsider the objectives of the ISAs as a whole, together with the obligation, if any, that should attach, for purposes of discussion at the September IAASB meeting.

¹ The October 2005 Clarity Exposure Drafts and respondents’ letters are located on the IAASB website at www.ifac.org/IAASB/ExposureDrafts.php.

5. The Task Force also reported² on issues of principle raised in relation to:
- The application of the guidelines for specifying requirements, specifically whether it has been done in a consistent and appropriate manner with specific regard to the applicability of the requirements in the context of the audits of small and medium sized entities (SMEs); and
 - The overall structure and drafting of the ISAs under the new drafting conventions.

Activities Since the May 2006 IAASB Meeting

6. The Clarity Task Force met in May and June to discuss the significant issues raised, and detailed comments made, by respondents relating specifically to the four ISA Exposure Drafts (EDs).

Matters for IAASB Consideration Applicable to Each of the Proposed Revised Redrafted ISAs

REQUIREMENTS

7. Based on respondents' comments, the Task Force believes that the following main considerations, in addition to the guidelines³ for specifying requirements agreed by the IAASB in October, need to be addressed when clarifying the requirements of the ISAs:
- (a) Are each of the proposed new requirements in fact necessary – that is, would their absence have potential consequence to the quality or consistency of audits having regard to the international context?; and
- Does a requirement focus too much on the 'how to' instead of the question of whether a matter has been considered and appropriately addressed?
- (b) Does the wording of the requirements:
- Express clearly the action to be taken (with reference, in particular, to "shall consider"⁴)?
 - Convey adequately their applicability to both large and small entities?

² The relevant May 2006 IAASB material is Agenda Items 6-A, which is located on the IAASB website at www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0065.

³ The guidelines identified in the Explanatory Memorandum accompanying the October 2005 Clarity EDs were as follows: "The IAASB will determine the requirements of a Standard as follows: (a) The requirement is necessary to achieve the objective stated in the Standard; (b) The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and (c) The objective stated in the Standard is unlikely to have been met by the requirements of other Standards."

⁴ As explained in Agenda Item 6-A in the May IAASB meeting material, respondents found requirements using 'shall consider' ambiguous. The Task Force believes that use of 'shall consider' should be reassessed on a case-by-case, but does not accept that the use of 'shall consider' should be stopped altogether. It does reflect a reasonable action particularly where the IAASB believes that the auditor needs to take account of and review a matter(s) and evaluate whether it is applicable in the circumstances in order to make a judgment or deciding on a course of action.

- Identify clearly any conditionality attaching to a requirement?
- (c) Standing back and considering each ISA on the whole, is the totality and specificity of the requirements such that, for the topic at hand, it may result in an instinctive reaction to ‘comply’ rather than apply judgment in light of the varying circumstances of the audit?

APPLICATION MATERIAL

8. In terms of the application material, there are two main considerations applicable to each of the ISAs:
 - (a) Is there anything more of a specific nature that can be said that would contribute to a better understanding of how a requirement might be applied in the audit of an SME (in particular, on documentation)?; and
 - (b) Do any sentences or paragraphs remain that need to be further streamlined (e.g., bullet points) to improve readability?
9. The Task Force has considered the above in revising the ISA EDs and is satisfied with the outcome.

Matters for IAASB Consideration Relating to Individual Proposed Revised Redrafted ISAs

10. There are certain areas where respondents’ comments have suggested to the Task Force the need to reconsider some of the material contained in the extant ISAs (beyond editing), or to introduce new guidance, in order to improve the clarity of the ISAs in certain respects. These are identified in Appendices I-IV to this Agenda Item for each ISA respectively. The Task Force believes such changes are within the scope of the Clarity project.
11. The Appendices identify also other main issues raised by respondents in relation to the four ISA EDs individually where the disposition thereof is not self-evident based on consideration of the matters identified in paragraphs 7-8 above or in the versions of the ISAs showing changes from the ED in mark-up.

Material Presented (Note: Agenda Items 6-A.1, 6-B.1, 6-C.1 and 6-D.1 (i.e., the ‘Mark-up’ versions of the ISAs will be used for purposes of the discussions at the meeting.)

Agenda Item 6-A (Pages 1321 – 1360)	Revised ISA 315 (Redrafted) – Clean
Agenda Item 6-A.1 (Pages 1361 – 1406)	Revised ISA 315 (Redrafted) – Mark-up from Exposure Draft
Agenda Item 6-B (Pages 1407 – 1426)	Revised ISA 330 (Redrafted) – Clean
Agenda Item 6-B.1 (Pages 1427 – 1446)	Revised ISA 330 (Redrafted) – Mark-up from Exposure Draft

Agenda Item 6-C Revised ISA 240 (Redrafted) – Clean
(Pages 1447 – 1490)

Agenda Item 6-C.1 Revised ISA 240 (Redrafted) – Mark-up from Exposure Draft
(Pages 1491 – 1538)

Agenda Item 6-D Revised ISA 300 (Redrafted) – Clean
(Pages 1539 – 1550)

Agenda Item 6-D.1 Revised ISA 300 (Redrafted) – Mark-up from Exposure Draft
(Pages 1551 – 1562)

Action Requested

12. The IAASB is asked to agree the four revised Redrafted ISAs in the agenda material presented, in light of respondents' comment. In doing so, the IAASB is asked to:
- Indicate whether it is satisfied that the main considerations applicable to each of the proposed revised Redrafted ISAs indicated above (see paragraphs 7-8) have been addressed adequately;
 - Consider the matters noted in the Appendices to this Agenda Item in relation to each of the proposed revised Redrafted ISAs; and
 - Advise on how to deal with any matter that requires further attention.

Appendix I

Proposed Revised ISA 315 (SEE AGENDA ITEM 6-A)

CONTROLS RELEVANT TO THE AUDIT

1. Several respondents indicated that practice varies in terms of applying the requirements of extant ISA 315 pertaining to obtaining an understanding of internal controls, controls and control activities *relevant to the audit*. Further, there is difficulty in interpreting the intent of the ISA and in determining whether a control, or control activity, is relevant. Respondents urged the IAASB to consider whether the ISA defines sufficiently what is meant by ‘controls relevant to the audit’ and the considerations appropriate when the auditor is making the necessary judgment.
2. Members of the Task Force confirm that such concerns do exist in practice. The Task Force has therefore:
 - Improved the wording of ISA 315 with respect to references to *internal control*, *controls* and *control activities*, as appropriate;
 - Brought forward application material as ‘essential’ explanatory material that appears most pertinent to appropriately clarifying and qualifying the reference to relevant controls; and
 - Introduced some additional application material, specifically: (a) for controls, the auditor’s consideration of the significance of the identified risk to which the control relates; and (b) for control activities, the auditor’s consideration of whether the auditor thinks it is likely to be appropriate to rely on the control in determining the extent of substantive testing.
3. The Task Force does not believe it can go further without altering the intent or substance of the ISA. For example, the Task Force did not consider it appropriate to adopt the suggestion to limit the need to understand relevant internal controls to only whether there is an assessed risk of material misstatement and a preliminary expectation of placing reliance on the related control.

APPLICATION MATERIAL FOR SMES, INCLUDING GUIDANCE ON DOCUMENTATION

4. Respondents urged the IAASB to consider whether the application material pertaining to SMEs was adequate. It was noted that while such material describes the characteristics of SMEs that may differ from other entities, it often did not guide the auditor as to the consequences of such characteristics on application of the requirement, the relevant considerations or the types of procedures that may be suitable. In some cases, the guidance is largely repetitive of other points made, and not particularly helpful.
5. Of particular importance, in light of the increase in the number of requirements as a result of redrafting, respondents felt that additional guidance on the nature and extent of documentation is required to assist in clarify expectation and in managing the potential documentation burden.

6. The Task Force agrees with these points. It has therefore, with the assistance of the UK Auditing Practices Board's SME task force, redrafted some of the generic guidance to be more specific, and expanded the guidance pertaining to documentation.

APPLICABILITY OF THE REQUIREMENT RELATING TO UNDERSTANDING THE ENTITY'S RISK ASSESSMENT PROCESS

7. Several respondents identified the requirement relating to understanding the 'entity's risk assessment process' (drawn largely from the extant requirement of ISA 315) as dealing with circumstances or processes that may exist only in audits of larger entities.
8. The Task Force believes that the improved wording should help alleviate this concern. However, it also believes that the ISA should emphasize the auditor's consideration of whether the absence of a risk assessment process, or the existence of one that is informal, is appropriate in the circumstances. The Task Force has proposed additional wording in this regard.

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE AND MATERIAL WEAKNESS IN INTERNAL CONTROL

9. ED ISA 315 identified the requirement for the auditor to consider material weaknesses in internal control in reference to matters to communicate with those charged with governance. Some respondents noted that requirements of the ISA, in general, should directly serve towards fulfilling the objective stated in the ISAs; this requirement was noted as a point in case where this linkage appears unclear.
10. The Task Force believes that the focus of the ISA could be improved by directing explicitly the auditor to consider whether a material weakness exists, rather than via a 'communication' requirement. This appears appropriate in light of the revisions made to ISA 260, and in work being undertaken with respect to defining material weaknesses.
11. The Task Force also considers the existing definition of material weakness unhelpful. It therefore proposes to remove it from the definitions section of the revised redrafted ISA 315 until an improved definition is determined.

COMPONENTS OF INTERNAL CONTROL

12. A recurring theme in many responses that expressed concern over new elevations was that including requirements that describe in detail specific components of a matter, or that list matters of consideration, creates requirements that are too prescriptive or at a level that imposes undue documentation. Respondents referred to the additions made to the requirements pertaining to the components of internal control (paragraph 17 of ED ISA 315) as a case in point.
13. The Task Force agrees with this point in principle and has reconsidered whether the requirements in the ED (with reference in particular to the components of internal control) represent requirements or, rather, application material supporting a requirement.
14. Several respondents, however, commented on the descriptive nature of the requirements pertaining to the information systems relevant to financial reporting (paragraph 17(c) of ED ISA 315), and recommended reconsideration of whether: (a) such detail is necessary in

the requirements; and (b) each element is applicable in virtually all audit engagements. The Task Force notes that paragraph 17(c) of ED ISA 315 is contained in extant ISA 315, and does not believe it can be removed, or repositioned within the application material, without potentially weakening the ISA.

OTHER AREAS OF NOTE

Discussion Among the Engagement Team

15. Respondents commented variously on whether the requirement for the engagement partner to communicate to engagement team members not involved the discussion about the susceptibility of the entity's financial statements to material misstatements is necessary to the fulfillment of the objective stated in the ISA.
16. The Task Force notes that this is a requirement of extant ISA 240, but a matter that is generally applicable to both misstatements and misstatements arising from fraud. Accordingly, placement within ISA 315 is considered appropriate.

Elevation of Matters in the Application Material

17. Two respondents questioned variously whether certain matters in the present tense in extant ISA 315 represent items that should be elevated as requirements, including:
 - Understanding how transactions originate within business processes, and how the entity's business processes and information system ensure compliance with laws and regulations (see ED ISA 315 paragraph A77).
 - Matters that may affect the auditor's understanding of the entity's selection and application of accounting policies (see ED ISA 315 paragraph A24).
 - Specific risk assessment procedures in addition to inquiry to obtain audit evidence about the design and implementation of relevant (see ED ISA 315 paragraph A62).
18. The Task Force considers these items to be, in substance, matters guiding the application of the related requirements, rather than requirements in and of themselves. Further, elevation would result in a degree of specificity for which a number of other respondents felt would be inappropriate.

Definitions

19. It was suggested that the term defined in the 'Definitions' section be expanded (e.g., to include definitions of: 'assertion'; 'assertion level'; each component of internal control; 'controls relevant to the audit'; 'business risk'; etc.).
20. The Task Force considers many of these to represent descriptions of items, rather than definitions per se.

Appendix II

Proposed Revised ISA 330 (SEE AGENDA ITEM 6-B)

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE AND MATERIAL WEAKNESSES

1. A respondent noted that although ED ISA 315 requires the auditor to communicate a material weakness in the *design or implementation* of internal control with those charged with governance, there was no corresponding requirement in ED ISA 330 regarding a material weakness in *operating effectiveness*. It was recommended that one be added to ISA 330.
2. The Task Force agrees that this is appropriate. It has therefore included a requirement that is modeled on the approach suggested in ISA 315.

EXTENT OF TESTS OF CONTROLS

3. Some respondents raised concern over the proposed requirement in ED ISA 330 paragraph 15 to increase the extent of tests of controls the more the auditor relies on their operating effectiveness. It was noted that it is unnecessary in light of the existing requirement to “test controls” and that it is flawed in that its focus on extent only.
4. The Task Force agrees that the appropriate action when intending to increase reliance on a control is not always to increase the extent of testing, but rather to seek more persuasive audit evidence, which can result from modifying the nature, timing or extent of procedures, rather than extent only. The Task Force has therefore amended the ISA accordingly.

RELIANCE ON INTERNAL CONTROLS

21. One respondent noted that national experience with the application of extant ISA 330 indicates that there will be confusion as to the implications of ED ISA 330 paragraph 8(a) and in particular the requirement for the auditor to test controls when the auditor’s risk assessment “includes an expectation that the controls are operating effectively.” It was noted that many practitioners are misinterpreting this to mean that the auditor is obliged to adopt an audit approach that uses tests of the operating effectiveness of those controls, even though it may be more efficient to perform a substantive audit. The problem is partly due to the fact that ISA 330 does not explicitly state that the auditor must test the operating effectiveness of controls only when the auditor is adopting an approach in which the auditor will be relying on the effective operations of controls when designing and performing substantive procedures.
22. The Task Force has sought to respond to this point by clarifying paragraphs 7(a)(ii), 8(a) and A4(b) in the proposed revised ISA 330.

APPLICATION MATERIAL FOR SMES

23. Respondents urged the IAASB to consider whether the application material pertaining to SMEs was adequate.
24. In response, the Task Force has introduced new material that explains that there may be circumstances in smaller entities (e.g., little or no documentation of controls) limiting the efficiency of an audit approach comprising tests of controls. Further, additional general

guidance pertaining to documentation has been added. Because of the nature of the requirements of the ISA, the Task Force noted few additional areas where useful application material pertaining to SMEs could be added.

STRUCTURE

5. Some respondents noted that structure and flow of ED ISA 330 does not emphasize adequately considerations relating to significant risks, nor allow the reader to follow easily considerations relating to each of the nature, extent and timing of tests of controls or substantive procedures.
6. The Task Force agrees with these points. It has therefore introduced new sub-heading, as appropriate, to assist in guiding the reader through the ISA, and has reordered some material to improve its flow.

Appendix III

Proposed Revised ISA 240 (SEE AGENDA ITEM 6-C)

FRAUD IN THE CONTEXT OF AN AUDIT OF FINANCIAL STATEMENTS

1. ED ISA 240 was the only draft to contain a separate ‘introductory section’ that served to set out the context in which the ISA is set. Respondents made various suggestions – either to expand or reduce the material therein – and asked the IAASB to consider a consistent practice across all ISAs and to clarify the status of such material.
2. The Task Force is of the view that certain material setting out the context of the auditor’s consideration of fraud is essential to a proper understanding of the auditor’s responsibilities under the ISA. It defines further the scope of the ISA and accordingly should be retained in the introduction of the ISA (as part of the scope of the ISA, rather than as a separate section within the introduction or split between it and the application material).
3. The Task Force is also of the view that only the material that is specific to fraud should be retained within the ISA. Material that are of general applicability – in particular, that which relates to the inherent limitation of an audit (e.g., detection risk, the subsequent detection of a material misstatement) and the responsibilities of management – should be placed in ISA 200 as an amendment.
4. The Task Force’s proposed amendments to ISA 200 are shown in mark-up in Exhibit I in Agenda Item 6-C.

THE PRESUMPTION OF RISKS OF FRAUD IN REVENUE RECOGNITION

5. Several respondents raised concern over the general applicability of the proposed requirement in the ED relating to the presumption that there is a risk of fraud in revenue recognition (ED ISA 240 paragraph 20). It was questioned whether it is appropriate to single out revenue recognition when there may be other areas where specific attention is needed. It was also noted that fraud in revenue recognition is unlikely to be a risk prevalent in smaller entities.
6. The Task Force has reconfirmed its view that the auditor should be required to consider the risks of fraud in revenue recognitions, based on a presumption that there are such risks. This view takes account of the fact that fraud in revenue (either overstatement or understatement) may exist in entities of all sizes, and that it is consistent with the related extant requirement pertaining to documentation of this consideration (removal of which would weaken the ISA).
7. The Task Force has, however, reworded the requirement, which may help alleviate respondents’ concerns. Further, the Task Force has introduced some additional guidance to explain further the context in which the requirement is set, and to emphasize the fact that it is a presumption that may be rebutted where the circumstances of the audit do not warrant further consideration.

RISKS OF MANAGEMENT OVERRIDE OF CONTROLS

8. Several respondents noted that the proposed requirement for the auditor to consider the need to perform procedures in addition to those specified in the ISA in order to respond to the risks of management override of controls (see ED ISA 240 paragraph 26) is unnecessary in light of the obligation in the proposed amended Preface to perform other procedures as necessary in the circumstances.
9. The extant ISA makes clear that there may be other risks of management override of control to which a response may be required. Accordingly, the Task Force believes that this requirement is necessary to clarify that the auditor also considers the need to perform procedures to address these risks. The Task Force has therefore retained the proposed requirement, and improved the wording of the requirement to make this point clear.

DOCUMENTATION

10. The decision of the IAASB to retain ISA 240 as a stand-alone ISA and to allow for some repetition in ISA 240 of material in ISAs 315 and 330 reduces the ability to effectively cross-refer related documentation requirements. The Task Force believes the clearest approach is to revert to wording of the documentation requirements in extant ISA 240.

OTHER AREAS OF NOTE

Professional Skepticism

11. One respondent suggested that it may be appropriate to consider the following application material pertaining to professional skepticism for elevation as requirements:
 - The description of professional skepticism (ED ISA 240 paragraph A13);
 - The direct confirmation with a third party or using the work of an expert to assess a document's authenticity where the auditor has doubts about the reliability of a document (ED 240 paragraph A14); and
 - The corroboration of responses to inquiries of management (ED 240 paragraph A22).
12. The Task Force is of the view it would be inappropriate to specify the specific procedures that might be performed arising generally from the auditor's maintenance of an attitude of professional skepticism. Such guidance is clearly in the nature of application material.

Public Sector Considerations

13. One respondent noted that the scope of ISA 240 is too narrow for public sector auditing. It was recommended that the ISA include a statement to the effect that in the public sector, the auditor's responsibilities to consider fraud in an audit of financial statements may be affected by legislation, regulation, ordinances or ministerial directives. The terms of the mandate may be a factor that the auditor needs to take into account when exercising judgment.
14. The Task Force has not accepted this suggestion. The Task Force notes that the material does not relate to the application of a requirement for the audit the financial statements of a public sector entity (which should be included in those considerations in the application material), but rather to the broader mandate they assume in those audits. It may therefore

be viewed as application material not directly relevant to the ISA. Such matters may better be dealt with by INTOSAI in their auditing guidelines. A similar type of statement is contained in ISA 315, paragraph A19; this has been retained for discussion purposes only.

Appendix IV

Proposed Revised ISA 300 (SEE AGENDA ITEM 6-D)

COMMUNICATION WITH MANAGEMENT

1. A new paragraph has been added regarding communication with management. The content of this paragraph is extracted from a paragraph in extant ISA 300 dealing with communication with those charged with governance. It was removed pending incorporation into ISA 260, “Communication with Those Charged with Governance.” When discussing ISA 260 at the May 2006 meeting, the IAASB agreed that this material should be reinstated in ISA 300.

ELEVATION OF MATTERS IN THE APPLICATION MATERIAL

2. One respondent urged the IAASB to consider whether the matters regarding documentation in extant paragraphs A13 and A14 of ED ISA 300 should be elevated to requirements.
3. The Task Force considers these matters to be, in substance, matters guiding the application of the related requirements, rather than requirements in and of themselves.

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