

**Minutes of the 21st Meeting of the  
INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD  
Held on July 10-13, 2006 in Brussels**

**Voting Members**

Present: John Kellas (Chairman)  
Denise Esdon (Deputy Chair)  
Phil Cowperthwaite  
Sukanta Dutt (July 10, July 12)  
Josef Ferlings (July 11-13)  
John Fogarty  
Jan Bo Hansen  
Diana Hillier  
Kjell Larsson  
Marcel Pheijffer  
Ian McPhee  
Will Rainey  
Bodo Richardt  
Makoto Shinohara  
David Swanney (July 10-12)  
Roberto Tizzano  
Gérard Trémolière

Absent: Craig Crawford

**Technical Advisors**

Kelly Ånerud (Mr Larsson)  
Wolfgang Böhm (Mr Ferlings)  
Philip Ashton (Ms Hillier)  
Cédric Gélard (Mr Trémolière)  
Jon Grant (Mr Rainey)  
Jennifer Haskell (Mr Hansen)  
Richard Mifsud (Mr McPhee)  
Greg Shields (Mr Cowperthwaite)  
Sylvia Smith (Mr Crawford)  
George Tucker (Ms Esdon)  
Hans Verkruijsse (Mr Pheijffer)  
Sharon Walker (Mr Fogarty)  
Yuichi Yamamoto (Mr Shinohara)

**Non-Voting Observers**

Present: Jennifer Rand  
Hisashi Yamaura  
David Damant  
Jean-Philippe Rabine  
Jürgen Tiedje (July 13)

**Public Interest Oversight Board (PIOB) Observer**

Present: Arnold Schilder (July 10-11)

**IAASB Technical Staff**

Present: Jim Sylph (Technical Director), James Gunn, Michael Nugent, Alta Prinsloo, Ken Siong, Jan Tyl

## 1. Opening Remarks and Minutes

Mr Kellas introduced Mr Jean-Philippe Rabine, a non-voting observer representing the European Commission and Mr Arnold Schilder, a PIOB member, and welcomed as public observers a group of Russian translators of ISAs. He noted that Mr Jürgen Tiedje would join the meeting later in the week.

Mr Kellas noted that Mr Ferlings would be absent on Monday, Messrs Dutt and Swanney would leave the meeting prior to its conclusion and that Mr Crawford had expressed his apologies for his not being able to attend the meeting at short notice. Mr Ferlings had appointed Mr Böhm as his proxy, Mr Crawford appointed Ms Smith as his proxy, and Messrs Dutt and Swanney appointed Mr Kellas as their proxy.

Following agreement to an amendment submitted by Ms Hillier, the minutes of the public session of the previous IAASB meeting were approved.

It was noted that Agenda item 1 referred to the IAASB Consultative Advisory Group minutes as being attached. These had not in fact been attached as they were in draft form. Although the IAASB and now the public have access to the minutes, it was suggested that they would be included in future IAASB agenda papers for information, once finalized.

## 2. Modifications

Mr Hansen introduced the topic, noting that the purpose of the discussion was for the IAASB to consider final wording changes to the proposed ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report,” and ISA 706, “Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor’s Report,” before approving them for close off under the “old drafting conventions.” He then led a review of the final wording changes.

### *Proposed ISA 705*

#### PERVASIVENESS OF MATERIAL MISSTATEMENTS GIVING RISE TO A MODIFICATION

A member asked whether for misstatements confined to specific elements, accounts or items in the financial statements, the test for pervasiveness should be that they *affect* or *could affect* a substantial proportion of the financial statements, rather than that the misstatements themselves *represent* or *could represent* such a proportion. Mr Hansen explained that the latter should apply because it is the magnitude of the actual misstatement that is relevant to the evaluation of pervasiveness. It was also suggested that the description of pervasiveness should include the notion of the overall presentation of the financial statements no longer being consistent with the auditor’s understanding of the entity and its environment. It was, however, noted that such an outcome could also result from material misstatements that are not pervasive. Subject to changing the phrase “when such misstatements cannot be confined” to “when such misstatements are not confined,” the IAASB agreed with the wording of the description of pervasiveness.

#### OTHER COMMENTS OR CHANGES

In addition to editorial changes, the IAASB also agreed the following:

- The requirements and guidance addressing a pervasive inability to obtain sufficient appropriate audit evidence should make reference to materiality for consistency.

- The column headed “Pervasive” in the table providing an overview of the different types of modified opinions should be changed to “Material and Pervasive.”
- In relation to multiple uncertainties, the guidance should be amended to indicate that, in such a situation, the auditor is not precluded from disclaiming an opinion.
- The requirements and guidance relating to the Basis for Modification paragraph should be streamlined to eliminate overlap.
- The example illustrating when the disclosure of omitted information would be considered voluminous should be deleted.
- The requirements pertaining to the form of the modified opinion and the description of the auditor’s responsibility in the case of a disclaimer of opinion should be limited to circumstances where there is an inability to obtain sufficient appropriate audit evidence. This is to ensure that these requirements do not also apply to disclaimers arising from multiple uncertainties. The IAASB agreed that disclaimers arising from multiple uncertainties would be such extremely rare occurrences that the appropriate wording of the opinion paragraph and description of the auditor’s responsibility in these circumstances should be left to the auditor’s judgment.

Mr Hansen explained that the task force had considered the nature of the changes made to the original exposure draft and did not view these changes as representing departures from the principles in the exposure draft. The IAASB agreed that re-exposure would not be necessary.

#### APPROVAL

The IAASB approved the close off version of the proposed ISA 705, with one dissenting vote. Mr Ferlings dissented because of the specific requirement to include in the auditor’s report information that management has decided not to disclose but is required to be disclosed under the applicable financial reporting framework. In his view, the IAASB did not have the appropriate authority to establish such a requirement and, therefore, in doing so the IAASB was overstepping its standard-setting mandate and assuming a regulatory role. He believed that it is the responsibility of regulators to enforce compliance with the requirements of the framework, and they have the tools and the means to do so, including requiring the auditor to include such omitted disclosures in the auditor’s report if appropriate. Accordingly, he was of the view that the ISA should not require auditors to provide such disclosures in the auditor’s report.

Mr Sylph advised the IAASB that due process had been followed in developing and finalizing the close off version of the proposed ISA 705.

#### *Proposed ISA 706*

In addition to editorial changes, the IAASB agreed that the example illustrating an uncertainty relating to the future outcome of an exceptional litigation or regulatory action should be deleted.

Mr Hansen indicated that the task force had considered the nature of the changes made to the original exposure draft and did not view these changes as warranting re-exposure. The IAASB agreed that the changes were responsive to comments received on exposure and, accordingly, concluded that re-exposure would not be necessary.

#### APPROVAL

The IAASB approved the close off version of the proposed ISA 706, with two dissenting votes. Ms Esdon dissented because of the way in which the ISA was structured. In her view, although the ISA states that it establishes standards and provides guidance on the circumstances when the auditor includes an Emphasis of Matter paragraph in the auditor's report, the only requirement pertaining to such a paragraph relates to how the auditor should include it in the auditor's report. In addition, she found that the examples provided did not support the guidance regarding the rare circumstances applicable to emphasis of matter. Mr Cowperthwaite dissented because, in his view, there should be a requirement to include an Emphasis of Matter paragraph only when the matter is of such importance that it is fundamental to users' understanding of the financial statements. The absence of such a requirement was inconsistent with the guidance stating that such a paragraph would be appropriate only in rare circumstances, as well as the guidance stating that widespread use of such a paragraph would diminish the effectiveness of such communications. Accordingly, he did not believe that the ISA established appropriate boundaries around the use of Emphasis of Matter paragraphs.

Mr Sylph advised the IAASB that due process had been followed in developing and finalizing the close off version of the proposed ISA 706.

#### *Proposed Conforming Amendments*

The IAASB also discussed further proposed conforming amendments, which were agreed except for the following:

- In relation to ISA 510, "Opening Balances," the task force proposed that, in the event the auditor is unable to obtain sufficient appropriate audit evidence concerning opening balances, the auditor should only be allowed to disclaim an opinion regarding the results of operations but not to qualify such opinion. The IAASB disagreed on the basis that the auditor should still be able to express an opinion on the rest of the results of operations except for the line item affected (e.g. opening inventory). Accordingly, the IAASB concluded that the auditor should continue to be allowed the option to qualify.
- In relation to ISA 570, "Going Concern," the task force proposed to delete the guidance discussing disclaimers of opinion arising from multiple uncertainties, as such guidance was now included in the proposed ISA 705. The IAASB concluded that it remained appropriate to continue to include such guidance in ISA 570.
- The task force proposed certain conforming amendments to ISAE 3400 addressing the examination of prospective financial information, and ISRE 2410 addressing interim reviews. The IAASB concluded that it would be preferable to defer conforming amendments on these pronouncements until such time as they are next revised.

The IAASB also considered how the principles in the proposed ISA 705 should be applied to corresponding figures covered by ISA 710, "Comparatives." The task force was of the view that this was unclear and that any changes to ISA 710 could represent more than just conforming amendments. The IAASB concluded that a full revision of ISA 710 would be unnecessary at this time because this issue could be clarified when ISA 710 is redrafted under clarity.

#### WAY FORWARD

The task force will redraft the close-off versions of the proposed ISAs 705 and 706 under the clarity drafting conventions and present the redrafted ISAs for the IAASB's consideration for re-exposure under clarity next year.

### **3. Clarity**

#### PROPOSED REVISED REDRAFTED ISAS

Mr Kellas provided a brief summary of the general comments received on four proposed redrafted ISAs exposed in October 2005. He noted that, in relation to requirements, the main issues raised by respondents included whether each of the proposed requirements is necessary and applicable to entities of all sizes, and expresses clearly the action to be taken. In relation to the application material, the issues raised included whether additional material could be developed that would contribute to a better understanding of how a requirement might be applied in the audit of a small or medium-sized entity (SME).

He noted that work to develop further the objectives is ongoing by the clarity task force. He also noted that some respondents urged the IAASB to clarify the status and authority of material included in the introductory sections of the ISA, a matter of particular concern to those jurisdictions that intend to embed the ISAs into law. The task force expects to present recommendations, together with a final set of proposed objectives, at the September IAASB meeting.

The task force summarized the main specific issues raised by respondents in relation to each of the four exposed redrafted ISAs. Highlighted for IAASB consideration were those areas where respondents' comments had 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. The task force noted that it viewed the proposed changes as being within the scope of the clarity project.

The IAASB discussed each of the proposed revised Redrafted ISAs.

#### *General*

While accepting that the objectives are subject to further consideration, one member urged the task force to ensure that the objectives feature prominently the outcomes expected of the auditor, and take a less procedural form than that in the material presented.

It was noted that the ISAs often refer to the responsibilities of management and those charged with governance. Their responsibilities, however, are established by law and regulations, and not by the ISAs. The task force agreed to consider further how the ISAs refer to the responsibilities of others and the authority of such references could be clarified.

It was noted that use of the terms "formal" and "informal" in the ISAs creates translation difficulties. Use of the suggested alternatives of "documented/undocumented" and "structured/unstructured" in certain contexts was not without concern. The task force agreed to consider further alternatives.

It was observed that some of the proposed considerations specific to public sector entities in the application material of the ISAs focus more on the differences in scope of public sector audits, rather than on the application of the requirements of the ISA in the context of an audit of a public sector entity. The IAASB agreed revised wording for such paragraphs.

Mr Kellas noted that there was some concern over the use of the phrase “reducing audit risk to an acceptably low level” in the ISAs, particularly when it is combined with the phrase “to obtain sufficient appropriate audit evidence.” He noted that the task force would consider how these phrases interrelate with the concept of reasonable assurance in its work to revise ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” and how those phrases should be used in the ISAs.

The IAASB agreed that references within the ISAs to the design and implementation of internal control should be made consistent with ISA 700 (Revised), “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements,” which used the phrase “design, implement and maintain internal control.” The task force noted, however, that it would need to consider whether this may have any unintended consequences, particularly in relation to the related requirement in ISA 240 pertaining to representations to be obtained about management’s responsibilities with respect to fraud prevention and detection.

### *ISA 315*

The IAASB discussed the proposed changes made in response to comments urging the IAASB to consider whether the ISA sufficiently explained “controls relevant to the audit” and the considerations appropriate when the auditor is making the necessary judgment. Certain additional editorial changes were agreed to improve the wording of the draft document. Although a few members remained concerned about whether the guidance was clear enough, the IAASB was satisfied that the task force had explored the issue fully and agreed with its conclusion that further changes might alter the substance of the extant ISA.

Except as noted below, the IAASB agreed the changes recommended by the task force to the exposed ISA.

The IAASB did not agree with the proposal by the task force to remove the requirement (as exposed) for the auditor to consider specific matters in making the judgment as to whether a risk is a significant risk. It was of the view that such considerations are essential to the proper and consistent risk assessment. Accordingly, it was agreed to reinstate the requirement, along with certain editorial changes.

In addition to editorial changes, the IAASB asked the task force to consider further the following:

- Whether there is merit in including further introductory material in this ISA, in light of its importance.
- The clarity of the suggested phrase “...taking account of relevant controls as appropriate” in the requirement dealing with the auditor’s identification and assessment of risks of material misstatement.

### *ISA 330*

The IAASB agreed the changes recommended by the task force to the exposed ISA. However, in addition to editorial changes, the IAASB asked the task force to consider further the following:

- As part of its consideration of objectives, whether in fact reference to “reducing audit risk to an acceptably low level” should feature in the objective of this ISA in particular.

- Whether the term “significant” or “material” should be used when referring to the auditor’s consideration of classes of transactions, account balances, and disclosures.
- Whether use of the phrase “more reliance” on internal control is appropriate.
- Whether the proposed requirement for the auditor to establish the continuing relevance of substantive audit evidence obtained in previous audits, which was elevated as a requirement on exposure, remains appropriate in light of the rarity of such circumstances. If so, whether there should be a related documentation requirement as in the case of the use of prior period audit evidence about the operating effectiveness of controls.
- Whether further changes are needed to align the elements of the requirement dealing with the auditor’s consideration of the reasons for the risk assessment with the related requirement in ISA 315.

### *ISA 300*

In addition to editorial changes, the IAASB agreed the changes recommended by the task force to the exposed ISA.

The IAASB agreed with the proposed deletion of the public sector consideration dealing with the fact that there may be legislative requirements that create an obligation to accept, and the inability to withdraw from, an engagement, or that affect the use of engagement letters. However, those considerations are likely to be relevant both in the public and private sectors and should be included in ISA 210, “Terms of Engagements” and ISA 220, “Quality Control for Audits of Historical Financial Information” when they are clarified.

### *ISA 240*

The IAASB deliberated the content and placement of the introductory section, and the related proposed conforming amendments to ISA 200. Some members were of the view that much of the related application material should be placed as part of the introductory section; others felt that most of the material could be positioned as application guidance. On balance, the IAASB agreed that the recommended wording for the introductory section, and its focus on matters specifically relevant to fraud, appeared balanced and appropriate. It also agreed that the related application material dealing with the characteristics of fraud should be restructured to give greater emphasis to the fraudulent financial reporting element of fraud, and that discussion of the responsibilities of the auditor with respect to the authentication of documents be repeated in both ISA 240 and ISA 200. The IAASB asked, however, that the task force review the material again, and also consider whether the use of relevant subheadings would help improve the clarity of the section.

The IAASB deliberated the retention of the requirement, as elevated on exposure, dealing with the auditor’s presumption of risks of material misstatement due to fraud in revenue recognition. The IAASB concluded that it was clear that the intent of extant ISA 240 is to require the auditor to make this presumption, which is supported by the related documentation requirement when the auditor concludes that there no such risks are present. Further, it is applicable to both small and large entities. Accordingly, the IAASB agreed to retain the requirement as drafted by the task force, together with certain editorial changes to the related application material.

In addition to editorial changes, the IAASB agreed the changes recommended by the task force to the exposed ISA.

The IAASB asked that the task force submit revised versions of the four redrafted ISAs for approval at the September 2006 meeting.

#### PROJECT STATUS

Mr Kellas summarized the status of the clarity project overall. In addition to the matters noted above, he noted the following as requiring consideration by the task force and IAASB:

- The explanatory memorandum and bases for conclusions that are to accompany the final approved versions of the exposed documents may also need to explain the current state of the development of objectives for the remaining ISAs.
- The direction that the revision of ISA 200 and the redrafting of ISA 500 should take, and the need for, and possible content of, a new ISA on evaluating audit evidence and forming an opinion.
- The status of the Glossary and the consistency between it and the redrafted ISAs.

Mr Kellas noted that the Steering Committee had discussed a tentative 2006-2008 project timetable and that this would be made available publicly after further consideration by staff.

Mr Kellas reiterated that the priority for the IAASB at this point was to reach agreement at the September meeting on the matters of principle in relation to objectives, and hence to approve the revised Preface.

#### **4. Materiality and Misstatements**

Ms Esdon led the discussion of proposed ISA 320 (Revised and Redrafted), "Materiality in the Identification and Evaluation of Misstatements" and ISA 450 (Redrafted), "Evaluation of Misstatements Identified during the Audit."

##### *ISA 320 (Revised)*

Members' comments included the following:

- Concern was expressed that the use of the present tense in an introductory paragraph (paragraph 7) of the proposed revised ISA could be interpreted as requiring action by the auditor. Concern was also expressed about the use of the word "important" in the application material. It was noted that the present tense may be used in descriptions of existing requirements. The task force was asked to ensure that present tense statements and application material containing the word "important" are descriptions of or can be linked to existing requirements. (A similar comment was made in the context of ISA 450.)
- As drafted, the objective (paragraph 8) referred only to the fact that the auditor determines a materiality level or levels, while the proposed revised ISA also deals with the auditor's consideration of the materiality level or levels as the audit progresses. It was agreed that the objective should be expanded to include the latter.
- A member suggested amendments to the considerations specific to public sector entities in the application material (paragraph A2) to link the guidance more closely with the audit of financial statements.

- Concern was expressed that the guidance on use of benchmarks (paragraphs A3-A7) may be read as implying that a benchmark is always used in determining materiality for the financial statements as a whole. Messrs Fogarty and Kellas suggested minor amendments to the text to address this concern.

### ISA 450

The members' comments included the following:

- It was noted that the objective (paragraph 3) referred to the evaluation of *uncorrected* misstatements, while the proposed ISA deals with the accumulation of misstatements, considerations as the audit progresses, communication and correction of misstatements, and the evaluation of uncorrected misstatements. It was suggested that "uncorrected" be deleted.
- It was suggested that the definition of "fraud" (paragraph 4(c)) be aligned with that in other "clarified" ISAs.
- It was suggested that the statement that it may be necessary for management to examine a class of transactions, account balance or disclosure to identify corrected misstatements therein (paragraph 8) be further clarified in the application material. The IAASB previously agreed that this statement is not limited to projected misstatements.
- It was noted that the requirement for the auditor to obtain a written representation from management (paragraph 11) did not align with the requirement for the auditor to communicate with those charged with governance (paragraph 12) and with the related application material. Paragraph 11 did not recognize the fact that uncorrected misstatements may be material or that management may not agree that an uncorrected misstatement is in fact a misstatement. The task force was asked to align the requirements and application material.
- It was also noted that the requirement for the auditor to obtain a written representation from management may have to be amended as a result of the upcoming revision of ISA 580, "Management Representations." It was suggested that this be treated as a conforming amendment to ISA 450 (Redrafted) when ISA 580 (Revised and Redrafted) is completed.
- Referring to the requirements for the auditor to evaluate the effect of uncorrected misstatements, it was suggested that some of the related application material (paragraph A13) (stated in the present tense in the close off document) be moved to the requirements section (paragraph 15). A small majority of IAASB members were of the view that the requirement should be for the auditor to specifically consider each misstatement separately to evaluate its effect on the relevant classes of transactions, account balances or disclosures, whether it is appropriate to offset misstatements, and the financial effect of classification misstatements.
- It was suggested that the requirement for the auditor to consider the effect of uncorrected misstatements related to prior periods (paragraph 16) be expanded to refer to the fact that the auditor should apply the same approach from period to period.
- The task force was asked to reconsider the placement of requirements dealing with communication with those charged with governance (in particular that in paragraph 16).
- It was suggested that the requirement for the auditor to document all misstatements accumulated during the audit (paragraph 19(b)) be expanded to indicate that the documentation should

distinguish between factual, judgmental and projected misstatements. Although this was implied in the application material, it was not linked to a requirement. However, it was stated in the present tense in the close off document.

- Referring to the statement in the application material that the auditor cannot simply assume that a misstatement is an isolated occurrence (paragraph A3), a question was asked whether a requirement exists in the ISAs for the auditor to consider the consequences of misstatements identified during the audit. Although implied by paragraph 6, an explicit requirement may be necessary.

The task force was asked to revise the proposed ISAs based on the IAASB's comments and to submit them for approval at the October 2006 meeting.

## 5. Experts

Mr Ferlings led the discussion of the Issues Paper and draft ISA. The IAASB was asked to provide the task force with guidance in relation to the issues and to the flow and wording of the draft ISA.

### ENGAGEMENT TEAM AND INDEPENDENCE

Mr Ferlings explained that it was not entirely clear to the task force whether, under the existing definition of "engagement team" in ISQC 1, all internal and external experts involved in an audit engagement, including those who are only peripherally involved, should be considered a part of the engagement team. As well as affecting the application of ISQC 1 and those ISAs that use this term (e.g., ISAs 220, 240 and 315), it was noted that this definition has significant independence implications since it appears in the IFAC Code of Ethics. The task force has therefore commenced liaison with the independence task force of the International Ethics Standards Board for Accountants (IESBA) in this regard.

The IAASB debated the task force's suggestion of differentiating between internal and external experts by excluding external experts from the definition of engagement team and, therefore, from ISQC 1 and the ISAs except ISA 620. It was noted that the effect of this approach would be consistent with some national equivalents of ISA 620 that deal only with external experts because internal experts are dealt with under quality control standards. The IAASB questioned whether the contractual/employment relationship with the expert should be a primary criterion for determining how the auditor is to deal with an expert's work, or whether other criteria, such as the nature of the expert's work and the significance of the matter to which it relates, should be the overriding determinants. It was noted that differentiating between internal and external experts appeared inconsistent with the IAASB's decision in an analogous situation in ISA 600 not to distinguish between related and unrelated auditors. It was also noted that ISQC 1 and ISA 220 are sufficiently flexible to allow for the necessary differences of approach to the auditor's review, supervision and direction of an external expert versus an internal expert.

It was agreed that ISA 620 should essentially treat internal and external experts in the same way, but that the extent to which the expert is subject to quality control procedures under ISQC 1 and ISA 220 would influence the nature, timing and extent of procedures the auditor will perform with respect to the expert's work. Also, while the IAASB was of the view that the definition of "engagement team" does not need to be changed for the purpose of ISQC 1 and the ISAs, it acknowledged that IESBA may need to change it for the purpose of the Code. The task force was, therefore, asked to continue

liaising with the IESBA's independence task force and to consider how any change to the definition that IESBA may consider necessary for the Code would affect ISQC 1 and the ISAs. Mr Sylph agreed to draw this matter to the attention of IESBA and to report back on the priority it is receiving.

#### PRINCIPAL EVIDENCE

The IAASB debated the task force's proposal to introduce a new concept of "principal evidence" to identify a cut off point beyond which certain procedures would be required to be performed by the auditor. The task force defined principal evidence as evidence that is critical to support the auditor's conclusions regarding a significant risk.

The IAASB concluded that the concept of "principal evidence" was an unnecessary complication. It was agreed that instead, the ISA should adopt a "sliding scale" approach whereby the nature, timing and extent of the auditor's procedures would be determined by such factors as the nature of the expert's work and the significance of the matter to which it relates. It was also agreed that many of the procedures required by the current draft only when the expert provided "principal evidence", should actually be performed in nearly all cases where an expert is used; however, the emphasis to be given to different procedures and the extent to which they are performed will vary significantly with the circumstances. The task force was asked to consider how ISAs 600 and 330 have dealt with similar concepts, and to be consistent with them where possible. The IAASB agreed that a sliding scale approach is also appropriate to the nature and extent of documentation, and that the ISA should require specific documentation only when involvement of the expert is significant to the auditor's conclusions on a material matter.

#### OTHER ISSUES

The IAASB also agreed that:

- Obtaining an appropriate representation from an expert may often assist the auditor in evaluating the expert's objectivity, which affects the reliability of the evidence the expert provides.
- The ISA should not deal with engagement acceptance issues as they are adequately dealt with in ISQC 1.
- The task force should review ISA 315's coverage of the risks of material misstatement due to management's need for expertise in preparing the financial statements, rather than dealing with this topic in ISA 620.
- The ISA should require the auditor to determine whether an auditor's expert is needed; however, there is no need for requirements in circumstances where an auditor's expert is not needed even though expertise has been applied in the preparation of the financial statements.

### **6. The Auditor's Report on Summary Financial Statements Derived from Audited Financial Statements**

Mr Dutt led the discussion of the summary of significant comments on the exposure draft of proposed ISA 800, "The Independent Auditor's Report on Summary Audited Financial Statements" and the task force's recommendations. The IAASB also reviewed a revised proposed ISA 800.

The IAASB debated whether the requirements and guidance for reports on summary financial information should be retained within the ISAs. A small number of members did not agree with the

task force that an engagement to report on summary financial information is in fact an audit because it is based on the audit of the financial statements from which it is derived. They referred to the fact that the report does not contain an audit opinion. They were also concerned that users may conclude that the auditor has obtained a higher level of assurance than what in reality is the case. Mr Kellas was of the view that the classification of the requirements and guidance within IAASB's standards would not affect the users of the report. Of importance is the wording in the report. The nature of the engagement should be clarified in the report.

The IAASB debated the task force's recommendation that, where established criteria for preparing summary financial information do not exist, the auditor should accept the engagement only when management's criteria for preparing summary financial information result in the summary financial information that meets the conditions of paragraph 11 of the revised proposed ISA. This includes disclosure of management's criteria in the summary financial information. Some members were of the view that management would not develop criteria for preparing summary financial information and that paragraph 11 in fact sets out the criteria to be applied by management when established criteria do not exist. Other members were of the view that, according to the International Framework for Assurance Engagements, where established criteria do not exist, management has to develop such criteria and that the criteria have to be available to the intended users. Mr Dutt clarified that paragraph 11 is the basis on which the auditor would evaluate the criteria (established or otherwise) applied by management in preparing the summary financial information. They were not intended to be management's criteria – the IAASB could not take the role of the accounting standard setter. The task force was asked to consider examples of summary financial information and related reports issued in various jurisdictions in considering this point further.

The IAASB debated the task force's recommendation with regard to the form of opinion on summary financial information. Two alternatives were presented during the meeting: (1) "... the summary financial statements derived from the audited financial statements are *a fair summary* of those financial statements in accordance with the criteria set out in Note x;" and (2) "... the summary financial statements derived from the audited financial statements in accordance with the criteria set out in Note x are *consistent* with those financial statements." A small majority of members preferred alternative (1). One member noted that it was not possible to make a decision until the outcome of the debate on management's criteria is known. It was agreed that the revised proposed ISA should reflect alternative (1).

Mr Kellas questioned whether it is necessary to disclose in the summary financial information the law or regulation in accordance with which the audited financial statements from which the summary financial information is derived need not be made available to the intended users of the summary financial information. This seemed to him to be the IAASB seeking to override national law and regulation, and promoting the view that it would never be reasonable to use the summary statements on their own. There may be perfectly good reasons why summary statements are sufficient for certain purposes, but it would be important for users to understand that they were not the same as full financial statements. Accordingly, it is important for the report to state clearly that the summary financial information is not a substitute for the audited financial statements.

In addition to the above, other comments on the revised proposed ISA included the following:

- Concern was expressed about the requirements and guidance for engagement acceptance. They were considered to be overly complicated for this type of engagement. They overemphasized the criteria for preparing summary financial information, while such criteria may not exist.
- It was noted that the procedures to be performed by the auditor as prescribed in paragraph 14 may be interpreted as a complete list of procedures, while the auditor may also perform other procedures.
- With regard to the auditor's procedures, the meaning of the word "recalculate" was questioned. The task force was asked to consider clarifying its meaning.
- It was suggested that the auditor's report might be simplified. It was agreed that the requirement to identify management should be deleted. It was also agreed to delete the reference to the planning and performing of the engagement in the statement of the auditor's responsibility. It was questioned why the statement of the auditor's responsibility does not include a reference to ethical requirements.
- The task force was asked to consider deleting the guidance on restriction on distribution. Some members found the guidance confusing.
- Referring to the requirements and guidance on auditor association, it was questioned whether the auditor should allow use of the auditor's name or reference to the fact that the summary financial information is derived from the audited financial statements when the auditor has not reported on the summary financial information. A member was of the view that any reference to the auditor, irrespective of the circumstances, is misleading when the auditor has not reported on the summary financial information.

The task force was asked to take account of the IAASB's comments and to submit a close off document for approval at the December 2006 meeting.

## **7. Material Weaknesses**

Mr Ashton noted that even though the task force had identified different approaches to defining or describing material weaknesses around the world, the issues surrounding the meaning of a "material weakness" were reasonably focused. He highlighted the principal differences between an "ISA audit" and an "integrated audit" in relation to material weaknesses. It was noted that care should be exercised in referring to the term "ISA audit" as it could suggest that the IAASB had defined such a term. Mr Ashton then led a discussion of significant issues.

### **FACTORS TO CONSIDER IN IDENTIFYING MATERIAL WEAKNESSES**

The IAASB generally supported the provision of enhanced guidance in terms of factors the auditor might consider in identifying material weaknesses. It was noted that the discussion of factors could be related more broadly to such aspects as an ineffective control environment, the entity's risk assessment process and errors in the preparation of the financial statements more generally, and not be limited to consideration of actual misstatements only. A member observed that the provision of such guidance may not be straightforward because these factors tend to be judgmental. Therefore, those to whom the auditor is reporting would need to understand the limited nature of the matters being reported.

Mr Rabine reported on the discussions held at the EC regarding the topic and indicated that the term “material weakness” is used in the EC’s 8<sup>th</sup> directive but is undefined. The EC thus supported the provision of further guidance. He also emphasized that such guidance should be framework-neutral, and a simple approach should be adopted. Dr Yamaura also gave an overview of the approach to internal control reporting in Japan and suggested that the concept of “significant deficiencies” should be avoided as it could be confusing to practitioners in Japan.

#### DEFINITION OF A CONTROL DEFICIENCY

In relation to the task force’s proposal to define “control deficiency” as a generic control problem, the IAASB generally agreed that it would be helpful to have a term to describe a control issue that is at a lower level than a material weakness. It was, however, noted that care should be taken in using terms similar to those used in the PCAOB’s Auditing Standard 2, unless the same definitions were adopted. The IAASB agreed that where common terms are used in audits performed under ISAs and PCAOB standards, the task force should try to understand whether there are good reasons for having different definitions.

#### CONSIDERATION OF THE EFFECTS OF A MATERIAL WEAKNESS ON THE CURRENT PERIOD FINANCIAL STATEMENTS

The task force proposed that the definition of material weakness should be related only to consideration of potential material misstatements that could arise for the current period financial statements being audited.

Some concern was raised regarding this approach in that it could lead to indications of potentially serious issues in future not being reported by the auditor on the ground that such indications did not give rise to material misstatements in the current period. Mr Ashton noted that consideration of the requirements and guidance in other ISAs might apply in such situations, such as the requirement to perform some forward-looking evaluation under the going concern standard. The IAASB generally agreed that the evaluation of the materiality of identified weaknesses should be made in the context of knowledge of the entity’s circumstances and not on whether a material misstatement did in fact arise.

A member questioned whether the auditor would report an identified material weakness in the case of a lending institution that has loose lending controls even though no material misstatement has arisen in the current period. It was observed that this situation should be covered by the entity’s risk assessment process, as it would represent a business risk that the entity should be controlling. There was a clear view that such an issue should be reported to those charged with governance even if it does not constitute a material weakness in relation to the financial statements being audited. The IAASB asked the task force to consider this further.

One member cautioned against trying to define a material weakness precisely because, in an audit performed under the ISAs, the determination of whether an identified control issue is a material weakness is heavily dependent on the auditor’s judgment.

#### LIKELIHOOD VS. RISK OF MATERIAL MISSTATEMENT

The task force proposed to clarify the definition of a material weakness in terms of the likelihood or risk of a material misstatement occurring, and suggested a preference for a risk-based approach. Some members were of the view that a likelihood approach would be more appropriate on the

ground that it would be more straightforward to refer to the probability of occurrence than not reducing the risk to an acceptably low level. In addition, the risk approach used audit terminology, which would seem inconsistent with reporting material weaknesses from management's perspective. Other members supported the risk approach because auditors work with a risk-based approach in the ISAs and material weaknesses are only relevant insofar as they affect the financial statements. In addition, the risk approach would be consistent with the risk-based approach management would use for internal control. The IAASB generally agreed that both approaches would lead to the same result. Accordingly, the guidance could indicate that the outcome of one construct would not be different from that of the other.

#### LEVEL AT WHICH WEAKNESSES ARE TO BE REPORTED

The IAASB generally agreed that "material weakness" could continue to be defined at the level of a material misstatement. It was, however, noted that in the U.S., the AICPA's Auditing Standards Board had in the past created a category called "reportable conditions" at a lower reporting threshold. This was based on research evidence that suggested that practitioners were not reporting material weaknesses because these were viewed as extreme events. In view of this, it was questioned whether there was a need to define material weaknesses. It was noted that, since ISAs do not establish an external reporting requirement for material weaknesses, the IAASB could consider not defining them and, instead, consider defining the point at which there is an internal requirement to communicate reportable conditions to management and those charged with governance. Further, it was argued that it would not be in the public interest for the ISAs to require the reporting of only those weaknesses at the very serious level that would be reported to the outside world were there to be a public reporting standard.

Mr Ashton noted that changing the reporting level would be viewed as a change in the scope of this project. In addition, consideration would need to be given to any potential unintended consequences of doing so. In particular, if the term "material weakness" were no longer to be used in the ISAs, there would be a risk of regulators around the world creating a confusing array of definitions of that term for their own purposes.

The IAASB concluded that the reporting threshold should be lowered to include weaknesses at the intermediate level, as this would appear to be the level at which auditors are currently reporting in practice anyway. Such a category should be suitably described, with a subset being material weaknesses. The task force should also define material weaknesses to ensure consistency of practice. In addition, a definition of material weakness would support the requirement in the EC's 8<sup>th</sup> Directive for auditors to report material weaknesses. One member cautioned against attempting to define the different categories of weaknesses precisely as it could make auditors' task of categorizing the weaknesses unnecessarily difficult.

#### OTHER ISSUES

The IAASB also agreed the following:

- It would be helpful for guidance to explain that identified weaknesses are not to be evaluated in isolation but should be considered together where appropriate.

- Weaknesses that management has not remediated on cost-benefit grounds should be reported for the record but without the auditor making a judgment on management's cost-benefit analysis.
- Where weaknesses have been identified as a result of actual misstatements, the auditor's communication of the weaknesses should include quantification of such misstatements for information.
- The task force should consider whether it should be left to the auditor's judgment to decide to report a matter that has already been reported by others (whether in a different form or under different circumstances).
- It should be left to the auditor's judgment to decide whether to report weaknesses that have been remediated by the completion of the audit, depending on such considerations as the importance of the matter to those charged with governance and whether the auditor has had time to test the operating effectiveness of the relevant controls.
- The task force should consider highlighting the context in which the auditor is reporting weaknesses, particularly the limitation of the assurance provided on the controls and the fact that the report is a derivative product of the audit.
- ISA 720 could be amended to include guidance to address consideration of internal control statements made by management or those charged with governance in documents containing the financial statements. Such statements would fall under the "material misstatements of fact" rubric in ISA 720, and the necessary amendment to this ISA could be made when it is redrafted under the clarity project.

#### WAY FORWARD

To facilitate the development of the relevant requirements and guidance, the IAASB agreed that the task force could create a new ISA immediately after ISA 315. Mr Ashton will present the IAASB's preliminary decisions on this project to the IAASB CAG in September and report back on the CAG's input at the October IAASB meeting.

#### **8. Written Representations**

Mr Fogarty led the discussion of the paper submitted by the task force. The paper was prepared to address the issues raised by CAG representatives at the CAG meeting in May 2006. Mr Fogarty noted that the CAG discussion generated many views in relation to the task force's proposals. He then reminded the members of a comment made in an earlier discussion, that certain management representations could be viewed as an expression of the auditor's expectations to be met for a successful completion of the audit. In light of this view, representations are not the auditor's way of instructing management what it should do, but, rather, evidence about what management does and believes in relation to the assumptions underlying the financial statements. Where general representations have not been obtained, adjusting the level of work will not replace them and, similarly, representations cannot be used to reduce the level of the auditor's effort. However, the failure to obtain general representations means that the assumptions underlying management activities and beliefs that are necessary for the performance of an audit of financial statements have not been met.

Mr Fogarty then asked the IAASB to discuss the issues addressed in the paper, (a) the effect of obtaining written representations on the auditor's responsibility to obtain sufficient appropriate audit evidence, (b) the appropriateness of effectively "establishing" management responsibilities in an auditing standard, (c) the meaning of failure to obtain general written representations, and (d) the meaning of materiality in relation to written representations.

A technical advisor asked whether the task force viewed general representations as audit evidence, and whether the task force still believed that the auditor should issue a disclaimer when management refuses to provide the required representations. Mr Fogarty replied that the process of obtaining representations is evidence. Where management shows unwillingness to provide a representation, this is an indication that a problem may exist. Where management refuses to provide general representations, the assumptions underlying management activities and beliefs that are necessary for the performance of an audit of financial statements have not been met and the auditor moves to another form of activity because additional audit work does not solve the problem.

Another member asked about the purpose of specific representations. Mr Fogarty explained that no specific representations would be specified as requirements and their use by auditors would be as judged necessary by the auditor. Where a specific representation, that the auditor determined was necessary, was not obtained, the auditor would assess the effect on the report.

Another member argued that there was an inherent contradiction in the requirement to issue a disclaimer when general representations have not been obtained because management had already acknowledged the responsibility for the financial statements in the engagement letter. Mr Fogarty replied that management acknowledges the responsibility in the engagement letter but provides representations about the fulfillment of that responsibility in the representations letter. It was noted that the linkage between the engagement and representation letter would not be possible in the public sector because engagement letters are not used. Mr Fogarty replied that auditors in the public sector have a different authority because the auditor often has the force of law and a careful thought would have to be given to the application of this ISA in the public sector.

Three members argued that in some jurisdictions, when directors sign the financial statements, they assume all responsibility for the statements under law and should not be required to sign additional representations about it. Mr Fogarty reiterated that value for the auditor is in the process of obtaining the representations. It was further argued that directors would have to obtain legal advice on this requirement. Mr Fogarty replied that the process is about confirming that the assumptions underlying management activities and beliefs that are necessary for the performance of an audit of financial statements have been met.

Mr Kellas asked whether it was reasonable to issue a disclaimer in circumstances, where, for example, lawyers change the wording of required representations. Mr Fogarty stated that the significance of representations should not be underestimated and the IAASB should defend the notion of fundamental tenets of an audit, including the combination of acceptance and fulfillment of management responsibilities.

Other members then expressed their doubts in relation to the required disclaimer when general representations have not been obtained. Mr Fogarty replied that the initial task force's approach was perhaps severe; however, the task force accepted that some flexibility was needed in this respect. Mr Fogarty then asked whether the IAASB agreed with the task force's views.

It was proposed to discuss the issue of general representations with members of the business community. Mr Damant added that the IAASB CAG had already begun such dialogue. It was also suggested that the dialogue could also be facilitated through PAIB. Other participants noted that communication prior to exposure is important, but should not be done prior to the IAASB having a clear picture as to what would be proposed.

Other members expressed their support for the direction of the project and proposed some improvements, including the following:

- Considering the implications when the terms of engagement are signed by the audit committee and representations by a relevant person.
- Whether it would be possible to provide further explanation of the link between the engagement and representation letters.
- Whether it would be beneficial to include the guidance on who should sign the letter in the terms of engagement.
- Use of the term “materiality” in relation to written representations should be reconsidered and the requirement should be relegated to the application material because it relates primarily to specific representations. Further, it should be made clear that such “materiality” would be different for different items for which a specific representation is requested. Also, the term used should not imply that it is “tolerable error.”

Mr Fogarty noted that the task force appreciated the views expressed by the IAASB and would meet the following day to work on the draft ED and present the ED possibly at the October meeting.

## **9. Convergence**

Mr Kellas led the discussion of “Modifications to IAASB’s International Standards – A Guide for National Standards Setters Who Adopt These Standards,” amended to reflect comments received at the previous IAASB meeting. The IAASB briefly discussed the paper and agreed two changes, including the deletion of paragraph 15 dealing with the position of the individual auditor which may conflict with the Preface as currently drafted.

The IAASB unanimously approved the guide.

## **10. PIOB Observer Comments**

Prior to his departure, Mr Schilder commented on the IAASB's professional approach, as noted in the PIOB's first annual report. He emphasized the importance of integrity and an open-minded approach to debates of issues, including (where appropriate) challenging previous decisions.

Mr Schilder noted that the IAASB's agenda is ambitious and, therefore, requires commitment, hard work and effective communication with stakeholders.

He briefly addressed the composition of the IAASB and noted the variety of inputs which could be obtained through an appropriate balance of practitioners and non-practitioners.

## **11. Next Meeting**

The next meeting of the IAASB has been scheduled for September 18-22, 2006 in Montreal.

## **12. Closing Remarks**

Mr Kellas thanked the Institut des Reviseurs d'Entreprises for hosting the meeting, and its staff for the assistance offered with the meeting arrangements.

Mr Kellas closed the meeting.