

IAASB CLARITY PROJECT

ISA – 265

ISA – 450

ISA – 320

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CLARITY PROJECT

Institute of Chartered Accountants of Pakistan

CLARITY PROJECT

Overview

- ▶ To improve the quality of International Standards on Auditing (ISAs), the International Auditing and Assurance Standard Board (IAASB) started a project known as Clarity Project in 2004
- ▶ The project was completed in 2009

CLARITY PROJECT (Cont...)

Overview (Cont...)

- ▶ General improvements arising from the project include:
 - ▶ Identification of auditor's overall objective with respect to the ISA
 - ▶ Clarifying the requirements of the ISA, Improving overall readability and understandability of the ISAs through structural and drafting improvements
 - ▶ Includes considerations specific to public sector and smaller entities. [e.g. ISA 320 "Materiality" explains that profit before taxation might be the best basis for materiality. However, in case of owners managed entities (Small entities) where owners take much of the profit in the form of remuneration, a benchmark such as profit before remuneration and taxation may be more relevant]

CLARITY PROJECT (Cont...)

Why are changes important?

- ▶ Changes will lead to more consistency in the application of ISAs
- ▶ ISAs will be accepted globally (especially in jurisdictions where ISAs are not followed)
- ▶ It will improve the quality of audit

(Audit firms will have to update their audit methodology in line with the clarity project)

CLARITY PROJECT (Cont...)

New set of ISAs

As a result of the project:

- ▶ 2 new ISAs have been issued
- ▶ 15 ISAs have been revised
- ▶ 20 ISAs have been redrafted

The new set of ISAs will be effective for audit of financial statements for periods beginning on or after 15 December 2009.

CLARITY PROJECT (Cont...)

Clarity convention changes

- ▶ At present, the ISAs include:
 - ▶ Bold text (must follow) which explains the key requirements
 - ▶ Normal text containing explanatory guidance in relation to bold text
- ▶ For instance ISA 500 “Audit Evidence” requires that:
“The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusion on which to base the audit opinion”
- ▶ However, obtaining audit evidence is a professional judgment of the auditor

CLARITY PROJECT (Cont...)

Clarity convention changes (Cont...)

However, as a result of the clarity project, all ISAs are now divided into the following headings:

- ▶ Scope
- ▶ Objective
- ▶ Definitions
- ▶ Requirements **(must follow)**
- ▶ Application and Other Explanatory Material
(explaining the requirements in detail)

CLARITY PROJECT (Cont...)

New Standards

- ▶ **ISA 265** – "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management"
- ▶ **ISA 450** – "Evaluation of misstatements identified during the audit"

CLARITY PROJECT (Cont...)

Revised Standards

- ▶ **ISA 200** – "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing"
- ▶ **ISA 260** – "Communication with Those Charged With Governance"
- ▶ **ISA 320** – "Materiality in Planning and Performing an Audit"
- ▶ **ISA 402** – "Audit Considerations Relating to an Entity Using a Third Party Service Organization"
- ▶ **ISA 505** – "External Confirmations"
- ▶ **ISA 540** – "Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures"
- ▶ **ISA 550** - "Related Parties"
- ▶ **ISA 580** – "Written Representations"

CLARITY PROJECT (Cont...)

Revised Standards (Cont. . .)

- ▶ **ISA 600** – “Special Considerations – Audits of Group Financial Statements (including the work of Component Auditors)”
- ▶ **ISA 620** – “Using the work of an Auditor’s Expert”
- ▶ **ISA 705** – “Modifications to the Opinion in the Independent Auditor’s Report”
- ▶ **ISA 706** - “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report”
- ▶ **ISA 800** – “Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks”
- ▶ **ISA 805** – “Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statements
- ▶ **ISA 810** – “Engagements to Report on Summary Financial Statements”

CLARITY PROJECT (Cont...)

Redrafted Standards

- ▶ **ISQC 1** – “Quality Control for Firms that Perform Audit and Reviews of Financial Statements, and Other Assurance and Related Service Engagements”
- ▶ **ISA 210** – “Agreeing the Terms of Engagements”
- ▶ **ISA 220** – “Quality Control for an Audit of Financial Statements”
- ▶ **ISA 230** – “Audit Documentation”
- ▶ **ISA 240** – “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”
- ▶ **ISA 250** – “Consideration of Laws and Regulations in an Audit of Financial Statements”
- ▶ **ISA 300** – “Planning an Audit of Financial Statements”
- ▶ **ISA 315** – “Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its environment”
- ▶ **ISA 330** – “The Auditor’s Responses to Assessed Risks”
- ▶ **ISA 500** – “Audit Evidence”

CLARITY PROJECT (Cont...)

Redrafted Standards (Cont. . .)

- ▶ **ISA 501** – "Audit Evidence – Specific Considerations for selected items"
- ▶ **ISA 510** – "Initial Audit Engagements – Opening Balances"
- ▶ **ISA 520** – "Analytical Procedures"
- ▶ **ISA 530** – "Audit Sampling"
- ▶ **ISA 560** – "Subsequent Events"
- ▶ **ISA 570** – "Going Concern"
- ▶ **ISA 610** – "Using the work of Internal Auditors"
- ▶ **ISA 700** – "Forming an Opinion and Reporting on Financial Statements"
- ▶ **ISA 710** – "Comparative Information – Corresponding Figures and Comparative Financial Statements"
- ▶ **ISA 720** – "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements"

NEW STANDARDS

ISA 265 – “Communicating Deficiencies in Internal Control to Those Charged with Governance and Management”

- ▶ Scope and context for developing the standard
- ▶ Definitions
- ▶ Requirements
- ▶ Conclusion

ISA 265 (Cont...)

Scope and context for developing the standard

- ▶ This standard deals with the auditor's responsibility to communicate deficiencies in internal control that the auditor has identified in an audit of financial statements to the management and those charged with governance
- ▶ This standard is an extension of ISA 315 – “Understanding the entity and its environment and assessing the risks of material misstatement” and ISA 330 – “The auditor's procedures in response to assessed risks”
- ▶ ISA 260 – Communication of Audit Matters with those charged with governance” will still be applicable for communication to those charged with governance in relation to audit

ISA 265 (Cont...)

Scope and context for developing the standard (Cont...)

- ▶ An important part of the auditor's communication responsibilities under the old ISAs was the communication of material weaknesses in internal control noted during the audit. During the clarity project, the IAASB resolved to clarify the definition of the term "material weakness". It recognized that this definition was rather general

ISA 265 (Cont...)

Definitions

- ▶ Term material weakness no longer used in the ISAs
- ▶ Standard introduces two new terms:
 - ▶ A deficiency in internal control
 - ▶ A significant deficiency
- ▶ No longer a requirement to communicate material weaknesses in the ISA, but a requirement to communicate significant deficiencies

ISA 265 (Cont...)

Definitions (Cont...)

Deficiency in internal control

- ▶ A control is designed, implemented, or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis, or
- ▶ A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing

ISA 265 (Cont...)

Definitions (Cont...)

Significant deficiency

A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance

Material weakness (as per old ISA)

A weakness in internal control that could have a material effect on the financial statements

ISA 265 (Cont...)

Requirements

- ▶ The Auditor shall determine whether on the basis of the work performed, he has identified any deficiency or significant deficiency in internal controls (**combination of deficiencies could result in significant deficiency**)

ISA 265 (Cont...)

Requirements (Cont...)

- ▶ The auditor shall communicate in writing to the management:
 - ▶ **significant deficiencies** in internal control. This requirement also applies if significant deficiencies have been communicated in prior audit but no remedial action has been taken
 - ▶ **Other deficiencies** in internal control identified during the audit that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. No requirement to communicate other deficiencies to management in writing and deficiencies that have been already communicated to management by the auditor or other parties even if no remedial action has been taken

ISA 265 (cont...)

Requirements (Cont...)

- ▶ If the auditor considers it inappropriate communicate with management in circumstances where he suspects the management of fraud or other irregularity, he is required to communicate **significant deficiencies** or a combination of deficiencies to those charged with governance on a timely basis in sufficient detail so as to enable them to discharge their oversight responsibilities

ISA 265 (Cont...)

Requirements (Cont...)

Content of written communication

- ▶ Description of the significant deficiencies
- ▶ An explanation of their potential effects
- ▶ Management response

Following information should also be communicated:

- ▶ Purpose of audit
- ▶ Audit does not include expression of opinion on effectiveness of internal control
- ▶ Significant deficiencies reported limited to those identified during the audit

ISA 265 (Cont...)

Conclusion

- ▶ IAASB does not intend that further work be performed beyond practice of communicating material weaknesses under old standards
- ▶ Significant deficiency regarded as being at the same level of significance as material weakness under old standards
- ▶ No expectation that new standard should result in reporting of more matters than would have been the case with material weaknesses under old standards

ISA 450 – "Evaluation of misstatements identified during the audit"

- ▶ Scope and context for developing the standard
- ▶ Definitions
- ▶ Requirements
- ▶ Conclusion

ISA 450 (Cont...)

Scope and context for developing the standard

- ▶ This standard deals with the auditor's responsibility to evaluate:
 - ▶ the effect of identified misstatements on the audit; and
 - ▶ the effect of uncorrected misstatements, if any, on the financial statements
- ▶ The auditor's conclusion under ISA 700 "Forming an audit opinion and reporting on financial statements" requires that financial statements are free from material misstatements (both identified and uncorrected)
- ▶ Whether the misstatement is material or not is determined under ISA 320 "Materiality in planning and performing an audit"

ISA 450 (Cont...)

Definitions

Misstatement

- ▶ A difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. **(For example a portfolio of shares in which there is evidence of short term profit taking is classified as Available for Sale whereas it should be classified as at fair value through profit and loss)**
- ▶ Such a difference can arise from fraud or error. **(For example a misstatement may arise due to fraudulent financial statements relating to revenue recognition)**

ISA 450 (Cont...)

Definitions (Cont. . .)

Uncorrected misstatements

These are misstatements that the auditor has accumulated during the audit and that have not been corrected

ISA 450 (Cont...)

Requirements (Cont...)

Accumulation of identified misstatements

- ▶ All identified misstatements other than clearly trivial should be accumulated. A misstatement is classified as clearly trivial where the auditor expects that accumulation of such amounts would not have a material effect on the financial statements
- ▶ Clearly trivial is not another expression for not material. The auditor expects such matters to be inconsequential. In case of an uncertainty about whether a matter is clearly trivial, it is considered not to be clearly trivial

ISA 450 (Cont...)

Requirements (Cont. . .)

- ▶ To evaluate the effect of misstatements, the auditor may classify the misstatements into factual misstatements, judgmental misstatements and projected misstatements

ISA 450 (Cont...)

Requirements (Cont. . .)

- ▶ **Factual misstatements** are misstatements about which there is no doubt. For example, revaluation gain on an AFS financial instrument is taken to income statement
- ▶ **Judgmental misstatements** are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable. For example, charging depreciation on computer equipment at a rate of 10% would be inadequate
- ▶ **Projected misstatements** are the auditor's best estimate of misstatements in population, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn

ISA 450 (Cont...)

Requirements (Cont. . .)

Consideration of identified misstatements

- ▶ During the audit, the auditor shall consider the effect of identified misstatements on the audit process. Revision in the overall audit strategy and the audit plan are needed if:
 - ▶ The accumulated misstatements approaches materiality threshold. If such is the case, there is a risk that possible undetected misstatements could exceed materiality. Risk of undetected misstatement arises due to sampling risk (size of misstatement)
 - ▶ Nature of identified misstatements indicate that aggregated misstatements could be material because existence of a misstatement may be an evidence that other misstatements may exist. For example where the auditor identifies that a misstatement arose from a break down in internal control (nature of misstatement)

ISA 450 (Cont...)

Requirements (Cont. . .)

- ▶ If as a result of a request by auditor, management has examined and corrected identified misstatements, the auditor is required to perform additional audit procedures to determine whether misstatements remain

ISA 450 (Cont...)

Requirements (Cont. . .)

Communication and correction of misstatement

- ▶ The auditor is required to communicate on a timely basis and all misstatements accumulated during the audit to an appropriate level of management (**unless prohibited by law or regulation**)
- ▶ The auditor is also required to request the management to correct those misstatements
- ▶ Management may refuse to correct misstatements communicated by the auditor. If the management does so, the auditor is required to obtain an understanding of the reason for not making the correction
- ▶ The auditor shall also consider the impact of not making the correction on the audit opinion

ISA 450 (Cont...)

Requirements (Cont. . .)

Evaluating the effect of uncorrected misstatements

- ▶ While evaluating the effect of uncorrected misstatements, the auditor is required to reassess materiality thresholds to ensure that it remains appropriate in the circumstances
- ▶ The requirement to reassess materiality entails from the fact that materiality is often based on estimated financial results and may not remain appropriate as the audit progresses and actual results are known. Therefore, materiality should be adjusted for actual figures

ISA 450 (Cont...)

Requirements (Cont. . .)

- ▶ The auditor shall determine whether uncorrected misstatements are material. In making this determination, the auditor shall consider:
 - ▶ Size and nature of misstatements
 - ▶ The effect of uncorrected misstatements relating to prior periods

ISA 450 (Cont...)

Requirements (Cont. . .)

Size and nature of misstatements

- ▶ The effect of each misstatement is considered on the relevant class of transaction, account balance and disclosure and the financial statements and taken as a whole (**size of misstatement**)
- ▶ Certain circumstances may cause the auditor to evaluate uncorrected misstatements as material even if they are lower than materiality for financial statements as a whole (**nature of misstatement**). For instance a misstatement may also imply fraud. In such cases, the size of misstatement is not considered and every misstatement is deemed to be material
- ▶ Although it is not possible to design audit procedures to detect misstatements solely on the basis of their nature, the auditor should consider not only the size but the nature of the misstatement

ISA 450 (Cont...)

Requirements (Cont. . .)

- ▶ Individual misstatements cannot be offset against each other unless immaterial
- ▶ Large number of small misstatements

ISA 450 (Cont...)

Requirements (Cont. . .)

Effect of uncorrected misstatements relating to prior periods

- ▶ The auditor is required to evaluate the effect of uncorrected misstatements relating to prior periods on current period's financial statements. The approach adopted should be consistent from period to period

ISA 450 (Cont...)

Requirements (Cont. . .)

Written representations

- ▶ The auditor is required to request a written request from management whether they believe the effects of uncorrected misstatements are immaterial individually or in relation to financial statements as a whole
- ▶ A summary of such items shall be attached to or included in such representation

ISA 450 (Cont...)

Conclusion

- ▶ The IAASB has issued clear guidelines in this standard regarding evaluation of identified and uncorrected material misstatements by the auditor and communication of the same to an appropriate level of management and where necessary to those charged with governance

REVISED STANDARD

ISA 320 – "Materiality in Planning and Performing an Audit"

- ▶ Introduction
- ▶ Definitions
- ▶ Requirements

ISA 320 (Cont...)

Introduction

- ▶ The IAASB, as a result of clarity conventions, has made significant improvements to ISA 320
- ▶ The standard introduces the concept of performance materiality
- ▶ The standard includes specific guidelines including the basis of calculation of materiality

ISA 320 (Cont. . .)

Definitions

Performance materiality

- ▶ Performance materiality means the amount or amounts set by auditor at less than materiality for both financial statements as a whole and for a particular class of transaction, account balance or disclosure to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.
- ▶ IAS 530 “Audit Sampling” also refers performance materiality as tolerable misstatement

Materiality (under old ISA)

- ▶ Information is material if its omission or misstatement could influence the economic decision of the users taken on the basis of financial statements

ISA 320 (Cont. . .)

Requirements

Why materiality is important?

- ▶ ISA 200 – "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing" requires that auditor should obtain sufficient appropriate audit evidence to reduce audit risk to acceptable low level
- ▶ ISA also defines audit risk as the risk that the auditor expresses a wrong opinion when the financial statements are materiality misstated

ISA 320 (Cont. . .)

Requirements

Use of materiality

The concept of materiality is applied through out the audit specially in:

- ▶ Planning and performance of audit (**determining the nature, timing and extent of audit procedures**)
- ▶ Evaluating the effect of identified and uncorrected misstatements
- ▶ Forming of auditor's opinion

ISA 320 (Cont. . .)

Requirements

Use of performance materiality

- ▶ The concept of performance materiality places emphasis on the fact that planning the audit to detect individually material misstatements overlooks the fact that aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and leaves no margin for possible undetected misstatements
- ▶ In order to overcome this problem, the auditor is now required to determine performance materiality for both particular class of transaction, account balance and disclosure and for financial statements as a whole to reduce to an appropriately low level the probability that aggregate of uncorrected and undetected misstatements would exceed materiality

ISA 320 (Cont. . .)

Requirements (Cont. . .)

Application of materiality concept

Materiality is calculated for financial statements taken as a whole. However, the auditor may identify particular classes of transactions, account balances and disclosure for which misstatements of lesser amounts than materiality could be expected to influence the economic decisions of users taken on the basis of financial statements. The auditor considers the following factors:

- ▶ Whether law or regulation or other financial reporting framework affects user expectations regarding the measurement or disclosure of certain items. **(For example related party transactions)**
- ▶ Key disclosures in relation of the industry in which the entity operates

ISA 320 (Cont. . .)

Requirements (Cont. . .)

Calculation of materiality

- ▶ Under the old ISA, information was regarded as material if it affected the economic decision of the user based on the financial statements. However, the old standard did not contain any specific guideline pertaining to the calculation of materiality
- ▶ Although the focus of the revised standard remains on the economic decision of the user taken on the basis of financial statements, the revised standard includes more comprehensive guidelines for the calculation of materiality
- ▶ It uses the benchmark approach for determination of materiality for financial statements as a whole

ISA 320 (Cont. . .)

Requirements (Cont. . .)

- ▶ Under the benchmark approach, a percentage is often applied to a chosen benchmark as a starting point in determining materiality. Determination of such a percentage is a matter of professional judgment. The following factors affect the identification of an appropriate benchmark:
 - ▶ Elements of financial statements (e.g. Assets, Liabilities etc)
 - ▶ Focus areas of the users of financial statements
 - ▶ Nature of the entity, industry and the economic environment
 - ▶ Ownership structure of the entity
 - ▶ The volatility of the chosen benchmark

ISA 320 (Cont. . .)

Requirements (Cont. . .)

The selection of an appropriate benchmark depends on the specific circumstances of the entity. For example:

- ▶ **Profit before tax** is an appropriate benchmark for profit oriented entities
- ▶ **Total revenue** is an appropriate benchmark for companies that do not have a history of profits
- ▶ **Total expenses** is an appropriate benchmark for a company that has not yet commenced its operations
- ▶ **Net assets value** is an appropriate benchmark for mutual funds
- ▶ **Total Equity** is an appropriate benchmark for companies that are facing capital deficiency

THE END