Hong Kong Institute of
Certified Public Accountants
香港會計師公會

5 January 2007

To: **Members of the Hong Kong Institute of CPAs**
**All other interested parties**

# INVITATION TO COMMENT ON IAASB EXPOSURE DRAFTS OF INTERNATIONAL STANDARDS ON AUDITING

## Part A

- **Proposed ISA 230 (Redrafted), *Audit Documentation***
- **Proposed ISA 560 (Redrafted), *Subsequent Events***
- **Proposed ISA 610 (Redrafted), *The Auditor's Consideration of the Internal Audit Function***
- **Proposed ISA 720 (Redrafted), *The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements***

***Comments to be received by 16 March 2007***

## Part B

- **Proposed ISA 540 (Revised and Redrafted), *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures***
- **Proposed ISA 580 (Revised and Redrafted), *Written Representations***

***Comments to be received by 16 April 2007***

The Hong Kong Institute of Certified Public Accountants' (Institute) Auditing and Assurance Standards Committee is seeking comments on the IAASB Exposure Drafts which have been posted on the Institute's website at: www.hkicpa.org.hk/professionaltechnical/assurance/exposuredraft/.

The Explanatory Memorandum to the Exposure Drafts provides background information and explanation of the proposed ISAs.

In summary, the IAASB's intentions in developing the revisions to the ISAs are set out below:

- proposed ISAs 230, 560, 610 and 720 are redrafted to contain clearer requirements and easy to understand application guidance with no changes proposed to the requirements in the standards;
- proposed ISA 540, which combines the extant ISA 540 and ISA 545 *Auditing Fair Value Measurements and Disclosures*, is revised to reinforce best practice and cause the auditor to give appropriate attention to areas of accounting judgement, such as assumptions, and to possible bias;

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- proposed ISA 580 is revised to improve the quality and appropriateness of written representations sought by the auditor and, in particular, to deal with concerns about whether auditors may over-rely on representations at the expense of other evidence.

In accordance with the Institute's ISA Convergence Due Process, comments are invited from any interested party and the Institute would like to hear from both those who do agree and those who do not agree with the proposals contained in the IAASB Exposure Drafts.

Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the IAASB Exposure Drafts to be considered, comments on the exposure drafts of proposed redrafted ISAs 230, 560, 610 and 720 are requested to be received by the Institute on or before **16 March 2007**. Comments on the exposure drafts of proposed revised and redrafted ISAs 540 and 580 are requested to be received by the Institute on or before **16 April 2007**. Comments may be sent by mail, fax or e-mail to:

Patricia McBride
Executive Director
Hong Kong Institute of CPAs
37/F., Wu Chung House
213 Queen's Road East
Hong Kong

Fax number (+852) 2865 6776
E-mail: commentletters@hkicpa.org.hk

Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

January 2007
Exposure Draft

PART A

Response Due Date
16 March 2007

*ED of Proposed ISA 230 (Redrafted), 560 (Redrafted), 610 (Redrafted) and 720 (Redrafted)*

# Audit Documentation

# Subsequent Events

# The Auditor's Consideration of the Internal Audit Function

# The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements

Response Due Date
16 April 2007

PART B

*ED of Proposed ISA 540 (Revised and Redrafted) and 580 (Revised and Redrafted)*

# Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

# Written Representations

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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This Exposure Draft may be filed in the "Exposure Drafts, Invitations to Comment" section of Volume III of the Institute Members' Handbook.

The Exposure Draft can also be found on the Institute's website at: www.hkicpa.org.hk/professionaltechnical/assurance/exposuredraft/.

International
Auditing
and Assurance
Standards Board

**Exposure Draft**
December 2006
Comments are requested by March 31, 2007

*Proposed Redrafted International Standard on Auditing*

# ISA 230, Audit Documentation

International Federation of Accountants

## REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 230 (Redrafted), "Audit Documentation," for publication in December 2006. The proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by e-mail, so that they will be received by **March 31, 2007**. All comments will be considered a matter of public record. Comments should be addressed to:

Executive Director, Professional Standards
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

Copies of the exposure drafts may be downloaded free-of-charge from the IFAC website at http://www.ifac.org.

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## EXPLANATORY MEMORANDUM

# Introduction

This memorandum provides background to proposed International Standard on Auditing (ISA) 230 (Redrafted), "Audit Documentation." The proposed ISA has been redrafted in accordance with conventions the IAASB agreed to apply to all ISAs. The IAASB approved the proposed redrafted ISA for exposure in December 2006.

# Background

As part of its project to improve the clarity of its International Standards, the IAASB has undertaken to redraft all of its ISAs in accordance with its new clarity drafting conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. ISA 230 is in the latter category.

The current timetable envisages that all ISAs will have been revised and redrafted, or redrafted only, by late 2008 and the IAASB has provisionally agreed that the complete set of ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2008. This date will depend on satisfactory progress being made, and will be amended to a later date should that prove necessary. The IAASB believes that it is in the interests of auditors and others who use the ISAs that the standards should be released as soon as they are approved so as to facilitate their implementation.

The accompanying exposure draft represents:

a) The amendment of the extant ISA 230 to reflect required changes that go beyond the drafting of the ISA to its substance as a result of the amendment to the *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*[1] (Preface) that the IAASB approved in September 2006 (amended extant ISA 230); and

b) The redrafting of the amended extant ISA 230 in accordance with the new drafting conventions (including changes made to enhance the clarity of the ISA as described below). The content of the extant ISA 230, which was issued in September 2005, has not otherwise been subject to substantive review and revision. Accordingly, comments are not sought on other issues that may be thought to exist.

The conventions used by the IAASB in redrafting the amended extant ISA 230 for exposure, and the authority and obligation attaching to those conventions, are established in the amended Preface. Respondents should consider the proposed redrafted ISA in light of the authority and obligation attaching to these conventions, as established in the amended Preface.

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[1] The Preface can be accessed at http://web.ifac.org/download/IAASB_Preface.pdf.

# Changes Required as a Result of Amending the Preface

## Documentation Relating to Significant Professional Judgments Made

The IAASB considered whether the new obligation in relation to objectives required an amendment to the requirements of the extant ISA 230. The exposure draft of the proposed amendments to the Preface that the IAASB issued in October 2005 did not specify such a requirement. Some respondents asked for greater certainty about whether there is a related documentation requirement and if so, the nature of that requirement. A few respondents found it particularly important that a link be established between objectives and documentation. One placed particular importance on the need for it to be clear that there should be appropriate documentation of how the auditor applied professional judgment.

In deliberating these comments, the IAASB came to the view that audit documentation in connection with objectives can add value to the audit process only if it focuses the auditor on the consideration of how professional judgment was applied in significant areas of the audit. Absent this context, the IAASB considers that a specific requirement for documentation about conclusions in relation to objectives may lead to 'boilerplate' documentation that contributes little to the quality of the audit. Accordingly, the IAASB agreed that the extant ISA 230 should be amended to:

- Expand the extant requirement for the auditor to document significant matters arising from the audit and the conclusions reached on those matters, to refer specifically to the significant professional judgments made in reaching those conclusions (see paragraph 8 of Exhibit 1 in the supplement,[2] and paragraph 7(c) in the exposure draft).
- Expand the related application material to highlight why such documentation is important, and the circumstances in which it would be appropriate to prepare audit documentation relating to the use of professional judgment, where the matters and judgments are significant (see paragraphs 18-19 of Exhibit 1 in the supplement, and paragraphs A9-A10 in the exposure draft).
- Clarify that audit documentation that meets the requirements of ISA 230, together with the specific documentation requirements of other relevant ISAs, provides evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor (see paragraph 3 of Exhibit 1 in the supplement, and paragraph 2 in the exposure draft).
- Clarify that the summary (completion memorandum) that the auditor may prepare in connection with significant matters identified during the audit is likely to help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant ISA objective that the auditor has not met or is unable to meet that would prevent the auditor from achieving the auditor's overall objective (see paragraph 20 of Exhibit 1 in the supplement, and paragraph A11 in the exposure draft).

The IAASB believes that these changes, taken together, should serve to enhance the auditor's judgment on significant matters and thereby the quality of the audit, while also providing

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[2] The Supplement to the Exposure Draft can be accessed at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0071.

documentation that may assist audit oversight authorities and others when reviewing audit files. It also believes that these amendments should not be subject to concern about over-documentation, as the documentation suggested focuses on those areas where significant judgment is applied and ought to feature already in good audit files.

### Documentation of Departure from a Requirement

The IAASB has also amended the wording of the requirement in the extant ISA 230 relating to documentation of a departure from a relevant requirement. The amended requirement now focuses on documentation of how the alternative audit procedures performed achieve the aim of the requirement from which the auditor departed, consistent with the revised Preface.

The IAASB has also amended the guidance in the extant ISA 230 regarding the issue of the relevance of a requirement to align such guidance with the revised Preface. As it is intended that the primary reference to relevance will be incorporated in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements,"[3] a reference to ISA 200 is incorporated in anticipation of the latter's revision. (Any necessary further alignment will be made when the two ISAs are approved in final form.) The amended guidance states that a requirement is not relevant only in the cases where the ISA itself is not relevant, or where the circumstances envisioned do not apply because the requirement is conditional and the condition does not exist (see paragraph 14 of Exhibit 1 in the supplement,[4] and paragraph A17 in the exposure draft).

## Changes Made to Enhance the Clarity of Proposed Redrafted ISA 230

In addition to reflecting the application of the clarity drafting conventions, proposed redrafted ISA 230 incorporates the following changes that the IAASB considered necessary to enhance the clarity of the ISA.

### Specific Documentation Requirements in Other ISAs

During the IAASB's deliberation of the proposed redrafted ISA, some uncertainty arose regarding when an ISA (other than ISA 230) might include one or more documentation requirements. The IAASB therefore decided to provide guidance to explain that:

- Other ISAs contain specific documentation requirements that are intended to clarify the application of ISA 230 in the particular circumstances of those other ISAs;
- Such specific documentation requirements do not limit the application of ISA 230; and
- The absence of a documentation requirement in any particular ISA is not intended to suggest that there is no documentation that will be prepared as a result of complying with that ISA.

This clarifying guidance has been included in paragraph A6 of the exposure draft.

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3 The IAASB is currently deliberating a proposed revised ISA 200 and expects to issue this as an exposure draft in the first half of 2007.

4 The Supplement to the Exposure Draft can be accessed at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0071.

### Documentation of Compliance with ISAs

The IAASB noted differing interpretations about the intent of the extant ISA 230 regarding whether the auditor is expected to document compliance with every requirement of the ISAs. The IAASB therefore agreed to provide expanded guidance to clarify that it is unnecessary for the auditor to document separately compliance with matters for which compliance is self-evident within the audit file. A number of examples have been provided to illustrate this point (see paragraph A7 of the exposure draft).

### Special Considerations in the Audit of Small Entities

Consistent with its decision to include any special considerations relevant to the audit of small entities within the text of ISAs themselves, the IAASB has considered whether the guidance in paragraphs 29-33 of International Auditing Practice Statement (IAPS) 1005, "The Special Considerations in the Audit of Small Entities," should be incorporated in the proposed redrafted ISA. The IAASB is of the view that such guidance is already covered in one way or another by the extant ISA 230 and ISA 315 (Redrafted). Accordingly, the IAASB concluded that none of the guidance in IAPS 1005 needs be included in the proposed redrafted ISA 230.

The IAASB, however, agreed to provide further guidance in the following respects:

(a) To clarify that the audit documentation for the audit of a smaller entity will generally be less extensive than that for the audit of a larger entity, and in particular this would be so in a case where the engagement partner performs the whole audit (see paragraph A14 of the exposure draft); and

(b) To clarify that, when preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together on a single working paper, with appropriate cross-references to any supporting working papers (see paragraph A15 of the exposure draft).

## Effective Date

See Background.

## Guide for Respondents

The IAASB is seeking comments **only** on:

(a) Changes required to the extant ISA 230 as a result of amending the Preface; and

(b) Changes resulting from applying the clarity drafting conventions to the amended extant ISA and their effect on the content of the ISA.

Respondents are asked to respond in particular to the following questions:

1. Is the objective to be achieved by the auditor, as stated in the proposed redrafted ISA, appropriate?

2. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?[5]

3. Do you agree with the changes described above as being helpful to the clarity of the redrafted ISA, including whether considerations in the audit of small entities have been dealt with appropriately?

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the IAASB to be made aware of this view.

**Translations**

Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted by respondents in reviewing the exposure draft.

## Supplement to the Exposure Draft

To assist respondents in tracking changes, IAASB staff has prepared a supplement that contains the following exhibits.

(a) Exhibit 1 is a mark-up version of the amended extant ISA 230 that tracks the changes required to the extant ISA 230 as a result of amending the Preface.

(b) Exhibit 2 is an analysis of the decisions the IAASB made with respect to the treatment of the present tense in the explanatory paragraphs of the amended extant ISA 230. This identifies existing sentences in the present tense and indicates whether they are now treated as requirements or as application material.

(c) Exhibit 3 shows how the material in the amended extant ISA 230 has been reflected in the proposed redrafted ISA. In particular, the analysis:

- Maps the material of the amended extant ISA to the proposed redrafted ISA; and
- Identifies explanatory material that is proposed to be eliminated as a result of redrafting.

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[5] The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.
- In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

  The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

This staff-prepared supplement is available on the IAASB website at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0071. It is provided for information purposes only and do not form part of the exposure draft.

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 230**

**(REDRAFTED)**

# AUDIT DOCUMENTATION

(Effective for audits of financial information for periods beginning on or after [date])*

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International Standard on Auditing (ISA) 230 (Redrafted), "Audit Documentation" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of ISAs.

* See footnote 2.

# Introduction

## Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to prepare audit documentation. The Appendix lists other ISAs containing subject matter-specific documentation requirements and guidance. The specific documentation requirements of other ISAs do not limit the application of this ISA. Laws or regulations may establish additional documentation requirements.

*Nature and Purposes of Audit Documentation*

2. Audit documentation that meets the requirements of this ISA together with the specific documentation requirements of other relevant ISAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor. Audit documentation serves a number of purposes, including the following:

   - Assisting the audit team to plan and perform the audit.
   - Assisting members of the audit team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA 220, "Quality Control for Audits of Historical Financial Information."
   - Enabling the audit team to be accountable for its work.
   - Retaining a record of matters of continuing significance to future audits.
   - Enabling an experienced auditor to conduct quality control reviews and inspections[1] in accordance with ISQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements."
   - Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

## Effective Date

3. This ISA is effective for audits of financial information for periods beginning on or after [date].[2]

[1] As defined in ISA 220.

[2] This effective date will not be earlier than December 15, 2008.

## Objective

4. The objective of the auditor is to have a sufficient and appropriate record of the basis for the auditor's report, and evidence that the audit was performed in accordance with ISAs and applicable legal and regulatory requirements.

## Definitions

5. For purposes of the ISAs, the following terms have the meanings attributed below:

    (a) Audit documentation – The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used).

    (b) Experienced auditor – An individual (whether internal or external to the firm) who has a reasonable understanding of (i) audit processes, (ii) ISAs and applicable legal and regulatory requirements, (iii) the business environment in which the entity operates, and (iv) auditing and financial reporting issues relevant to the entity's industry.

## Requirements

### Timely Preparation of Audit Documentation

6. The auditor shall prepare audit documentation on a timely basis. (Ref: Para. A1)

### Documentation of the Audit Procedures Performed and Audit Evidence Obtained

*Form, Content and Extent of Audit Documentation*

7. The auditor shall prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2-A5, A14-A15)

    (a) The nature, timing, and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements; (Ref: Para. A6-A7)

    (b) The results of the audit procedures and the audit evidence obtained; and

    (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8-A11)

8. The auditor shall document discussions of significant matters with management and others, including when and with whom the discussions took place. (Ref: Para. A12)

9. If the auditor has identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency in forming the final conclusion. (Ref: Para. A13)

*Departure from a Relevant Requirement*

10. If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and, unless otherwise clear, the reasons for the departure. (Ref: Para. A16-A17)

*Identification of Specific Items or Matters Being Tested, and of the Preparer and Reviewer*

11. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
    (a) The identifying characteristics of the specific items or matters being tested; (Ref: Para. A18)
    (b) Who performed the audit work and the date such work was completed; and
    (c) Who reviewed the audit work performed and the date and extent of such review.[3] (Ref: Para. A19)

**Assembly of the Final Audit File**

12. The auditor shall complete the assembly of the final audit file on a timely basis after the date of the auditor's report. (Ref: Para. A20-A21)
13. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation before the end of its retention period. (Ref: Para. A22)
14. If the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor shall, regardless of the nature of the modifications or additions, document:
    (a) When and by whom they were made, and (where applicable) reviewed;
    (b) The specific reasons for making them; and
    (c) Their effect, if any, on the auditor's conclusions.

**Changes to Audit Documentation in Exceptional Circumstances after the Date of the Auditor's Report**

15. If, in exceptional circumstances after the date of the auditor's report, the auditor has to perform new or additional audit procedures or draw new conclusions, the auditor shall document:

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[3] Paragraph 26 of ISA 220 establishes the requirement for the auditor to review the audit work performed through review of the audit documentation, which involves the auditor documenting the extent and timing of the reviews. Paragraph 25 of ISA 220 describes the nature of a review of work performed.

(a) The circumstances encountered;

(b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached; and

(c) When and by whom the resulting changes to audit documentation were made, and (where applicable) reviewed. (Ref: Para. A23)

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## Application and Other Explanatory Material

### Timely Preparation of Audit Documentation (Ref: Para. 6)

A1. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared at the time the work is performed is likely to be more accurate than documentation prepared subsequently.

### Documentation of the Audit Procedures Performed and Audit Evidence Obtained

*Form, Content and Extent of Audit Documentation* (Ref: Para. 7)

A2. The form, content and extent of audit documentation depend on factors such as:

- The size and complexity of the entity.
- The nature of the audit procedures to be performed.
- The identified risks of material misstatement.
- The significance of the audit evidence obtained.
- The nature and extent of exceptions identified.
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- The audit methodology and tools used.

A3. Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include:

- Audit programs.
- Analyses.
- Issues memoranda.
- Summaries of significant matters.

- Letters of confirmation and representation.
- Checklists.
- Correspondence (including e-mail) concerning significant matters.

Abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) may be included as part of audit documentation if considered appropriate. Audit documentation, however, is not a substitute for the entity's accounting records. The audit documentation for a specific audit engagement is assembled in an audit file.

A4. The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

A5. Oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

Documentation of Compliance with ISAs (Ref: Para. 7(a))

A6. In principle, compliance with the requirements of this ISA will result in the audit documentation being sufficient in the circumstances. Other ISAs contain specific documentation requirements that are intended to clarify the application of this ISA in the particular circumstances of those other ISAs. These specific documentation requirements do not limit the application of this ISA. Furthermore, the absence of a documentation requirement in any particular ISA is not intended to suggest that there is no documentation that will be prepared as a result of complying with that ISA.

A7. Audit documentation provides evidence that the audit complies with the ISAs. However, it is neither necessary nor practicable for the auditor to document every matter considered in an audit. Further, it is unnecessary for the auditor to document separately compliance with matters for which compliance is self-evident within the audit file. For example:

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- Documentation of specific procedures performed to corroborate management's responses to the auditor's inquiries provides some evidence that the auditor has maintained appropriate professional skepticism in compliance with the ISAs.
- Documentation of the engagement partner's timely involvement in the audit, such as participation in the team discussions required by ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," provides some evidence that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the ISAs.

### Documentation of Significant Matters (Ref: Para. 7(c))

A8. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:

- Matters that give rise to significant risks (as defined in ISA 315 (Redrafted)).
- Results of audit procedures indicating (a) that the financial information is materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an emphasis of matter paragraph in the auditor's report.

A9. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment required in performing the work and evaluating the results. Documentation that provides an understanding of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

A10. Examples of circumstances in which it would be appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- The information or factors considered by the auditor that were important in forming the relevant professional judgment when a requirement provides that the auditor 'shall consider' certain information or factors.
- The basis for the auditor's conclusions where the auditor considered it necessary to obtain further audit evidence by performing significant further audit procedures in addition to those necessary to meet the requirements of an ISA.
- The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It is also likely to help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant ISA objective that the auditor has not met or is unable to meet that would prevent the auditor from achieving the auditor's overall objective.

Documentation of Discussions of Significant Matters with Management and Others (Ref: Para. 8)

A12. The documentation is not limited to records prepared by the auditor but may include other appropriate records such as minutes of meetings prepared by the entity's personnel and agreed by the auditor. Others with whom the auditor may discuss significant matters may include those charged with governance, other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

Documentation of how Inconsistencies have been Addressed (Ref: Para. 9)

A13. The documentation of how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.

Considerations Specific to Smaller Entities (Ref. Para. 7)

A14. The audit documentation for the audit of a smaller entity will generally be less extensive than that for the audit of a larger entity. Further, in the case of an audit where the engagement partner will perform all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an audit team (for example, there will be no matters to document relating to team discussions or supervision).

A15. When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together on a single working paper, with cross-references to supporting working papers where appropriate. Examples of matters that may be documented together in a small audit include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality, assessed risks, significant matters noted during the audit, and conclusions reached.

*Departure from a Relevant Requirement* (Ref: Para. 10)

A16. [As explained in [proposed] ISA 200 (Revised), "Overall Objective of the Independent Auditor, and Fundamental Concepts Relevant to an Audit of Financial Statements,"][4] the objectives and requirements in ISAs are designed to assist in meeting the overall objective

[4] Approval of this exposure draft is expected in the first half of 2007.

of the auditor. Accordingly, other than in exceptional circumstances, the ISAs call for compliance with each requirement that is relevant in the circumstances of the audit.

A17. The documentation requirement applies only to requirements that are relevant in the circumstances. As explained in [proposed] ISA 200 (Revised), a requirement is not relevant only in the cases where:

(a) The ISA is not relevant (for example, in a continuing engagement, nothing in ISA 510, "Initial Engagements—Opening Balances," is relevant); or

(b) The circumstances envisioned do not apply because the requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

*Identification of Specific Items or Matters Being Tested, and of the Preparer and Reviewer* (Ref: Para. 11)

A18. Recording the identifying characteristics serves a number of purposes. For example, it enables the audit team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter being tested. For example:

- For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
- For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).
- For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period from April 1 to September 30, starting with report number 12345 and selecting every 125th report).
- For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
- For an observation procedure, the auditor may record the process or subject matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

A19. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The audit documentation, however, identifies who reviewed specified elements of the audit work performed and when.

## Assembly of the Final Audit File (Ref: Para. 12-13)

A20. ISQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. Under ISQC 1, an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

A21. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the audit team before the date of the auditor's report.

A22. ISQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. Under ISQC 1, the retention period for audit engagements ordinarily is no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report.

## Changes to Audit Documentation in Exceptional Circumstances after the Date of the Auditor's Report (Ref: Para. 15)

A23. Examples of such exceptional circumstances are facts which become known to the auditor after the financial information has been issued regarding the audited financial information that existed at the date of the auditor's report that, if known at that date, might have caused the financial information to be amended and the auditor to modify the auditor's report.

# Appendix

## Specific Audit Documentation Requirements and Guidance in Other ISAs

The following lists the main paragraphs that contain specific documentation requirements and guidance in other ISAs:

- ISA 210, “Terms of Audit Engagements”–Paragraph 5;
- ISA 220 (Revised), “Quality Control for Audits of Historical Financial Information”–Paragraphs 11–14, 16, 25, 27, 30, 31 and 33;
- ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”–Paragraphs 44-47;
- ISA 250, “Consideration of Laws and Regulations”–Paragraph 28;
- [Proposed] ISA 260 (Revised and Redrafted), “Communication with Those Charged with Governance”–Paragraph 21;
- ISA 300 (Redrafted), “Planning an Audit of Financial Statements”–Paragraphs 11 and A17-A20;
- ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”–Paragraphs 33 and A127-A130;
- ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks”–Paragraphs 29-31 and A59;
- ISA 505, “External Confirmations”–Paragraph 33;
- [Proposed] ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Estimates, and Related Disclosures”–Paragraphs 21 and A111;
- [Proposed] ISA 580 (Revised and Redrafted), “Written Representations”–Paragraph 21; and
- ISA 600, “Using the Work of Another Auditor”–Paragraph 14.

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International
Auditing
and Assurance
Standards Board

**Exposure Draft**
December 2006
Comments are requested by March 31, 2007

*Proposed Redrafted International Standard on Auditing*

# ISA 560, Subsequent Events

International Federation
of Accountants

## REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 560 (Redrafted), “Subsequent Events,” for publication in December 2006. The proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by e-mail, so that they will be received by **March 31, 2007**. All comments will be considered a matter of public record. Comments should be addressed to:


Executive Director, Professional Standards
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org


Copies of the exposure draft may be downloaded free-of-charge from the IFAC website at http://www.ifac.org.

**CONTENTS**

**EXPLANATORY MEMORANDUM**

## Introduction

This memorandum provides background to proposed International Standard on Auditing (ISA) 560 (Redrafted), "Subsequent Events." The proposed ISA has been redrafted in accordance with conventions agreed by the International Auditing and Assurance Standards Board (IAASB) to be applied to all ISAs. The IAASB approved the proposed redrafted ISA for exposure in December 2006.

## Background

As part of its project to improve the clarity of its International Standards, the IAASB has undertaken to redraft all of its ISAs in accordance with its new clarity drafting conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the Clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. ISA 560 is in the latter category.

The conventions used by the IAASB in redrafting ISA 560 for exposure, and the authority and obligation attaching to those conventions, are established in the amended *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*[1] (Preface), approved by the IAASB in September 2006.

## Additional Issues in Relation to the Clarity of Proposed Redrafted ISA 560

In addition to the changes arising from the application of the clarity drafting conventions to the extant ISA 560, the redrafting of the ISA also raised two major issues that the IAASB has determined may require further consideration.

### Application of the Requirements of ISA 560 to Securities Offering Documents

The first sentence of paragraph 20 of the extant ISA 560 includes the following bold-lettered sentence representing a basic principle or essential procedure:

> "In cases involving the offering of securities to the public, the auditor should consider any legal and related requirements applicable to the auditor in all jurisdictions in which the securities are being offered."

Furthermore, paragraph 20 includes additional guidance on the application of subsequent events procedures in relation to such documents.

[1] The Preface can be accessed at http://web.ifac.org/download/IAASB_Preface.pdf.

Through the clarification process, the IAASB has identified a number of ISAs that address matters in relation to securities offering documents, including, for example, extant ISA 560 and extant ISA 720, "Other Information in Documents Containing Audited Financial Statements." The auditor's responsibilities in relation to such securities offering documents are ordinarily set forth in local securities laws and regulations. Such responsibilities may therefore vary significantly among different jurisdictions. The IAASB questions whether it would be appropriate for the ISAs to retain the references to auditor's responsibilities in relation to such documents without having undertaken a specific project to understand the nature and scope of these responsibilities in various jurisdictions. Consequently, the basic principle or essential procedure in the first sentence of paragraph 20 of the extant ISA 560, together with its accompanying guidance, has been redrafted and included in the application material of proposed redrafted ISA 560.

The IAASB is seeking comments on its proposed treatment of this issue (see the Guide for Respondents below).

**Restriction of Subsequent Events Procedures and Dual Dating of the Auditor's Report for Amended Financial Statements**

Paragraph 11, and paragraph 16 together with paragraph 17, of the extant ISA 560 include guidance that, when management has revised the financial statements due to facts discovered after the date of the auditor's report, the auditor would provide management with, or issue, a new auditor's report and extend the procedures referred to in paragraph 5 (subsequent events procedures) to the date of the new auditor's report. Furthermore, paragraph 17 of the extant ISA 560 includes a bold-lettered basic principle or essential procedure that, in the circumstances described in paragraph 11, the new auditor's report include an emphasis of matter paragraph referring to the note in the financial statements that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor.

Nevertheless, the third and fourth sentences of paragraph 17 provide for an exception to the other basic principles, essential procedures and guidance in paragraphs 16 and 17 (and perhaps, by extension, in paragraph 11) by allowing the auditor to restrict the subsequent events procedures regarding the revised financial statements to the effects of the subsequent event that necessitated the revision, when local regulations in the country permit this and the new auditor's report contains a statement to that effect.

Some members of the IAASB take the view that the third and fourth sentences of paragraph 17 of the extant ISA 560 allow the auditor to limit subsequent events procedures to amendments of the financial statements and to provide an additional auditor's report date for the completion of these procedures ("dual dating") as long as this is not prohibited by local regulations. Some other members of the IAASB contend that paragraphs 11 and 16 of the extant ISA 560 do not permit the restriction of subsequent events procedures to amendments of the financial statements and such "dual dating" of the auditor's report unless specifically provided for by local regulations.

The proposed elevation, by means of the Clarity project, of paragraphs 11 and 16 and the first sentence of paragraph 17 in the extant ISA 560 to requirements in paragraphs 10, 15 and 16 of the proposed redrafted ISA 560, without a concomitant elevation of the third and fourth sentences of paragraph 17, would result in the explicit prohibition of the restriction of subsequent events procedures to amendments in the amended financial statements and of the resultant "dual dating" of the auditor's report. Consequently, the IAASB chose to include an exception in paragraphs 10 and 16 of the proposed redrafted ISA 560 by referring to such restriction on subsequent events procedures and the "dual dating" of the auditor's report through the delineation of the circumstances when this is permitted in paragraph 11. Rather than allow such an exception based on local regulations, the IAASB chose to base the exception on whether the financial reporting framework allows management to restrict the amendment of the financial statements to the effects of subsequent events causing the amendment and whether those responsible for approving the amended financial statements are permitted to restrict their approval to that amendment.

As the elevation of extant paragraph 17, amended as noted in new paragraph 11, to the requirements section of the proposed redrafted ISA may be perceived by some as a substantive change from the extant ISA, the IAASB is seeking comments on this issue (see Guide for Respondents below).

**Special Considerations in the Audit of Small Entities and Public Sector Entities**

Consistent with IAASB's decision to include any special considerations relevant to the audit of small entities within the text of ISAs themselves, the guidance in paragraphs 88, 89, 90 and 91 of International Auditing Practice Statement (IAPS) 1005, "The Special Considerations in the Audit of Small Entities," has been revised as considered necessary and incorporated in this proposed redrafted ISA. Consequently, paragraphs 88, 89, 90 and 91 of IAPS 1005 will be withdrawn when the redrafted ISA 560 becomes effective.

In addition, where considered necessary, any special considerations in the audit of public sector entities have also been included in this proposed redrafted ISA.

One issue raised through the consideration of public sector issues related to the application of the requirements in paragraphs 10 and 14 in the proposed redrafted ISA 560. These paragraphs require the auditor to issue a new auditor's report on the amended financial statements when management has amended these due to facts becoming known to the auditor after the date of the auditor's report.

With respect to the public sector, this issue does **not** relate to circumstances in which the public sector entity has **not** amended its financial statements because such amendment would be prohibited by law, regulation or the financial reporting framework. Rather, the issue relates to the situation in which a public sector entity **has** amended its financial statements due to facts becoming known to the auditor of those financial statements after the date of the auditor's report, whether before, or after, the date the financial statements have been issued (as defined in paragraph 5(d) in proposed redrafted ISA 560). The noted requirements in paragraphs 10 and 14 would require the auditor of the financial statements of the public sector entity to issue a new auditor's report on those financial statements when these have been so amended by the public sector entity. The question arises whether there may be circumstances in which the auditor of the financial statements of the public sector entity is prohibited by law or regulation from issuing a new auditor's report on the amended financial statements.

The IAASB is seeking comments from the public sector on this issue (see the Guide for Respondents below).

## Effective Date

The current timetable envisages that all ISAs will have been revised and redrafted, or redrafted only, by late 2008 and the IAASB has provisionally agreed that the complete set of ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2008. This date will depend on satisfactory progress being made, and will be amended to a later date should that prove necessary. The IAASB believes that it is in the interests of auditors and others who use the ISAs that the standards should be released as soon as they are approved so as to facilitate their implementation.

## Guide for Respondents

The IAASB is seeking comments **only** on changes resulting from applying the clarity drafting conventions and their effect on the content of the ISA. Respondents are asked to respond in particular to the following questions:

1. Is the objective to be achieved by the auditor, stated in the proposed redrafted ISA, appropriate?
2. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?[2]
3. Do you agree with the changes described above as being necessary to the clarity of the redrafted ISA, including whether considerations in the audit of small entities and public sector entities have been dealt with appropriately? In particular, do you have any comments on the public sector issue requiring additional consideration described in the section on the considerations in the audits of small entities and public sector entities above?
4. Do you agree with the IAASB's proposed treatment of the issue in relation to the application of the proposed redrafted ISA 560 to securities offering documents as noted above?
5. Do you agree with the IAASB's treatment of the restriction of subsequent events procedures and dual dating of the auditor's report for amended financial statements?

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[2] The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.
- In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

  The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the IAASB to be made aware of this view.

### Translations

Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comments on potential translation issues noted in reviewing the proposed redrafted ISA.

## Supplement to the Exposure Draft

To assist respondents in tracking changes, IAASB staff has prepared an analysis of the decisions that have been made by the IAASB with respect to the treatment of the present tense in the explanatory paragraphs of the extant ISA. This analysis also demonstrates how the material in the extant ISA has been reflected in the proposed redrafted ISA. In particular, the analysis:

- Identifies existing sentences in the present tense and whether they are now treated as a requirement or as application material;
- Maps the material of the extant ISA to the proposed redrafted ISA; and
- Identifies explanatory material that is proposed to be eliminated as a result of redrafting.

These staff-prepared mapping documents are available on the IAASB website at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0072. They are for information purposes only and do not form part of the exposure draft.

# PROPOSED INTERNATIONAL STANDARD ON AUDITING 560 (REDRAFTED)

## SUBSEQUENT EVENTS

(Effective for audits of financial statements for periods beginning on or after [date])*

## CONTENTS



International Standard on Auditing (ISA) 560 (Redrafted), "Subsequent Events" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of ISAs.

* See footnote 1.

# Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. (Ref: Para. A1)

2. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. For example, International Accounting Standard (IAS) 10, "Events After the Balance Sheet Date" deals with the treatment in financial statements of events, both favorable and unfavorable, that occur between the date of the financial statements (referred to as the "balance sheet date" in the IAS) and the date when the financial statements are authorized for issue. Such financial reporting frameworks ordinarily identify two types of events:

   (a) Those that provide evidence of conditions that existed at the date of the financial statements; and

   (b) Those that provide evidence of conditions that arose after the date of the financial statements.

   ISA 700, "The Independent Auditor's Report on General Purpose Financial Statements" explains, that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.

### Effective Date

3. This ISA is effective for audits of financial statements for periods beginning on or after [date].[1]

# Objectives

4. The objectives of the auditor are to:

   (a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that materially affect the financial statements are appropriately reflected in those financial statements, and

   (b) Respond appropriately to facts that become known to the auditor after the date of the auditor's report that materially affect the financial statements.

1 This date will not be earlier than December 15, 2008.

## Definitions

5. For purposes of the ISAs the following terms have the meanings attributed below:

   (a) Date of the financial statements – The date of the end of the latest period covered by the financial statements, which is normally the date of the most recent balance sheet in the financial statements subject to audit.

   (b) Date of approval of the financial statements – The date on which those with the recognized authority assert that they have prepared the entity's complete set of financial statements, including the related notes, and that they have taken responsibility for them. (Ref: Para. A2)

   (c) Date of the auditor's report – The date selected by the auditor to date the report on the financial statements. The auditor's report is not dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements.[2] Sufficient appropriate audit evidence includes evidence that the entity's complete set of financial statements has been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

   (d) Date the financial statements are issued – The date that the auditor's report and audited financial statements are made available to third parties, which may be, in many circumstances, the date that they are filed with a regulatory authority. In the case of the public sector, this may be the date the audited financial statements and the auditor's report thereon are presented to the legislature.

   (e) Subsequent events – Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

## Requirements

**Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report** (Ref: Para. A3-A8)

6. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on all matters to which previously applied audit procedures have provided satisfactory conclusions.

7. The audit procedures required by paragraph 6 shall be completed as near as practicable to the date of the auditor's report. Such audit procedures take into account the auditor's risk assessment and shall include the following:

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2 In rare circumstances, law or regulation also identifies the point in the financial statement reporting process at which the audit is expected to be complete.

(a) Obtaining an understanding of the procedures management has established to ensure that subsequent events are identified.

(b) Reading minutes of the meetings of the entity's owners, management and those charged with governance held after the date of the financial statements and inquiring about matters discussed at meetings for which minutes are not yet available. (Ref: Para. A8)

(c) Reading the entity's latest available interim external financial statements and interim internal management financial statements.

(d) Inquiring of management as to whether any subsequent events have occurred which might affect the financial statements.

8. When the auditor identifies events that materially affect the financial statements, the auditor shall determine whether such events are properly accounted for and adequately disclosed in the financial statements.

**Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued** (Ref. A9-A11)

9. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, the auditor becomes aware of a fact which may materially affect the financial statements, the auditor shall:

(a) Discuss the matter with management,

(b) Determine whether the financial statements need amendment, and, if so,

(c) Determine whether management will amend the financial statements.

10. When management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances and shall issue a new auditor's report on the amended financial statements. Unless the circumstances in paragraph 11 apply, the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements and, accordingly, the audit procedures referred to in paragraph 6 shall be extended to the date of the new auditor's report.

11. When the financial reporting framework allows management to restrict the amendment of the financial statements to the effects of the subsequent event or events causing that amendment and those responsible for approving the financial statements are permitted to restrict their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events required in paragraph 6 regarding the amended financial statements to that amendment. In such cases, the auditor shall include, in the new auditor's report, a statement that the auditor's procedures are so restricted and provide an additional auditor's report date on that amendment.

12. When management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then:

- If the auditor's report has not yet been issued to the entity, the auditor shall modify the opinion appropriately so that the auditor expresses a qualified opinion or an adverse opinion as described in ISA 705, "Modifications to the Opinion in the Independent Auditor's Report" and then issue the auditor's report; or alternatively
- If the auditor's report has already been issued to the entity, the auditor shall notify management or those charged with governance, as appropriate, not to issue the financial statements and the auditor's report thereon to third parties. If the financial statements are nevertheless subsequently issued, the auditor shall take action, in light of the auditor's legal rights and obligations and the recommendations of the auditor's legal counsel, to prevent reliance on the auditor's report.

**Facts Which Become Known to the Auditor After the Financial Statements have been Issued**

13. After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, if after the financial statements have been issued, the auditor becomes aware of a fact that existed at the date of the auditor's report and that, if known at that date, may have caused the financial statements to be amended or the auditor to modify the auditor's report, the auditor shall:

    (a) Discuss the matter with management,

    (b) Determine whether the financial statements need amendment, and, if so,

    (c) Determine whether management will amend the financial statements.

14. If management amends the financial statements, the auditor shall:

    (a) Carry out the audit procedures necessary in the circumstances,

    (b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation, and

    (c) Issue a new auditor's report on the amended financial statements.

15. The auditor shall include in the new auditor's report an emphasis of matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report issued by the auditor.

16. Unless the circumstances in paragraph 11 apply, the auditor shall date the new auditor's report no earlier than the date of approval of the amended financial statements and, accordingly, the auditor shall extend the audit procedures referred to in paragraph 6 to the date of the new auditor's report.

17. If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need amendment, the auditor shall notify management and those charged with governance that action will be taken by the auditor to prevent

future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take action, in light of the auditor's legal rights and obligations and the recommendations of the auditor's legal counsel, to prevent future reliance on the auditor's report.

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## Application and Other Explanatory Material

### **Introduction** (Ref: Para. 1)

A1. When the audited financial statements are included in other documents subsequent to the issuance of the financial statements, the auditor may have additional responsibilities relating to subsequent events that the auditor may need to consider, such as legal or regulatory requirements involving the offering of securities to the public in other jurisdictions in which the securities are being offered. For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those referred to in paragraphs 6 and 7 up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.

### **Definitions** (Ref: Para. 5(b))

A2. Paragraph 5(b) of this ISA defines the date of approval of the financial statements. In some jurisdictions, the law or regulation identifies the individuals or bodies (for example, management or those charged with governance) that are responsible for concluding that a complete set of financial statements has been prepared, and specifies the necessary approval process. In other jurisdictions, the approval process is not prescribed in law or regulation and the entity follows its own procedures in preparing and finalizing its financial statements in view of its management and governance structures. In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of the ISAs is the earlier date on which those with the recognized authority determine that a complete set of financial statements has been prepared.

### **Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report** (Ref: Para. 6-8)

A3. The audit procedures required by paragraph 6 are in addition to procedures which may be applied to specific transactions occurring after the date of the financial statements to obtain audit evidence as to account balances as at the date of the financial statements, for example, the testing of inventory cut-off and payments to creditors.

A4. In inquiring of management as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:

- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- Whether there have been any developments regarding contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.

A5. In addition to the audit procedures required by paragraph 7, the auditor may consider it necessary and appropriate to:

- Read the entity's latest available budgets, cash flow forecasts and other related management reports,
- Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims, or
- Consider whether specific written representations covering particular subsequent events may be necessary to obtain sufficient appropriate audit evidence.

*Considerations Specific to Smaller Entities*

A6. It is often the case that more time elapses between the date of the financial statements and the approval of the financial statements by the owner-manager in the case of small entities than in the case of large entities. The period to be covered by the auditor's subsequent events procedures may therefore often be longer than that in the audit of a small entity, which allows more opportunity for the occurrence of subsequent events that can affect the financial statements. Nevertheless, this ISA requires the auditor to perform audit procedures to cover the entire period from the date of the financial statements up to the date of the auditor's report.

A7. Paragraph 7 of this ISA stipulates certain audit procedures in this context that the auditor is required to perform pursuant to paragraph 6. The subsequent events procedures that the auditor of a small entity performs may, however, depend on the information that is available and, in particular, the extent to which the accounting records have been prepared since the date of the financial statements. When the accounting records are not up-to-date, and accordingly no interim financial statements (whether for internal or external purposes) have been prepared, or and minutes of meetings of management or those charged with governance have not been prepared, relevant audit procedures may take the form of inquiry of the owner-manager, documentation of the owner-manager's responses, and inspection of available books and records, including bank statements. Paragraph A4 of this ISA gives examples of some of the additional matters that it may be appropriate for the auditor to consider in the course of these inquiries.

*Considerations Specific to Public Sector Entities* (Ref. Para. 7(b))

A8. In the public sector, the auditor would read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available.

**Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued** (Ref: Para. 9-12)

A9. As agreed in the terms of engagement, management has a responsibility to inform the auditor of facts of which it becomes aware during the period from the date of the auditor's report to the date the financial statements are issued (see ISA 210, "Terms of Engagement").

A10. When, in some jurisdictions, law, regulation or the financial reporting framework may permit management not to issue the amended financial statements, the auditor need not issue a new auditor's report. This is often the case when issuance of the financial statements for the following period is imminent, provided appropriate disclosures are made in such statements

*Considerations Specific to Public Sector Entities*

A11. In the public sector, the actions taken in accordance with paragraph 12 when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor's report.

### PROPOSED CONFORMING AMENDMENTS

## ISA 210, "Terms of Audit Engagements"

The following additional bullet is added to paragraph 8:

- The agreement of management to inform the auditor of facts, that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.

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International
Auditing
and Assurance
Standards Board

**Exposure Draft**
December 2006
Comments are requested by March 31, 2007

*Proposed Redrafted International Standard on Auditing*

# ISA 610, The Auditor's Consideration of the Internal Audit Function

## REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 610 (Redrafted), "The Auditor's Consideration of the Internal Audit Function," for publication in December 2006. This proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by e-mail, so that they will be received by **March 31, 2007**. All comments will be considered a matter of public record. Comments should be addressed to:

Executive Director, Professional Standards
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

Copies of the exposure draft may be downloaded free-of-charge from the IFAC website at http://www.ifac.org.

## CONTENTS

## EXPLANATORY MEMORANDUM

## Introduction

This memorandum provides background to proposed International Standard on Auditing (ISA) 610 (Redrafted), "The Auditor's Consideration of the Internal Audit Function." The proposed ISA has been redrafted in accordance with conventions agreed by the International Auditing and Assurance Standards Board (IAASB) to be applied to all ISAs. The IAASB approved the proposed redrafted ISA for exposure in December 2006.

## Background

As part of its project to improve the clarity of its International Standards, the IAASB has undertaken to redraft all of its ISAs in accordance with its new clarity drafting conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the Clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. ISA 610 is in the latter category.

The conventions used by the IAASB in redrafting ISA 610 for exposure, and the authority and obligation attaching to those conventions, are established in the amended *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*[1] (Preface), approved by the IAASB in September 2006.

## Effective Date

The current timetable envisages that all ISAs will have been revised and redrafted, or redrafted only, by late 2008 and the IAASB has provisionally agreed that the complete set of ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2008. This date will depend on satisfactory progress being made, and will be amended to a later date should that prove necessary. The IAASB believes that it is in the interests of auditors and others who use the ISAs that the standards should be released as soon as they are approved so as to facilitate their implementation.

## Guide for Respondents

The IAASB is seeking comments **only** on changes resulting from applying the clarity drafting conventions and their effect on the content of the ISA. Respondents are asked to respond in particular to the following questions:

1. Is the objective to be achieved by the auditor, stated in the proposed redrafted ISA, appropriate?

[1] The Preface can be accessed at http://web.ifac.org/download/IAASB_Preface.pdf.

2. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?[2]

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the IAASB to be made aware of this view.

**Translations**

Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed redrafted ISA.

## Supplement to the Exposure Draft

To assist respondents in tracking changes, IAASB staff has prepared an analysis of the decisions that have been made by the IAASB with respect to the treatment of the present tense in the explanatory paragraphs of the extant ISA. This analysis also demonstrates how the material in the extant ISA has been reflected in the proposed redrafted ISA. In particular, the analysis:

- Identifies existing sentences in the present tense and whether they are now treated as a requirement or as application material;
- Maps the material of the extant ISA to the proposed redrafted ISA; and
- Identifies explanatory material that is proposed to be eliminated as a result of redrafting.

These staff-prepared mapping documents are available on the IAASB website at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0073. They are for information purposes only and do not form part of the exposure draft.

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[2] The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.
- In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

  The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 610**

**(REDRAFTED)**

# THE AUDITOR'S CONSIDERATION OF THE INTERNAL AUDIT FUNCTION

(Effective for audits of financial information for periods beginning on or after [date])*

## CONTENTS



International Standard on Auditing (ISA) 610 (Redrafted), "The Auditor's Consideration of the Internal Audit Function" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of ISAs.

* See footnote 2.

# Introduction

## Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the external auditor's considerations when obtaining an understanding of and determining whether to use the work of the internal audit function, and the extent to which the external auditor may use that work. This ISA does not deal with instances when internal audit personnel assist the external auditor in carrying out external audit procedures.

*Relationship Between the Internal Audit Function and the External Auditor*

2. The role of the internal audit function is determined by management or those charged with governance.[1] The objectives of management and those charged with governance differ from those of the external auditor whose overall objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with the auditor's findings. The objectives of the internal audit function vary according to the requirements of management or those charged with governance. (Ref: Para. A1-A2)

3. The internal audit function may achieve its objectives in a manner similar to that of the external auditor. Accordingly, certain aspects of the internal audit function's activities may be useful to the external auditor in determining the nature, timing and extent of audit procedures to be performed.

4. Notwithstanding its degree of autonomy and objectivity, the internal audit function is not independent of management or the entity. The external auditor has sole responsibility for the audit opinion expressed and, accordingly, that responsibility is not reduced by the external auditor's use of the work of the internal audit function.

## Effective Date

5. This ISA is effective for audits of financial statements for periods beginning on or after [date].[2]

# Objective

6. The objective of the external auditor is to obtain an understanding of the internal audit function and determine whether the activities of the internal audit function are relevant to planning and performing the audit and, if relevant, the effect on the procedures performed by the external auditor.

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1 In some circumstances, the role of the internal audit function may be determined by law or regulation.

2 This date will not be earlier than December 15, 2008.

## Requirements

### Obtaining an Understanding of the Internal Audit Function

7. The external auditor shall obtain an understanding of the internal audit function in conjunction with obtaining an understanding of internal control (as required by ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"). The understanding obtained by the auditor shall include an understanding of the organizational status of the internal audit function and the scope of the internal audit function's responsibilities. (Ref: Para. A3-A5)

### Planning to Use the Work of the Internal Audit Function

8. When the external auditor intends to use the work of the internal audit function, the external auditor shall evaluate:

   (a) The objectivity and technical competence of members of the internal audit function;

   (b) Whether the internal audit function is carried out with due professional care; and

   (c) The effect of any constraints or restrictions placed on the internal audit function by management or those charged with governance. (Ref: Para. A6)

9. In making judgments about the effect of the internal audit function's work on the external auditor's procedures, the external auditor shall consider:

   (a) The materiality of the related financial statement amounts;

   (b) The risk of material misstatement of the assertions related to those financial statement amounts; and

   (c) The degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the relevant assertions. (Ref: Para. A7-A9)

### Using the Work of the Internal Audit Function

10. When the external auditor uses specific work of the internal audit function, the external auditor shall perform procedures to evaluate the adequacy of that work. (Ref: Para. A10-A11)

11. When evaluating specific work performed by the internal audit function, the external auditor shall consider the adequacy of the scope of work and whether the evaluation of the internal audit function remains appropriate. The external auditor shall evaluate whether:

   (a) The work is performed by persons having appropriate skills and expertise;

   (b) The work is properly supervised, reviewed and documented;

   (c) Sufficient appropriate audit evidence is obtained to be able to draw reasonable conclusions;

(d) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and

(e) Any exceptions or unusual matters disclosed by the internal audit function are properly resolved.

***

## Application and Other Explanatory Material

### Scope and Objectives of the Internal Audit Function (Ref: Para. 2)

A1. An internal audit function may be responsible for providing analyses, evaluations, assurances, recommendations, and other information to the entity's management and those charged with governance.

A2. The scope and objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and those charged with governance. Internal audit function activities may include one or more of the following:

- Monitoring of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.
- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, measure, classify and report financial and operating information, and specific inquiry into individual items including detailed testing of transactions, balances and procedures.
- Review of the economy, efficiency and effectiveness of operating activities including non-financial activities of an entity.
- Review of compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

### Obtaining an Understanding of the Internal Audit Function (Ref: Para. 7)

A3. An effective internal audit function may affect the nature, timing, and extent of audit procedures performed by the external auditor, but cannot eliminate them entirely.

A4. As a result of obtaining an understanding of the internal audit function, the external auditor may conclude that the internal audit function's activities are not relevant to the financial statement audit. In such circumstances, the external auditor need not consider the internal audit function further. In other circumstances, the external auditor may conclude that it would not be effective to include the effect of the work of the internal audit function in the external auditor's risk assessment, and the scope of the external auditor's understanding of the work of the internal audit function would be determined accordingly.

A5. Factors that may affect the external auditor's understanding of the internal audit function include:

*Organizational status of the internal audit function:* The status of the internal audit function within the entity and the effect such status has on the internal audit function's ability to be objective:

- Whether the internal audit function reports to an officer of appropriate authority to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal audit function.
- Whether the internal audit function has direct access and reports regularly to the board of directors, those charged with governance, or the owner-manager.
- Whether those charged with governance oversee or the owner-manager oversees employment decisions related to the internal audit function.

Ideally, the internal audit function reports to the highest level of management, or to those charged with governance, and is free of any other operating responsibility. In addition, the internal audit function needs to be free to communicate fully with the external auditor.

*Scope of the internal audit function*:

- The nature and extent of internal audit assignments performed.
- Whether, and to what extent, management acts on the recommendations of the internal audit function and how such action is evidenced.

**Planning to Use the Work of the Internal Audit Function** (Ref: Para. 8-9)

A6. Factors, in addition to those identified in paragraph A5, that may affect the external auditor's evaluation of the internal audit function include:

*Technical competence*:

- Whether the persons performing the internal audit function have adequate technical training and proficiency as internal auditors.
- Whether there are established policies for hiring and training the internal audit staff.

*Due professional care:*

- Whether internal audit activities are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals, work programs and working papers.

A7. As the risk of material misstatement of the financial statement item increases, the need for the auditor to perform his or her own tests of the relevant assertions increases.

A8. When planning to use the work of the internal audit function, the external auditor may review the internal audit function's tentative plan for the period and discuss that plan with the internal audit function. It also may be useful to agree in advance the following matters:

- The timing of such work;
- The extent of audit coverage;
- Materiality levels;
- Proposed methods of sample selection;
- Documentation of the work performed; and
- Review and reporting procedures.

A9. Liaison with the internal audit function is likely to be most effective when meetings are held at appropriate intervals throughout the period. It may be useful for the external auditor to be advised of and have access to relevant reports of the internal audit function and to be informed of any significant matters that come to the attention of the internal audit function when these matters may affect the work of the external auditor. Similarly, it may be useful for the external auditor to inform the internal audit function of any significant matters that may affect the internal audit function.

**Using the Work of the Internal Audit Function** (Ref: Para. 10)

A10. The nature, timing, and extent of the procedures to be performed when evaluating the work of an internal audit function are matters of professional judgment depending on the extent of the effect of the internal audit function's work on the external auditor's.

A11. The external auditor's testing of the internal audit function's work may include one or a combination of the following:

- Re-performance of work performed by the internal audit function;
- Examination of other similar items; or
- Observation of procedures performed by the internal audit function.

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**Exposure Draft**
December 2006
Comments are requested by March 31, 2007

*Proposed Redrafted International Standard on Auditing*

# ISA 720, The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements

International Federation
of Accountants

## REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 720 (Redrafted), "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements," for publication in December 2006. This proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by e-mail, so that they will be received by **March 31, 2007**. All comments will be considered a matter of public record. Comments should be addressed to:


Executive Director, Professional Standards
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org


Copies of the exposure draft may be downloaded free-of-charge from the IFAC website at http://www.ifac.org.

## CONTENTS

**EXPLANATORY MEMORANDUM**

## Introduction

This memorandum provides background to proposed International Standard on Auditing (ISA) 720 (Redrafted), "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements." The proposed ISA has been redrafted in accordance with conventions agreed by the International Auditing and Assurance Standards Board (IAASB) to be applied to all ISAs. The IAASB approved the proposed redrafted ISA for exposure in December 2006.

## Background

As part of its project to improve the clarity of its International Standards, the IAASB has undertaken to redraft all of its ISAs in accordance with its new clarity drafting conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the Clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. ISA 720 is in the latter category.

The conventions used by the IAASB in redrafting ISA 720 for exposure, and the authority and obligation attaching to those conventions, are established in the amended *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*[1] (Preface), approved by the IAASB in September 2006.

Consistent with IAASB's decision to include any special considerations relevant to the audit of small entities within the text of ISAs themselves, the guidance in paragraph 106 of International Auditing Practice Statement (IAPS) 1005, "The Special Considerations in the Audit of Small Entities" has been redrafted as considered necessary and incorporated in this proposed redrafted ISA. Consequently, paragraph 106 of IAPS 1005 will be withdrawn when the redrafted ISA becomes effective.

In addition, where considered necessary, any special considerations in the audit of public sector entities have also been included in this proposed redrafted ISA. These issues were addressed with the assistance of a representative of the Financial Audit Guidelines Subcommittee of the International Organization of Supreme Audit Institutions.

## Effective Date

The current timetable envisages that all ISAs will have been revised and redrafted, or redrafted only, by late 2008 and the IAASB has provisionally agreed that the complete set of ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2008. This date will depend on satisfactory progress being made, and will be amended to a later date should that prove necessary. The IAASB believes that it is in the interests of auditors and others

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1 The Preface can be accessed at http://web.ifac.org/download/IAASB_Preface.pdf.

who use the ISAs that the standards should be released as soon as they are approved so as to facilitate their implementation.

## Guide for Respondents

The IAASB is seeking comments **only** on changes resulting from applying the clarity drafting conventions and their effect on the content of the ISA. Respondents are asked to respond in particular to the following questions:

1. Is the objective to be achieved by the auditor, stated in the proposed redrafted ISA, appropriate?
2. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?[1]

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the IAASB to be made aware of this view.

### Request for Specific Comment

The IAASB would particularly welcome comment on the statement made in the second sentence of paragraph 2 relating to the applicability of the proposed redrafted ISA to reading other information in documents used in securities offerings. This sentence is drawn from, and consistent with, paragraph 1 of the extant ISA 720. However, the ISAs have not been developed to provide the basis for engagements in connection with prospectuses and, as they are not directly applicable to a number of potential engagements relating to securities offerings, the IAASB currently doubts whether a generic reference of this nature is helpful. Similar references are made in a small number of other ISAs. The IAASB would welcome views on whether to retain the existing reference or whether it would be preferable to delete the few references to securities offerings in this and other ISAs.

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[1] The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.
- In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

  The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

### Translations

Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed redrafted ISA.

## Supplement to the Exposure Draft

To assist respondents in tracking changes, IAASB staff has prepared an analysis of the decisions that have been made by the IAASB with respect to the treatment of the present tense in the explanatory paragraphs of the extant ISA. This analysis also demonstrates how the material in the extant ISA has been reflected in the proposed redrafted ISA. In particular, the analysis:

- Identifies existing sentences in the present tense and whether they are now treated as a requirement or as application material;
- Maps the material of the extant ISA to the proposed redrafted ISA; and
- Identifies explanatory material that is proposed to be eliminated as a result of redrafting.

These staff-prepared mapping documents are available on the IAASB website at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0074. They are for information purposes only and do not form part of the exposure draft.

## PROPOSED INTERNATIONAL STANDARD ON AUDITING 720

## (REDRAFTED)

## THE AUDITOR'S RESPONSIBILITY IN RELATION TO OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

(Effective for audits of financial statements for periods beginning on or after [date])*

## CONTENTS



International Standard on Auditing (ISA) 720 (Redrafted), "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of ISAs.

* See footnote 1.

# Introduction

## Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility in relation to other information in documents containing audited financial statements. The auditor reads the other information as the credibility of the audited financial statements may be undermined by inconsistencies which may exist between the audited financial statements and other information. (Ref: Para. A1)

2. This ISA has been drafted in terms of documents containing audited financial statements that are provided to owners on the same terms, and at the same time, as the financial statements; for example documents such as annual reports. This ISA may also be applied, adapted as necessary in the circumstances, to other documents containing audited financial statements, such as those used in securities offerings. (Ref: Para. A2-A5)

## Effective Date

3. This ISA is effective for audits of financial statements for periods beginning on or after [date].[1]

# Objective

4. The objective of the auditor is to avoid being associated with other information that may undermine the credibility of the audited financial statements, through:

   (a) Reading the other information and responding appropriately to identified material inconsistencies with the audited financial statements; and

   (b) Responding appropriately to misstatements of fact in the other information that are unrelated to matters appearing in the audited financial statements and of which the auditor becomes aware when reading the other information for the purpose of identifying material inconsistencies.

# Definitions

5. For purposes of the ISAs the following terms have the meanings attributed below:

   (a) Other information – Financial and non-financial information (other than the financial statements or the auditor's report thereon) which is included, either by law, regulation or custom, in a document containing audited financial statements, that is provided to owners on the same terms, and at the same time, as the financial statements. (Ref: Para A6)

   (b) Inconsistency – A statement contained in other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously

[1] This effective date will not be earlier than December 15, 2008.

obtained and, possibly, about the basis for the auditor's opinion on the financial statements.

(c) Misstatement of fact – A statement, contained in other information, that is unrelated to matters appearing in the audited financial statements and is incorrectly stated or presented.

## Requirements

### Reading Other Information

6. The auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.

7. The auditor shall make appropriate arrangements with the entity to obtain the other information on a timely basis. If it is not possible to obtain the other information prior to the date of the auditor's report, the auditor shall read such other information at the earliest practicable opportunity thereafter. (Ref: Para. A7)

### Material Inconsistencies

8. If, on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the audited financial statements or the other information needs to be amended.

9. If an amendment is necessary to the audited financial statements and the entity refuses to make the amendment, the auditor shall express either a qualified or adverse opinion on those financial statements.

10. If an amendment is necessary to the other information and the entity refuses to make the amendment, the auditor shall either include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency or take other appropriate action. (Ref: Para. A8-A9)

### Misstatements of Fact

11. While reading the other information for the purpose of identifying material inconsistencies, the auditor may become aware of an apparent misstatement of fact. If the auditor becomes aware of such a misstatement of fact, the auditor shall discuss the matter with the entity's management. (Ref: Para. A10)

12. When, following such discussions, the auditor still considers that there is an apparent misstatement of fact, the auditor shall request management to consult with a qualified third party, such as the entity's legal counsel, and the auditor shall consider the advice received.

13. If the auditor concludes that there is a misstatement of fact in the other information which management refuses to correct, the auditor shall take further appropriate action. (Ref: Para. A11)

### Availability of Other Information After the Date of the Auditor's Report

14. When reading other information after the date of the auditor's report, the auditor may identify a material inconsistency or become aware of an apparent misstatement of fact in the other information. In such circumstances the auditor shall determine whether the audited financial statements or the other information needs to be amended.

15. When revision of the audited financial statements is necessary, the auditor shall follow the relevant requirements in [proposed] ISA 560 (Redrafted), "Subsequent Events."

16. When revision of the other proposed information is necessary and the entity agrees to make the revision, the auditor shall carry out the procedures necessary under the circumstances. (Ref: Para A12)

17. When revision of the other information is necessary but management refuses to make the revision, the auditor shall take further appropriate action. (Ref: Para A13)

***

## Application and Other Explanatory Material

### Scope of this ISA (Ref: Para 1-2)

A1. In the absence of any separate requirement in the particular circumstances of the engagement (see paragraph A3), the scope of the auditor's opinion does not cover other information and the auditor has no specific responsibility for determining whether or not other information is properly stated.

A2. Other information may comprise, for example:

- A report by management or those charged with governance on operations.
- Financial summaries or highlights.
- Employment data.
- Planned capital expenditures.
- Financial ratios.
- Names of officers and directors.
- Selected quarterly data.

A3. The auditor may have additional responsibilities in relation to other information that are beyond the scope of this ISA. For example, some jurisdictions may require the auditor to apply specific procedures to certain of the other information such as required supplementary data. When there is such an obligation, the auditor's responsibilities are determined by the nature of the engagement and by law and regulation and professional standards. If such other information is omitted or contains deficiencies, the auditor may be required by law or regulation to refer to the matter in the auditor's report.

*Considerations Specific to Smaller Entities*

A4. Unless required by law or regulation, smaller entities are less likely to issue documents containing audited financial statements. However, an example of such a document would be where a legal requirement exists for an accompanying report by those charged with governance. Examples of other information that may be included in a document containing the audited financial statements of a smaller entity are a detailed income statement and a management report.

*Considerations Specific to Public Sector Entities*

A5. For public sector entities, in addition to the requirements of this ISA, there may exist a statutory obligation to report specifically on other information. The procedures described in this ISA are not designed to satisfy such legislative or other audit requirements related to, for example, the expression of an opinion on the reliability of performance indicators and other information contained in the annual report.

**Definitions** (Ref: Para 5(a))

A6. For purposes of the ISAs, the definition of other information does not encompass, for example:

- A press release or a transmittal memorandum, such as a covering letter, accompanying the document containing audited financial statements.
- Information contained in analyst briefings.
- Information contained on the entity's web site.

**Reading Other Information** (Ref: Para 6-7)

A7. Obtaining the other information prior to the date of the auditor's report enables the auditor to resolve possible material inconsistencies and apparent misstatements of fact with management on a timely basis. An agreement with the entity as to when the other information will be available may be helpful.

**Material Inconsistencies** (Ref: Para 8-10)

A8. When the entity refuses to amend the other information the other appropriate action may include not issuing the report or withdrawing from the engagement. The auditor may base the decision on what further action to take on advice from the auditor's legal counsel.

*Considerations Specific to Public Sector Entities*

A9. In the public sector, withdrawal from the engagement or withholding the issue of the auditor's report may not be options. This is particularly the case for national audit agencies that are appointed to audit the financial statements of public sector entities. In such cases the auditor may, as an alternative action, describe the material inconsistency in an Other Matter(s) paragraph in the auditor's report.

**Misstatements of Fact** (Ref: Para 11-13)

A10. When discussing an apparent misstatement of fact with the entity's management, the auditor may not be able to evaluate the validity of some statements included within the other information and management's responses to the auditor's inquiries, and may conclude that valid differences of judgment or opinion exist.

A11. When the auditor concludes that there is a misstatement of fact that management refuses to correct the actions taken could include notifying those charged with governance in writing of the auditor's concern regarding the other information and obtaining legal advice.

**Availability of Other Information After the Date of the Auditor's Report** (Ref: Para 14-17)

A12. The auditor's responsibility with respect to facts discovered after the date of the auditor's report that give rise to a revision of the other information may include reviewing the steps taken by management to ensure that individuals in receipt of the previously issued financial statements, the auditor's report thereon, and the other information are informed of the revision.

A13. When management refuses to make the revision of such other information that the auditor concludes is necessary, appropriate further actions by the auditor may include notifying those charged with governance in writing of the auditor's concern regarding the other information and obtaining legal advice.

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International
Auditing
and Assurance
Standards Board

**Exposure Draft**
December 2006
Comments are requested by April 30, 2007

*Proposed Revised and Redrafted International Standard on Auditing*

# ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

# Proposed Withdrawal of ISA 545, Auditing Fair Value Measurements and Disclosures

International Federation of Accountants

## REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures," for publication in December 2006. The proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by e-mail, so that they will be received by **April 30, 2007**. All comments will be considered a matter of public record. Comments should be addressed to:


Executive Director, Professional Standards
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org


Copies of the exposure draft may be downloaded free-of-charge from the IFAC website at http://www.ifac.org.

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# EXPLANATORY MEMORANDUM

## Introduction

This memorandum provides background to proposed International Standard on Auditing (ISA) 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures," and the proposed withdrawal of ISA 545, "Auditing Fair Value Measurements and Disclosures." The International Auditing and Assurance Standards Board (IAASB) approved the proposed revised and redrafted ISA for exposure in December 2006.

## Background

In December 2004, the IAASB issued an exposure draft of proposed ISA 540 (Revised), "Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)." The comment period closed on April 30, 2005.

The IAASB gave due consideration to the comments received on the proposed ISA and also consulted further with the IAASB Consultative Advisory Group.

The exposure draft of proposed ISA 540 (Revised) was issued using the current drafting conventions of IAASB standards. For such exposure drafts, IAASB is following a process whereby the exposure draft is revised to reflect changes considered necessary by IAASB as a result of the responses to the consultation. The revised ISA is described as the "close-off" document, and represents the final ISA that the IAASB would have published had the drafting conventions not been changed as a result of the IAASB's Clarity Project. A Basis for Conclusions, explaining the more significant issues raised by respondents to the exposure draft and how the IAASB has addressed them, is issued at this point, and the "close-off" document is attached to the minutes of the IAASB meeting at which it was approved. The clarity drafting conventions are then applied to the "close-off" document to arrive at a redrafted ISA that is exposed for comment on the clarity changes only (unless in any particular case there is a specific issue on which further consultation (in effect re-exposure) is deemed necessary).

The IAASB approved the "close off" document of ISA 540 (Revised)[1] following the IAASB's current drafting conventions in September 2006. That document incorporates the changes based on the comments received on the December 2004 exposure draft. The basis for the IAASB's conclusions is explained in the *Basis for Conclusions: Close Off Document – ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)*.[2]

The Basis for Conclusions and "close off" documents are referenced here for information purposes only and do not form part of the exposure draft.

The proposed ISA has been redrafted in accordance with conventions agreed by the IAASB to be applied to all ISAs. The conventions used by the IAASB in redrafting this ISA for exposure, and the

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[1] The "close off" document of ISA 540 (Revised) can be accessed at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0069.

[2] The Basis for Conclusion can be accessed at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0069.

authority and obligation attaching to those conventions, are established in the amended *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*[3] (Preface), approved by the IAASB in September 2006.

The proposed ISA has also been revised to include auditing considerations relating to fair value accounting estimates and disclosures, incorporating and updating material of continuing relevance contained in ISA 545.

## Significant Proposals

### Combination of ISAs 540 and 545

Proposed ISA 540 (Revised) was exposed and considered on the basis that it excluded considerations relating to the audit of fair value measurements and disclosures. The proposed revised and redrafted ISA 540 combines ISAs 540 (Revised) and 545 in one ISA. It is therefore applicable to the audit of accounting estimates, including fair value accounting estimates, and related disclosures.

Several factors have persuaded the IAASB to conclude that ISAs 540 (Revised) and 545 should be combined. First, as financial reporting standards move further towards fair value measurement, references therein are increasing predominantly in connection with the measurement of fair value for financial statement items where there is a need to derive fair value through a process of estimation. As a result, the distinction between accounting estimates and fair value accounting estimates is often becoming more difficult to draw. Maintaining a separate ISA on fair values therefore appears to have little foundation from an auditing point of view, as similar issues often arise in auditing accounting estimates and fair value accounting estimates. The prevailing view of several respondents to the December 2004 exposure draft was therefore that the ISAs should be combined or amalgamated.

Second, the incorporation of ISA 545 in ISA 540 (Revised) focuses the requirements and guidance on auditing fair values on areas of estimation uncertainty and risk. The IAASB believes that this is appropriate, and the combination will enhance the auditor's understanding of auditing issues associated with accounting estimates and fair value accounting estimates specifically because it highlights the similarities between the two and contrasts their subtle differences.

Third, the combination effectively revises ISA 545. It aligns the requirements and guidance on auditing fair values fully with the audit risk model, and improves them for matters covered as part of the revision of ISA 540 (e.g., use of ranges, indicators of possible management bias, etc.).

Finally, in accordance with the principles of the Clarity project, it minimizes unnecessary duplication.

The following highlight some of the more significant changes made to ISA 540 (Revised) to effect the combination of ISAs 540 (Revised) and 545.

*Measurement Objectives*

The proposed revised and redrafted ISA sets out in its introduction the fact that how management makes an accounting estimate, and the auditor's consideration thereof, depends on the measurement

[3] The Preface can be accessed at http://web.ifac.org/download/IAASB_Preface.pdf.

objective of the accounting estimate. That measurement objective will vary depending on the nature of the accounting estimate: from a forecast of the future outcome of a transaction, event or condition giving rise to the need for the accounting estimate (the more familiar 'accounting estimates') to the estimation of the current price at which a hypothetical current transaction would have occurred ('fair value accounting estimates'). The IAASB believes that this provides essential context for the proper application of the requirements of the proposed revised and redrafted ISA.

*Requirements and Application and Other Explanatory Material*

The requirements of the proposed revised and redrafted ISA 540 are applicable to the audit of accounting estimates, including fair value accounting estimates, and related disclosures. The wording of certain of the requirements of ISA 540 (Revised) was amended to make them applicable to both forms of accounting estimates.

The proposed revised and redrafted ISA incorporates the requirements of ISA 545 for the auditor to determine the need to use the work of an expert. It also requires the auditor to evaluate whether the method of measurement used is appropriate in the circumstances. The IAASB considers these matters to be of continuing relevance to the audit of fair value accounting estimates, as well being applicable to accounting estimates other than fair value accounting estimates.

The proposed revised and redrafted ISA 540 introduces guidance on certain relevant fair value auditing considerations that are not addressed at present in extant ISA 545. These include, for example: considerations relating to the need for management to use assumptions that reflect, or are consistent with, those that marketplace participants would use in determining fair value; and considerations relating to the accuracy and reliability of the variables that are incorporated in valuation models.

The application material of ISA 540 (Revised) has also been redrafted in order to achieve an appropriate balance in terms of the nature and extent of the combined application material.

### Withdrawal of ISA 545

The IAASB is satisfied that all material within ISA 545 of continuing relevance has been appropriately considered. Subject to comments on the exposure draft, ISA 545 will be withdrawn when the proposed redrafted and revised ISA 540 becomes effective.

## Effective Date

The proposed revised and redrafted ISA 540 will not become effective at a date earlier than December 15, 2008.

## Guide for Respondents

The IAASB has carefully considered the comments on the December 2004 exposure draft and is not seeking, and will not consider, comments on matters that have been debated and resolved in arriving at the "close off" document (that is, matters relating to the audit of accounting estimates and related disclosures, other than those involving fair value measurements and disclosures).

The IAASB is seeking comments **only** on the following:

## Redrafting of ISA 540 (Revised)

Comments are sought on the changes resulting from applying the clarity drafting conventions and their effect on the content of the ISA. Respondents are asked to respond (including explanation) in particular to the following questions:

1. Is the objective to be achieved by the auditor, stated in the proposed revised and redrafted ISA, appropriate?
2. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?[4]

## Combination of ISAs 540 (Revised) and 545

Comments are sought on the proposed combination of ISAs 540 and 545, its effect on the content of the ISA, and the proposed withdrawal of ISA 545. Respondents are also asked to comment on whether the special considerations in the audit of small entities and public sector entities in relation to fair value accounting estimates have been dealt with appropriately in the proposed revised and redrafted ISA 540.

## Audit Documentation

The proposed revised and redrafted ISA includes a requirement that states that the audit documentation shall include:

(a) The basis for the auditor's conclusions about the reasonableness of accounting estimates that give rise to significant risks; and

(b) Indicators of possible management bias.

The exposure draft of proposed ISA 230 (Redrafted), "Audit Documentation," issued December 2006, deals with the auditor's responsibility to prepare audit documentation. It states that the auditor shall prepare audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments in reaching those conclusions. There is a view that the matters addressed in (a) and (b) above are covered under the topic of significant matters. In accordance with that view, including specific additional audit documentation requirements in this (and possibly other) individual ISAs appears unnecessary and may undermine the general effect of ISA 230 (Redrafted).

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[4] The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.
- In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

  The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

While accepting that the foregoing argument has some merit, and without necessarily establishing a precedent for future standards, the IAASB is of the view that including a specific audit documentation requirement in proposed ISA 540 (Revised and Redrafted) in respect of the above matters is appropriate to promote consistency in the application of the general requirements of ISA 230 (Redrafted).

Respondents' views are sought on the inclusion of the specific proposed documentation requirement in ISA 540 (Revised and Redrafted), having regard to proposed ISA 230 (Redrafted).

### Translations

Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed revised and redrafted ISA.

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure drafts, it will be helpful for the IAASB to be made aware of this view.

## Supplement to the Exposure Draft

To assist respondents in tracking changes as a result of redrafting the ISA in accordance with the IAASB clarity drafting conventions, IAASB staff has prepared for the proposed revised and redrafted ISA an analysis of the decisions that have been made by the IAASB with respect to the treatment of the present tense in the explanatory paragraphs of the "close off" document. This analysis also demonstrates how the material in the "close off" document has been reflected in the proposed revised and redrafted ISA. In particular, the analysis:

- Identifies existing sentences in the present tense and whether they are now treated as a requirement or as application material;
- Maps the material of each "close off" document to the proposed redrafted ISA; and
- Identifies explanatory material that is proposed to be eliminated as a result of redrafting.

These staff-prepared mapping documents are available on the IAASB website http://www.ifac.org/Guidance/EXD-Details.php?EDID=0069. They are for information purposes only and do not form part of the exposure draft.

## PROPOSED INTERNATIONAL STANDARD ON AUDITING 540

## (REVISED AND REDRAFTED)

## AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES

(Effective for audits of financial statements for periods beginning on or after [date])*

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* See footnote 2.

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International Standard on Auditing (ISA) 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of ISAs.

# Introduction

## Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the audit of accounting estimates, including fair value accounting estimates, and related disclosures. Specifically, it expands on how ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" and ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks," and other relevant ISAs, are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

*Nature of Accounting Estimates*

2. Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this ISA, such financial statement items are accounting estimates. The degree of estimation uncertainty associated with accounting estimates varies widely; it affects the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias. Accordingly, this ISA applies to all accounting estimates, including fair value accounting estimates, and disclosures of amounts that involve estimation uncertainty. (Ref: Para. A1-A10)

3. The measurement objective for some accounting estimates is to forecast the future outcome of a transaction, event or condition giving rise to the need for the accounting estimate. For other accounting estimates, including fair value accounting estimates, however, the measurement objective is different. For example, the concept of a fair value measurement ordinarily assumes a hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as "marketplace participants" or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.[1] Accordingly, the measurement objective for fair value is ordinarily to estimate the price at which a transaction would have occurred at the measurement date.

4. A difference between the future outcome of an accounting estimate and the amount originally recognized in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed future outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

## Effective Date

5. This ISA is effective for audits of financial statements for periods beginning on or after [date].[2]

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[1] Different definitions of fair value may exist among financial reporting frameworks.

[2] This date will not be earlier than December 15, 2008.

## Objective

6. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether the accounting estimates, including fair value accounting estimates, and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework.

## Definitions

7. For purposes of the ISAs, the following terms have the meanings attributed below:

   (a) Accounting estimate – An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this ISA addresses only accounting estimates involving measurement at fair value, however, the term "fair value accounting estimates" is used.

   (b) Auditor's point estimate or auditor's range – The amount, or range of amounts, respectively, derived from audit evidence (whether obtained by the auditor or provided by a third-party expert engaged by the auditor) for use in evaluating management's point estimate.

   (c) Estimation uncertainty – The susceptibility of a financial statement item to an inherent lack of precision in its measurement.

   (d) Management bias – A lack of neutrality by management in the preparation and presentation of information.

   (e) Management's point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

   (f) Significant assumption(s) – An assumption(s) used in making an accounting estimate where a reasonable variation in the assumption(s) would materially affect the measurement of the accounting estimate.

## Requirements

### Risk Assessment Procedures and Related Activities

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by ISA 315 (Redrafted), the auditor shall obtain an understanding of the following: (Ref: Para. A11)

   (a) The requirements of the applicable financial reporting framework relevant to accounting estimates. (Ref: Para. A12-A14)

   (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A15-A20)

(c) How management makes the accounting estimates (i.e., management's process for making the accounting estimates), and an understanding of the data on which they are based, including: (Ref: Para. A21-A22)

(i) Relevant controls; (Ref: Para. A23-A24)

(ii) Whether management has used an expert, from either within or outside the entity; (Ref: Para. A25-A26)

(iii) The assumptions underlying the accounting estimates; (Ref: Para. A27-A28)

(iv) Whether, and if so why, there has been a change from the prior period in the methods for making the accounting estimates; and (Ref: Para. A29)

(v) Whether, and if so how, management has assessed the effect of estimation uncertainty. (Ref: Para. A30)

9. The auditor shall review the outcome, or re-estimation, of accounting estimates made in the prior period financial statements. The nature and extent of the auditor's review is determined taking account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. (Ref: Para. A31-A36)

**Identifying and Assessing the Risks of Material Misstatement**

10. In identifying and assessing the risks of material misstatement, as required by ISA 315 (Redrafted), the auditor shall:

(a) Evaluate the degree of estimation uncertainty associated with an accounting estimate, and the susceptibility of the accounting estimate to bias; and (Ref: Para. A37-A38)

(b) Determine which accounting estimates, whether recognized or disclosed in the financial statements, have high estimation uncertainty and may, therefore, give rise to significant risks. (Ref: Para. A39-A43)

**Responses to the Assessed Risks of Material Misstatement**

11. Based on the assessed risks of material misstatement, the auditor shall determine, to the extent not already done: (Ref: Para. A44)

(a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and (Ref: Para. A45-A48)

(b) Whether the methods for making the accounting estimates have been applied consistently, and the basis for changes, if any, in accounting estimates from the prior period. (Ref: Para. A49-A50)

12. The auditor shall determine the need to use the work of an auditor's expert to obtain sufficient appropriate audit evidence regarding accounting estimates that give rise to risks of material misstatement.[3] (Ref: Para. A51)

13. In responding to the assessed risks of material misstatement, as required by ISA 330 (Redrafted), the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (Ref: Para. A52-A53)

    (a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (Ref: Para. A54-A59)

    (b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether: (Ref: Para. A60-A62)

        (i) The method of measurement used is appropriate in the circumstances; and (Ref: Para. A63-A65)

        (ii) The assumptions used by management are reasonable. (Ref: Para. A66-A72)

    (c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A73-A75)

    (d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose: (Ref: Para. A76-A80)

        (i) When the auditor uses assumptions or a method for making a point estimate or a range that differ from management's, the auditor shall obtain an understanding of management's assumptions or method sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. (Ref: Para. A81)

        (ii) When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Para. A82-A85)

## Further Substantive Procedures to Respond to Significant Risks

### *Estimation Uncertainty*

14. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA 330 (Redrafted), the auditor shall evaluate the following: (Ref: Para. A86)

    (a) How management has considered alternative assumptions or outcomes, and why it has rejected them. Where this has not been done by management, the auditor shall inquire of management about how it has addressed the effects of estimation

[3] The IAASB has a project in progress to revise ISA 620, "Using the Work of an Expert." The IAASB will consider the need for, or modification of the wording of, this requirement as part of the deliberations relating to the future exposure and finalization of proposed revised ISA 620.

uncertainty on the accounting estimate, and shall evaluate whether it has been adequately addressed. (Ref: Para. A87-A90)

(b) Whether the significant assumptions used by management are reasonable. (Ref: Para. A91-A92)

(c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the requirements of the applicable financial reporting framework relevant to the accounting estimates, management's intent to carry out specific courses of action and its ability to do so. (Ref: Para. A93)

15. Where, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall consider whether it is necessary to develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A94-A95)

*Recognition and Measurement Criteria*

16. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether management's decision to:

(a) recognize, or to not recognize, the accounting estimates in the financial statements; or (Ref: Para. A96-A97)

(b) use fair value as the measurement basis for the accounting estimates, (Ref: Para. A98)

is in accordance with the requirements of the applicable financial reporting framework.

*Disclosures of Estimation Uncertainty*

17. For accounting estimates that give rise to significant risks, the auditor shall evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements, in the context of the applicable financial reporting framework. (Ref: Para. A99-A101)

### Evaluating the Reasonableness of the Accounting Estimates and Related Disclosures, and Determining Misstatements

18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates and related disclosures in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (Ref: Para. A102-A106)

### Indicators of Possible Management Bias

19. The auditor shall determine whether there are indicators of possible management bias in the making of accounting estimates. (Ref: Para. A107-A108)

### Written Representations

20. The auditor shall obtain written representations from management regarding the reasonableness of significant assumptions used by it in making accounting estimates. (Ref: Para. A109-A110)

**Documentation**

21. The audit documentation shall include:

    (a) The basis for the auditor's conclusions about the reasonableness of accounting estimates that give rise to significant risks; and

    (b) Indicators of possible management bias. (Ref: Para. A111)

***

## Application and Other Explanatory Material

**Nature of Accounting Estimates** (Ref: Para. 2)

A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. The Appendix to this ISA discusses fair value measurements and disclosures under different financial reporting frameworks.

A2. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.
- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.

A3. For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded or exchanged.

In some cases, the sensitivity of an accounting estimate to changes in assumptions may be so great that a reliable accounting estimate cannot be made.

A4. Additional examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful accounts;
- Inventory obsolescence;
- Warranty obligations;
- Depreciation method or asset useful life;
- Outcome of long term contracts; and
- Costs arising from litigation settlements and judgments.

A5. Additional examples of situations where fair value accounting estimates may be required include:

- Complex financial instruments which are not traded in an active and open market.
- Property or equipment held for disposal.
- Certain assets or liabilities acquired in a business combination.
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

A6. Not all financial statement items requiring measurement at fair value, however, involve estimation uncertainty. For example, this may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value. However, estimation uncertainty may exist even in such circumstance, for example where valuation of quoted securities held for investment purposes at the listed market price requires adjustment under the entity's applicable financial reporting framework if the holding is significantly large in size or is subject to restrictions in marketability, where only bid and asked prices are available, or where there are multiple sources of quoted market prices.

A7. Estimation involves judgments based on information available at the time of preparation of the financial statements. For many accounting estimates, these include judgments about assumptions relating to matters that are uncertain at the time of estimation.

*Management Bias*

A8. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and are influenced by management judgment. Such judgment may involve unintentional or intentional management bias as a result of motivation to achieve a desired result. The susceptibility of an accounting estimate to management bias increases with the degree of subjectivity of the decisions involved in making the accounting estimate. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

A9. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature. ISA 240 (Redrafted), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" establishes requirements and provides guidance on the auditor's responsibilities relating to fraud in an audit of financial statements.

*Considerations Specific to Public Sector Entities*

A10. Public sector entities may have significant holdings of specialized assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value. Measurement at fair value therefore ordinarily requires estimation and may be complex, and in some rare cases may not be possible at all.

**Risk Assessment Procedures and Related Activities** (Ref: Para. 8)

A11. The risk assessment procedures and related activities required by this ISA assist the auditor in developing an expectation of the nature and type of accounting estimates that an entity may have. The expectation is used for purposes of identifying and assessing risks, and planning the nature, timing and extent of further audit procedures.

*Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework* (Ref: Para. 8(a))

A12. Obtaining an understanding of the requirements of the applicable financial reporting framework assists the auditor in determining whether it, for example:

- Prescribes certain conditions for the recognition,[4] or methods for the measurement, of accounting estimates.
- Specifies certain conditions that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability as criteria for determining whether to use a fair value measurement basis or how it is applied.
- Specifies required or permitted disclosures.

It also provides the auditor with a basis for discussion with management about how it has applied those requirements relevant to the accounting estimate, and the auditor's determination of whether they have been applied appropriately.

A13. In some cases, management may be able to make a point estimate directly. In other cases, management may be able to make a reliable point estimate only after considering

[4] Most financial reporting frameworks require incorporation in the balance sheet or income statement of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognize such items, including accounting estimates.

alternative assumptions or outcomes from which it is able to determine a point estimate. Financial reporting frameworks may, or may not, provide guidance for management on determining point estimates where alternatives exist. Some financial reporting frameworks, for example, require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome.[5] Others may require, for example, that the point estimate used for fair value accounting estimates be based on a discounted probability-weighted expected value.

A14. Financial reporting frameworks may require the disclosure of information concerning the significant assumptions to which the accounting estimate is particularly sensitive. Furthermore, where there is a high degree of estimation uncertainty, some financial reporting frameworks do not permit an accounting estimate to be recognized in the financial statements, but certain disclosures may be required in the notes to the financial statements.

*Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates* (Ref: Para. 8(b))

A15. In preparing the financial statements, management has the responsibility to determine whether a transaction, event or condition gives rise to the need to make an accounting estimate, and that all necessary accounting estimates have been recognized, measured and disclosed in the financial statements in accordance with the applicable financial reporting framework.

A16. Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:

- Its knowledge of the entity's business and the industry in which it operates.
- Its knowledge of the implementation of strategies in the current period.
- Where applicable, its cumulative experience of preparing the entity's financial statements in prior periods.

In such cases, the auditor may obtain an understanding of how management identifies the need for accounting estimates through, for example, inquiry of management. In other cases, where management's process may be more structured, the auditor may perform risk assessment procedures directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.

A17. The completeness of accounting estimates is often a primary consideration of the auditor, particularly accounting estimates relating to liabilities. The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor

5 Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.

in identifying circumstances, or changes in circumstances, that may give rise to the need for an accounting estimate.

A18. Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- The requirements of the applicable financial reporting framework have changed.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A19. During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. ISA 315 (Redrafted) provides guidance when the auditor identifies a material weakness in the entity's risk assessment processes.

Considerations Specific to Smaller Entities

A20. For smaller entities, obtaining this understanding is often straightforward because the range of business activities of those entities is often more limited than that of a larger entity and the transactions are often less complex. Further, often a single person, for example the owner-manager, determines the need to make an accounting estimate and the auditor may focus inquiries accordingly.

*Obtaining an Understanding of How Management Makes the Accounting Estimates* (Ref: Para. 8(c))

A21. Management is responsible for establishing financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods.
- Developing or identifying relevant assumptions that affect accounting estimates.
- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.

A22. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:

- The types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).

- Whether, and if so how, management has used recognized measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and if so, how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

Relevant Controls (Ref: Para. 8(c)(i))

A23. Matters that the auditor may consider in obtaining an understanding of relevant controls include, for example:

- The experience and competence of those who make the accounting estimates.
- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
- The controls over the review and approval of accounting estimates by appropriate levels of management and, where appropriate, those charged with governance.
- The controls over data and the segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates.

A24. Other controls may be relevant to making the accounting estimates. For example, in some cases the entity may use a specific model for making an accounting estimate and put into place specific processes around use of that model, thereby making certain control activities over that process particularly relevant.

Use of Experts (Ref: Para. 8(c)(ii))

A25. Management may have, or the entity may employ individuals with, the experience and competence necessary to make the required point estimates. In some cases, however, management may need to engage an expert to make, or assist in making, them. This need may arise because of, for example:

- The complexity of the matter requiring estimation, for example the measurement of mineral or hydrocarbon reserves in extractive industries.
- The complexity of the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements at fair value.
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

Considerations specific to smaller entities

A26. In smaller entities, the circumstances that give rise to the need for an accounting estimate often are such that the owner-manager is capable of making the required point estimate. In some cases, however, an expert is needed to make, or assist in making, it, and the owner-manager may not have the experience or competence necessary to identify this need. Discussion with the owner-manager early in the audit process about the nature of the accounting estimates and the adequacy of the process to make them may assist the owner-manager in determining the need to use an expert.

Assumptions (Ref: Para. 8(c)(iii))

A27. Assumptions are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- How management assesses whether the assumptions are relevant and complete (i.e., that all relevant variables have been taken into account).
- Where applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- The nature and extent of documentation, if any, supporting the assumptions.

A28. With respect to fair value accounting estimates, the nature of the assumptions used by management may differ from those used in other accounting estimates. The difference relates to the measurement objective of fair value accounting estimates, and thereby the need for management to use assumptions that reflect, or are consistent with, those assumptions which knowledgeable, willing arm's length parties (sometimes referred to as "marketplace participants" or equivalent) would use in determining fair value when exchanging an asset or settling a liability. Specific assumptions will also vary with the characteristics of the asset or liability being valued and the valuation method used (for example, a market approach, or an income approach).

Changes in Methods for Making Accounting Estimates (Ref: Para. 8(c)(iv))

A29. Once management has selected a specific estimation method, it is important that management consider changes in the environment or circumstances affecting the entity or changes in the requirements of the applicable financial reporting framework relevant to accounting estimates. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method provides a more appropriate basis of measurement, or that the change is supported by a change in the requirements of the applicable financial reporting framework, or a change in circumstances.

Estimation Uncertainty (Ref: Para. 8(c)(v))

A30. Matters that the auditor may consider in obtaining an understanding of whether, and if so how, management has assessed the effect of estimation uncertainty include, for example:

- Whether, and if so how, management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.
- How management determines the accounting estimate when analysis indicates a number of outcome scenarios.
- Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.

*Reviewing the Outcome or Re-Estimation of Prior Period Accounting Estimates* (Ref: Para. 9)

A31. The outcome of an accounting estimate will often differ from the accounting estimate recognized in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

A32. The review of the outcome or re-estimation of prior period accounting estimates may also assist the auditor in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's attitude of professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures. However, the review is not intended to call into question the judgments made in the prior year that were based on information available at the time.

A33. The nature and extent of the auditor's review depend on the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement. For example, the auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as a risk assessment procedure is sufficient for purposes of the review.

A34. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognized in the prior period financial statements and the outcome or the re-estimated amount in the current period financial statements. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, the auditor's consideration of the outcome of prior period fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, from which the auditor can judge the likely effectiveness of management's current process; for prior period fair value accounting estimates that are re-estimated, the auditor may direct the review towards determining whether the method of measurement has been applied consistently.

A35. Because of the nature of the measurement objectives of accounting estimates, a difference between the outcome of an accounting estimate and the amount recognized in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the prior period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in preparing and presenting those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

A36. A retrospective review is also required by ISA 240 (Redrafted). That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. However, as a practical matter, the auditor's review of the outcome, or re-estimation, of accounting estimates made in the prior period financial statements as a risk assessment procedure in accordance with this ISA may be carried out in conjunction with the review required by ISA 240 (Redrafted).

## Identifying and Assessing the Risks of Material Misstatement

*Estimation Uncertainty* (Ref: Para. 10(a))

A37. The degree of estimation uncertainty associated with an accounting estimate, and its susceptibility to bias, may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The degree of sensitivity of the accounting estimate to changes in assumptions.

- The existence of recognized measurement techniques that may mitigate the estimation uncertainty.
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- The availability of reliable data from external sources.

A38. Matters that the auditor considers in assessing the risks of material misstatement may also include:

- The actual or expected magnitude of an accounting estimate.
- The recorded amount of the accounting estimate in relation to the amount expected by the auditor to be recorded.
- Whether management has used an expert in making the accounting estimate.
- The outcome of the review of prior period accounting estimates.

*High Estimation Uncertainty and Significant Risks* (Ref: Para. 10(b))

A39. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.
- Accounting estimates that are not calculated using recognized measurement techniques.
- Accounting estimates where the results of the auditor's review of the outcome, or re-estimation, of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.

A40. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation; that is, the materiality of the amount recognized or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty.

A41. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A99-A101).

A42. Where the auditor determines that an accounting estimate gives rise to a significant risk, ISA 315 (Redrafted) requires, to the extent not already done, the auditor to evaluate the design of the entity's related controls, including relevant control activities, and to determine whether they have been implemented.

A43. In some cases, the estimation uncertainty of an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. ISA 570, "Going Concern" establishes requirements and provides guidance in such circumstances.

**Responses to the Assessed Risks of Material Misstatement** (Ref: Para. 11)

A44. ISA 330 (Redrafted) requires the auditor to design and perform audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial statement and assertion levels. Paragraphs A45-A101 focus on specific responses at the assertion level only.

*Application of the Requirements of the Applicable Financial Reporting Framework* (Ref: Para. 11(a))

A45. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures. Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor's attention.

A46. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework may depend, in part, on the auditor's understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations.

A47. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.

A48. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.

*Consistency in Methods and Basis for Changes* (Ref: Para. 11(b))

A49. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time.

A50. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, is a matter of judgment.

*Determining the Need to Use the Work of an Expert* (Ref: Para. 12)

A51. The auditor may have the necessary skill and knowledge to plan and perform audit procedures relating the accounting estimates that give rise to risks of material misstatement, or may determine that it is necessary to use the work of an auditor's expert. ISA 620, "Using the Work of an Expert" provides guidance in determining the need to use the work of an auditor's expert and the auditor's responsibilities when using such work.

*Responses to the Assessed Risks of Material Misstatements* (Ref: Para. 13)

A52. The auditor's decision as to which response identified in paragraph 13 to undertake, individually or in combination, to respond to the risks of material misstatement is influenced by such matters as:

- The nature of the accounting estimate, including whether it arises from routine or non routine transactions.
- Whether the procedure(s) is expected to effectively provide the auditor with sufficient appropriate audit evidence.
- The assessed risk of material misstatement, including whether the assessed risk is a significant risk.

A53. Additional guidance explaining the circumstances in which each of the responses may be appropriate is provided in paragraphs A54-A85.

Events Occurring Up to the Date of the Auditor's Report (Ref: Para. 13(a))

A54. Determining whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:

- Occur; and
- Provide audit evidence that confirms or contradicts the accounting estimate.

A55. Events occurring up to the date of the auditor's report may provide sufficient appropriate audit evidence such as to remove the need to perform additional procedures on the accounting estimate. For example, sale of inventory of a superseded product shortly after the period end may provide audit evidence relating to the estimate of the net realizable value of that inventory. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained.

A56. For some accounting estimates, it may be unlikely that events occurring up to the date of the auditor's report will provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates often develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate. Paragraph 13 identifies other responses to the risks of material misstatement that the auditor may undertake.

A57. In some cases, events that contradict the accounting estimate may be indicative of management having ineffective processes for making accounting estimates, or the existence of management bias in the making of accounting estimates.

A58. A decision by the auditor not to undertake this approach does not relieve the auditor from complying with [proposed] ISA 560 (Redrafted), "Subsequent Events." [Proposed] ISA 560 (Redrafted) requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under [proposed] ISA 560 (Redrafted) is particularly relevant.

Considerations specific to smaller entities

A59. In the case of some smaller entities, the auditor's review of events occurring up to the date of the auditor's report may be a particularly effective response for accounting estimates other than fair value accounting estimates where there is a long period after the balance sheet date available for review of such events.

Testing How Management Made the Accounting Estimate (Ref: Para. 13(b))

A60. Testing how management made the accounting estimate may be an appropriate response when, for example:

- The accounting estimate is derived from the routine processing of data by the entity's accounting system.
- The auditor's review of the outcome, or re-estimation, of similar accounting estimates made in the prior period financial statements suggests that management's current period process is likely to be effective.
- The accounting estimate is based on a large population of items of a similar nature that individually are not significant.

A61. Testing how management made the accounting estimate may involve, for example, the following:

- Testing the extent to which data on which the accounting estimate is based is accurate, complete and relevant, and whether the accounting estimate has been properly determined using such data and management assumptions.
- Considering the source, relevance and reliability of external data.
- Recalculating the accounting estimate, and reviewing information about an accounting estimate for internal consistency.

- Considering management's review and approval processes.
- Considering whether there are any indicators of possible management bias in the making of the accounting estimate (see paragraphs A107-A108).

Considerations specific to smaller entities

A62. In smaller entities, the making of accounting estimates by management is likely to be less structured than in larger entities. Smaller entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Even if the entity has no established process, it does not mean that management is not able to provide a basis upon which the auditor can test the accounting estimate.

Method of measurement (Ref: Para. 13(b)(i))

A63. In many cases, particularly in relation to measurement at fair value, the applicable financial reporting framework may not prescribe the method of measurement, or may specify alternative methods for measurement. In such cases, evaluating whether the method of measurement used is appropriate in the circumstances under the applicable financial reporting framework is a matter of professional judgment. For this purpose, matters that the auditor may consider include, for example:

- Management's rationale for the method selected.
- Whether management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.
- Whether the method is appropriate in the circumstances given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.
- Whether the method is appropriate in relation to the business, industry and environment in which the entity operates.

A64. In some cases, management may have determined that different methods result in a range of significantly different estimates. In such cases, obtaining an understanding of how the entity has investigated the reasons for these differences may assist the auditor in evaluating the appropriateness of the method selected.

A65. In some cases, particularly when determining fair value, management may make the accounting estimate by using a model. Matters that the auditor may consider in such circumstances include, for example, whether:

- The model is suitable for the purpose of achieving the measurement objective of the accounting estimate.
- The model is appropriate in relation to the business, industry and environment in which the entity operates.
- The model incorporates relevant variables that are appropriately supported.

- Where applicable, management periodically calibrates the valuation model and tests it for validity based on observable market data.

Assumptions (Ref: Para. 13(b)(ii))

A66. The auditor's evaluation of the assumptions used by management is based only on information available to the auditor at the time of the audit. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

A67. Assumptions may be supported by differing types of evidence from internal and external sources. Further, for fair value accounting estimates, management is generally faced with a range of different assumptions used by different marketplace participants. In some cases, assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

A68. Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:

- Whether individual assumptions appear reasonable.
- Whether the assumptions are interdependent and internally consistent.
- Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.

A69. The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies. In such cases, the auditor may perform audit procedures to evaluate the reasonableness of such assumptions by considering, for example, whether the assumptions are consistent with:

- The general economic environment and the entity's economic circumstances.
- The plans of the entity.
- Assumptions made in prior periods, if relevant.
- Past experience of, or previous conditions experienced by, the entity, to the extent this historical information may be considered representative of future conditions or events.
- Other assumptions used by management relating to the financial statements.

A70. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates, in addition to those discussed above where applicable, may include, for example:

- Whether, and if so how, management has incorporated market-specific inputs into the development of assumptions, where relevant.

- Whether the assumptions are consistent with observable market conditions, and the characteristics of the asset or liability being measured at fair value.
- Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different market participant assumptions exist.
- Whether, and if so how, management considered assumptions used in, or information about, comparable transactions, assets or liabilities, where appropriate.

A71. The reasonableness of the assumptions used may depend on management's intent and ability to carry out courses of action relevant to them. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Considering management's history of carrying out its stated intentions.
- Reviewing written plans and other documentation, including, where applicable, formally approved budgets, authorizations, minutes, etc.
- Considering management's reasons for a particular course of action.
- Considering management's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments.

A72. In evaluating the reasonableness of the assumptions supporting an accounting estimate, the auditor may identify one or more significant assumptions. If so, it may indicate that the accounting estimate has high estimation uncertainty and may, therefore, give rise to a significant risk. Additional responses to significant risks are described in paragraphs A86-A101.

Testing the Operating Effectiveness of Controls (Ref: Para. 13(c))

A73. Testing the operating effectiveness of the controls over how management made the accounting estimate may be an appropriate response when, for example:

- Controls exist for the review and approval of the accounting estimates by appropriate levels of management and, where appropriate, by those charged with governance.
- The accounting estimate is derived from the routine processing of data by the entity's accounting system.

A74. Testing the operating effectiveness of the controls is required however, in accordance with ISA 330 (Redrafted), when:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or

(b) Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.

### Considerations specific to smaller entities

A75. Controls over the process to make an accounting estimate may exist in smaller entities, but the formality with which they operate varies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses identified in paragraph 13.

### Developing a Point Estimate or Range (Ref: Para. 13(d))

A76. Developing a point estimate or a range to evaluate management's point estimate may be an appropriate response when, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.
- The auditor's review of the outcome, or re-estimation, of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.
- The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.
- There are alternative sources of relevant data available to the auditor which can be used in making a point estimate.

A77. Even when the entity's controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and if so, their nature and extent.

A78. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

A79. The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

A80. The auditor may develop a point estimate or a range in a number of ways, for example by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Further developing management's consideration of alternative assumptions or outcomes, for example by introducing a different set of assumptions.
- Employing or engaging an expert with specialized expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

Understanding Management's Assumptions or Method (Ref: Para. 13(d)(i))

A81. When the auditor makes a point estimate or a range and uses assumptions or a method different than those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range for use in evaluating the reasonableness of management's point estimate. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the reliability of an accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

Narrowing a Range (Ref: Para. 13(d)(ii))

A82. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the 'auditor's range'), the range cannot be one that comprises all possible outcomes if it is to be useful. Such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to identify a material misstatement.

A83. Narrowing the range to a point where all outcomes within the range are considered reasonable may be achieved by:

- Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur, and
- Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable.

A84. Ordinarily, a range that has been narrowed to be equal to or less than the amount lower than materiality determined for purposes of assessing risks and designing further audit procedures[6] is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A86-A101.

A85. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate. In such cases, that point estimate is used as the auditor's point estimate.

## Further Substantive Procedures to Respond to Significant Risks (Ref: Para. 14)

A86. Paragraph 10(b) requires the auditor, in identifying and assessing the risks of material misstatement, to determine which accounting estimates have high estimation uncertainty and may, therefore, give rise to significant risks. Paragraph A39 provides examples of accounting estimates that may have high estimation uncertainty. ISA 330 (Redrafted) requires the auditor to perform substantive procedures that specifically respond to significant risks. In auditing accounting estimates that give rise to significant risks, the auditor's further substantive procedures are primarily directed towards the evaluation of:

- How management has assessed the effect of estimation uncertainty on the accounting estimate, and the effect such uncertainty may have on the appropriateness of the recognition of the accounting estimate in the financial statements; and
- The adequacy of related disclosures.

### *Estimation Uncertainty*

#### Management's Consideration of Estimation Uncertainty (Ref: Para. 14(a))

A87. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterized as a range of outcomes by management, such as "pessimistic" and "optimistic" scenarios.

A88. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.

[6] See ISA 320 (Revised), "Materiality in Planning and Performing an Audit."

A89. This is not intended to suggest that one particular method of addressing estimation uncertainty (such as sensitivity analysis) is more suitable than another, or that management's consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed how estimation uncertainty may affect the accounting estimate that is important, not the specific manner in which it is done.

Considerations specific to smaller entities

A90. Often, smaller entities may use simpler means to assess the estimation uncertainty. In these circumstances, in addition to the auditor's review of available documentation, the auditor generally obtains audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise and experience to address the estimation uncertainty of the accounting estimate. In such cases, the auditor may explain to management the process or the different methods available for doing so, and the documentation thereof.

Significant Assumptions (Ref: Para. 14(b))

A91. The evaluation of significant assumptions for accounting estimates that give rise to significant risks is required because of the influence that such assumptions are likely to have on such accounting estimates. Support for significant assumptions derived from management's knowledge may be obtained from management's continuing processes of strategic analysis and risk management. Even without established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of and discussions with management.

A92. The auditor's considerations in evaluating assumptions made by management are described in paragraphs A66-A70.

Management Intent and Ability (Ref: Para. 14(c))

A93. The auditor's considerations in relation to assumptions made by management and management's intent and ability are described in paragraphs A12 and A71.

*Development of a Range* (Ref: Para. 15)

A94. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where in the auditor's judgment:

- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.

- It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A95. The auditor's considerations in determining a range for this purpose are described in paragraphs A79-A85.

*Recognition and Measurement Criteria*

Recognition of the Accounting Estimates in the Financial Statements (Ref: Para. 16(a))

A96. Where management has recognized an accounting estimate in the financial statements, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have been met. Where the auditor judges that it is the estimation uncertainty associated with an accounting estimate that gives rise to a significant risk, this evaluation focuses on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

A97. With respect to accounting estimates that have not been recognized, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have, in fact, been met. Even where an accounting estimate has not been recognized and the auditor concludes that this treatment is appropriate, there may be a need for adequate disclosure of the circumstances in the notes to the financial statements. The auditor may also determine that there is a need to draw the reader's attention to a significant uncertainty by adding an emphasis of matter paragraph to the auditor's report. ISA 706, "Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report," establishes requirements and provides guidance concerning such paragraphs.

Measurement at Fair Value (Ref: Para. 16(b))

A98. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

*Disclosures of Estimation Uncertainty* (Ref: Para. 17)

A99. The presentation of financial statements in conformity with the applicable financial reporting framework includes adequate disclosure of material matters. In relation to accounting estimates having significant risk, even where the auditor is able to obtain sufficient appropriate audit evidence, the auditor may conclude that estimation uncertainty relating to such estimate needs to be disclosed in light of the circumstances and facts involved. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the auditor's range is in relation to materiality (see related discussion in paragraph A84).

A100. In some cases, the applicable financial reporting framework may specify additional requirements for disclosures regarding uncertainties. For example, some financial reporting frameworks prescribe:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as "Key Sources of Estimation Uncertainty" or "Critical Accounting Estimates."
- The disclosures of the range of possible outcomes, and the assumptions used in determining the range.

A101. Where the applicable financial reporting framework does not prescribe disclosure of estimation uncertainty, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. ISA 705, "Modifications to the Opinion in the Independent Auditor's Report" provides guidance on the implications for the auditor's report when the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading.

**Evaluating the Reasonableness of the Accounting Estimates and Related Disclosures, and Determining Misstatements** (Ref: Para. 18)

A102. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. In such cases, where the auditor has used a range, a misstatement exists when management's point estimate lies outside the auditor's range. The misstatement is measured as the difference between management's point estimate and the nearest point of the auditor's range. Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a financial statement misstatement.

A103. Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias (see paragraphs A107-A108).

A104. [Proposed] ISA 450 (Redrafted), "Evaluation of Misstatements Identified during the Audit" provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statement. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements).
- Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).

- The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.

A105. In some cases, it may not be possible for the auditor to obtain sufficient appropriate audit evidence about an accounting estimate that could be material to the financial statements. ISA 705 establishes requirements and provides guidance regarding expressing either a qualified opinion or disclaimer of opinion in these circumstances.

A106. Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognized in the financial statements.

### Indicators of Possible Management Bias (Ref: Para. 19)

A107. During the audit, the auditor may become aware of judgments and decisions made by management which give rise to indicators of possible management bias. Such indicators do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in [proposed] ISA 450 (Redrafted).

A108. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
- Selection or construction of significant assumptions that yield a point estimate favorable for management objectives.
- Selection of a point estimate by management such that the outcome scenario is indicative of a pattern when considered in conjunction with the optimism or pessimism of other accounting estimates.

### Written Representations (Ref: Para. 20)

A109. [Proposed] ISA 580 (Revised and Redrafted), "Written Representations" discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognized or disclosed in the financial statements may include representations:

- About the appropriateness of the measurement processes, including related assumptions, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.

- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- That no subsequent events require adjustment to the accounting estimates and disclosures included in the financial statements.

A110. For those accounting estimates not recognized or disclosed in the financial statements, written representations may also include representations about:

- The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met (see paragraph A97).
- The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value (see paragraph A98).

### Documentation (Ref: Para. 21)

A111. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A108 for examples of indicators of possible management bias.

# Appendix

(Ref: Para. A1)

The purpose of this appendix is only to provide a general discussion of fair value measurements and disclosures under different financial reporting frameworks, for background and context.

## Fair Value Measurements and Disclosures Under Different Financial Reporting Frameworks

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.
2. Definitions of fair value may differ among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement" defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as "entity-specific value," "value in use," or similar terms, but may still fall within the concept of fair value in this ISA.
3. Financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management's intent to carry out certain courses of action with respect to the specific asset or liability.
4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:
   - Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information;
   - Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met;
   - Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows;

- Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework); or
- Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.

5. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable.

6. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value, such as adjustments for estimated closing costs on sale, adjustments related to the property's condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications. Further, in some cases, collateral assigned (for example, when collateral is assigned for certain types of investment in debt) may need to be considered in determining the fair value or possible impairment of an asset or liability.

7. In most financial reporting frameworks, underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, in this case, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. An entity, however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management's plan to dispose of an asset on an accelerated basis to meet specific business objectives may be relevant to the determination of the fair value of that asset.

### Prevalence of Fair Value Measurements

8. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the determination of, financial statements in a number of ways, including the measurement at fair value of the following:

   - Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument, routinely or periodically "marked-to-market."

- Specific components of equity, for example when accounting for the recognition, measurement and presentation of certain financial instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.
- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.
- Specific assets or liabilities adjusted to fair value on a one-time basis. Some financial reporting frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity's or unit's group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.
- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity's applicable financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.
- Information disclosed in notes to financial statements or presented as supplementary information, but not recognized in the financial statements.

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International
Auditing
and Assurance
Standards Board

**Exposure Draft**
December 2006
Comments are requested by April 30, 2007

*Proposed Revised and Redrafted International Standard on Auditing*

# ISA 580, Written Representations

International Federation of Accountants

## REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 580 (Revised and Redrafted), "Written Representations," for publication in December 2006. The proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by e-mail, so that they will be received by **April 30, 2007**. All comments will be considered a matter of public record. Comments should be addressed to:

Executive Director, Professional Standards
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

Copies of the exposure drafts may be downloaded free-of-charge from the IFAC website at http://www.ifac.org.

**CONTENTS**

# EXPLANATORY MEMORANDUM

## Introduction

This memorandum provides background to, and an explanation of, the proposed International Standard on Auditing (ISA) 580 (Revised and Redrafted), “Written Representations,” approved for exposure by the International Auditing and Assurance Standards Board (IAASB) in December 2006.

## Background

The IAASB commenced this project in April 2004 in response to developments that indicated a need to revise extant ISA 580, “Management Representations.” These included concerns that auditors may be over relying on written representations. During the project, the IAASB considered matters such as the reasons for obtaining written representations, the evidence that they provide, and from whom they should be requested.

The IAASB believes that the proposed revised ISA will enhance auditor performance in an audit of financial statements through more stringent requirements and expanded guidance.

## Significant Proposals

### Relevant Parties

Diversity of the authority or responsibility of management and those charged with governance across jurisdictions makes it difficult to establish universal identification of the persons from whom the auditor should request written representations. Furthermore, individuals other than management or those charged with governance may have specialized knowledge about specific assertions in the financial statements. The proposed revised ISA therefore requires the auditor to determine relevant parties from whom written representations (both general and specific, see below) should be requested.

Relevant parties are to be requested to provide the written representations based on their knowledge and belief, having made appropriate inquiries to be able to provide such representations.

### General Written Representations

The IAASB is of the view that an audit of financial statements in accordance with the ISAs is based on the fundamental premises that management is responsible for (a) preparing and presenting the financial statements in accordance with the applicable financial reporting framework; (b) designing, implementing and maintaining internal control relevant to preparing and presenting financial statements that are free from material misstatement, whether due to fraud or error; and (c) the completeness of information made available to the auditor.

The IAASB acknowledges that legislation, the applicable financial reporting framework, or custom may establish management’s specific responsibilities for preparing and presenting the financial statements. However, the extent of those responsibilities may differ across jurisdictions. The IAASB therefore proposes that ISA 200, “Objective and General Principles Governing an Audit of Financial Statements” be amended to explain that ISAs are written, and audits are conducted, based on the abovementioned premises.

There is a risk that the premises may not be understood by management or, where appropriate, those charged with governance. To avoid misunderstanding, a proposed conforming amendment to ISA 210, "Terms of Audit Engagements" requires the auditor to obtain the acknowledgement and agreement of management and, where appropriate, those charged with governance that they understand the responsibilities.

The proposed revised ISA requires the auditor to request relevant parties to provide general written representations about the premises (see paragraphs 8-10.) Audit evidence obtained during the audit may support or contradict the validity of the premises; however, such evidence is not sufficient without obtaining the general written representations. This is because the auditor may not be able to judge management's knowledge, judgments or intentions solely on other audit evidence.

When relevant parties do not provide the general representations requested by the auditor, or where the auditor concludes that such representations are not reliable, the IAASB is of the view that the auditor is unable to obtain sufficient appropriate audit evidence, and that the possible effects on the financial statements of such inability are pervasive. The auditor therefore is required to disclaim an opinion on the financial statements in such circumstances.

The proposed revised ISA, however, explains that a general written representation that has been modified from that requested by the auditor does not necessarily mean that relevant parties did not provide the representation. The reason for the modification nevertheless may affect the opinion in the auditor's report. (See paragraph A19.)

## Specific Written Representations

Extant ISA 580 requires the auditor to obtain written representations on matters material to the financial statements *when other sufficient appropriate audit evidence cannot reasonably be expected to exist*. To avoid over reliance on written representations, the proposed revised ISA requires the auditor to obtain written representations regarding specific assertions in the financial statements ("specific written representations") *when the auditor considers it necessary to corroborate other audit evidence*. These specific written representations are in addition to those required in accordance with the other ISAs.

Specific written representations are particularly relevant in relation to assertions that involve judgment or intent, or that may not be complete. They do not constitute sufficient appropriate audit evidence by themselves and, accordingly, they do not relieve the auditor of the responsibility to obtain other audit evidence.

When relevant parties do not provide specific written representations requested by the auditor, the IAASB is of the view that it constitutes a scope limitation. Where this is the case, the auditor is required to consider the effect thereof on the opinion in the auditor's report.

## Threshold Amount

The IAASB is of the view that, in some circumstances, the auditor may decide that it would be more effective if the written representations were limited to matters above threshold amounts established by the auditor for the purposes of such representations, having given effect to the possibility of immaterial matters aggregating to become material. The proposed revised ISA therefore provides guidance in this regard, indicating that the auditor may consider agreeing the threshold amounts with relevant parties. (See paragraph A16.)

## Effective Date

The IAASB will determine the effective date of the final ISA after considering the comments received on exposure. It is not envisaged that this date will be earlier than December 15, 2008.

## Guide for Respondents

The IAASB welcomes comments on the proposed revised ISA. Apart from the request for specific comments set out below, the IAASB is seeking comments on all matters addressed in the exposure draft. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in this exposure draft (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view.

### Request for Specific Comments

*General Written Representations Regarding the Financial Statements and Internal Control*

In approving the proposed revised ISA for public comment, some IAASB members were concerned about the details of the general written representations regarding the financial statements. In particular, they were concerned about the third bullet of paragraph 8, which requires relevant parties to state whether specific matters, where relevant in view of the applicable financial reporting framework, have been recognized, measured or disclosed in accordance with that framework. They suggested that the sub-bullets be moved to the application material.

The majority of the IAASB took the view that the detailed elements of the representation were required in order to reinforce the implications of the overall representation about the preparation of the financial statements in accordance with the applicable financial reporting framework. Retaining these details would help to avoid misunderstanding, and thereby improve the quality of the representation received.

**Question 1: Respondents are asked for their views on this matter.**

All IAASB members agreed that relevant parties should be requested to confirm that they acknowledge and understand their responsibility for designing, implementing and maintaining internal control relevant to preparing and presenting financial statements that are free from material misstatement (see paragraph 9). Some IAASB members, however, were concerned about requesting relevant parties to confirm whether they believe that the internal control they have maintained is adequate for that purpose (see paragraph 9). They were of the view that the requirement will be interpreted as requiring relevant parties to assess the effectiveness of internal control.

The majority of IAASB members, however, argued that it is important that relevant parties not only acknowledge and understand their responsibility for internal control, but also confirm whether they believe that the internal control is adequate to support the preparation and presentation of the financial statements. Without this, there would be the possibility that those responsible might acknowledge their responsibilities but be aware of shortcomings in the internal control that may be relevant to the financial statements without informing the auditor. The representation is based on relevant parties' knowledge and belief, having made *appropriate inquiries* to be able to provide such representation (see paragraph 6). It is not envisaged that such inquiries will entail a comprehensive assessment of the effectiveness of internal control.

**Question 2: Respondents are asked to comment on the requirement for the auditor to request relevant parties to confirm whether they believe that the internal control they have maintained is adequate for preparing and presenting financial statements that are free from material misstatement.**

*Disclaimer of Opinion when General Written Representations are Not Obtained*

Some IAASB members were concerned about the requirement in paragraph 19 for the auditor to disclaim an opinion on the financial statements when relevant parties do not provide the general written representations about the premises, relating to management's responsibilities, on which an audit is conducted (see paragraph 8-10). Their concern was that this did not give scope for the auditor to judge the seriousness of the matter, particularly as the requirement would be triggered by a failure to provide one of the detailed elements of the representation (see question 1 above).

The majority of IAASB members, however, were of the view that a failure to provide a specific element of the written representation would undermine the validity of the general written representation itself. If relevant persons had a concern about one or more aspects of the requested written representations it would be open to them to modify such representations appropriately to reflect this. In those circumstances the auditor would be required to use judgment to evaluate the effect of the modified written representations. Paragraph A19 was added to explain how written representations that have been modified from those requested by the auditor may affect the audit and the audit opinion.

**Question 3: Respondents are asked to comment on the requirement in paragraph 19 for the auditor to disclaim an opinion on the financial statements when relevant parties do not provide the general written representations about the premises, relating to management's responsibilities, on which an audit is conducted.**

*Date of the Written Representations*

In accordance with paragraph 11, the general written representations should be as of the same date as the auditor's report on the financial statements. Paragraph 13 requires the auditor to determine whether it is necessary to request relevant parties to provide an updated specific written representation when the specific written representation is as of a date earlier than that of the auditor's report on the financial statements.

An IAASB member is of the view that the requirement in paragraph 11 may not be practical and that the date of the general written representations should be the same date as the approval of the financial statements.

**Question 4: Respondents are asked to comment on the date of the general written representations.**

*Objective and Requirements*

The proposed revised ISA has been drafted in accordance with the clarity drafting conventions.

**Question 5: Respondents are asked to consider whether the objective for the proposed revised ISA is appropriate, and whether the proposed requirements are appropriate responses to that objective.**

## Comments on Other Matters

Recognizing that the proposed revised ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below.

*Special Considerations in the Audit of Small Entities*

Respondents are asked to comment on whether, in their opinion, considerations in the audit of small entities have been dealt with appropriately in the proposed revised ISA. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

*Special Considerations in the Audit of Public Sector Entities*

A representative of the Financial Audit Guidelines Subcommittee of the International Organization of Supreme Audit Institutions participated in the development of the exposure draft. Respondents are asked to comment on whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the proposed revised ISA. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

*Developing Nations*

Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed revised ISA in a developing nation environment. Reasons should be provided, as well as suggestions for alternative or additional guidance.

*Translations*

The IAASB welcomes comment from respondents on potential translation issues noted in reviewing the proposed revised ISA.

# PROPOSED INTERNATIONAL STANDARD ON AUDITING 580
# (REVISED AND REDRAFTED)
# WRITTEN REPRESENTATIONS

(Effective for audits of financial statements for periods beginning on or after [date])*

## CONTENTS



* See footnote 1.

International Standard on Auditing (ISA) 580 (Revised and Redrafted), "Written Representations" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of ISAs.

# Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to request written representations, and the auditor's actions when relevant parties do not provide the requested written representations, or when the auditor concludes that such written representations are not reliable. Appendix 1 lists other ISAs containing requirements and guidance for written representations. Those requirements do not limit the application of this ISA.

### Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after [date].[1]

# Objective

3. The objective of the auditor is to corroborate, by means of written representations:

   (a) The validity of the premises, relating to management's responsibilities, on which an audit is conducted;[2] and

   (b) Other audit evidence obtained with regard to specific assertions in the financial statements.

# Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:

   (a) Written representations – Written statements provided by relevant parties from within the entity to the auditor at the auditor's request. Written representations are either general or specific. Written representations in the context of this ISA do not include financial statements, the assertions therein, and supporting books and records.

   (b) General written representations – Written representations regarding the premises, relating to management's responsibilities, on which an audit is conducted.

   (c) Specific written representations – Written representations regarding specific assertions in the financial statements.

   (d) Relevant parties – Parties responsible for preparing and presenting the financial statements and assertions therein. Regarding specific assertions, relevant parties may also include individuals who have specialized knowledge about those specific

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1 This effective date will not be earlier than December 15, 2008.

2 The term "management" has been used in this ISA to describe those responsible for preparing and presenting the financial statements. Other terms may be appropriate depending on the legal framework in the particular jurisdiction.

assertions and are part of the process followed in preparing and presenting the financial statements and assertions therein. (Ref: Para. A1-A2)

(e) The premises, relating to management's responsibilities, on which an audit is conducted – Those responsibilities of management and, where appropriate, those charged with governance that are fundamental to the conduct of an audit in accordance with the ISAs. They are explained in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements."

## Requirements

### Relevant Parties

5. The auditor shall determine the relevant parties from whom general and specific written representations shall be requested. (Ref: Para. A1-A3)

6. The auditor shall request that relevant parties provide written representations based on relevant parties' knowledge and belief, having made appropriate inquiries for them to be able to provide such representations.

### General Written Representations

7. The auditor shall request relevant parties to provide the general written representations about the financial statements, including internal control, and the completeness of information made available to the auditor set out in paragraphs 8-10 for all financial statements and periods covered by the auditor's report. Such general written representations provide necessary audit evidence about the validity of the premises, relating to management's responsibilities, on which an audit is conducted. However, by themselves, they do not constitute sufficient appropriate audit evidence about the validity of the premises. Accordingly, they do not relieve the auditor of the responsibility to obtain other audit evidence. (Ref: Para. A4-A11, A16)

*Financial Statements*

8. The auditor shall request relevant parties to provide written representations that they acknowledge and understand their responsibility for preparing and presenting the financial statements, and whether they believe that the financial statements are prepared in accordance with the applicable financial reporting framework (or are fairly presented in accordance with the applicable financial reporting framework, when that framework is a fair presentation framework). The representations shall include:

   - Whether the selection and application of accounting policies are appropriate;
   - Whether all transactions have been recorded; and
   - Whether the following matters, where relevant in view of the applicable financial reporting framework, have been recognized, measured or disclosed in accordance with that framework:
     - Plans or intentions that may affect the carrying value or classification of assets and liabilities;

- Liabilities, both actual and contingent;
- Title to or control over assets, and the liens or encumbrances on assets, and assets pledged as collateral;
- Aspects of contractual agreements that may affect the financial statements, including noncompliance; and
- Events subsequent to the period end.

*Internal Control*

9. The auditor shall request relevant parties to provide a written representation that they acknowledge and understand their responsibility for designing, implementing and maintaining internal control relevant to preparing and presenting financial statements that are free from material misstatement, whether due to fraud or error, and whether they believe that the internal control they have maintained is adequate for that purpose.

*Completeness of Information*

10. The auditor shall request relevant parties to provide a written representation whether they believe that all records, documentation, unusual matters of which they are aware, and other information relevant to the audit have been made available to the auditor.

*Form and Date of General Written Representations*

11. The general written representations shall be in the form of a representation letter addressed to the auditor. The general written representations shall be as of the same date as the auditor's report on the financial statements. (Ref: Para. A15)

**Specific Written Representations**

12. Other ISAs contain requirements for specific written representations. In addition to those, a specific written representation may be necessary to corroborate other audit evidence, particularly where judgment, intent or completeness is involved. The auditor shall determine whether specific written representations relating to specific assertions in the financial statements are necessary. Such specific written representations do not constitute sufficient appropriate audit evidence by themselves. Accordingly, they do not relieve the auditor of the responsibility to obtain other audit evidence. (Ref: Para. A12-A14, A16)

13. The auditor shall determine whether it is necessary to request relevant parties to provide an updated specific written representation when the specific written representation is as of a date earlier than that of the auditor's report on the financial statements. (Ref: Para. A15)

**Evaluating the Reliability of Written Representations**

14. Circumstances such as the following may cause the auditor to doubt the reliability of one or more written representations:

    - One or more written representations are inconsistent with other audit evidence; or

- The auditor has identified significant issues related to management's commitment to competence, communication and enforcement of integrity and ethical values, or diligence.

15. When a written representation is inconsistent with other audit evidence, the auditor shall determine the reasons for the inconsistency. When the auditor's doubt remains unresolved, the auditor shall reconsider the reliability of other written representations and take appropriate action. (Ref: Para. A17)

16. When the auditor has identified significant issues related to management's commitment to competence, communication and enforcement of integrity and ethical values, or diligence, the auditor shall assess the effect of these issues on the reliability of written representations and take appropriate action. (Ref: Para. A18)

17. When the auditor concludes that the general written representations about the financial statements, including internal control, or the completeness of information made available to the auditor (see paragraphs 8-10) are not reliable, the premises, relating to management's responsibilities, on which an audit is conducted are not valid, and the auditor shall follow the requirement in paragraph 19.

### When Relevant Parties Do Not Provide Requested Written Representations

18. When relevant parties do not provide the general or specific written representations requested by the auditor, the auditor shall (a) ask for the reasons; (b) reconsider the assessment of the integrity of management and, where appropriate, those charged with governance; and (c) take appropriate actions, including determining the possible effects on the opinion in the auditor's report, having regard to the requirements in paragraphs 19-20. (Ref: Para. A19)

19. When relevant parties do not provide the general written representations about the premises, relating to management's responsibilities, on which an audit is conducted (see paragraphs 8-10) (or the auditor concludes that such general written representations are unreliable (see paragraph 17)), the auditor is unable to obtain sufficient appropriate audit evidence. The possible effects on the financial statements of such inability are pervasive. Therefore, in accordance with ISA 705, "Modifications to the Opinion in the Independent Auditor's Report," the auditor shall disclaim an opinion on the financial statements.

20. When relevant parties do not provide specific written representations requested by the auditor, it constitutes a scope limitation. Where this is the case, the auditor shall consider the effect on the opinion in the auditor's report in accordance with ISA 705.

### Documentation

21. Where an identified significant issue related to management's commitment to competence, communication and enforcement of integrity and ethical values, or diligence exists (see paragraph 16), but the auditor concludes that a written representation is nevertheless reliable, the auditor shall document the reasons for the conclusion.

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## Application and Other Explanatory Material

### Relevant Parties (Ref: Para. 4(d), 5)

A1. To identify relevant parties from whom general written representations are to be requested, it is important to consider the governance structure of the entity, relevant legislation, and circumstances of the engagement. Ordinarily, management is the party responsible for preparing and presenting the financial statements and the assertions therein. Relevant parties therefore include the entity's chief executive officer and chief financial officer or other equivalent persons in entities that do not use such titles. In some circumstances, however, other individuals or bodies, such as those charged with governance, are also responsible.

A2. The auditor applies professional judgment in identifying relevant parties from whom specific written representations are to be requested. The auditor may identify individuals other than those described in paragraph A1 who have specialized knowledge relating to specific assertions in the financial statements and are part of the process followed in preparing and presenting the financial statements and assertions therein. For example:

- An entity may employ an actuary who has responsibility for and specialized knowledge about actuarially determined accounting measurements.
- Staff engineers may have responsibility for and specialized knowledge about environmental liability measurements.
- Internal counsel may provide information essential to provisions for legal claims.

A3. Where uncertainty exists as to the identity of relevant parties, it may be necessary for the auditor to agree with the engaging party, prior to accepting the engagement, who the relevant parties are. This is discussed in ISA 210, "Terms of Audit Engagements."

### General Written Representations (Ref: Para. 7-11)

A4. Legislation, the applicable financial reporting framework, or custom may establish management's responsibility for preparing and presenting the financial statements and for the assertions therein. However, the extent of this responsibility may differ across jurisdictions. Despite these differences, an audit in accordance with the ISAs is conducted on the premises that management is responsible for: preparing and presenting the financial statements in accordance with the applicable financial reporting framework; designing, implementing and maintaining internal control relevant to preparing and presenting financial statements that are free from material misstatement, whether due to fraud or error; and the completeness of information made available to the auditor. Audit evidence obtained during the audit may support or contradict the validity of these premises However, such evidence is not sufficient without obtaining the general written representations described in paragraphs 8-10. This is because the auditor may not be able to judge relevant parties' knowledge, judgments or intentions based on other audit evidence. For example, an auditor could not conclude that all relevant information has been made available without asking whether all such information had been made available.

A5. The expression of relevant parties' responsibilities in law and their signing of the financial statements do not, by themselves, provide sufficient other audit evidence, or serve as a substitute for the written representations required by the ISAs.

A6. Requesting representations about important matters is an effective auditing procedure for a number of reasons. When relevant parties do not provide the representations requested by the auditor, it may alert the auditor to possibly significant issues. Further, the requirement to make written, rather than oral, representations is likely to cause the relevant parties to pay greater attention to such matters. Having to make the general written representations reinforces relevant parties' responsibilities in relation to the financial statements and the audit, and prompts them to consider specific issues more thoughtfully. Obtaining a representation letter may be particularly useful where there is a need to clarify the relevant parties' understanding of the premises, relating to management's responsibilities, on which an audit is conducted.

A7. The general written representations relating to relevant parties' responsibility for (a) designing, implementing and maintaining internal control relevant to preparing and presenting financial statements that are free from material misstatement, whether due to fraud or error, and (b) the completeness of information made available to the auditor, are relevant for all audits. However, some general representations relating to relevant parties' responsibility for preparing and presenting the financial statements in accordance with the applicable financial reporting framework may not always be relevant. For example, written representations relating to liabilities may not be necessary where the financial statements were prepared and presented on a cash basis in accordance with the applicable financial reporting framework.

A8. All periods covered by the auditor's report on the financial statements need to be covered by the general written representations and specific written representations because relevant parties need to reaffirm that the representations they previously made with respect to prior periods remain appropriate. The auditor and relevant parties may agree to a form of representation letter that updates previous representations by addressing whether there are any changes to such representations and, if so, what they are.

A9. Situations may arise where relevant parties who were in place during the period being audited are not in place at the time the written representations are requested by the auditor. Relevant parties, who were not in place during the period being audited, may assert that they are not in a position to provide some or all of the representations requested by the auditor; however, this fact does not diminish their responsibilities. Accordingly, the auditor's responsibility to obtain written representations from them is not affected.

A10. [Proposed] ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance" requires the auditor to communicate with those charged with governance the representations the auditor requested from relevant parties. In some circumstances, it may be appropriate for the auditor to request that the representation letter also be agreed by those charged with governance to ensure that all those charged with governance agree with the written representations that the auditor considers essential to forming an opinion on the financial statements.

*Considerations Specific to Public Sector Entities*

A11. The mandates for audits of the financial statements of public sector entities may be broader than those of other entities. As a result, the objectives of an audit of the financial statements of a public sector entity may give rise to additional general written representations. These may include representations acknowledging economy, efficiency and effectiveness of programs, projects and other activities, or that transactions and events have been carried out in accordance with legislation or proper authority.

**Specific Written Representations** (Ref: Para. 12)

A12. A specific written representation may be necessary to corroborate other audit evidence; in particular, where judgment, intent or completeness is involved. For example, when auditing the valuation of investments where management's intent is crucial to the accounting treatment, it may not be possible to obtain sufficient appropriate audit evidence without a specific written representation from relevant parties in relation to their intentions.

A13. Evaluating judgment or intent is inherently subjective, and therefore uncertain. In some cases, the auditor may obtain audit evidence supporting, or which is inconsistent with, relevant parties' assertions by considering matters directly or indirectly linked to the assertion. When evaluating relevant parties' judgments and intentions the auditor may consider one or more of the following:

- The entity's past history in carrying out its stated intentions.
- The entity's reasons for choosing a particular course of action.
- The entity's ability to pursue a specific course of action.
- The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

A14. A specific written representation does not provide sufficient appropriate audit evidence by itself. For example, a written response to a specific inquiry in relation to the cost of an asset is not a substitute for the audit evidence in relation to such cost that the auditor would ordinarily expect to obtain. Furthermore, audit evidence is influenced by its source and nature. For example, where the source of a specific written representation is not independent from the entity.

**Date of Written Representations** (Ref: Para. 11, 13)

A15. Because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the general written representations are made as of the date of the auditor's report. However, in some circumstances it may be appropriate for the auditor to obtain a specific written representation during the course of the audit. Where this is the case, it may be necessary to request relevant parties to provide an updated specific written representation.

**Threshold Amounts** (Ref: Para. 7, 12)

A16. In some circumstances, the auditor may decide that it would be more effective if general and specific written representations were limited to matters above threshold amounts established by the auditor for the purposes of such representations, having given effect to the possibility of immaterial matters aggregating to become material. Accordingly, any such threshold amount will be relatively small in relation to materiality. For this purpose, the auditor may consider agreeing on the threshold amounts with relevant parties. Threshold amounts may vary with different written representations. It may not be appropriate to subject some matters to a threshold amount. For example it may not be appropriate to limit representations to a threshold amount about the responsibilities of relevant parties or matters related to fraud because of qualitative considerations.

**Evaluating the Reliability of Written Representations** (Ref: Para 15-16)

A17. The appropriate action to be taken in relation to identified inconsistencies may include considering whether the auditor's risk assessment remains appropriate and, if not, revising the risk assessment and determining the nature, timing and extent of further audit procedures to respond to the assessed risks. It may also include the actions referred to in paragraph A18 below.

A18. In the event that the auditor identifies issues related to management's commitment to competence, communication and enforcement of integrity and ethical values, or diligence, appropriate action may include discussing the matter with those charged with governance and, where possible, withdrawing from the engagement unless those charged with governance put in place appropriate corrective measures. Such action may not be sufficient, however, to enable the auditor to issue an unmodified audit opinion.

A19. A written representation that has been modified from that requested by the auditor does not necessarily mean that relevant parties did not provide the written representation. However, such modification may affect the opinion in the auditor's report. For example:

- The general written representation relating to the financial statements may state that relevant parties believe that, except for material noncompliance with a particular requirement of the applicable financial reporting framework, the financial statements are prepared in accordance with that framework. The requirement in paragraph 19 does not apply because the auditor concluded that relevant parties have provided reliable general written representations. However, the auditor considers the effect of the noncompliance on the opinion in the auditor's report in accordance with ISA 705.
- The general written representation relating to internal control may state that relevant parties believe that, except for internal control over a particular account balance, it has maintained internal control adequate for preparing and presenting financial statements that are free from material misstatement, whether due to fraud or error. The requirement in paragraph 19 does not apply because the auditor concluded that relevant parties have provided reliable general written representations. Furthermore, the auditor may be able to obtain sufficient appropriate other audit evidence in relation to that account balance and, as a result, the statement in the general representation may not affect the opinion in the auditor's report. However, the

auditor considers whether a material weakness in internal control existed and the effect thereof on the audit.

- The general written representation relating to completeness of information made available to the auditor may state that relevant parties believe that, except for information destroyed in a fire, all records, documentation, unusual matters of which they are aware, and other information relevant to the audit have been made available to the auditor. The requirement in paragraph 19 does not apply because the auditor concluded that relevant parties have provided reliable general written representations. The auditor considers the effects of the pervasiveness of the information destroyed in the fire on the financial statements and the effect thereof on the opinion in the auditor's report in accordance with ISA 705. Depending on the pervasiveness of the effects, the auditor may disclaim an opinion.

## Appendix 1

(Ref: Para. 1)

## List of ISAs Containing Requirements for Written Representations

ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statement” – paragraph 39

ISA 250, “Consideration of Laws and Regulations” – paragraph 23

[Proposed] ISA 450 (Redrafted), “Evaluation of Misstatements Identified during the Audit” – paragraph 16

[Proposed] ISA 540 (Revised and Redrafted) (Combined ISA 540-545), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures” – paragraph 20

[Proposed] ISA 550 (Revised and Redrafted), “Related Parties” – paragraph 24

ISA 570, “Going Concern” – paragraph 26(c)

# Appendix 2

## Illustrative Representation Letter

The following illustrative letter includes written representations (some of which are specific written representations) that are required by this and other ISAs in effect as of [date]. It is assumed in this example that the requirement of ISA 570, "Going Concern" to obtain a written representation is not relevant and that there are no exceptions to the representations requested by the auditor. If there were exceptions, the representations would need to be modified to reflect the exceptions as discussed in paragraph A19. Where the auditor determines that one or more additional specific written representations are sufficiently important, the auditor may conclude that the inclusion thereof in the representation letter is appropriate. Although such inclusion of specific written representations on a variety of matters may serve to focus relevant parties' attention on those matters, and thus cause the relevant parties to specifically address those matters in more detail than would otherwise be the case, the auditor needs to be aware of the limitations of specific written representations as audit evidence as set out in this ISA.

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20XX[3] for the purpose of expressing an opinion as to whether the financial statements [give a true and fair view][are presented fairly, in all material respects,] in accordance with [specify the applicable financial reporting framework]. We confirm, to the best of our knowledge and belief, having made appropriate inquiries to be able to provide our representations, that:

*Financial Statements*

- We acknowledge and understand our responsibility for preparing and presenting the financial statements and believe that the financial statements are prepared in accordance with [specify the applicable financial reporting framework] (or are fairly presented in accordance with [specify the applicable financial reporting framework]), including the following:
    - Our selection and application of accounting policies is appropriate.
    - All plans or intentions that may materially alter the carrying value or classification of assets and liabilities in the financial statements have been accounted for or disclosed in accordance with the applicable financial reporting framework.

[3] Where the auditor reports on more than one period, the auditor adjusts the date so that the letter pertains to all periods covered by the auditor's report.

- All liabilities, both actual and contingent, have been recorded and, where appropriate, disclosed in accordance with the applicable financial reporting framework.
- The entity has satisfactory title to, or control over, all assets disclosed in the financial statements and, where appropriate, all liens or encumbrances on these assets have been disclosed in accordance with the applicable financial reporting framework.
- We have complied with the aspects of contractual agreements that could have a material effect on the financial statements and instances of noncompliance have been disclosed in accordance with the applicable financial reporting framework.
- All transactions have been recorded.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. ([Proposed] ISA 540 (Revised and Redrafted) (Combined ISA 540-545))
- All events subsequent to the year end for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.
- *[A written representation with regard to related party transactions and the effects of related party relationships will be inserted when proposed ISA 550 (Revised and Redrafted) is finalized.]*
- *[A written representation with regard to related party disclosures in the financial statements will be inserted when proposed ISA 550 (Revised and Redrafted) is finalized.]*
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. ([Proposed] ISA 450 (Redrafted))

*Internal Control*

- We acknowledge and understand our responsibility for the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error, and believe that the internal control we have maintained is adequate for that purpose.

*Completeness of Information*

- All records, documentation, unusual matters of which management is aware, and other information relevant to the audit have been made available to you.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (ISA 240 (Redrafted))
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements. (ISA 240 (Redrafted))

- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (ISA 240 (Redrafted))
- We have disclosed to you all known actual or possible noncompliance with laws and regulations whose effects should be considered when preparing financial statements. (ISA 250)
- *[A written representation with regard to the completeness of related parties, related party relationships and related party transactions will be inserted when proposed ISA 550 (Revised and Redrafted) is finalized.]*

(Relevant Party)

(Relevant Party)

**PROPOSED CONFORMING AMENDMENTS**

## ISA 200, "Objective and General Principles Governing an Audit of Financial Statements"

33a. ISAs are written, and audits are conducted, on the premises that management and, where appropriate, those charged with governance:

- Acknowledge and understand their responsibility for preparing and presenting the financial statements in accordance with the applicable financial reporting framework;
- Acknowledge and understand their responsibility for designing, implementing and maintaining internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
- Will provide complete information to the auditor.

## ISA 210, "Terms of Audit Engagements"

Agreement on Written Representations

5a. **The auditor should obtain the acknowledgement and agreement of management and, where appropriate, those charged with governance that they understand their responsibilities for:**

- **Preparing and presenting the financial statements in accordance with the applicable financial reporting framework;**
- **Designing, implementing, and maintaining internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and**
- **Providing complete information to the auditor.**

5b. ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" explains that audits are conducted on the premises that these responsibilities are acknowledged and understood by management and, where appropriate, those charged with governance. These premises are fundamental to the audit; however, there is a risk that they may not be understood by management or those charged with governance. To avoid misunderstanding, agreement is reached with management and, where appropriate, those charged with governance about their responsibilities as part of agreeing the terms of engagement. Since [proposed] ISA 580 (Revised and Redrafted), "Written Representations" requires the auditor to request written representations about the validity of these premises, it may also be appropriate to make management aware that receipt of such representations from relevant parties will be expected together with specific written representations. It also may be useful to agree with management, or those charged with governance, who the relevant parties are.

5c. When management, or those charged with governance, will not make the necessary acknowledgement and agreement, or will not provide the requested general or specific written representations, the auditor will be unable to obtain sufficient appropriate audit evidence. In such circumstances, it may not be appropriate for the auditor to accept the engagement. In some cases, however, law or regulation prevents the auditor from refusing an engagement. In these cases, the auditor may need to explain to management and those charged with governance the importance of these matters, and the effect that they may have on the opinion in the auditor's report.

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# News & Events

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### IAASB Makes Further Progress on Clarity Standards; Issues Proposals to Enhance Written Representations

*(New York/December 22, 2006)* -- At its most recent meeting in London in December, the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board under the auspices of the International Federation of Accountants (IFAC), approved new proposals to enhance the written representations that auditors request from management, those charged with governance and others, as well as five new exposure drafts written in accordance with its new clarity drafting conventions.

**Written Representations**
The proposals, which are incorporated in proposed International Standard on Auditing (ISA) 580 (Revised and Redrafted), *Written Representations*, provide for general written representations regarding the financial statements, including internal control, and the completeness of information made available to the auditor, and for written representations about specific assertions in the financial statements.

"The aim of this project was to improve the quality and appropriateness of written representations sought by the auditor and, in particular, to deal with concerns about whether auditors may over-rely on representations at the expense of other evidence," explains John Kellas, IAASB Chairman.

**New Clarity Exposure Drafts**
As part of its comprehensive program to enhance the clarity of international standards, the IAASB has also issued the following

exposure drafts of proposed ISAs:

- ISA 230 (Redrafted), *Audit Documentation*;
- ISA 540 (Revised and Redrafted), *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*;
- ISA 560 (Redrafted), *Subsequent Events*;
- ISA 610 (Redrafted), *The Auditor's Consideration of the Internal Audit Function*; and
- ISA 720 (Redrafted), *Reading Other Information in Documents Containing Audited Financial Statements*.

Proposed ISA 540 (Revised and Redrafted) is a combination of ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)* and ISA 545, *Auditing Fair Value Measurements and Disclosures*. The IAASB approved ISA 540 (Revised) in September 2006 as a basis for applying the clarity drafting conventions. As part of the redrafting of ISA 540 (Revised), the IAASB decided that the similarities between estimates and fair value information could be emphasized, and redundancy eliminated, by combining ISA 540 (Revised) and ISA 545 within the proposed revised and redrafted ISA 540.

"The proposed ISA 540 (Revised and Redrafted) will reinforce best practice and cause the auditor to give appropriate attention to areas of accounting judgment, such as assumptions, and to possible bias. The other proposed redrafted standards contain clear requirements and easy to understand application guidance," notes Mr. Kellas.

The exposure drafts form part of the IAASB's ambitious 18-month program to redraft existing standards and to develop new and revised standards following the new drafting conventions, which were developed after extensive consultation with interested parties, such as the IAASB's Consultative Advisory Group and national auditing standard setters, and public consultation. Key elements of the new drafting conventions include: basing each standard on the objective of the auditor with respect to the subject matter of the standard; separating the requirements that the auditor is required to follow from guidance on their application; eliminating the present tense to describe actions by the auditor, which raised ambiguity about whether such actions were required; and other structural and drafting improvements to enhance the overall readability and understandability of the standards. Standards redrafted in this way are described as "redrafted." If further revision has been undertaken, a standard is described as "revised and redrafted."

### How to Comment

Comments on the exposure drafts of proposed redrafted ISAs 230, 560, 610 and 720 are requested by March 31, 2007. Comments on the exposure drafts of proposed ISAs 540 (Revised and Redrafted) and 580 (Revised and Redrafted) are requested by April 30, 2007. The exposure drafts may be viewed by going to http://www.ifac.org/EDs. Comments may be submitted by email to EDComments@ifac.org. They can also be faxed to the attention of the Executive Director, Professional Standards at +1 (212) 286-9570 or mailed to IFAC, 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA. All comments will be considered a matter of public record and will ultimately be posted of IFAC's website.

**About the IAASB and IFAC**
The objective of the IAASB, an independent standard-setting board within IFAC, is to serve the public interest by setting high quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The Public Interest Oversight Board oversees the activities of the IAASB and, as one element of that oversight, establishes the criteria for its due process and working procedures.

IFAC is the worldwide organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC is comprised of 155 members and associates in 118 countries, representing more than 2.5 million accountants in public practice, education, government service, industry and commerce. In addition to setting international auditing and assurance standards through the IAASB, IFAC, through its independent standard-setting boards, sets international ethics, education, and public sector accounting standards. It also issues guidance to encourage high quality performance by professional accountants in business.

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