



30 November 2006

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

**Exposure Drafts of Proposed ISA 260 (Revised and Redrafted) *Communication with Those Charged with Governance*, ISA 320 (Revised and Redrafted) *Materiality in Planning and Performing an Audit* and ISA 450 (Redrafted) *Evaluation of Misstatements Identified during the Audit***

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/exposedraft/](http://www.hkicpa.org.hk/professionaltechnical/assurance/exposedraft/).

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

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

1. Is the objective to be achieved by the auditor, stated in each of the proposed redrafted ISAs, 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 judgement by auditors?

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, they are requested to be received by the Institute on or before **26 January 2007**. Comments may be sent by mail, fax or e-mail to:

Patricia McBride  
Director, Standard Setting  
Hong Kong Institute of Certified Public Accountants  
37<sup>th</sup> Floor, Wu Chung House  
213 Queen's Road East  
Wanchai, Hong Kong

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

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

November 2006  
Exposure Draft

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Response Due Date  
26 January 2007

*ED of proposed ISA 260 (Revised and Redrafted)*

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## **Communication with Those Charged with Governance**

*ED of proposed ISA 320 (Revised and Redrafted)*

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## **Materiality in Planning and Performing an Audit**

*ED of proposed ISA 450 (Redrafted)*

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## **Evaluation of Misstatements Identified during the Audit**



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

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IAASB Press release

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/exposedraft/](http://www.hkicpa.org.hk/professionaltechnical/assurance/exposedraft/)

*Proposed Redrafted International Standard on  
Auditing*

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**ISA 260 (Revised), Communication  
with Those Charged with Governance**



**International Federation  
of Accountants**

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## 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) 260 (Revised and Redrafted), “Communication with Those Charged with Governance,” for publication in October 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 **February 15, 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, 14<sup>th</sup> Floor  
New York, New York 10017 USA

Email responses should be sent to: [Edcomments@ifac.org](mailto: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) 260 (Revised and Redrafted), “Communication with Those Charged with Governance.” 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 October 2006.

### Background

In March 2005, the IAASB issued an exposure draft of proposed ISA 260 (Revised), “Communication with Those charged with Governance.” The comment period closed on July 31, 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 basis for the IAASB’s conclusions, are explained in the *Basis for Conclusions: ISA 260 (Revised), Communication with Those charged with Governance*.

The IAASB approved a “close off” document of ISA 260 (Revised) in the “old style” (i.e., following the IAASB’s current drafting conventions) in May 2006. That document incorporates the changes based on the comments received on the March 2005 exposure draft. It formed the basis for the proposed redrafted ISA.

The Basis for Conclusions and “close off” document are available on the IAASB website at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0063>. They are referenced here for information purposes only and do not form part of the exposure drafts.

The conventions used by the IAASB in redrafting these ISAs for exposure, and the authority and obligation attaching to those conventions, are established in the amended Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface), approved by the IAASB in September 2006. Some respondents may wish to consider the proposed redrafted ISA in light of the authority and obligation attaching to the conventions, as established in the amended Preface. Accordingly, for this purpose the IAASB has made available to respondents the amended Preface on the IAASB website at [http://www.ifac.org/IAASB/downloads/Preface\\_Amended\\_September\\_2006.pdf](http://www.ifac.org/IAASB/downloads/Preface_Amended_September_2006.pdf).<sup>1</sup>

### Effective Date

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

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<sup>1</sup> Before the IAASB issues an international pronouncement in final form, the Public Interest Oversight Board (PIOB) performs a review to satisfy itself whether the IAASB has complied fully with its due process. The IAASB concluded that the PIOB should be advised of the amendments to the Preface at the same time as it is given the first four ISAs redrafted in accordance with the amended Preface (i.e., ISAs 240, 300, 315 and 330). The last of these ISAs was approved in October 2006 and, at the date of issuing this exposure draft, the PIOB has not yet completed its review of due process for the Preface and the four ISAs. Only when this is completed can a document be considered “final.” The Preface and the four ISAs therefore will be issued in final form only when the PIOB is satisfied that the stated due process has been fully complied with.

## Guide for Respondents

The IAASB has carefully considered the comments on the March 2005 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.

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?<sup>2</sup>

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.

## Supplements to the Exposure Drafts

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 “close off” document. This analysis demonstrates how the material in the “close off” document 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 “close off” document to the proposed redrafted ISA; and
- Identifies explanatory material that is proposed to be eliminated or repositioned as a result of redrafting.

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<sup>2</sup> 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.

These Staff-prepared mapping documents are available on the IAASB website at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0063>. They are for information purposes only and do not form part of the exposure drafts.

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 260  
(REVISED AND REDRAFTED)  
COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE**

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

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International Standard on Auditing (ISA) 260 (Revised and Redrafted), “Communication with Those Charged with Governance” 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.

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\* See footnote 1.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements. Although this ISA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities. This ISA does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.
2. This ISA has been drafted in terms of an audit of financial statements, but may also be applicable, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation and presentation of the other historical financial information.
3. Recognizing the importance of effective two-way communication during an audit of financial statements, this ISA provides an overarching framework for the auditor's communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the requirements of this ISA, are identified in other ISAs (see Appendix 1). Further matters, not required by this ISA, may be required to be communicated by laws or regulations, by agreement with the entity, or by additional requirements applicable to the engagement, e.g., the standards of a national professional accountancy body. Nothing in this ISA precludes the auditor from communicating any other matters to those charged with governance. (Ref: Para. A28-A31)

### Effective Date

4. This ISA is effective for audits of financial statements for periods beginning on or after [date].<sup>3</sup>

### Objectives

5. The objectives of the auditor are to:
  - (a) Communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and the scope and timing of the audit;
  - (b) Obtain from those charged with governance, information relevant to the audit; and
  - (c) Provide those charged with governance with timely observations arising from the audit that are relevant to their responsibility to oversee the financial reporting process.
 (Ref: Para. A1-A5)

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<sup>3</sup> This date will not be earlier than December 15, 2008.

## Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) “Those charged with governance” means the person(s)<sup>4</sup> with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include some or all management personnel, e.g., executive members of a governance board of a private or public sector entity, or an owner-manager. In some cases, those charged with governance are responsible for approving<sup>5</sup> the entity’s financial statements (in other cases management has this responsibility). For discussion of the diversity of governance structures, see paragraphs A6-A12.
  - (b) “Management” means the person(s)<sup>2</sup> who have executive responsibility for the conduct of the entity’s operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, e.g., executive members of a governance board, or an owner-manager. Management is responsible for preparing the financial statements, overseen by those charged with governance, and in some cases management is also responsible for approving<sup>3</sup> the entity’s financial statements (in other cases those charged with governance have this responsibility).

## Requirements

### Those Charged with Governance

- 7. The auditor shall determine the appropriate person(s) within the entity’s governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated.
- 8. When the appropriate person(s) with whom to communicate is not clearly identifiable from the engagement circumstances, the auditor shall agree with the engaging party on the relevant person(s) within the entity’s governance structure. (Ref: Para. A6-A9)

### *Communication with a Subgroup of Those Charged with Governance*

- 9. The auditor shall consider whether communication with a subgroup of those charged with governance, e.g., an audit committee, or an individual, adequately fulfills the auditor’s responsibility to communicate with those charged with governance. In some circumstances, the auditor may also need to communicate with the governing body. (Ref: Para. A10-A11)

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<sup>4</sup> “Person” in this context could be an organization, e.g., a corporate trustee (i.e., not necessarily a “natural person”).

<sup>5</sup> “Approving” in this context means they have the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

*When All of Those Charged with Governance are Involved in Managing the Entity*

10. In some cases, all of those charged with governance are involved in managing the entity, e.g., a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this ISA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 14(c). The auditor shall nonetheless consider whether communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Ref: Para. A12)

**Matters to be Communicated**

11. Communication by management with those charged with governance of matters the auditor is required to communicate does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor’s communication with those charged with governance.

*The Auditor’s Responsibilities in Relation to the Financial Statement Audit*

12. The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:
  - (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and
  - (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

This communication is often included in the engagement letter or other form of contract that records the agreed terms of the engagement. (Ref: Para. A13-A14)

*Planned Scope and Timing of the Audit*

13. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: Para. A15-A19)

*Significant Findings from the Audit*

14. The auditor shall communicate with those charged with governance (Ref: Para. A20):
  - (a) The auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice not to be appropriate and, when considered necessary, shall request changes (Ref: Para. A21-A22);
  - (b) Significant difficulties, if any, encountered during the audit (Ref: Para. A23);
  - (c) Unless all of those charged with governance are involved in managing the entity:

- (i) Material weaknesses, if any, in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention and have been communicated to management as required by ISA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," or ISA 330, "The Auditor's Responses to Assessed Risks;"
- (ii) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management (Ref: Para. A24); and
- (iii) Representations the auditor is requesting from management; and
- (d) Other matters, if any, arising from the audit that are, in the auditor's professional judgment, significant to the oversight of the financial reporting process (Ref: Para. A25).

### *Auditor Independence*

15. In the case of listed entities,<sup>6</sup> the auditor shall communicate with those charged with governance:
- (a) A statement that the engagement team and others in the firm as appropriate,<sup>7</sup> the firm and, when applicable, network firms have complied with relevant ethical requirements<sup>8</sup> regarding independence; and
  - (b) (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence.<sup>9</sup> This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and
  - (ii) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level. (Ref: Para. A26-A27)

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<sup>6</sup> The *IFAC Code of Ethics for Professional Accountants* (IFAC Code) defines a listed entity as: "An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body."

<sup>7</sup> The IFAC Code requires that "members of assurance teams, firms and, when applicable, network firms be independent of assurance clients." In addition to the members of the engagement team, the IFAC Code includes as part of the assurance team, "all others within a firm who can directly influence the outcome of the assurance engagement." See the definitions section of the IFAC Code for further elaboration.

<sup>8</sup> Relevant ethical requirements ordinarily comprise the IFAC Code together with national requirements that are more restrictive.

<sup>9</sup> This is a requirement of the IFAC Code.

## **The Communication Process**

### *Establishing the Communication Process*

16. The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. (Ref: Para. A32-A40)

### *Forms of Communication*

17. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 15, and significant findings from the audit when, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. (Ref: Para. A41-A43)

### *Timing of Communications*

18. The auditor shall communicate with those charged with governance on a timely basis. (Ref: Para. A44-A45)

### *Adequacy of the Communication Process*

19. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall take appropriate action to address the effectiveness of the communication process. If the two-way communication between the auditor and those charged with governance is not adequate, there is a risk the auditor may not have obtained all the audit evidence required to form an opinion on the financial statements. The auditor shall consider the effect, if any, on the auditor's assessment of the risks of material misstatements.
20. The auditor need not design specific procedures to support the evaluation required by the preceding paragraph; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. (Ref: Para. A46-48)

## **Documentation**

21. Where matters required by this ISA to be communicated are communicated orally, the auditor shall document them, and how, and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication. (Ref: Para. A49)

\* \* \*

## **Application and Other Explanatory Material**

### **The Role of Communication** (Ref: Para. 5)

- A1. This ISA focuses primarily on communications from the auditor to those charged with governance. However, effective two-way communication is also very important in assisting:

- (a) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor’s independence and objectivity;
  - (b) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
  - (c) Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.
- A2. Although the auditor is responsible for communicating matters required by this ISA, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility.
- A3. Clear communication of specific matters required by this ISA is an integral part of every audit. The auditor is not, however, required to perform procedures specifically to identify other significant matters to communicate with those charged with governance.

*Legal Considerations*

- A4. In some jurisdictions the auditor may be required to notify a regulatory or enforcement body of certain matters communicated with those charged with governance. For example, in some countries the auditor has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action.
- A5. Laws or regulations may prevent the auditor from communicating certain matters with those charged with governance, or others within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In such circumstances, it may be appropriate for the auditor to seek legal advice.

**Those Charged with Governance** (Ref: Para. 7-8)

- A6. Governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example:
- In some jurisdictions a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a “two tier board” structure). In other jurisdictions, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a “one tier board” structure).
  - In some entities, those charged with governance hold positions that are an integral part of the entity’s legal structure, e.g., company directors. In others, e.g., some government entities, a body that is not part of the entity is charged with governance.

- In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.
- A7. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, e.g., the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.
- A8. Such diversity means that it is not possible for this ISA to specify for all audits, the person(s) with whom the auditor is to communicate particular matters. Also, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, e.g., entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. In deciding with whom to communicate matters, the auditor’s understanding of an entity’s governance structure and processes obtained in accordance with ISA 315 is relevant.
- A9. [Proposed] ISA 600 (Revised), “The Audit of Group Financial Statements” includes specific matters to be communicated by group auditors with those charged with governance. When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (for example, common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

*Communication with a Subgroup of Those Charged with Governance* (Ref: Para. 9)

- A10. When considering communicating with a subgroup of those charged with governance, or an individual, the auditor may take into account such matters as:
- The respective responsibilities of the subgroup, or individual, and the governing body.
  - The nature of the matter to be communicated.
  - Relevant legal or regulatory requirements.
  - Whether the subgroup, or individual, (a) has the authority to take action in relation to the information communicated, and (b) can provide further information and explanations the auditor may need.
  - Whether there is also a need to communicate the information, in full or in summary form, with the governing body. This decision may be influenced by the auditor’s assessment of how effectively and appropriately the subgroup, or individual,

communicates relevant information with the governing body. The auditor may make explicit in agreeing the terms of engagement that, unless prevented by laws or regulations, the auditor retains the right to communicate directly with the governing body.

A11. Audit committees (or similar subgroups with different names) exist in many jurisdictions. Although their specific authority and functions may differ, communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:

- The auditor will be invited to regularly attend meetings of the audit committee.
- The chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.
- The audit committee will meet the auditor without management present at least annually.

*When All of Those Charged with Governance are Involved in Managing the Entity* (Ref: Para. 10)

A12. In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognize this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are family members involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

### **Matters to be Communicated**

*The Auditor's Responsibilities in Relation to the Financial Statement Audit* (Ref: Para. 12)

A13. The auditor may communicate such matters as:

- The auditor's responsibility for performing the audit in accordance with ISAs, which is directed towards the expression of an opinion on the financial statements. The matters that ISAs require to be communicated, therefore, include significant matters arising from the audit of the financial statements that are relevant to those charged with governance in overseeing the financial reporting process.
- The fact that ISAs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- When applicable, the auditor's responsibility for communicating particular matters required by laws or regulations, by agreement with the entity or by additional requirements applicable to the engagement, e.g., the standards of a national professional accountancy body.

A14. Laws or regulations, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with those charged with

governance. For example, (a) an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or (b) the mandate of a public sector auditor may provide for matters to be communicated that come to the auditor’s attention as a result of other work, such as performance audits.

*Planned Scope and Timing of the Audit* (Ref: Para. 13)

A15. Communication regarding the planned scope and timing of the audit may:

- (a) Assist those charged with governance in, e.g., understanding better the consequences of the auditor’s work for their oversight activities, discussing with the auditor issues of risk and materiality, and identifying any areas in which they may request the auditor to undertake additional procedures; and
- (b) Assist the auditor to understand better the entity and its environment.

A16. Care is required when communicating with those charged with governance about the scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

A17. Matters communicated may include the following:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- The auditor’s approach to internal control relevant to the audit.
- The application of materiality, focusing on the factors to be considered.

A18. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, the extent to which the auditor will use the work of internal audit, and how the external and internal auditors can best work together in a constructive and complementary manner.
- The views of those charged with governance of:
  - \_ The appropriate person(s) in the entity’s governance structure with whom to communicate.
  - \_ The allocation of responsibilities between those charged with governance and management.
  - \_ The entity’s objectives and strategies, and the related business risks that may result in material misstatements.
  - \_ Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
  - \_ Significant communications with regulators.

- Other matters those charged with governance consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity’s internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.
- The responses of those charged with governance to previous communications with the auditor.

A19. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor’s sole responsibility to determine the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

*Significant Findings from the Audit* (Ref: Para. 14)

A20. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

*Significant Qualitative Aspects of Accounting Practices* (Ref: Para. 14 (a))

A21. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures. Open and constructive communication about significant qualitative aspects of the entity’s accounting practices may include comment on the acceptability of significant accounting practices. Appendix 2 provides guidance on the matters that may be included in this communication.

A22. If requested changes are not made to a significant accounting practice the auditor considers to be inappropriate, it may be appropriate to inform those charged with governance that the auditor will consider the effect of this on the financial statements of the current and future years, and on the auditor’s report.

*Significant Difficulties Encountered During the Audit* (Ref: Para. 14 (b))

A23. Significant difficulties encountered during the audit may include such matters as:

- Significant delays in management providing required information.
- An unnecessarily brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- The unavailability of expected information.
- Restrictions imposed on the auditor by management.

- Management’s unwillingness to make or extend its assessment of the entity’s ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor’s opinion (refer ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report”).

Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 14 (c) (ii))

A24. Significant matters discussed, or subject to correspondence with management may include such matters as:

- Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
- Concerns about management’s consultations with other accountants on accounting or auditing matters.
- Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 14 (d))

A25. Other significant matters arising from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements, that have been corrected.

*Auditor Independence* (Ref: Para. 15)

A26. The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:

- (a) Threats to independence, which may be categorized as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and
- (b) Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm’s own systems and procedures.

Matters communicated may include inadvertent violation of relevant ethical requirements as they relate to auditor independence, and any remedial action taken or proposed.<sup>10</sup>

A27. The communication requirements relating to auditor independence that apply in the case of listed entities may also be relevant in the case of some other entities, particularly those that may be of significant public interest because, as a result of their business, their size or their corporate status, they have a wide range of stakeholders. Examples of entities that are not listed entities but where communication of auditor independence may be appropriate include public sector entities, credit institutions, insurance companies, and retirement

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<sup>10</sup> The IFAC Code includes guidance on safeguards that could be applied if there has been an inadvertent violation relating to a financial interest in an assurance client.

benefit funds. Communications regarding independence may not be relevant, e.g., where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond a financial statement audit.

*Supplementary Matters* (Ref: Para. 3)

- A28. Those charged with governance are responsible for ensuring, through oversight of management, that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.
- A29. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, e.g., significant deficiencies in governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorization.
- A30. In determining whether to communicate supplementary matters with those charged with governance, the auditor may discuss matters of this kind of which the auditor has become aware with the appropriate level of management, unless it is inappropriate to do so in the circumstances.
- A31. If a supplementary matter is communicated, it may be appropriate for the auditor to make those charged with governance aware that:
- (a) Identification and communication of such matters is incidental to the purpose of the audit, which is to form an opinion on the financial statements;
  - (b) No procedures were carried out with respect to the matter other than any that were necessary to form an opinion on the financial statements; and
  - (c) No procedures were carried out to determine whether other such matters exist.

**The Communication Process**

*Establishing the Communication Process* (Ref: Para. 16)

- A32. Clear communication of the auditor's responsibilities, the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication.
- A33. Matters that may also contribute to effective two-way communication include discussion of:
- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.

- The form in which communications will be made.
- The person(s) in the audit team and amongst those charged with governance who will communicate regarding particular matters.
- The auditor’s expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit, e.g. strategic decisions that may significantly affect the nature, timing and extent of audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

A34. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor’s view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A46).

#### Considerations Specific to Smaller Entities

A35. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of listed or larger entities.

#### Communication with Management

A36. Many matters may be discussed with management in the ordinary course of an audit, including matters required by this ISA to be communicated with those charged with governance. Such discussions recognize management’s executive responsibility for the conduct of the entity’s operations and, in particular, management’s responsibility for preparing the financial statements.

A37. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management’s competence or integrity with management. In addition to recognizing management’s executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

#### Confidentiality

A38. The requirements of national professional accountancy bodies, laws or regulations may impose obligations of confidentiality that restrict the auditor's communications with those charged with governance. In some circumstances, potential conflicts between the auditor's

obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

- A39. On occasions, those charged with governance may wish to provide third parties, e.g., bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it is important that the third parties be informed that the communication was not prepared with them in mind, e.g. by stating in written communications with those charged with governance:
- (a) That the communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor, and should not be relied upon by third parties;
  - (b) That no responsibility is assumed by the auditor to third parties; and
  - (c) Any restrictions on its disclosure or distribution to third parties.
- A40. In certain jurisdictions, particularly in the public sector, the auditor may be required to submit copies of certain reports prepared for those charged with governance to relevant regulatory, funding or other bodies. Similarly, there may be a requirement that reports will be made public. In such circumstances, application of the preceding paragraph is modified appropriately. Further, unless required by laws or regulations to provide a third party with a copy of the auditor's written communications with those charged with governance, the auditor may require the prior consent of those charged with governance before doing so.

*Forms of Communication* (Ref: Para. 17)

- A41. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The auditor may communicate matters other than those identified in paragraph 17 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.
- A42. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:
- Whether the matter has been satisfactorily resolved.
  - Whether management has previously communicated the matter.
  - The size, operating structure, control environment, and legal structure of the entity.
  - In the case of a special purpose financial statement audit, whether the auditor also audits the entity's general purpose financial statements.
  - Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.

- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- Whether there have been significant changes in the membership of a governing body.

A43. When a significant matter is discussed with an individual member of those charged with governance, e.g., the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

*Timing of Communications* (Ref: Para. 18)

A44. The appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

- Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.
- It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly, it may often be appropriate to communicate material weaknesses in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention as soon as practicable.
- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, e.g., when accepting an engagement to provide non-audit services, and at a concluding discussion. A concluding discussion may also be an appropriate time to communicate findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices.
- When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.

A45. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being audited.
- Any legal obligation to communicate certain matters within a specified timeframe.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The time at which the auditor identifies certain matters, e.g., the auditor may not identify a particular matter (e.g., noncompliance with a law) in time for preventive

action to be taken, but communication of the matter may enable remedial action to be taken.

*Adequacy of the Communication Process* (Ref: Para. 19-20)

A46. As noted in paragraph A1, effective two-way communication assists both the auditor and those charged with governance. Further, ISA 315 identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment. Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements.

A47. Observations resulting from audit procedures performed for other purposes that may support the auditor's evaluation of the two-way communication between the auditor and those charged with governance may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, e.g., the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A48. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor's opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g.

shareholders in a general meeting), or the responsible government minister or Parliament in the public sector.

- Withdrawing from the engagement where permitted in the relevant jurisdiction.

**Documentation** (Ref: Para. 21)

A49. Documentation of oral communication may include a copy of minutes prepared by the entity retained on the audit file where those minutes are an appropriate record of the communication.

## **Requirements of ISQC 1 and Other ISAs that Refer to Communications with Those Charged With Governance<sup>11</sup>**

The following lists paragraphs in ISQC 1 and other ISAs effective as of [date], unless noted otherwise, that contain specific requirements to communicate with “those charged with governance” (or “board of directors,” “audit committee,” “supervisory board,” or “persons ultimately responsible for the overall direction of the entity”). It does not list requirements to communicate with management. These paragraphs are to be understood and applied in the context of the accompanying material in the Standards from which they come.

**ISQC 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements”** [Effective June 15, 2005]

42. **The firm should assign responsibility for each engagement to an engagement partner. The firm should establish policies and procedures requiring that:**
- (a) **The identity and role of the engagement partner are communicated to key members of client management and those charged with governance; ...**

**ISA 210, “Terms of Audit Engagements”** [Amended as a result of ISA 800 (Revised). Close off document approved October 2006]

19. **If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report to other parties, such as the board of directors or shareholders, the circumstances necessitating the withdrawal.**

**ISA 230, “Audit Documentation”** [Effective June 15, 2006]

16. **The auditor should document discussions of significant matters with management and others on a timely basis.**
17. ... Others with whom the auditor may discuss significant matters include those charged with governance ...

**ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”** [To be issued December 2006]

21. The auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

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<sup>11</sup> Not all Standards listed in this Appendix have yet been redrafted following the new clarity drafting conventions.

38. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor’s ability to continue performing the audit, the auditor shall:

...

- (c) If the auditor withdraws:
  - (i) Discuss with the appropriate level of management and those charged with governance the auditor’s withdrawal from the engagement and the reasons for the withdrawal; and ...

40. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

41. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

- (a) Management;
- (b) Employees who have significant roles in internal control; or
- (c) Others where the fraud results in a material misstatement in the financial statements,

the auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.

42. In accordance with ISA 260, “The Auditor’s Communication with Those Charged with Governance,” the auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor’s judgment, relevant to their responsibilities.

**ISA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”**  
 [Effective December 15, 2004]

32. **The auditor should, as soon as practicable, either communicate with those charged with governance, or obtain evidence that they are appropriately informed, regarding noncompliance that comes to the auditor’s attention.** However, the auditor need not do so for matters that are clearly inconsequential or trivial and may reach agreement in advance on the nature of such matters to be communicated.
33. **If in the auditor’s judgment the noncompliance is believed to be intentional and material, the auditor should communicate the finding without delay.**
34. **If the auditor suspects that members of senior management, including members of the board of directors, are involved in noncompliance, the auditor should report the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or a supervisory board.** Where no higher authority exists, or if the auditor

believes that the report may not be acted upon or is unsure as to the person to whom to report, the auditor would consider seeking legal advice.

**ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”** [To be issued December 2006]

32. The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility, and, as required by ISA 260, “The Auditor’s Communication with Those Charged with Governance,” with those charged with governance (unless all of those charged with governance are involved in managing the entity).

**ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks”** [To be issued December 2006]

19. The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility and, as required by ISA 260, “The Auditor’s Communication with Those Charged with Governance,” with those charged with governance (unless all of those charged with governance are involved in managing the entity)

**Proposed ISA 450 (Redrafted), “Evaluation of Misstatements Identified during the Audit”** [Exposure draft]

15. The auditor shall communicate with those charged with governance<sup>12</sup> uncorrected misstatements and the effect that they may have on the opinion in the auditor’s report, and request their correction. The written representation obtained from management in accordance with paragraph 11 shall form part of this communication. In communicating the effect that material uncorrected misstatements may have on the opinion in the auditor’s report, the auditor shall address them individually. (Ref: Para. A20)
16. The auditor shall communicate with those charged with governance the reasons for, and the implications of a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, including possible implications in relation to future financial statements. (Ref: Para. A21)
17. The auditor shall communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

**Proposed ISA 550 (Revised and Redrafted), “Related Parties”** [Exposure draft]

21. If the auditor identifies related party relationships or transactions not previously identified or disclosed by management, the auditor shall:

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<sup>12</sup> In accordance with ISA 260 (Revised), “Communication with Those Charged with Governance,” if this matter has been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

- (d) If the non-identification or non-disclosure appears intentional, (i) communicate this information to those charged with governance, and . . . .
22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance concerning:
- (a) The completeness and accuracy of information provided to the auditor regarding related party relationships and transactions;
  - (b) The appropriateness of related party disclosures in the financial statements; and
  - (c) The appropriateness of the accounting for related party relationships and transactions, having particular regard to their business rationale.
24. Unless all of those charged with governance are involved in managing the entity, the auditor shall, in order to establish a common understanding with them and to alert them to significant related party relationships and transactions of which they may not have been aware, communicate with them:
- (a) The nature, extent, business rationale and disclosure of significant related party relationships and transactions, including those involving actual or perceived conflicts of interest; and
  - (b) Significant issues identified during the audit regarding the entity’s related party relationships and transactions.

**ISA 570, “Going Concern”** [Effective December 15, 2004] [Conforming amendment issued with this ISA]

- 39a. **The auditor should communicate with those charged with governance events or conditions the auditor has identified that may cast significant doubt on the entity’s ability to continue as a going concern.**

**Proposed ISA 600 (Revised and Redrafted), “The Audit of Group Financial Statements”**  
[Exposure draft]

47. If fraud has been identified in components, or information indicates that a fraud may exist, the group auditor shall communicate this as soon as practicable to group management. If the group auditor believes or suspects that group or component management may be involved in the fraud, the group auditor shall communicate this to those charged with governance of the group.
48. Where another auditor is required by statute, regulation or for another reason to express an audit opinion on the financial statements of a component, and the group auditor becomes aware of matters that may be significant to the financial statements of the component of which component management may be unaware, the group auditor shall request group management to inform component management of such matters. If group management refuses to communicate the matter to component management, the group auditor shall discuss the matter with those charged with governance of the group.
49. In a group audit, the group auditor shall communicate with those charged with governance of the group the following matters in addition to those required by [proposed] ISA 260, “Communication with Those Charged with Governance:”

- (a) The planned work to be performed on the financial information of the components.
- (b) The group auditor's planned involvement in the work to be performed by the other auditors on the financial information of significant components.
- (c) Instances where the group auditor's evaluation of the work of another auditor gave rise to a concern about the quality of the work performed by that other auditor.
- (d) Any limitations on the group audit. For example, where the group auditor's access to component information, those charged with governance of components, component management, or the other auditors (including relevant audit documentation sought by the group auditor) may have been restricted.

**ISA 700, "The Independent Auditor's Report on General Purpose Financial Statements"**

[Amended as a result of ISA 800 (Revised). Close off document approved October 2006]

52. **The auditor should date the report on the financial statements no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. Sufficient appropriate audit evidence should include evidence that all statements that comprise the financial statements have been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.**
55. In some jurisdictions, the law or regulation identifies the individuals or bodies (for example, the directors) that are responsible for concluding that all the statements that comprise the financial statements have been prepared ...

**ISA 705, "Modifications to the Independent Auditor's Report"** [Close off document approved July 2006]

31. **If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit which the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor should request the removal of the limitation. If management refuses, the auditor should communicate the matter with those charged with governance and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence on which to base an unmodified opinion. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should determine the implications as follows:**
- (a) **If the possible effects of the scope limitation are material but not pervasive to the financial statements, the auditor should qualify the opinion; or**
  - (b) **If the possible effects of the scope limitation are both material and pervasive to the financial statements so that a qualification of the opinion would be inadequate to communicate the gravity of the situation:**
    - (i) **The auditor should resign from the audit; or**
    - (ii) **If resignation from the audit before issuing the auditor's report is not practicable or possible, the auditor should disclaim an opinion.**

**In relation to subparagraph (b)(i), if the auditor is aware of matters that would have given rise to a modification of the opinion regarding misstatements identified during the audit, the auditor should communicate such matters to those charged with governance before resigning.**

38. **When the auditor expects to modify the opinion in the auditor’s report, the auditor should communicate with those charged with governance the circumstances that lead to the expected modification and the proposed wording of the modification.**

**ISA 706, “Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor’s Report”** [Close-off document approved July 2006]

19. **When the auditor expects to include an Emphasis of Matter or an Other Matter(s) paragraph in the auditor’s report, the auditor should communicate with those charged with governance regarding this expectation, and the proposed wording of this paragraph.**

**ISA 720, “Other Information in Documents Containing Audited Financial Statements”** [Effective December 15, 2004]

18. **If the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor should consider taking further appropriate action.** The actions taken could include such steps as notifying those persons ultimately responsible for the overall direction of the entity in writing of the auditor’s concern regarding the other information and obtaining legal advice.
23. **When (after the date of the auditor’s report) revision of the other information is necessary but management refuses to make the revision, the auditor should consider taking further appropriate action.** The actions taken could include such steps as notifying those charged with governance in writing of the auditor’s concern regarding the other information and obtaining legal advice.

**Appendix 2**

(Ref: Para. 14(a), and A21-A22)

**Qualitative Aspects of Accounting Practices**

The communication required by paragraph 14(a), and discussed in paragraphs A21 and A22, may include such matters as:

**Accounting Policies**

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant policies as well as information on accounting policies used by similar entities.
- The initial selection of, and changes in significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

**Accounting Estimates**

- For items for which estimates are significant, issues discussed in 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" including, for example:
  - \_ Management's identification of accounting estimates.
  - \_ Management's process for making accounting estimates.
  - \_ Risks of material misstatement.
  - \_ Indicators of possible management bias.
  - \_ Disclosure of estimation uncertainty in the financial statements.

**Financial Statement Disclosures**

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (e.g., disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).
- The overall neutrality, consistency, and clarity of the disclosures in the financial statements.

### **Related Matters**

- The potential effect on the financial statements of significant risks, exposures, and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by unusual transactions including non-recurring amounts recognized during the period, and the extent to which such transactions are separately disclosed in the financial statements.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, e.g., correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.

**CONFORMING AMENDMENTS**  
**INTERNATIONAL STANDARD ON AUDITING 570**  
**GOING CONCERN**

The following heading and paragraphs are inserted after paragraph 39:

**Communication with Those Charged with Governance**

**39a. The auditor should communicate with those charged with governance events or conditions the auditor has identified that may cast significant doubt on the entity's ability to continue as a going concern.**

39b. When events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor discusses with those charged with governance:

(a) Whether the events or conditions constitute a material uncertainty;

(b) Whether use of the going concern assumption is appropriate in the preparation of the financial statements; and

(c) The adequacy of related disclosures in the financial statements.





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*Proposed Redrafted International Standards on  
Auditing*

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ISA 320 (Revised), Materiality in  
Planning and Performing an Audit

ISA 450, Evaluation of Misstatements  
Identified during the Audit



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## 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 drafts, proposed International Standard on Auditing (ISA) 320 (Revised and Redrafted), “Materiality in Planning and Performing and Audit” and proposed ISA 450 (Redrafted), “Evaluation of Misstatements Identified during the Audit,” for publication in October 2006. The proposed ISAs 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 **February 15, 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, 14<sup>th</sup> Floor  
New York, New York 10017 USA

Email responses should be sent to: [Edcomments@ifac.org](mailto: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 Standards on Auditing (ISA) 320 (Revised and Redrafted), “Materiality in Planning and Performing an Audit” and ISA 450 (Redrafted), “Evaluation of Misstatements Identified during the Audit.” The proposed ISAs have 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 ISAs for exposure in October 2006.

## Background

In December 2004, the IAASB issued an exposure draft of proposed ISA 320 (Revised), “Materiality in the Identification and Evaluation of Misstatements.” 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 IAASB concluded that the clarity and flow of the requirements and guidance would be enhanced by addressing materiality and misstatements in separate ISAs; that is, an ISA on materiality in planning and performing an audit and an ISA on evaluating misstatements identified during the audit. This, and the basis for the IAASB’s other conclusions, are explained in the *Basis for Conclusions: ISA 320 (Revised), Materiality in Planning and Performing an Audit and ISA 450, Evaluation of Misstatements Identified during the Audit*.

The IAASB approved “close off” documents of ISA 320 (Revised) and ISA 450 in the “old style” (i.e., following the IAASB’s current drafting conventions) in May 2006. Those documents incorporate the changes based on the comments received on the December 2004 exposure draft. They formed the basis for the proposed redrafted ISAs.

The Basis for Conclusions and “close off” documents are available on the IAASB website at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0062>. They are referenced here for information purposes only and do not form part of the exposure drafts.

The conventions used by the IAASB in redrafting these ISAs for exposure, and the authority and obligation attaching to those conventions, are established in the amended Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface), approved by the IAASB in September 2006. Some respondents may wish to consider the proposed redrafted ISAs in light of the authority and obligation attaching to the conventions, as established in the amended Preface. Accordingly, for this purpose the IAASB has made available to respondents the amended Preface on the IAASB website at [http://www.ifac.org/IAASB/downloads/Preface\\_Amended\\_September\\_2006.pdf](http://www.ifac.org/IAASB/downloads/Preface_Amended_September_2006.pdf).<sup>1</sup>

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<sup>1</sup> Before the IAASB issues an international pronouncement in final form, the Public Interest Oversight Board (PIOB) performs a review to satisfy itself whether the IAASB has complied fully with its due process. The IAASB concluded that the PIOB should be advised of the amendments to the Preface at the same time as it is given the first four ISAs redrafted in accordance with the amended Preface (i.e., ISAs 240, 300, 315 and 330). The last of these ISAs was approved in October 2006 and, at the date of issuing this exposure draft, the PIOB has not yet completed

## Effective Date

The proposed redrafted ISAs 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” documents.

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

1. Is the objective to be achieved by the auditor, stated in each of the proposed redrafted ISAs, 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?<sup>2</sup>

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.

## Supplements to the Exposure Drafts

To assist respondents in tracking changes, IAASB staff has prepared for each of the proposed redrafted ISAs 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” documents. These analyses demonstrate how the material in the “close off” documents has been reflected in the proposed redrafted ISAs. In particular, the analysis:

- Identifies existing sentences in the present tense and whether they are now treated as a requirement or as application material;

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its review of due process for the Preface and the four ISAs. Only when this is completed can a document be considered “final.” The Preface and the four ISAs therefore will be issued in final form only when the PIOB is satisfied that the stated due process has been fully complied with.

<sup>2</sup> 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.

EXPLANATORY MEMORANDUM

- Maps the material of each close off document to the proposed redrafted ISA; and
- Identifies explanatory material that is proposed to be eliminated or repositioned 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=0062>. They are for information purposes only and do not form part of the exposure drafts.

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 320  
(REVISED AND REDRAFTED)**

**MATERIALITY IN PLANNING AND PERFORMING AN AUDIT**

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

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International Standard on Auditing (ISA) 320 (Revised and Redrafted), “Materiality in Planning and Performing an Audit” 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.

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\* See footnote 4.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the determination of materiality and its application in planning and performing an audit of financial statements. ISA 450, “Evaluation of Misstatements Identified during the Audit” deals with how materiality is applied in evaluating misstatements identified during the audit of financial statements.

### Materiality in the Context of an Audit

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
  - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
  - Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
  - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.<sup>3</sup> The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered. (Ref: Para. A1)
3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining a materiality level or levels for the audit. If the applicable financial reporting framework does not include a discussion of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.
4. The auditor’s determination of a materiality level or levels is a matter of professional judgment, and is affected by the auditor’s perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:
  - (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
  - (b) Understand that financial statements are prepared and audited to levels of materiality;
  - (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

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<sup>3</sup> For example, the International Accounting Standards Board’s “Framework for the Preparation and Presentation of Financial Statements” indicates that, for a profit oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

- (d) Make reasonable economic decisions on the basis of the information in the financial statements.
- 5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the financial statements and the opinion in the auditor's report.
- 6. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments affect the nature, timing and extent of audit procedures. The materiality level or levels determined when planning the audit do not necessarily establish a threshold below which misstatements identified during the audit will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below the materiality level or levels. It is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature; however, the auditor considers not only the size but also the nature of any identified misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements and the opinion in the auditor's report (see ISA 450).

### **Effective Date**

- 7. This ISA is effective for audits of financial statements for periods beginning on or after [date].<sup>4</sup>

### **Objective**

- 8. The objective of the auditor is to determine, and reconsider as the audit progresses, an appropriate materiality level or levels to enable the auditor to plan and perform the audit. (Ref: Para. A2)

### **Requirements**

#### **Determining Materiality when Planning the Audit**

##### *Materiality Level for the Financial Statements as a Whole*

- 9. When establishing the overall audit strategy, the auditor shall determine a materiality level for the financial statements as a whole for purposes of:
  - (a) Determining the nature, timing and extent of risk assessment procedures;
  - (b) Identifying and assessing the risks of material misstatement; and
  - (c) Determining the nature, timing and extent of further audit procedures. (Ref: Para. A3-A10)

##### *Materiality Levels for Particular Classes of Transactions, Account Balances or Disclosures*

- 10. When establishing the overall strategy for the audit, the auditor shall also consider whether, in the specific circumstances of the entity, there are particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality level for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. In such circumstances, the

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<sup>4</sup> This date will not be earlier than December 15, 2008.

auditor shall determine the materiality levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A11-A12)

*Amounts Lower than the Materiality Level or Levels for Purposes of Assessing Risks and Designing Further Audit Procedures*

11. The auditor shall determine an amount or amounts lower than the materiality level for the financial statements as a whole (and an amount or amounts lower than the materiality level for particular classes of transactions, account balances or disclosures, if applicable) for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks. (Ref: Para. A13)

**Considerations as the Audit Progresses**

12. The auditor shall revise the materiality level for the financial statements as a whole (and the materiality level for a particular class of transactions, account balance or disclosure, if applicable) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different materiality level or levels initially. (Ref: Para. A14)
13. If the auditor concludes that lower materiality level or levels than that initially determined are appropriate, the auditor shall reconsider the lower amount or amounts determined for purposes of assessing risks of material misstatement and designing further audit procedures, and the appropriateness of the nature, timing and extent of further audit procedures.

**Documentation**

14. The auditor shall document the following amounts and the factors considered in their determination:
  - (a) The materiality level for the financial statements as a whole (see paragraph 9);
  - (b) The materiality level for a particular class of transactions, account balance or disclosure, if applicable (see paragraph 10);
  - (c) The amount or amounts determined for purposes of assessing risks of material misstatement and designing further audit procedures (see paragraph 11); and
  - (d) Any changes made to (a)-(c) as the audit progressed (see paragraphs 12-13).

\* \* \*

**Application and Other Explanatory Material**

**Materiality in the Context of an Audit** (Ref: Para. 2)

*Considerations Specific to Public Sector Entities*

- A1. In the case of a public sector entity, legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions.

**Materiality and Audit Risk** (Ref: Para. 8)

A2. ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” requires the auditor to plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatement. Materiality and audit risk are considered throughout the audit, in particular, when:

- (a) Identifying and assessing the risks of material misstatement (see ISA 315 (Redrafted), “Identifying and Assessing the Risk of Material Misstatements Through Understanding the Entity and Its Environment”);
- (b) Determining the nature, timing and extent of further audit procedures (see ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks”); and
- (c) Evaluating the effect of uncorrected misstatements on the financial statements and the opinion in the auditor’s report (see ISA 450).

**Determining Materiality when Planning the Audit**

*Considerations Specific to Public Sector Entities*

A3. The determination of materiality level or levels in an audit of the financial statements of a public sector entity is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs.

*Materiality Level for the Financial Statements as a Whole*

Use of Benchmarks in Determining Materiality (Ref: Para. 9)

A4. Determining a materiality level for the financial statements as a whole requires the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in that determination. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (e.g., assets, liabilities, equity, income, expenses);
- Whether there are items on which the attention of the users of the particular entity’s financial statements tends to be focused (e.g., for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity’s ownership structure and the way it is financed (e.g., if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity’s earnings); and
- The relative volatility of the benchmark.

- A5. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.
- A6. When an appropriate benchmark has been identified, relevant financial data to be used in determining the materiality level for the financial statements as a whole is identified. Relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (e.g., a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, the materiality level is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality level is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.
- A7. The materiality level is determined in relation to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, the materiality level is determined in relation to the financial statements prepared for that financial reporting period.
- A8. Determining a percentage to be applied to a chosen benchmark requires the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances.

#### Considerations Specific to Small Entities

- A9. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

#### Considerations Specific to Public Sector Entities

- A10. In an audit of a public sector entity, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program activities. Where a public sector entity has custody of public assets, assets may be an appropriate benchmark.

*Materiality Levels for Particular Classes of Transactions, Account Balances or Disclosures*  
(Ref: Para. 10)

A11. Factors that may affect the auditor’s consideration of whether to determine materiality levels to be applied to particular classes of transactions, account balances or disclosures include the following:

- Whether law, regulations or the applicable financial reporting framework affect users’ expectations regarding the measurement or disclosure of certain items (e.g., related party transactions, and the remuneration of management and those charged with governance).
- The key disclosures in relation to the industry in which the entity operates (e.g., research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity’s business that is separately disclosed in the financial statements (e.g., a newly acquired business).

A12. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

*Amounts Lower than the Materiality Level or Levels for Purposes of Assessing Risks and Designing Further Audit Procedures* (Ref: Para. 11)

A13. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. The amount or amounts the auditor determines for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks is set to reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements in the financial statements exceeds the materiality level or levels. The determination of this amount or amounts is not a simple mechanical calculation and requires the auditor to exercise professional judgment. It is affected by the auditor’s understanding of the entity, updated during the execution of the risk assessment procedures, and by the nature and extent of misstatements accumulated in previous audits (e.g., for an entity with a history of large or numerous misstatements accumulated in previous audits, the amount or amounts so determined would be lower than if such misstatements were not present).

**Considerations as the Audit Progresses** (Ref: Para. 12)

A14. The materiality level for the financial statements as a whole (or the materiality level for a particular class of transactions, account balance or disclosure, if applicable) may need to be revised as a result of a change in circumstances that occurred during the audit, new information, or a change in the auditor’s understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used to determine the materiality level or levels, the auditor may need to revise the materiality level or levels.

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 450**

**(REDRAFTED)**

**EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT**

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

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\* See footnote 5.

International Standard on Auditing (ISA) 450 (Revised), “Evaluation of Misstatements Identified during the Audit” 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 evaluation of misstatements identified during the audit of financial statements. ISA 320, “Materiality in Planning and Performing an Audit” deals with the determination of materiality and its application in planning and performing an audit of financial statements. This ISA explains how materiality is applied in evaluating misstatements identified during the audit.

### **Effective Date**

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

### **Objective**

3. The objective of the auditor is to evaluate:
  - (a) The effect of identified misstatements on the audit; and
  - (b) The effect of uncorrected misstatements on the financial statements and whether the financial statements as a whole are free from material misstatement.

### **Definitions**

4. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Error – An unintentional misstatement in the financial statements.
  - (b) Factual misstatements – Misstatements about which there is no doubt.
  - (c) Judgmental 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.
  - (d) Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud and may result from:
    - (i) An inaccuracy in gathering or processing data from which the financial statements are prepared;
    - (ii) An omission of an amount or disclosure;
    - (iii) An incorrect accounting estimate arising from overlooking or clear misinterpretation of facts; and

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<sup>5</sup> This date will not be earlier than December 15, 2008.

- (iv) Management’s judgments concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor’s judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

- (e) Projected 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. Guidance on the determination of projected misstatements and evaluation of the results is set out in ISA 530, “Audit Sampling and Other Means of Testing.”
- (f) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that management has not corrected.

## **Requirements**

### **Accumulation of Identified Misstatements**

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial, distinguishing between factual misstatements, judgmental misstatements and projected misstatements. (Ref: Para. A1-A2)

### **Considerations as the Audit Progresses**

6. The auditor shall consider whether the overall audit strategy and audit plan need to be revised if the nature of identified misstatements and the circumstances of their occurrence are indicative that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material. (Ref: Para. A3)
7. The auditor shall also determine whether the overall audit strategy and audit plan need to be revised if the aggregate of misstatements accumulated during the audit approaches the materiality level or levels. (Ref: Para. A4)
8. If management, in response to the auditor’s findings or at the auditor’s request, has examined a class of transactions, account balance or disclosure and corrected misstatements that were found, the auditor shall perform further audit procedures to reevaluate the amount of misstatements remaining, if any. (Ref: Para. A5)

### **Communication and Correction of Misstatements**

9. The auditor shall communicate all misstatements accumulated during the audit to the appropriate level of management on a timely basis and request management to correct them. (Ref: Para. A6-A8)
10. If management refuses to correct some or all of the misstatements communicated to it by the auditor, the auditor shall obtain an understanding of management’s reasons for not making the

corrections and shall take that into account when evaluating whether the financial statements as a whole are free from material misstatement. (See paragraph 17.)

*Management Representations*

11. The auditor shall obtain written representation from management whether it believes the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representations. (Ref: Para. A9)

**Evaluating the Effect of Uncorrected Misstatements**

12. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess the materiality level or levels used in planning and performing the audit to confirm whether they remain appropriate in the context of the entity’s actual financial results. (Ref: Para. A10-A11)
13. The auditor shall evaluate whether uncorrected misstatements are material, individually or in aggregate. In making this evaluation, the auditor shall consider the size and nature of the misstatements, both in relation to particular classes of transactions, account balances and disclosures and the financial statements as a whole, and the particular circumstances of their occurrence. (Ref: Para. A12-A16)
14. The auditor shall also consider the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A17)

*Communication with Those Charged with Governance*

15. The auditor shall communicate with those charged with governance<sup>6</sup> uncorrected misstatements and the effect that they may have on the opinion in the auditor’s report, and request their correction. The written representation obtained from management in accordance with paragraph 11 shall form part of this communication. In communicating the effect that material uncorrected misstatements may have on the opinion in the auditor’s report, the auditor shall address them individually. (Ref: Para. A20)
16. The auditor shall communicate with those charged with governance the reasons for, and the implications of a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, including possible implications in relation to future financial statements. (Ref: Para. A21)
17. The auditor shall communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

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<sup>6</sup> In accordance with ISA 260 (Revised), “Communication with Those Charged with Governance,” if this matter has been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

## **Evaluating Whether the Financial Statements as a Whole are Free from Material Misstatement**

18. The auditor shall evaluate whether the financial statements as a whole are free from material misstatement. In making this evaluation, the auditor shall consider both the results of the evaluation of the uncorrected misstatements and the qualitative aspects of the entity's accounting practices. (Ref: Para. A22-23)
19. If the auditor concludes that, or is unable to conclude whether, the financial statements as a whole are materially misstated, the auditor shall consider the effect thereof on the opinion in the auditor's report. (Ref: Para. A24)

## **Documentation**

20. The auditor shall document:
  - (a) The amount below which misstatements would be regarded as clearly trivial;
  - (b) All misstatements accumulated during the audit, distinguishing between factual misstatements, judgmental misstatements and projected misstatements, and whether they have been corrected by management; and
  - (c) The auditor's conclusion as to whether uncorrected misstatements, individually or in aggregate, cause the financial statements as a whole to be materially misstated, and the basis for that conclusion. (Ref: Para. A25)

\* \* \*

## **Application and Other Explanatory Material**

### **Accumulation of Identified Misstatements** (Ref: Para. 5)

- A1. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for not material. Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality used in planning and performing the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are "clearly trivial," the matter is considered not "clearly trivial."
- A2. The distinction between factual misstatements, judgmental misstatements and projected misstatements assists the auditor in considering the effects of misstatements accumulated during the audit and in communicating them to management and those charged with governance.

### **Considerations as the Audit Progresses** (Ref: Para. 6-8)

- A3. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown

in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

- A4. If the aggregate of misstatements accumulated during the audit approaches the materiality levels or levels, there may be a greater than an acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality level. Undetected misstatements could exist because of the presence of sampling risk (the risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population was subjected to the same audit procedure) and non-sampling risk (the risk that the auditor may misinterpret audit evidence and thus not recognize misstatements when they occur).
- A5. The auditor may request management to examine a class of transactions, account balance or disclosure, for example, based on the auditor’s projection of misstatements identified in an audit sample to the entire population from which it was drawn.

**Communication and Correction of Misstatements** (Ref: Para. 9-10)

- A6. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if they disagree, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.
- A7. Laws or regulations may prevent the auditor from communicating certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In such circumstances it may be appropriate for the auditor to seek legal advice.
- A8. The correction by management of all misstatements communicated by the auditor assists management in maintaining accurate accounting books and records and reduces the risks of material misstatement of financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

*Management Representations* (Ref: Para. 11)

- A9. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtain written representation from management whether any uncorrected misstatements, other than those that are clearly trivial, are in management’s opinion immaterial, both individually and in the aggregate. In some circumstances, management may not believe that certain of the uncorrected misstatements are misstatements. For that reason, management may want to add to their written representation words such as: “We do not agree that items ... and ... constitute misstatements because [description of reasons].”

**Evaluating the Effect of Uncorrected Misstatements** (Ref: Para. 12-14)

- A10. The auditor’s initial determination of the materiality level or levels is often based on estimates of the entity’s financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor’s evaluation of the effect of uncorrected misstatements, the

materiality level or levels used in planning and performing the audit are reassessed based on the actual financial results.

- A11. ISA 320 explains that, as the audit progresses, the materiality level or levels are revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined different materiality level or levels initially. Thus, any significant revision of the materiality level or levels is likely to have been made before the auditor applies the materiality level or levels in evaluating the effect of uncorrected misstatements. However, as explained in ISA 320, if the materiality level or levels are revised to lower amount or amounts, the lower amount or amounts determined for purposes of assessing risks of material misstatements and designing further audit procedures, and the appropriateness of the nature, timing and extent of further audit procedures, are reconsidered to ensure that sufficient appropriate audit evidence is obtained on which to base the audit opinion.
- A12. Each misstatement is considered separately to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.
- A13. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset immaterial misstatements within an account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting such immaterial misstatements is appropriate.<sup>7</sup>
- A14. Determining whether a classification misstatement is material requires the use of professional judgment and the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals on the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.
- A15. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the materiality level for the financial statements as a whole (or for a particular class of transactions, account balance or disclosure, if any). Circumstances that may affect the evaluation include the extent to which the misstatement:
- Affects compliance with regulatory requirements;
  - Affects compliance with debt covenants or other contractual requirements; or

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<sup>7</sup> The identification of a number of immaterial misstatements within an account balance or class of transactions may require the auditor to reassess the risk of material misstatement for that account balance or class of transactions.

- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period’s financial statements but is likely to have a material effect on future periods’ financial statements.
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity’s financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (e.g., the significance of the matter to a segment or other portion of the entity’s business that has been identified as playing a significant role in the entity’s operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is a misclassification between certain account balances affecting items disclosed separately in the financial statements (e.g., misclassification between operating and non-operating income or recurring and non-recurring income items; or a misclassification between restricted and unrestricted resources in a not-for-profit entity);
- Is significant having regard to the auditor’s understanding of known previous communications to users, for example in relation to forecast earnings;
- Relates to items involving particular parties (e.g., whether external parties to the transaction are related to members of the entity’s management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users’ understanding of the financial position, financial performance or cash flows of the entity;
- Affects other information that will be communicated in documents containing the audited financial statements (e.g., information to be included in a “Management Discussion and Analysis” or an “Operating and Financial Review”) that may reasonably be expected to influence the economic decisions of the users of the financial statements. ISA 720, “Other Information in Documents Containing Audited Financial Statements” deals with the auditor’s consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

A16. ISA 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the effect of the misstatement is not material to the financial statements.

A17. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period’s financial statements. There are different acceptable approaches to the auditor’s evaluation of such uncorrected misstatements on the

current period’s financial statements. Using the same evaluation approach provides consistency from period to period.

*Considerations Specific to Public Sector Entities* (Ref: Para. 12-14)

A18. In the case of an audit of a public sector entity, the evaluation of the materiality of a misstatement may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud.

A19. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, are considered when assessing whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with regulation, legislation or other authority.

*Communication with Those Charged with Governance* (Ref: Para. 15-16)

A20. Where there is a large number of small uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

A21. To reduce the possibility of misunderstandings, the auditor may request a written representation from those charged with governance that explains why uncorrected misstatements brought to their attention have not been corrected. Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

**Evaluating Whether the Financial Statements as a Whole are Free from Material Misstatement** (Ref: Para. 18-19)

A22. In considering the qualitative aspects of the entity’s accounting practices, the auditor recognizes that management makes a number of judgments about the amounts and disclosures in the financial statements. During the audit, the auditor is alert for possible bias in management’s judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements, cause the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor’s evaluation whether the financial statements as a whole are materially misstated include the following:

- The selective correction of misstatements brought to management’s attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings).
- Possible management bias in the making of accounting estimates.

A23. ISA 540 (Revised), “Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)” addresses possible management bias in making accounting estimates. Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor’s evaluation of whether the financial statements as a whole are free from material misstatement.

A24. ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report” deals with circumstances that may result in a modification to the auditor’s opinion on the financial

statements, the type of opinion appropriate in the circumstances, and the content of the auditor's report when the auditor's opinion is modified.

**Documentation** (Ref: Para. 20)

A25. The following factors may affect the manner in which the auditor documents the auditor's conclusion, and the basis thereof, as to whether uncorrected misstatements, individually or in the aggregate, cause the financial statements as a whole to be materially misstated:

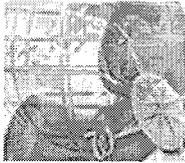
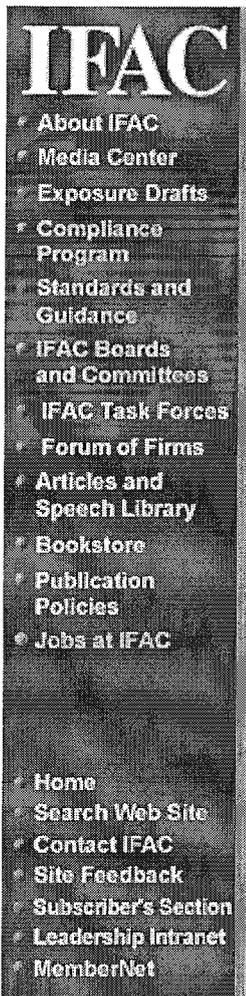
- (a) The consideration of the aggregate effect of uncorrected misstatements on the financial statements as a whole;
- (b) The evaluation of whether the materiality level for a particular class of transactions account balance or disclosure, if any, has been exceeded; and
- (c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (e.g., debt covenants).



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### IAASB Issues Exposure Drafts to Enhance the Clarity of Standards on Materiality, Misstatements, and Communications with Those Charged with Governance

(New York/November 15, 2006) -- As part of its comprehensive program to enhance the clarity of international standards, the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board under the auspices of the International Federation of Accountants (IFAC), has issued three exposure drafts of proposed International Standards on Auditing (ISAs) that follow its new clarity drafting conventions. These 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.

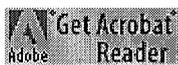
The IAASB developed the new drafting conventions after extensive consultation with interested parties, including its Consultative Advisory Group and national auditing standards setters, on how to enhance the clarity of its pronouncements. Key elements of the new drafting conventions include: basing the standards on objectives, as opposed to procedural considerations; using the word "shall" to identify requirements that the professional accountant is expected to follow in the vast majority of engagements; eliminating the present tense to describe actions by the professional accountant; and structural improvements to enhance the overall readability and understandability of the standards.

The following three proposed standards have been redrafted following the new drafting conventions:

- ISA 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit*;
- ISA 450 (Redrafted), *Evaluation of Misstatements Identified during the Audit*; and

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- ISA 260 (Revised and Redrafted), *Communication with Those Charged with Governance*.

"The concept of materiality, the evaluation of misstatements identified during the audit, and high quality and relevant discussions between those charged with governance and the auditor are fundamental to an audit," explains IAASB Chairman John Kellas. "We believe that the proposed redrafted standards contain clear requirements and easy to understand application guidance in these very important areas."

### **How to Comment**

Respondents are asked to comment on the application of the new drafting conventions only. Comments on all three exposure drafts are requested by February 15, 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](mailto: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. Its current membership consists of approximately 160 professional accountancy bodies in 120 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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