



CHARTERED CERTIFIED ACCOUNTANTS

Article topic: Financial Reporting

The 'Clarity' Project

June 2010

In 2004, the International Auditing and Assurance Standards Board (IAASB) undertook a programme in which the objective was to enhance the clarity of its ISAs. The IAASB said that the overall aim of its clarity project was to enhance the understandability of the ISAs which would then enable consistent application of the standards and in turn improve audit quality at a worldwide level.

All of the ISAs have been rewritten as part of the Clarity project and are effective for audits of financial statements commencing for periods beginning on or after 15 December 2009 (essentially December 2010 year ends). Each standard is now structured in a new way, with clear objectives, definitions and requirements, together with application and other explanatory material. The structure of the new standards make it easier to understand what is required and what is purely guidance. In addition, ISQC 1 has also been rewritten and the revised guidance on quality control procedures will also become effective at the same time as the Clarified ISAs.

A summary of the clarity project is as follows:

- 19 ISAs and ISQC 1 '*Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Service Engagements*' have been redrafted. You will see '(redrafted)' contained after the ISA/ISQC 1 number.
- 16 ISAs have been both revised and redrafted. You will see '(revised and redrafted)' contained after the ISA number.
- Two new standards have been issued: one relating to communication – ISA 265 '*Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*', and another relating to the evaluation of misstatements: ISA 450 '*Evaluation of Misstatements Identified During the Audit*'.

- ISA 540 'Audit of Accounting Estimates' and 545 'Auditing Fair Value Measurements and Disclosures' have both been combined in ISA 540 (revised and redrafted) 'Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures'.
- Each redrafted standard contain a new structure as follows:
 - Introduction.
 - Objective.
 - Definitions.
 - Requirements.
 - Application.
 - Other explanatory material.

Whilst all the ISAs have been rewritten, the main areas of audit work that are affected by the changes to Clarified ISAs are:

ISA 600 (revised and redrafted) The Audit of Group Financial Statements

The revised ISA covers a wider scope than the previous standard and sets out new requirements in respect of the relationship between the group engagement team and the component auditors. It will affect audit firms who are not the auditor for the entire group.

The Clarity project has given rise to the following areas which are likely to require additional thought and documentation:

- Consideration of whether the engagement is a group audit within the scope of ISA 600 (revised and redrafted).
- Scoping the group audit, including determining significant components in the group.
- Gaining an understanding of the group-wide internal control environment and the consolidation process.
- Determining materiality and performance materiality for the group and its components.
- Obtaining an understanding of the component auditors involved in the work.

ISA 550 (revised and redrafted) Related Parties

Related parties have always been a 'bone of contention' because of their subjective nature. This revised ISA contains a number of new specific requirements which place a much greater emphasis on a risk-based approach to auditing related parties.

This revised and redrafted standard recognises that risks of material misstatement are higher when related parties are involved. This clarified standard requires related party relationships and transactions to be considered explicitly in the engagement team's fraud discussion and an understanding of controls relevant to related parties to be obtained.

The standard requires that where controls are not present in this area, the auditor may be required to report the fact to those charged with governance. In addition, the updated standard requires the auditor to challenge any management assertion that transactions with related parties are on an arm's length basis.

ISA 540 (revised and redrafted) Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

This ISA brings with it new requirements for the auditor to adopt a higher degree of professional scepticism where accounting estimates, fair value estimates and related disclosures are concerned, with particular emphasis placed on management bias. As mentioned earlier, ISA 545 has been combined with ISA 540 (revised and redrafted). The ISA now also includes new requirements in respect of:

- Specific matters for the auditor to gain an understanding of in order to assess risk.
- Evaluation of estimation uncertainty and determining any significant risks.
- Requirement to perform substantive procedures to respond to significant risks.

The scope of this standard has been updated to be extended to fair values.

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

This is a new ISA which is designed to address the way in which auditors' report control deficiencies to those charged with governance. The main objective is to increase the quality of the communication to management and also to focus on the definition of a significant deficiency in internal control and/or a missing control which requires notification to management and/or those charged with governance.

It is important that auditors' risk assessments include consideration of the types of control they would expect to find at an audit client taking into consideration its size, complexity and nature. If relevant controls are missing, their absence should be reported to the appropriate level of management or to those charged with governance even if they do not directly impact on the planned audit procedures.

In some entities, management and those charged with governance may be two separate groups of people (particularly those entities with a large hierarchy). This standard requires the auditor to consider whether two 'letters of comment' are appropriate to address findings that may be dealt with by management and those findings which are required to be notified to those charged with governance.

ISA 450 Evaluation of Misstatements Identified During the Audit

This is another new standard and is derived from the revisions to ISA 320 on audit materiality. Amongst other things, it requires accumulating misstatements, reassessment of materiality and specific documentation. Both ISA 450 and ISA 320 require the auditor to reconsider their materiality determinations if information comes to light that would have changed their determination of materiality if they had known about the information at the planning stage of the audit.

ISA 530 Audit Sampling

The clarified ISAs provide a foundation for risk-based auditing which means that the auditors will plan their procedures using a risk assessment which is in turn built on an understanding of the entity and the environment in which it operates.

The clarified ISA emphasises the point that it would be extremely rare for any deviation or misstatement identified in a sample to be considered an anomalous error and not representative of the whole population. In circumstances where the auditor concludes that the misstatement is anomalous, then the standard requires the auditor to obtain sufficient appropriate audit evidence to support this conclusion.

Significant Difficulties

Two-way communication issues are already dealt with in ISA 260 paragraph 17.2 and the revised standard emphasises the importance of effective two-way communication. Where the auditor encounters significant difficulties during the course of an audit, then the auditor is required to notify such significant difficulties to the appropriate level of management or those charged with governance. The auditor should also consider their ability to accept reappointment if they conclude that the two-way communication has been inadequate.

ISA 570 Going Concern

ISA 570 has not been revised, but it has been redrafted in a way which has now given rise to a significant number of elevations - in particular, where events or conditions cast significant doubt on the entity's ability to continue as a going concern. Auditors should obtain evidence concerning

management's assertion where they conclude that the going concern basis is appropriate in their particular circumstances by evaluating management's plans for future actions and consideration must be made by the auditor as to whether those plans are feasible.

Auditor's Reports

ISAs 700, 705 and 706 deal with reporting matters. Different jurisdictions will have different formats of auditors' reports. Where auditors consider a modification of an auditor's report, or where an emphasis of matter paragraph is deemed to be appropriate, care should be taken over the form and content of the report. ISA 705 *Modifications to the Opinion in the Independent Auditor's Report* and ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Auditors' Report* should be consulted.

Conclusion

Getting to grips with the new standards for the first time will increase costs and audit firms are encouraged to prepare for the revised standards which can be adopted early. With sufficient planning and a good understanding of the Clarified ISAs, audit firms will keep increases in costs to a minimum. However, the only way to fully understand the requirements of the Clarified ISAs is to read them!

Steve Collings FMAAT FCCA DipIFRS is the audit and technical director at Leavitt Walmsley Associates Ltd and a partner in AccountancyStudents.co.uk. He is also the author of 'The Core Aspects of IFRS and IAS' and lectures on financial reporting and auditing issues.