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Interpretation and Application of International Standards on Auditing

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Leavitt Walmsley Associates Ltd

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PREFACE

Auditing throughout the world has undergone a substantial amount of change in recent years. The well-publicised corporate disasters that rocked the profession over the last few years have largely contributed to these changes. In many countries domestic standards were replaced with International Standards on Auditing (ISAs) in an attempt to ensure that auditors throughout the world were applying the same level of standards throughout an audit assignment and, thus, ensuring that audit quality remained consistent on a country by country basis.

Standards, whether they are International Financial Reporting Standards (IFRS) or ISAs, frequently change in an attempt to improve and clarify their application throughout the audit and accounting profession. This publication aims to assist auditors in the interpretation and application of auditing standards as it is often the case that many ISAs can be extremely complex and difficult to apply in real life situations. Throughout the profession, audit firms are often criticised for failing to apply auditing standards sufficiently enough to enable an efficient audit to take place. In today's modern profession the correct application of auditing standards is pivotal — not only to demonstrate to professional regulators that auditing standards have been applied throughout an audit assignment — but also to ensure the audit client receives a service that is both beneficial and cost effective to them, and undertaken in accordance with a prescribed framework.

This publication looks at the full ISAs. Most jurisdictions have adopted ISAs but have tailored them to their specific requirements, for example the UK has adopted ISAs but they are termed ISA (UK and Ireland). This publication has been written following the IAASB 'Clarity Project' which is discussed in Chapter 2. The final versions of the Clarified standards were issued in October 2009. The new standards, on which this publication is based, come into effect for audits for periods commencing on or after 15 December 2009, thus, in many cases, auditors will not be affected by this deadline until audits of December 2010 year ends.

Notwithstanding that the Clarified standards may not affect some auditors until December 2010 year ends, it is imperative that auditors are in the process of considering how they will be ready to implement the Clarified standards and this publication aims to assist accountants and auditors in understanding the requirements of each Clarified standard together with the Ethical standards by which professional accountants are bound.

Packed with illustrations, this publication illustrates the practicalities in applying the Clarified ISAs, providing a summary of the main technical content of the IFRS/IAS and providing illustrative financial statements and auditors' reports.

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Writing a book, whether a professional title or a work of fiction, is a project which brings with it a whole host of challenges and is certainly not a one-person project. This book would not have seen the light of day had it not been for certain individuals who have contributed significantly to its production. Every individual who knows me has, in one way or another, influenced my career and my writing and it is to all those that do know me that I express my heartfelt thanks and gratitude.

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All errors are my own and come with apologies.

ABOUT THE AUTHOR

Steven Collings FMAAT FCCA is the Audit and Technical Director at Leavitt Walmsley Associates Limited, who are based in Manchester in the United Kingdom. Steven qualified as a Member of the Association of Accounting Technicians (AAT) in 2000 and then went on to qualify as an Associate Chartered Certified Accountant (ACCA) in 2005. Steven also holds the ACCA Diploma in International Financial Reporting Standards (DipIFRS) and the Certificates in IFRS and International Auditing Standards from ACCA. Steven also holds Statutory Auditor status in the United Kingdom.

Steven has specialised in auditing and financial reporting issues and has been writing professionally for several years. He has written several articles which have been published in the various accounting media concerning auditing and financial reporting. Steven writes extensively for AccountingWEB.co.uk on financial reporting and auditing issues, and has also had several articles published in various professional journals.

Steven lectures on all aspects of financial reporting and auditing issues and regularly speaks at events held for accountants in practice.

Some examples of Steven's articles can be found on the book's companion website at www.wiley.com/go/collings

1 THE HISTORY OF AUDITING

In order to appreciate the significance of correct interpretation and application of International Standards on Auditing (ISAs), one needs to first set the historical context.

Auditing has been a worldwide profession for hundreds of years. Historically, auditing was concerned with accounting for government activities and reviewing the work done by tax collectors. In the early years of auditing, the keeping and maintaining of accounting records was done primarily to detect fraudulent activity. The industrial revolution in the mid 1700s to the mid 1800s was responsible for the increased demand in auditors because this period saw an increase in responsibility being passed from owners to managers. This led to an increased requirement for auditors who were independent of management and who were engaged not only to be alert for errors within financial records but also errors within the records. In simple terms, deliberate errors in order to achieve personal financial gain were deemed to be fraudulent activity (as is still the case today) whilst error was (and still is) unintentional.

During the early 1700s the concept of 'sampling' was introduced. Sampling is where auditors select a sample of items that make up various balances and was used where it is not economically viable to physically examine all the transactions that have taken place. This practice is still pivotal today. This is one of the main areas which this publication looks at in respect of the redrafted ISAs.

During the 1940s it was clear that the auditor's role had developed into that of providing an opinion on the financial statements and that the detection of fraud and error had taken a very much subordinate role in the objective of an audit. It developed that management were responsible for the prevention and detection of fraud and that the auditor's work should not be concerned primarily with detecting fraud but should be planned in such a way that they will detect a material fraud. This view was formalised much earlier in the United Kingdom (UK) than the 1940s, as Lord Justice Lopez in the Kingston Cotton Mill,1896, said that the auditor's role in an entity should be that of a 'watchdog' rather than a 'bloodhound'. Lord Justice Lopez said:

> *It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably careful, cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said to approach his work with suspicion, or with a foregone conclusion that there is something wrong. He is a watchdog not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and rely upon their representations, provided he takes reasonable care.*
>
> Lord Justice Lopez – Kingston Cotton Mill 1896.

The view here was that the auditor should act with such reasonable care and skill in order that their work will have a reasonable chance of detecting a material fraud and other errors. This view is still the same today with auditing standards now requiring auditors to adopt and maintain a degree of professional scepticism by assuming that the financial statements will contain a material misstatement due to fraud. This issue is discussed in Chapter 8.

RISK-BASED AUDITING

Since the early 1980s audit fees have increased to reflect the fact that audits need to be undertaken effectively and efficiently. Audit firms have developed a technique known as 'risk-based' auditing which involves the auditor determining the nature, timing and extent of various audit procedures. This method of auditing is based on the auditor's assessment of the risk that the financial statements of an entity contain a material misstatement.

REGULATION

In the vast majority of countries who practice audit, the auditing profession is regulated under legislation. For example, in the UK auditing is a regulated profession under the Companies Act. It is for this reason that not all professional accountants can practice audit-related work, unless they have obtained statutory auditor status.

The objective of the audit exercise is to enable the auditor to express an opinion on whether the financial statements present fairly in all material respects the entity's affairs at the reporting date as well as form an opinion on whether they have been properly prepared in accordance with the applicable reporting framework.

INTERNAL AND EXTERNAL AUDITING

Auditing predominantly takes two forms: internal and external audit. An internal audit function is usually a department that is set up within an entity which is staffed by employees of that entity who will provide internal audit functions which benefit the entity as a whole. In many cases, the role of internal audit is often outsourced. Internal audit departments will have their roles dictated by management of that organisation. Internal auditors will comply with their own set of auditing standards which are largely independent of the ISAs. Internal auditing functions by, amongst other things, examining, evaluating and reporting to management on the adequacy and effectiveness of components of the accounting and internal control systems. In other words, internal auditing exists to add value and improve an organisation's operations.

External audit, which this publication is concerned with, is usually a statutory requirement imposed on an entity. For example, in the UK, companies are required by statute to have their financial statements audited if, under the Companies Act 2006, any one of the thresholds shown in table 1.1 are breached.

Where reference to 'net' and 'gross' are made, this is in relation to intra-group trading. Gross means intra-group sales have not been eliminated, net means that elimination has occurred in accordance with the requirement of IAS 27 'Consolidated and Separate Financial Statements'.

Other jurisdictions may have their own eligibility criteria for audit and audit exemption. The auditor's opinion on the financial statements is not an opinion of absolute correctness because of the inherent limitations associated with an audit. The limitations inherent in an audit of general purpose financial statements are discussed in Chapter 4. There is often a concept

Table 1.1 Auditing thresholds

	Turnover	*Balance Sheet (Gross Assets)*	*No. of Employees*
Small company	£6.5 million	£3.26 million	50
Small group	£6.5 million net	£3.26 million net	50
	£7.8 million gross	£3.9 million gross	50
Medium-sized company	£25.9 million	£12.9 million net	250
Medium-sized group	£25.9 million net	£12.9 million net	250
	£31.1 million gross	£15.5 million gross	250

Note: The table relates to accounting periods which commence on or after 6 April 2008, following the amendment by statutory instrument 393.

of perception gap because some third parties often assume that an audited set of financial statements can give absolute assurance. It is for this very reason that reference to 'reasonable assurance' is made within the auditor's report.

It could also be the case that an entity is required to have a statutory audit because the members chose to have an audit when the company was incorporated. This is often the case when a company has such a condition in their Articles of Association.

External stakeholders, such as banks and financiers can also impose a requirement for audit on an entity even if they are not required by statute to have an audit undertaken on their financial statements. In an increasing number of cases, financiers do require a certain level of assurance. In today's modern profession, there are an increasing number of assurance engagements being carried out.

ASSURANCE ENGAGEMENT

An assurance engagement is one where a professional accountant evaluates, or measures, a subject matter that is the responsibility of another party against suitable criteria, and expresses an opinion which provides the intended user with a level of assurance about that subject matter. In other words, it is an engagement to express an opinion giving assurance to a set of people on information which is the responsibility of others.

An audit can be distinguished from other assurance engagements in the following ways:

Audit engagement: the auditor provides a high, but not absolute, level of assurance that the information audited is free from material misstatement. This is expressed positively in the audit report as 'reasonable assurance'.

Review engagement: the auditor provides a moderate level of assurance that the information subject to review is free of material misstatement. This is expressed in the form of 'negative assurance'.

Negative assurance is where an auditor gives an assurance that nothing has come to his/her attention which indicates that the financial statements have not been prepared according to the framework. In other words, the auditor gives his/her assurance in the absence of any evidence to the contrary.

FEATURES OF AN AUDIT

In general terms, an audit will involve the examination of an entity's financial statements and of the disclosures contained therein. As a rule, the auditor is not responsible for preparing the financial statements, though in some cases the auditors may be involved provided adequate safeguards have been implemented to maintain independence. The end result of the audit is the auditor's opinion on the financial statements as to whether the financial statements give a true and fair view, or present fairly in all material respects, the state of the entity's affairs.

In order to arrive at their opinion, the auditor must be seen to be *independent* of the entity that is being subject to audit. For the purposes of audit, 'independent' means not having any significant personal interest in the entity. Ensuring the auditor is independent also guarantees that the objective of the audit is achieved and a professional and unbiased view is taken.

Because it is highly unlikely that two audit assignments will be identical, it is important that audit assignments are undertaken in a logical and structured manner. The objective of the audit is to ensure that the financial statements of an entity give a true and fair view, or present fairly in all material aspects, the state of the company's affairs at its reporting date. It would therefore be irresponsible for the auditor to undertake an audit in a sporadic and unplanned manner.

Before any detailed audit work takes place on an audit assignment, the auditor is required to undertake a thorough programme of planning. Planning is a significant area impacted by the redrafting process of the Clarity project and is looked at in more detail in Chapter 13. Without sufficient planning, the auditor is unable to document that they have gained a sufficient understanding of the entity in order to enable an efficient audit to take place. The planning will take various forms and includes the following programme of documentation:

- the entity's background and history;
- its policies and procedures;
- key management and staff;
- significant accounting policies;
- the environment in which the entity operates;
- accounting systems;
- any problems encountered in previous audits;
- a timetable for key events;
- the audit budget;
- the audit strategy;
- meetings held with the client prior to the audit; and
- meetings of the audit team prior to the client.

A full risk assessment is also required at the planning stage and the audit strategy is then developed as a result of this risk assessment to ensure that the audit procedures adopted during the course of the audit are responsive to the risks identified at the planning stage.

A review of the entire audit process is summarised in table 1.2.

Table 1.2 shows that the initial step in the audit process is the planning of the audit. Two fundamental standards must be complied with in this respect: ISA 300 (redrafted) 'Planning an Audit of Financial Statements' and ISA 315 (redrafted) 'Obtaining an Understanding of the Entity and its Environment and Assessing the Risk of Material Misstatement'.

Table 1.2 The Audit Process

	New Audit	*Recurring Audit*
Legal and ethical matters	Consider	Review
Acceptance and letter of engagement	Prepare and issue	Review and update where necessary
Obtain an understanding of the entity and its environment	Obtain and prepare	Review and update where necessary

The auditor will document their understanding of the accounting and internal control systems present at the audit client. This will also involve the auditor undertaking a risk assessment in order that the procedures the auditor adopts during the course of the detailed audit work are responsive to those risks.

The next step is for the auditor to consider the various ways in which they will generate sufficient and appropriate audit evidence (audit evidence is discussed in Chapter 18). Audit evidence can be obtained from a variety of means, but usually from either tests of controls or substantive procedures, or a mix of both. In determining whether the evidence can be gathered from tests of controls (and, therefore, reduced detailed substantive testing) the auditor must assess whether the internal controls operate effectively; in other words, ensuring that the controls will prevent, detect and correct a material misstatement within the accounting systems in a timely manner. Tests of controls are often referred to as 'compliance tests'. Any significant deficiencies in internal controls will be notified to those charged with governance in accordance with the provisions of ISA 265 'Communicating Deficiencies in Internal Control to those Charged with Governance and Management' (see Chapter 11).

The above summary highlights the primary objective of the external audit. The objective of the audit looks at the primary needs of external stakeholders of an entity, as opposed to the requirements of an entity's management. External stakeholders usually include, amongst others, an entity's bankers, trade payables and receivables, employees, potential investors and employees. The audit is therefore concerned with ensuring that the general purpose financial statements are objective, free from bias and manipulation and relevant to the needs of the users of those financial statements.

INDEPENDENCE

Auditors are expected to be independent of the reporting entity. The Conceptual Framework Approach to Independence identifies two aspects of independence:

- independence of mind; and
- independence in appearance.

Independence of Mind

> *Independence of mind enables the auditor to form an opinion without being affected by influences that would compromise the auditor's professional judgement. Independence of mind will allow the auditor to act with integrity and exercise objectivity at all times during the course of the audit. Independence of mind will also allow the auditor to act with professional scepticism.*
>
> [IESBA Code]

Independence in Appearance

> *Independence in appearance is achieved when the auditor avoids facts and circumstances that are so significant that a reasonable and informed third party would conclude that the auditor's integrity, objectivity and professional scepticism has been compromised.*
>
> [IESBA Code]

Threats to Independence

Any threats to the auditor's independence must be eradicated in totality or mitigated to an acceptable level. The auditor also has an obligation to ensure that where they identify threats to independence adequate safeguards are applied. Where the auditor concludes that adequate safeguards cannot be applied to eradicate the threat in totality or mitigate it to an acceptable level, the auditor must resign from the audit engagement or decline the audit engagement. Threats to independence could arise in the following circumstances:

- Auditor's personal interest. The auditor may fear losing the audit fee.
- Intimidation. The auditor may be intimidated by dominant or aggressive management.
- Long association. If the auditor has had a long association with the client, they may be too sympathetic to the client.
- Performing non-audit work and subsequently auditing that work (referred to as a 'self-review' threat).

Chapter Roundup

The primary objective of the audit is for the auditor to express an opinion about the truth and fairness (or whether the financial statements present fairly, in all material respects) the state of the entity's financial affairs at the end of the reporting period.

Acceptance procedures include: consideration of legal and ethical issues, preparing the letter of engagement and obtaining an understanding of the entity.

The auditor should undertake a sufficient programme of planning before the detailed audit work commences to identify key areas of the audit and to devise the audit strategy. The auditor should also review the legal and ethical issues surrounding their engagement, review and update the letter of engagement, review and update their understanding of the entity and the environment in which it operates.

The auditor must be independent in order to maintain the objectivity of the audit. Any threats to this independence should be minimised to an acceptable level. Where such threats cannot be minimised to an acceptable level, then the auditor should consider their ability to continue as auditor.

The auditor does not have a direct responsibility to look for fraud during the course of an audit, as the responsibility for the prevention and detection of fraud rests with management. However, the auditor should plan their work and their procedures with an expectation that the financial statements might be materially misstated due to fraud.

2 THE CLARITY PROJECT

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 improve audit quality on a worldwide level.

All of the ISAs have been rewritten as part of the Clarity project. 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 makes it easier to understand what is required and what is purely guidance. In addition, ISQC 1 'Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements' has 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 to reflect the new Clarity conventions and format. 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 Controls 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 been combined in ISA 540 (revised and redrafted) 'Auditing Accounting Estimates and, Including Fair Value Accounting Estimates, and Related Disclosures'.

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

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

The revised ISA is far more wide-ranging than the previous standard and sets out new requirements in respect of the relationship between the group engagement team and the component auditors. It is therefore expected that this will have the most impact on group audits where you are not the auditor for the whole group.

The Clarity project in this area will result in auditors having to give more thought to this area of their work, the following areas 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

The revised ISA includes a number of specific new requirements to ensure that auditors place a greater emphasis on a risk-based approach in this area and improve the identification of related party relationships and transactions which have not already been disclosed by management.

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 introduces requirements for greater rigour and scepticism into the audit of accounting estimates, including the auditor's consideration of indicators of possible management bias. 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. The extension of this standard to be applicable to fair values was hardly surprising during the Clarity project given the ongoing debate concerning the use of fair values in financial reporting frameworks.

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 formal reporting.

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.

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. Among other things, it requires accumulating misstatements, reassessment of materiality and specific documentation.

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. Where auditors wish to make a decision as to whether a deviation or misstatement is anomalous, then they should obtain sufficient appropriate evidence to support the position.

ISA 260 Significant Difficulties

ISA 260 has been revised to emphasise the importance of effective two-way communication between the auditor and those charged with governance of the audit client. Where the auditor encounters significant difficulties during the course of an audit (for example, the unavailability of expected information), then the auditor is required to notify such significant difficulties to the appropriate level of management or those charged with governance. Where auditors feel that the two-way communication has not been effective, then they should consider their ability to accept re-appointment if the conclusion is that the level of two-way communication has been inadequate for their purposes.

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 considering 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' (Chapter 33) and ISA 706 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Auditors' Report' (Chapter 34) should be consulted.

A list of the revised and/or redrafted standards in the clarity project is given below:

- ISA 200 (revised and redrafted) 'Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with ISAs'.
- ISA 210 (redrafted) 'Agreeing the Terms of Audit Engagements'.
- ISA 220 (redrafted) 'Quality Control for an Audit of Financial Statements'.
- ISA 230 (redrafted) 'Audit Documentation'.
- ISA 240 (redrafted) 'The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements'.
- ISA 250 (redrafted) 'The Auditor's Responsibilities Related to Laws and Regulations in an Audit of Financial Statements'.
- ISA 260 (revised and redrafted) 'Communication with Those Charged with Governance'.
- ISA 265 'Communicating Deficiencies in Internal Control' (this is a new standard borne out of the Clarity Project).
- ISA 300 (redrafted) 'Planning an Audit of Financial Statements'.
- ISA 315 (redrafted) 'Obtaining an Understanding of the Entity and its Environment and Assessing the Risks of Material Misstatement'.
- ISA 320 and ISA 450 (revised and redrafted) 'Materiality and Evaluation of Misstatements' (ISA 450 is a new standard borne out of the Clarity Project).
- ISA 330 (redrafted) 'The Auditor's Procedures in Response to Assessed Risks'.
- ISA 402 (revised and redrafted) 'Audit Considerations Relating to an Entity Using a Third Party Service Organisation'.
- ISA 500 (redrafted) 'Considering the Relevance and Reliability of Audit Evidence'.
- ISA 501 (redrafted) 'Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures'.
- ISA 505 (revised and redrafted) 'External Confirmations'.
- ISA 510 (redrafted) 'Initial Audit Engagements — Opening Balances'.
- ISA 520 (redrafted) 'Analytical Procedures'.
- ISA 530 (redrafted) 'Audit Sampling'.
- ISA 540 (revised and redrafted) 'Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures'.
- ISA 550 (revised and redrafted) 'Related Parties'.
- ISA 560 (redrafted) 'Subsequent Events'.
- ISA 570 (redrafted) 'Going Concern'.
- ISA 580 (revised and redrafted) 'Written Representations'.
- ISA 600 (revised and redrafted) 'The Audit of Group Financial Statements'.
- ISA 610 (redrafted) 'The Auditor's Consideration of the Internal Audit Function'.
- ISA 620 (revised and redrafted) 'Using the Work of an Auditor's Expert'.

- ISA 700 (redrafted) 'The Independent Auditor's Report on General Purpose Financial Statements'.
- ISA 705 (revised and redrafted) 'Modifications to the Opinion in the Independent Auditor's Report'.
- ISA 706 (revised and redrafted) 'Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report'.
- ISA 710 (redrafted) 'Comparative Information, Corresponding Figures and Comparative Financial Statements'.
- ISA 720 (redrafted) 'The Auditor's Responsibility in Relation to Other Financial Information in Documents Containing Audited Financial Statements'.
- ISA 800 (revised and redrafted) 'Special Considerations — Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks'.
- ISA 805 (revised and redrafted) 'Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement'.
- ISA 810 — 'Engagements to Report on Summary Financial Statements'.
- ISQC 1 (redrafted) 'Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Service Engagements'.

The IAASB clarity project was primarily undertaken in order to improve the standards to achieve the following:

- Identifying the auditor's overall objectives when conducting an audit in accordance with the ISAs.
- Setting an objective in each ISA and establishing the auditor's obligation in relation to that objective.
- Clarifying the obligations imposed on the auditor by the ISAs and improving the language used to convey such requirements to the auditor.
- Improving the readability and understandability of the ISAs by restructuring and redrafting the ISAs.

The IAASB has redrafted several of the ISAs. Where an ISA has been redrafted it essentially means that the standard has a new structure to it. Each redrafted standard will contain a new structure as follows:

- Introduction.
- Objective.
- Definitions.
- Requirements.
- Application.
- Other Explanatory Material.

Introduction This paragraph contains information concerning the standard including the purpose, scope and subject matter of the ISA. It also contains information regarding the responsibilities of the auditor and others in the context of which the ISA is set.

Objective Each ISA contains a statement of the auditor's objective in the audit area which the ISA is set.

Definitions The Clarity Project included adding an element for greater understanding of the ISAs and as such, applicable terms contained within the ISAs have now been defined.

Requirements Each ISA is supported by clearly stated requirements. Phrases such as 'the auditor should' have now been replaced by phrases such as 'the auditor shall'. This improvement was welcomed by the profession because it clears any ambiguity because the word 'shall' indicates that the standard expects something of the auditor rather than 'should' which indicates that the standard 'may' expect something of the auditor in certain circumstances.

Application Each ISA clearly explains more precisely what the auditor is required to do in order to achieve the objective of the ISA in question. Where applicable, the ISA may also contain illustrative examples of procedures that may be applicable in certain circumstances.

Other Explanatory Material Other explanatory material may be contained within an ISA in order to help the auditor understand the ISAs overall objective and application.

The impact of the IAASB's Clarity Project is one which will contribute significantly to the enhancement and uniformity of audit quality on a worldwide level. The IAASB set out to undertake its clarity project in the hope that it will also encourage international convergence and assist audit firms that operate internationally by harmonising auditing standards.

The revised and redrafted ISAs are more rules based which is accentuated further by the removal of the word 'should' and replacing it with the word 'shall'. The auditing profession has long since been based on professional judgement and there are arguments that a more rules-based approach to auditing removes this judgement by imposing mandatory requirements on auditors in areas that might not, necessarily, be appropriate to certain entities. For example, there are lots of entities in the small-medium sector that have relatively simple internal controls and the rules-based ISAs might result in a company having such simple internal controls being over-audited. Conversely, entities who have relatively complex issues attached to their financial and reporting systems might be under-audited.

To combat these issues, auditors should ensure that they tailor the requirements of each ISA to their specific needs but keeping in mind that use of the word 'shall' in the context of an ISA means that the requirement is mandatory and must be carried out regardless of any other circumstances such as complexity, size or cost. The IAASB view such an approach to the application of auditing standards as one which will lead to consistent application of the ISAs and result in enhanced audit quality worldwide.

Chapter Roundup

The Clarity Project was completed in 2009 and has resulted in rewrites of the International Standards on Auditing (ISAs).

19 ISAs and ISQC 1 have been redrafted.

16 ISAs have been both revised and redrafted.

Two new standards have been issued: ISA 265 ‘Communicating Deficiencies in Internal Control to Those Charged with Governance and Management’ and ISA 450 ‘Evaluation of Misstatements Identified During the Audit’.

The Clarified ISAs are effective for audits of financial statements commencing on or after 15 December 2009.

A notable feature of the Clarified ISAs is removal of the word ‘should’ in the context of performing an audit procedure and replacing it with the word ‘shall’.

3 THE CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS

Professional accountants are governed by ethical standards by which they must comply. It is generally accepted that auditors have a direct responsibility to the shareholders of the entity in which they are auditing, however, professional accountants, whether they work in audit practice or not, are also required to act in the public interest. The Code of Ethics for Professional Accountants has been prescribed by the International Ethics Standards Board of Accountants (IESBA).

The Code of Ethics for Professional Accountants prescribes the requirements for professional accountants, whether they work in audit practice or not. Member bodies of IFAC must not apply any less stringent standards than those stated in their Code. In some jurisdictions, there could be Ethical requirements which differ from the IESBA Code. Professional accountants must be aware of the differences and must comply with the more stringent requirements and guidance unless a law or regulation prohibits such compliance.

The Code of Ethics for Professional Accountants is split into three parts:

- Part A establishes the fundamental principles of professional ethics for accountants, which provides a professional framework for applying those principles.
- Part B applies to professional accountants who work in practice.
- Part C applies to professional accountants who work in business and those professional accountants who work in practice may find Part C relevant to their needs.

FUNDAMENTAL PRINCIPLES

A professional accountant is required to observe compliance with five fundamental principles:

- Integrity.
- Objectivity.
- Professional Competence and Due Care.
- Confidentiality.
- Professional Behaviour.

Integrity

At all times during the course of their work, a professional accountant must be honest and straightforward in all professional and business relationships. In order for a professional accountant to observe the fundamental principle of integrity the professional accountant should not allow their name to be associated with reports, returns or other forms of communication where the professional accountant believes that the information:

(a) contains a materially false or misleading statement;
(b) contains statements or information obtained recklessly; or
(c) omits or obscures information required to be included where such omission or obscurity would be misleading.

In terms of auditing, it could be the case that an auditor's opinion is modified because the financial statements which have been subject to audit do not give a true and fair view, or present fairly in all material aspects. In these circumstances, where the auditor's opinion is modified then the professional accountant will not be considered to be in breach of the circumstances detailed in (a) to (c) above.

Objectivity

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.

In some cases, the auditor may be exposed to situations that may impair objectivity. The auditor should, in all cases, ensure that objectivity is not impaired by implementing safeguards to maintain independence and objectivity.

Professional Competence and Due Care

A professional accountant has a duty to maintain professional knowledge and skill at the level required to ensure that their client receives a competent and professional service. Audit firms must not, therefore, accept appointment as auditor unless they are competent and have sufficient resources available to undertake the work.

Professional accountants also have an obligation to act diligently in accordance with appropriate technical and professional standards when providing professional services. Professional competence can also be sub-divided into two phrases:

- Attainment of professional competence.
- Maintenance of professional competence.

In order to maintain professional competence, professional accountants must be up to date with technical developments. Continuing Professional Development will guarantee maintenance of professional competence and ensure that the professional accountant performs work competently within professional environments.

Confidentiality

Confidentiality is of paramount importance and section 140 of the IESBA Code of Ethics contains the obligations of a professional accountant to maintain confidentiality as well as establishing the circumstances where the professional accountant can depart from this fundamental principle.

Professional accountants have a duty to ensure that confidentiality is observed at all times. This means that the professional accountant should refrain from:

- Disclosing outside the audit firm confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose.
- Using confidential information acquired as a result of professional and business relationships to their personal advantage or to the advantage of third parties.

Even outside of the business or practice environment, a professional accountant has an obligation to preserve confidentiality. Professional accountants, therefore, must ensure that they do not, inadvertently or otherwise, disclose information in a social environment.

A professional accountant is also required to maintain confidentiality of information disclosed by a prospective client or employer.

A professional accountant should also consider the need to maintain confidentiality of information within a firm or employing organisation.

A professional accountant should take all reasonable steps to ensure that staff under the professional accountant's control and persons from whom advice and assistance is sought also respect the professional accountant's duty of confidentiality.

Professional Behaviour

At all times, professional accountants must comply with relevant laws and regulations and avoid all action which would discredit the profession. Accountants need to be seen to behave in a professional manner at all times, and this behaviour extends to the professional accountant's marketing or advertising.

The professional accountant must not mislead clients or employers by stating that they have professional qualifications, when they have not. Nor should they offer themselves available for work which they are not professionally competent to undertake. Professional accountants also have an obligation to ensure that they do not make disparaging references or unsubstantiated comparisons to the work of others.

THREATS AND SAFEGUARDS

At all times during the auditing process, the auditor must remain independent to ensure the audit objective is maintained. Varying degrees of circumstances or relationships can create threats which in turn may affect more than one fundamental ethical principle. Where the auditor identifies a threat then they are required to employ safeguards to ensure the threat is reduced to an acceptable level.

Auditing categorises threats into one or more of the following categories:

- Self-interest threat.
- Self-review threat.
- Advocacy threat.

- Familiarity threat.
- Intimidation threat.

A self-interest threat occurs when a financial or other interest will inappropriately influence the professional accountant's judgement or behaviour. This could occur, for example, where the professional accountant holds shares in a reporting entity or where the audit firm has undue dependence on the fees from an audit client.

A self-review threat occurs when the professional accountant relies on information prepared by the professional accountant or another individual in the professional accountant's firm. An example of a self-review threat is where the professional accountant prepares a set of financial statements for a reporting entity and then audits the same financial statements. In addition, where a member of the audit or assurance team has joined the audit firm from the audit client, then this will also give rise to a self-review threat if that person is engaged on the audit of his/her previous employer.

An advocacy threat occurs when the professional accountant promotes a client's or employer's position to the point that the professional accountant's objectivity is compromised. An example of an advocacy threat is the professional accountant representing a client in legal proceedings.

A familiarity threat arises when a professional accountant becomes disproportionately close or familiar with the client to the extent that they may be too sympathetic to their interests.

An intimidation threat occurs when the professional accountant is put under pressure by a client or employer to the extent that the professional accountant may be deterred from acting objectively.

SAFEGUARDS

Safeguards are actions by the professional accountant in an attempt to either eradicate the threats in totality or reduce those threats to an acceptable level and can fall into two categories:

- safeguards created by the profession, legislation or regulation; and
- safeguards in the actual working environment.

Safeguards created by the profession include compliance with professional standards, including those laid down by the professional accountant's professional body. There are also other safeguards which include:

- training and development;
- corporate governance regulations;
- regulatory monitoring by professional bodies; and
- external reviews.

Training and development includes training and experience requirements for entry into the profession and maintenance of these skills by undertaking Continuing Professional Development (CPD).

Regulatory monitoring includes reviews of professional accountants work by professional bodies (for example ACCA) to ensure that professional standards, independence and objectivity are maintained at all times.

External reviews can take various forms, but in terms of auditing are usually split into two types of review:

- hot file review; and
- cold file review.

A 'hot' file review is undertaken by an external file reviewer prior to the auditor's report being issued. Such reviews look at the audit work undertaken and whether the audit evidence is sufficient and appropriate enough to support the proposed opinion in the auditor's report.

A 'cold' file review is undertaken by an external file reviewer after the auditor's report has been issued. Such reviews can be mandatorily required by various professional bodies, or they can be undertaken as part of a regulatory monitoring visit. In addition, a cold file review can be undertaken on a periodic basis by the firm as part of their quality assurance procedures.

An audit firm should make sure that they have firm-wide safeguards which guarantee that the firm complies, in all respects, with the fundamental principles and ensure that their staff act, at all times, in the interests of the public.

There are varying procedures which firms can adopt to ensure that the firm has adequate safeguards in place to deal with threats, such as:

- Published policies to identify various threats and the procedures to be adopted in evaluating the significance of those threats. In instances where the threats cannot be eradicated or mitigated to an acceptable level, then the firm should resign or decline the engagement.
- Engaging different partners on audit and non-audit engagements.
- Engaging different staff on audit engagements where non-audit services have been provided to an audit client.
- Discussing difficult or contentious issues arising during the course of an audit with specifically trained staff, for example, complicated taxation matters should be referred to a firm's tax department or tax partner.
- Ensuring staff are kept technically up to date through the use of CPD.
- Formulating a disciplinary mechanism to promote a firm's policies and procedures.
- Ensuring regular, independent, file reviews are undertaken to make sure the firm's audit work is in compliance with auditing standards.
- Rotating senior personnel.

The above list is not exhaustive, but it provides examples of the issues which audit firms need to consider in order to ensure that adequate safeguards are put in place.

ACCEPTING AN AUDIT CLIENT

A key principle which professional accountants need to comply with is ensuring that they do not undertake work which they are not professionally competent to perform. This principle is of paramount importance to all professional accountants, including auditors. Where a potential client enquires about employing the services of a professional accountant, the professional accountant must ensure that they are technically, and professionally, competent to undertake the work on behalf of the client and that they also have the necessary resources available to service the client.

Prior to accepting an engagement, the professional accountant must also consider whether acceptance of a particular client would give rise to any threats to compliance with fundamental principles. For example, the professional accountant should consider whether the client is involved in illegal or immoral activities or whether the potential client has questionable financial reporting practices.

Where the professional accountant identifies such threats to the fundamental principles, then the professional accountant should consider whether these threats can be reduced to an acceptable level. Where these threats cannot be reduced to an acceptable level, or eradicated in totality, the professional accountant must decline the engagement.

In the absence of such threats, or where threats to the fundamental principles have been mitigated to an acceptable level, then the professional accountant must ensure that the services they have been asked to perform by the client can be performed competently by the professional accountant. Where the practice is a firm, the engagement partner should ensure that the firm has appropriate staff to deal with the client's affairs competently.

The firm should also ensure that they develop an appropriate level of understanding of the nature of the client's business and evaluate issues such as the complexity of the entity's operations and develop an understanding of the nature and scope of the work to be performed.

Clients in specialized industries may require the audit firm to ensure that they have the staff able to deal with such specialism competently. This may involve the use of experts (for example, where the audit client has complex financial instruments which require annual valuations). The audit firm must ensure that they have the necessary resources available to deal with such issues.

Where the professional accountant has been asked to act on behalf of a client in respect of their accounting requirements, the professional accountant needs to ensure that both accountant and client have a realistic timeframe to undertake the relevant work. The professional accountant should consider any deadlines imposed on its audit client. For example, a Solicitor may have to have the Accountants' Report submitted to their regulatory body (in the UK, the regulatory body for Solicitors is the Solicitors Regulation Authority, previously the Law Society) six months after the end of the reporting date. The professional accountant should ensure they are able to meet these deadlines at the same time as ensuring that the work they undertake for the client is undertaken competently and sufficiently.

On accepting an engagement, the incoming accountant will generally be required to initiate discussion with the client's previous accountant in order to obtain professional clearance. The incoming accountant will usually ask the outgoing accountant whether there is anything, professional or otherwise, that needs to be brought to the attention of the incoming accountant in order to help them decide whether or not to accept the engagement. Various jurisdictions may have other relevant legal, and other, regulations which govern such requests.

The outgoing accountant has a professional duty to ensure that the information they supply to the incoming accountant is provided to them honestly and free from any ambiguity.

CONFLICTS OF INTERESTS

A professional accountant has a duty, at all times, to identify any circumstances which might give rise to a conflict of interest. The firm should also ensure that they have procedures in place which will deal with any such conflicts of interest, which will generally entail notifying the client of a conflict of interest and seeking their consent to act in such circumstances. Where the professional accountant has been refused consent then the professional accountant has a duty not to act, or continue to act, for the party or parties giving rise to the conflict of interest.

Where a conflict of interest arises, then safeguards must be employed. Such safeguards could be the use of separate engagement teams (also known as 'Chinese walls'). Where the use of separate engagement teams are employed, then each team must observe confidentiality. The firm should also ensure that they undertake a regular review of the safeguards employed at firm level. The review of such safeguards should be undertaken by a senior official who is not involved with the relevant client engagements.

In some cases, conflicts of interests may create a threat to one or more of the fundamental principles. Where these threats cannot be eradicated in totality, or mitigated to an acceptable level, then the professional accountant has a duty not to accept the engagement.

FEES

Professional accountants have the freedom to quote whatever fee is deemed appropriate for the level of work involved. However, professional accountants need to be careful to avoid 'lowballing' — that is, where a professional accountant quotes a fee that is so low that it may become difficult to perform the required work in accordance with the technical and professional standards. This creates a self-interest threat.

Professional accountants have a duty to ensure that the fees they quote to a client are appropriate having regard to the level and skill of the staff required to perform the engagement. Professional accountants should also ensure that their clients are made aware of both the terms of the engagement and the fees agreed. This is usually achieved by way of a letter of engagement which the client is required to sign to confirm they understand the terms on which the professional accountant is engaged and also the nature and scope of the work which they will perform.

In the event that the client requires other services, for example, where the client requires taxation services to be completed by the firm, in addition to audit work, then a separate letter of engagement may be required.

There are instances where professional accountants may receive a referral fee or commission in relation to a client. Typically, this could occur where the client requires a specialist service which is not provided by the professional accountant so a referral fee may be received by the professional accountant in referring the client to another professional accountant who specialises in the area of work the client requires. This creates a self-interest threat to objectivity and professional competence and due care and the professional accountant referring the client to another professional accountant should ensure that they have relevant safeguards in place to deal with such a threat. This could involve:

- Disclosure of the commission or referral fee to another professional accountant for the work referred to them.
- Disclosure of the commission or referral fee to the client concerned and obtaining their permission to receive such a fee.

GIFTS AND HOSPITALITY

Some clients may offer gifts and/or hospitality to professional accountants and professional accountants need to ensure that acceptance of such gifts and hospitality does not breach the fundamental principles.

Whether or not this warrants a threat would depend on the nature, value and overall intent by the client of the offer of gifts and hospitality. For example, a client treating a professional accountant to lunch after completion of a long and difficult assignment might be construed by the professional accountant to be trivial and inconsequential after the professional accountant weighs up all the specific facts and circumstances. However, where the professional accountant concludes that threats to fundamental principles cannot be eradicated in totality or reduced to an acceptable level, then the professional accountant must not accept the gift or hospitality.

CLIENT ASSETS

A professional accountant has a duty to ensure that any threats to the fundamental principles by holding of client assets is eradicated in totality or reduced to an acceptable level. Professional accountants also have a duty to evaluate the source of such assets in order to comply with relevant laws and regulations, for example Money Laundering Regulations.

Where the professional accountant has custody of client assets, for example, by holding client money, then they should ensure that the self-interest threat that arises in such circumstances is reduced to an acceptable level. This can be achieved by:

- Holding client assets separately from the firm's assets.
- Using such assets for the purposes intended.
- Being able to readily account for such assets.
- Complying with all relevant laws and regulations in respect of holding such assets.

FAMILY AND CLOSE RELATIONSHIPS

Where family or close relationships exist between a member of the audit team and a director, officer or certain employee of the audit client, then this will create a self-interest, familiarity or intimidation threat, depending on a number of factors.

When an immediate family member or a member of the audit team is (a) a director or officer of the audit client, or (b) an employee that is able to exert influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion, the individual concerned must be removed from the audit team. There are no other safeguards which can be implemented because the closeness of such a relationship will not reduce the threat to an acceptable level if the individual concerned is not removed from the audit team.

There are also situations whereby a former member of the audit team may have taken up employment with the audit client. In such circumstances, independence is likely to be threatened to such an extent that it would be unlikely to be able to reduce the threat to an acceptable level. Independence would, therefore, be deemed to be compromised if a former member of the audit team or the audit partner joins the audit client as a director or officer; or as an employee with the ability to exert influence over the accounting records and financial statements to which the audit firm will express an opinion. Exceptions to this threat are where the individual is not entitled to any benefits or payments from the firm, unless made in accordance with fixed pre-determined arrangements, and any amount owed to the individual is not material to the firm: in addition, where the individual does not participate in the firm's business or professional activities.

Examples of safeguards which can be implemented to minimise the threat to acceptable could be to modify the audit plan and assign individuals to the audit who have sufficient experience in relation to the individual who has joined the client. The audit firm may also have the work of the former member of the audit client reviewed by another professional accountant.

NON-AUDIT SERVICES PROVIDED TO THE CLIENT

It is extremely common for audit firms to undertake non audit services on behalf of an audit client. For example, audit firms may provide taxation related services to an audit client. The threat here is in relation to a 'self-review' threat. In terms of auditing, the self-review threat must be reduced to an acceptable level, for example, by having a 'hot' file review or employing the use of 'Chinese walls'. If the threat to independence cannot be mitigated to an acceptable level, the audit firm should either cease to act in the capacity of auditors, or decline the engagement.

Chapter Roundup

Professional ethics are pivotal to the accountancy and auditing profession and professional accountants must ensure they comply, at all times, with professional ethics.

The fundamental principles include: integrity, objectivity and independence, professional competence and due care, confidentiality and compliance with technical standards.

Where threats to independence are identified, these must be reduced to an acceptable level.