

Auditing Abroad

Audit Risk

Summary of provisions of recently issued Exposure Drafts by IFAC

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INTRODUCTION



This summary provides some background to, and explanation of, the proposed International Standards on Auditing (ISAs) approved for exposure by the International Auditing and Assurance Standards Board (IAASB) of International Federation of Accountants (IFAC).

The IAASB believes the proposed ISAs will increase audit quality as a result of better risk assessments and improved design and performance of audit procedures to respond to the risks. The improved linkage of audit procedures and assessed risks is expected to result in a greater concentration of effort on areas where there is greater risk of misstatement. In some cases, this may result in a change to the audit approach, including the audit procedures performed. In many cases, implementation of the proposed ISAs will result in an overall increased work effort by the audit

OBJECTIVES AND PURPOSE OF IFAC

The mission of IFAC is the worldwide development and enhancement of an accountancy profession with harmonized standards, able to provide services of consistently high quality in the public interest. IFAC will carry out this mission within the framework of its Constitution and, in particular, will support the work of the International Accounting Standards Board in the manner provided for in the said constitution.

In carrying out this mission, IFAC shall act as an advisor and coordinator for its members.

team, particularly for new engagements or when first implemented on continuing engagements. It is also likely that to implement the new requirements, new skills and competencies may be required, the need for specialist assistance on audits may be increased. Auditors and their professional bodies may need to consider the training needs that will result from the new requirements.

Proposed ISA	Existing ISA to be replaced
Amendment to ISA 200, "Objective and General Principles Governing an Audit of Financial Statements"	Proposed addition only to ISA 200
ISA XX, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement"	ISA 310, "Knowledge of the Business" ISA 400, "Risk Assessments and Internal Control" ISA 401, "Auditing in a Computer Information Systems Environment"
ISA XX, "The Auditor's Procedures in Response to Assessed Risks"	ISA 400, "Risk Assessments and Internal Control" ISA 401, "Auditing in a Computer Information Systems Environment"
ISA XX, "Audit Evidence"	ISA 500, "Audit Evidence"

These proposed ISAs are the product of the Audit Risk project, jointly conducted by the International Auditing and Assurance Standards Board (IAASB) with U.S. Auditing Standards Board (ASB). By partnering with the ASB, the IAASB is furthering its goal of integrating the standard setting process with national standard setters in order to promote the convergence and acceptance of an international set of auditing standards. The IAASB believes that, the proposed Standards are an important step in accomplishing this goal since these Standards establish the basic framework for the audit process.

BACKGROUND

The business environment is subject to continuous change. Auditing practice likewise changes, and there is a need for standard setters to keep standards under review to ensure that they remain appropriate. Recent changes in the business environment has included the way entities are organized and conduct their business; the effects of globalization and technology; the increasing use of judgment and estimates, including fair values, required by accounting standards; and significantly increased pressures that may cause fraudulent financial reporting. The IAASB and the ASB decided that the core Auditing Standards should be reviewed in the light of these changes. Significant portions of the results of this review are the new and revised ISAs referred to above. The proposed ISAs include significant changes to improve standards and guidance on the auditor's performance of audits. This review was additional to the process of continuous review of Standards under which both the IAASB and the ASB are working to improve the quality of audits.

Since the initiation of the project, recent major corporate failures have undermined the public's confidence in the effectiveness of audits and led to an intense scrutiny of the work of auditors. Although the proposed ISAs were not conceived as a direct response to these events, the project's proposals to improve the overall

International Standards on Auditing (ISAs) contain basic principles and essential procedures together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance in their application

audit process have been influenced by them and therefore represent part of the IAASB's contribution to raising standards of audit practice and the consistency of their application around the world.

Appendix 1 to this summary provides additional background information about this project.

CHANGES TO EXISTING REQUIREMENTS

The proposed ISAs deal with the core of the audit – the auditor's assessment of the risk that the financial statements

could be wrong, and the way in which the auditor designs the rest of the audit to provide an effective audit response to the identified risks. The approach to the audit required by the proposed ISAs is summarized by the diagram in Appendix 2. Underlying this approach is the

“audit risk model”, which is the fundamental statement of the theoretical basis of today's audit. It is more fully explained in the amendment proposed to ISA 200, “Objective and General Principles Governing an Audit of Financial Statements.” The essentials of the audit risk model remain the same; however, new requirements and expanded guidance are proposed to enhance the auditors' implementation of the audit risk model. The proposed changes are significant, as described below, and are intended to improve auditor performance.

The proposed ISAs deal with their subject matter in different combinations than did the previous ISAs. There is no separate ISA on understanding the business, since the IAASB considered that to combine this with the documents on making risk assessments put the purpose of understanding the business into its proper context: it is a

The International Auditing and Assurance Standards Board (IAASB) is a committee of the International Federation of Accountants (IFAC) that works to improve the uniformity of auditing practices and related services throughout the world by issuing pronouncements on a variety of audit and assurance functions and by promoting their acceptance worldwide.

Authority of International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services. They contain basic principles and essential procedures together with guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

central part of the audit, whose importance in the risk assessment process needs to be understood. Previously, ISA 400, "Risk Assessments and Internal Control," dealt with understanding internal control and with testing controls and substantive testing. The IAASB wished to emphasize the fundamental importance of designing and performing audit procedures to respond to the auditor's risk assessments, and considered that an appropriate way of recognizing this, was to make this the subject of a separate ISA. Finally, in responding to the fact, that the computer systems are generally now the rule rather than the exception, their use has been assumed in the proposed ISAs, so a separate ISA such as the current ISA 401, "Auditing in a Computer Information Systems Environment," becomes unnecessary.

4.0 SIGNIFICANT CHANGES AND EFFECT ON THE AUDITOR'S WORK

Significant changes in the proposed ISAs and the way they are expected to affect the auditor's work are discussed below. In overview, they relate to the following:

- *the auditor is required to obtain an enhanced understanding of the entity's business.* The auditor is required to perform audit procedures to obtain a broader and deeper understanding of specified aspects of the entity and its environment, including its internal control.
- *The auditor is required to make risk assessments in all cases.* The required understanding of the entity provides a better basis for identifying risks of material misstatement at the financial statement level and in classes of transactions, account balances and disclosures. The auditor is required to perform a more rigorous assess-

ment in relating the identified risks to what can go wrong at the assertion level. By requiring the auditor to make risk assessments in all audits, the auditor can no longer default to a high-risk assessment.

- *The auditor is required to link the identified risks to audit procedures.* In designing and performing further audit procedures, the nature, timing and extent of the procedures are linked to the assessed risks.
- *The auditor is required to document specific matters.* The proposed documentation requirements are more specific, since the IAASB recognizes the importance of documentation in driving better performance of the audit.

The details of the more significant changes are outlined below. The explanation of significant changes is a summary of the main effects of the proposed Standards. It is essential to read the proposed ISAs in their entirety for a full appreciation of their effect on the auditor's work.

Expanded understanding of the entity. Proposed ISA XX, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement," specifies and expands upon what the auditor must understand about the entity whose financial statements are being audited. In particular, the auditor is required to obtain an understanding of business risks to the extent that they are relevant to the financial statements.

Sources of understanding and procedures for obtaining it. The proposed ISAs include requirements and guidance on where and how the auditor should obtain the required understanding. These new requirements are intended to provide rigor and substance to the auditor's procedures and to improve the auditor's knowledge by requiring the auditor to look beyond those involved in financial reporting and management to those with operational roles within the entity. In addition, the proposals emphasize that the information obtained during this phase of the auditor's work may constitute valid audit evidence, which contributes to the auditor's opinion but is not sufficient, in and of itself, to support the auditor's opinion. The audit procedures undertaken to obtain the necessary understanding are referred to as "risk assessment procedures."

Discussion among audit team. The members of the audit team are required to discuss the susceptibility of the entity's financial statements to fraud or error. This reinforces the requirement for the audit team to discuss fraud and error risks, introduced in ISA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements." The purpose of this requirement is to encourage the team to share information and ideas so that the collective wisdom of the team can be brought to bear on the risk identification process.

Internal control – increased requirements and guidance.

The requirements and guidance related to internal control have been substantially increased including specification of the components that comprise internal control, the extent of the required understanding of each of the components of internal control, and the auditor's procedures to obtain an understanding of internal control

- Internal control components of which an understanding is required now include the entity's risk assessment process and its monitoring of controls. This change, along with increased guidance on the entity's control environment, is intended to assist the auditor in better understanding the role that management and those charged with governance have in the entity's overall internal control and how such controls may affect the auditor's procedures
- In understanding the entity's internal control, the auditor is required to evaluate the design of controls and determine whether they have been implemented. This level of understanding is greater than that previously required. In particular, evaluation of the design and determination of the implementation of controls that address significant risks and controls that relate to assertions for which substantive procedures alone is not sufficient is required. In obtaining this level of understanding of internal control, the auditor is more likely to identify controls that are of relevance to the audit and is consequently encouraged to plan reliance on such controls.

Assessing the risks of material misstatement. By obtaining a broader understanding of the entity and its environment, including its internal control, the auditor gets a better basis for identifying risks of material misstatement. The audit evidence obtained from the risk assessment procedures supports the auditor's assessment. In performing the risk assessment, the auditor is required to assess the risks of material misstatement at the assertion level, identify risks that are significant in the auditor's judgment, and identify assertions where substantive procedures alone will not be sufficient. The proposed ISAs describe risk assessment as a combined assessment of inherent and control risk. The auditor may perform combined or separate assessments.

Responding to risks of material misstatement. The auditor's procedures should be responsive to the assessed risks and reduce audit risk to an appropriately low level. The auditor responds to risks at the financial statement level and at the assertion level. Because of the nature of risks at the financial statement level, the auditor is required to determine overall responses, such as assigning audit staff with special skills or incorporating additional elements of unpredictability in the selection of audit procedures to address such risks. In

responding to the risks of material misstatement at the assertion level, the nature, timing and extent of the auditor's procedures need to be clearly linked to the assessed risks. Proposed ISA XX, "The Auditor's Procedures in Response to Assessed Risks," emphasizes the nature of the procedures in determining the response to the assessed risks.

Testing the operating effectiveness of controls. In evaluating the entity's internal control, the auditor may identify controls and plan to rely on the effectiveness of such controls. For such controls, consistent with current ISAs, the auditor tests that the controls are operating effectively at relevant times during the audit. Proposed ISA XX, "The Auditor's Procedures in Response to Assessed Risks," contains new guidance concerning the use of audit evidence of the effectiveness of controls obtained in previous audits, including:

- If the auditor intends to rely on controls that have not changed (based on the auditor's evaluation of design and whether in operation in the current period) since they were last tested, the auditor tests the operating effectiveness of such controls at least every third audit. The longer the time elapsed since a control is tested, the less audit evidence the control may provide about its effectiveness in the current year
- For a significant risk, where the auditor plans to rely on the operating effectiveness of controls intended to mitigate the risk, the auditor obtains audit evidence about the operating effectiveness of relevant controls in the current period.

Substantive procedures. A new requirement is that for significant risks the auditor must perform substantive procedures that are specifically responsive to the risks. Although, there is no change to the current requirement to perform substantive procedures for material classes of transactions and account balances, the requirement has been extended to disclosures, considering their increased significance under financial reporting frameworks.

Evaluating the sufficiency and appropriateness of audit evidence. The sufficiency and appropriateness of audit evidence obtained is a matter of professional judgment. Proposed ISA XX, "The Auditor's Procedures in Response to Assessed Risks," provides additional guidance in performing this evaluation. If the auditor is unable to obtain sufficient and appropriate audit evidence, the auditor expresses a qualified opinion or a disclaimer of opinion.

Documentation requirements. Both proposed ISA XX, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," and ISA XX, "The Auditor's Procedures in Response to Assessed Risks," expand the documentation requirements. Some of the additional documentation requirements include:

- Details of each aspect of the understanding of the

- entity and its environment (including internal control);
- The procedures performed to obtain the understanding including the sources of information;
- The results of the risk assessments both at the financial statement and assertion levels;
- The nature, timing and extent of the auditor's procedures; and
- The linkage with the assessed risks and the results of the audit procedures.

SMALL ENTITIES

ISAs are developed to apply to all entities and the proposed ISAs have been drafted on this basis. While some aspects may seem more applicable to larger entities (e.g., the requirement to consider the entity's risk assessment process, the importance of governance arrangements and monitoring of controls), the underlying considerations and objectives are equally relevant to small entities. In such cases, the relevant processes may be simpler, but the aspects of a business to which they refer are equally important, though the means of dealing with them may be different and less formal. The effect is that, while they should be considered by all auditors, in the case of the small entity the auditor may find that some matters may be understood quite readily. The IAASB believes that in some cases auditors of small entities may already have an understanding close to that required by the proposed ISAs, and that the principal effect of the proposals will be to require the auditor to use that understanding in a more effective way.

The IAASB is, however, aware that additional guidance may be necessary for audits of small entities. It has therefore, approved a project to consider the effect of the proposed ISAs on International Auditing Practice Statement (IAPS) 1005, "The Special Considerations in the Audit of Small Entities," and to make proposals about whether to incorporate relevant guidance in the ISAs or a revision of the IAPS.

CONFORMING CHANGES

The proposed ISAs will have the most effect on the auditor's risk assessment process and in performing further audit procedures based on the risk assessment. However, the proposals will also affect other aspects of the audit. Therefore, when these proposed ISAs are approved, other ISAs will require revision for conformity and consistency. The IAASB believes that the proposed ISAs will require significant conforming changes to:

- ISA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements;"
- ISA 300, "Planning;"
- ISA 520, "Analytical Procedures;"
- ISA 530, "Audit Sampling and Other Selective Testing Procedures;" and
- ISA 540, "Audit of Accounting Estimates."

IAASB will continue to work on conforming changes during the exposure period.

Appendix 1: Background to the Project

JOINT WORKING GROUP REPORT AND THE U.S. PUBLIC OVERSIGHT BOARD REPORT

The project was heavily influenced by the findings and recommendations of the Joint Working Group (JWG) and the erstwhile Public Oversight Board's¹ (POB) Panel on Audit Effectiveness of U.S. In May 2000, the JWG published the results of its research in the report, "Developments in the Audit Methodologies of Large Accounting Firms." Since the initiation of the original research project, the POB issued a report in August 2000 on an extensive study of audit effectiveness. Both reports indicated that the fundamental audit risk model was not broken, but certain changes were needed. Where appropriate, the recommendations of the JWG and the POB have been adopted.

JOINT RISK ASSESSMENTS TASK FORCE

Both the IAASB and the ASB had projects to respond to the changes in the audit environment and to consider the recommendations of the JWG and the POB respectively. As the IAASB and ASB faced similar issues and had a common purpose of improving audit quality, the two bodies formed the Joint Risk Assessments Task Force to develop a common set of auditing standards. By partnering with the ASB, the IAASB is furthering its goal of integrating the standard setting process with national standard setters in order to promote the convergence and acceptance of an international set of auditing standards. The IAASB believes the proposed standards are an important step in accomplishing this goal since these standards establish the basic framework for the audit process.

The ASB will be issuing proposed Statements on Auditing Standards (SASs) that are the proposed ISAs modified to conform to certain specific U.S. requirements. The proposed ISAs and the proposed SASs are therefore expected to be the same in substance, except to the extent of additional requirements that are included in the U.S. versions to conform with other U.S. standards.

¹ Now Public Accountability Board

Appendix 2: Overview of the Proposed ISAs

<p>Perform risk assessment procedures</p> <p>Perform audit procedures to understand the entity and its environment:</p> <ul style="list-style-type: none"> ● industry, regulatory, and other external factors including applicable financial reporting framework ● nature of the entity ● objectives and strategies and related business risks ● measurement and review of the entity’s financial performance ● internal control 	<p>See paragraphs 7 to 94 of ISAXX, “understanding the entity and its environment and assessing the risks of material misstatement”</p>
<p>Assess the risks of material misstatement</p> <p>Assess the risks of material misstatement at the financial statement level and the assertion level by:</p> <ul style="list-style-type: none"> ● Identifying risks through considering <ul style="list-style-type: none"> — the entity and its environment, including its internal control — classes of transactions, account balances and disclosures ● Relating the identified risks to what can go wrong at the assertion level ● Considering the significance and likelihood of the risks 	<p>See paragraphs 95 to 114 of ISAXX, “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement”</p>
<p>Respond to assessed risks</p> <p>Respond to the risks at the financial statement level and assertion level by:</p> <ul style="list-style-type: none"> ● Developing overall responses to the assessed risks at the financial statement level; and ● Determining the nature, timing and extent of further audit procedures at the assertion level 	<p>See paragraphs 5 to 21 of ISA XX, “The Auditor’s Procedures in Response to Assessed Risks”</p>
<p>Prior to August 1998</p> <p>Perform further audit procedures that are clearly linked to risks at the assertion level by:</p> <ul style="list-style-type: none"> • Performing tests of the operating effectiveness of controls • Performing substantive procedures 	<p>See paragraphs 22 to 57 of ISA XX, “The Auditor’s Procedures in Response to Assessed Risks”</p>
<p>Evaluate Audit evidence obtained</p> <p>Evaluate whether sufficient and appropriate audit evidence has been obtained</p>	<p>See paragraphs 58 to 64 of ISA XX, “The Auditor’s Procedures in Response to Assessed Risks”</p>