

**Minutes of the 18<sup>th</sup> Meeting of the  
INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD  
Held on December 5-9, 2005 in Cape Town, Republic of South Africa**

**Voting Members***Present:*

John Kellas (Chairman)  
Denise Esdon (Deputy Chair)  
Mowafak Al Yafi  
Philip Ashton  
Craig Crawford  
Sukanta Dutt  
Josef Ferlings  
John Fogarty  
Rogério Gollo (December 6-9)  
Jan Bo Hansen  
Gen Ikegami  
Ian McPhee  
Will Rainey  
Bodo Richardt  
Roger Simnett  
Roberto Tizzano  
Gérard Trémolière

*Absent:*

Inga-Britt Ahlenius

**Technical Advisors**

Kelly Ånerud (Ms Ahlenius)  
Wolfgang Böhm (Mr Ferlings)  
Cédric Gélard (Mr Trémolière)  
Jon Grant (Mr Rainey)  
Jennifer Haskell (Mr Hansen)  
Diana Hillier (Mr Ashton)  
Richard Mifsud (Mr McPhee)  
Makoto Shinohara (Mr Ikegami)  
Sylvia Smith (Mr Crawford)  
Shook Kheng Tan (Mr Dutt)  
George Tucker (Ms Esdon)  
Sharon Walker (Mr Fogarty)

**Non-Voting Observers***Present:*

Thomas Ray  
Hisashi Yamaura  
David Damant

**Public Interest Oversight Board (PIOB) Members Observer***Present:*

Aulana Peters (December 7-9)

**IAASB Technical Staff***Present:*

Jim Sylph (Technical Director), Michael Nugent, Alta Prinsloo, Ken Siong, Jan Tyl

## **1. Opening Remarks and Minutes**

### WELCOME AND INTRODUCTIONS

Mr Kellas welcomed the following observers to the meeting – from the Public Accountants’ and Auditors’ Board (PAAB) of South Africa: Mr Kariem Hoosein (Chief Executive Officer) and Mr Bernard Agulhas (Director: Auditing Standards); from the South African Institute of Chartered Accountants: Ms Linda de Beer (Senior Executive: Standards) and Ms Thingle Pather (Project Director: Non-Financial Reporting and Auditing). Mr Kellas also noted that Ms Aulana Peters, a PIOB member, would be attending the meeting later in the week.

As a result of her new appointment within the United Nations, Ms Ahlenius tendered her resignation from the IAASB effective December 31, 2005. Mr. Kellas thanked her on behalf of the IAASB for her contribution.

Ms Ahlenius sent her apologies as she was not able to attend the meeting and has nominated Ms Ånerud as her proxy.

### MINUTES OF PREVIOUS MEETING

The minutes of of the previous IAASB meeting were approved as presented.

### IAASB CAG MEETING

The IAASB CAG met on November 30-December 1, 2005 in London. With the appointment of representatives from China and the Philippines, the CAG membership is now almost complete. The CAG Terms of Reference will be finalized shortly, taking into account comments from the PIOB, and are expected to be approved by the PIOB at its next meeting.

The CAG also discussed the development of the Working Groups which had been set up to enhance the CAG’s proactive role. The appropriate stages at which the CAG’s input is most useful to the IAASB Task Forces were also discussed and noted. The CAG’s next meeting, which will be open to the public, has been scheduled for May 11-12, 2006 in Europe.

## **2. Experts**

Mr. Ferlings led a discussion of an issues paper and a draft outline of a proposed revised ISA 620 “Using the Work of an Expert.”

### SCOPE - EXPERT EMPLOYEES OF THE ENTITY

The IAASB discussed whether the proposed revised ISA should address expert employees of the entity. It was suggested that the auditor’s consideration of expert employees involved in the preparation of the financial statements is essentially no different from that of the work of management itself, and should therefore be viewed as a normal part of evidence gathering rather than as a special topic requiring coverage in the ISA.

The extant ISA 620 deals with experts employed by the entity, and there would be a risk that excluding them from the revised ISA might be seen as creating a gap in the IAASB’s literature. It would also be important to overcome any perception that the auditor can rely on management’s

experts without fully auditing their work (particularly as the variety of experts used by management, and reliance on them, increases).

The IAASB agreed that the proposed revised ISA should refer to expert employees of the entity, primarily to distinguish them from experts engaged by the auditor. The IAASB asked the task force to consider how best to achieve this.

#### SCOPE - AUDITING, ACCOUNTING, AND TAX EXPERTS

The IAASB discussed whether the proposed revised ISA should cover experts in tax, accounting, and particular auditing techniques. It was agreed that given the increasing complexity of tax issues, particularly in a multinational environment, the level of tax knowledge needed for a complex audit could not always be expected to be within an auditor's core competency, and that tax experts should be included in scope of the revised ISA.

The IAASB debated whether an auditor's core competency should include all aspects of auditing techniques (such as IT auditing and statistical sampling), and accounting (such as accounting for complex financial instruments and foreign GAAP for a multinational entity), and what effect such consideration would have on this ISA, as well as on ISQC 1 and ISA 220. The IAASB discussed the various factors to be considered and asked the task force to present draft wording for the proposed revised ISA with accounting and auditing experts being excluded, but to note how the draft would be affected if they were included.

#### MEMBERS OF THE ENGAGEMENT TEAM

The IAASB considered whether experts who function as part of the engagement team should be covered by the revised ISA. It was agreed that experts who are contracted, rather than employed, by the firm should be included within the scope. Particular attention would need to be given to independence issues. The situation would, however, be more complex for experts employed by the firm. The IAASB tentatively agreed to include expert employees within the scope of the proposed revised ISA, but will reach a final decision after considering a draft of what might be included in the ISA.

#### OTHER MATTERS

The IAASB also agreed the following:

- A risk-based approach should be used in developing the proposed revised ISA.
- The term "expert" should be retained, rather than replaced with "specialist" as used by some national standard setters.
- Experts engaged by a third party should be excluded from the scope of the proposed revised ISA, given the assumption of an active relationship with the expert.
- The proposed revised ISA should address the use of experts in all phases of the audit, and not just during substantive testing.

The task force will liaise with the IFAC Ethics Committee regarding any potential conforming amendments.

The IAASB considered matters raised by the CAG at its previous meeting, including whether an auditor can sign a report when multiple experts are used, and whether separate guidance would be needed for experts “consulted” as opposed to experts who are part of the audit team. On the latter, it was noted that while independence considerations may differ, issues related to the expert’s competence are unlikely to be different. The IAASB agreed with the CAG that the proposed revised ISA should provide guidance on when an auditor should use an expert.

### **3. Communications with those charged with governance**

Mr McPhee noted that thirty four comment letters had been received on the March 2005 exposure draft of the proposed revised ISA 260. Respondents were generally supportive of the proposals.

Mr McPhee led the IAASB through the main issues raised by respondents.

#### **SPECIAL PURPOSE FINANCIAL INFORMATION**

The task force had amended the draft proposed revised ISA to make it applicable to audits of historical financial information where those charged with governance have a responsibility to oversee the preparation and presentation of that information.

The IAASB noted that, in general, it preferred not to complicate the application of ISAs by introducing specific adaptations needed to make them applicable to financial information other than general purpose financial statements. The IAASB agreed that the proposed revised ISA should state that it applies to the audit of general purpose financial statements and should include only a general statement about adaptation for audits of other historical financial information.

#### **“SIGNIFICANT” VERSUS “SERIOUS” ETC.**

The IAASB agreed that the term “significant” should be used as a single term to replace other similar terms such as “serious.” The IAASB discussed the need for a definition of “significant” (as opposed to “significance,” which is defined in the Glossary). It was noted that this may be difficult as the circumstances of engagements vary, and a “bright line” to distinguish significant matters from insignificant ones did not exist. The IAASB asked the task force to reconsider this issue.

#### **MATERIALITY**

The IAASB discussed (a) whether it is the “application” of materiality or the “concept” of materiality that should be communicated with those charged with governance, (b) whether the auditor should be encouraged to disclose specific materiality thresholds, and (c) the level of detail to be included in the guidance (for example, distinguishing between planning materiality and evaluation materiality). It was agreed that it is the application of materiality that should be communicated, that disclosure of specific thresholds should not be encouraged, and that the amount of detail in the proposed revised ISA should be reduced.

#### **MISSTATEMENTS**

The IAASB discussed whether the auditor should be required to communicate to those charged with governance misstatements that were identified and corrected as a result of audit procedures and that were brought to the attention of management. It was noted that the preparation and auditing of financial statements are often concurrent processes, and it may not be clear whether potential misstatements were identified as a result of audit procedures. In addition, it may be appropriate to

bring other corrected misstatements to the attention of those charged with governance, for example, ones caused by weaknesses in internal control. The IAASB concluded that it is the root cause of corrected misstatements that should determine whether they are required to be communicated. Accordingly, the task force was asked to draft relevant text taking this into account.

#### SUPPLEMENTARY MATTERS

Concern was expressed about whether the proposed requirement to communicate supplementary matters would, as drafted, create expectations that could not be fulfilled. While acknowledging the validity of the public interest objective that this requirement sought to meet, the IAASB considered a number of issues that this proposal would raise. The task force was asked to consider this matter further, and in particular, whether the wording of this paragraph could be clarified, and whether it would be appropriate to provide guidance as opposed to imposing a requirement.

#### OTHER MATTERS

The IAASB also agreed the following:

- The guidance relating to group audits should be moved to the proposed ISA 600 (Revised), “The Audit of Group Financial Statements.”
- Where an engagement letter is directed to those charged with governance, the proposed revised ISA should indicate that it may be an appropriate form of communication for a number of the matters required to be communicated. In addition, references to engagement letters throughout the draft should be brought together in one place.
- The text relating to communication of uncorrected misstatements should be moved to the proposed ISA “Evaluation of Misstatements Identified During the Audit,” which is being developed by the Materiality task force.
- The auditor should communicate to those charged with governance all representations the auditor is requesting from management, rather than merely a selection.
- The guidance dealing with matters required to be communicated by other ISAs or external requirements, or matters that have been agreed with the entity, should be mentioned in the introduction to the ISA to ensure readers of the ISA are aware of the complete communication framework, but further guidance in this respect would not be required.
- The task force should reconsider whether an appendix to the ISA, or other form of communication (such as a document on the IAASB website), should include a listing of the communication requirements contained in other ISAs.
- In response to concern raised by a regulator in relation to disclosure of communications to regulators, the proposed wording that written communications with those charged with governance should not be disclosed to others, or quoted or referred to, without the auditor’s prior written consent, should be amended to tone down the restriction.
- The proposed requirements to document processes with respect to (a) identifying the appropriate person(s) with whom to communicate, and (b) whether communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity, should be deleted. These

requirements were not included in the exposure draft, and they could impose significant additional burdens on auditors that may not be warranted.

#### WAY FORWARD

The IAASB asked the task force to present (a) a revised draft of the proposed revised ISA in the current format, and (b) a “clarified” draft for approval as an exposure draft at the March 2006 IAASB meeting.

#### **4. Related Parties**

Mr Kellas noted that the CAG had considered this item at its November 2005 meeting. Mr Trémolière then led a review of the proposed revised ISA 550, “Related Parties.”

#### FINANCIAL REPORTING FRAMEWORKS THAT DO NOT ESTABLISH RELATED PARTY REQUIREMENTS

The IAASB agreed that even where the applicable financial reporting framework does not establish related party accounting and disclosure requirements, the auditor should obtain an understanding of the related party relationships and transactions sufficient to evaluate whether their effects could result in the financial statements being misleading in the circumstances of the engagement. It was questioned whether, in these circumstances, the auditor’s responsibilities should be limited to performing the risk assessment procedures only. It was noted that even where the applicable financial reporting framework does not establish requirements specific to related parties, other accounting requirements could apply. Accordingly, the IAASB agreed that the other requirements of the proposed revised ISA, including response to assessed risks, written representations, and evaluation of related party relationships and transactions, should also apply.

#### REFERENCE TO INTERNATIONAL ACCOUNTING STANDARD (IAS) 24

The IAASB discussed the role of IAS 24 in the proposed revised ISA. The IAASB agreed that the ISA should provide some related party definitions that the auditor could refer to in the case where the applicable financial reporting framework does not establish related party requirements. It was questioned whether these definitions should be those of IAS 24 or whether the ISA should establish related party definitions based on those of IAS 24. It was noted that the latter alternative would allow the ISA to provide definitions that would not need to be updated every time the definitions in IAS 24 were changed. The IAASB therefore agreed that the IAS 24 definitions, extant as of December 9, 2005, provided an acceptable set of definitions that would apply for the purpose of the ISA when the applicable financial reporting framework has no definitions.

#### NATURE AND EXTENT OF MANDATORY IDENTIFICATION PROCEDURES

The IAASB broadly agreed to include as part of risk assessment procedures a minimum set of procedures to identify related party relationships and transactions not identified or disclosed by management. With regard to the procedure to review appropriate records or documents for transactions that are both significant and non-routine, the CAG had noted the difficulty in differentiating between the list of items that the auditor should be required to review in all circumstances and the list of items that the auditor may consider reviewing if appropriate. The IAASB agreed that the mandatory list of records or documents should be limited to (a) bank and legal confirmations, and (b) minutes of meetings of shareholders and those charged with governance, and other relevant statutory records.

## RELATED PARTY RELATIONSHIPS AND TRANSACTIONS INVOLVING A DOMINANT PARTY

The IAASB discussed the auditor's responsibilities in the case where a party appears to exert dominant influence over the entity. The IAASB agreed that it would be appropriate to emphasize that the dominant influence is of an active nature. It was noted that the proposed requirement for the auditor to seek to identify the parties to which the dominant party is related did not convey the required imperative. In addition, there was a need to allow for the element of uncertainty as to whether the auditor would identify any related parties as a result of performing the identification procedures. Accordingly, the IAASB agreed to amend the proposed requirement so that it would require the auditor to perform procedures intended to identify parties to which the dominant party is related. Furthermore, as the purpose of these procedures is to identify unidentified or undisclosed related parties, the IAASB agreed to combine the requirement with the other mandatory risk assessment procedures to identify related party relationships and transactions not identified or disclosed by management.

## OTHER CHANGES

In addition to editorial changes, the IAASB also agreed the following:

- The objective of the ISA should be amended as the focus on reducing to an acceptably low level the risk of not detecting material misstatements in the financial statements, was not appropriate.
- With respect to the evaluation of whether the effects of related party relationships and transactions could result in financial statements being misleading in the circumstances of the engagement, there should be guidance explaining the meaning of "circumstances of the engagement," consistent with that provided in the proposed ISA 701.
- With respect to the inherent limitation regarding the auditor's ability to identify all related party relationships and transactions, there should be a closer link to fraud.
- The general guidance discussing the inherent limitation and the reasons why there may be a higher risk that the entity may not identify and appropriately account for or disclose related party relationships and transactions, should be moved to a new section, "Related Parties in the Context of an Audit of Financial Statements," in the introduction to the redrafted ISA.
- With regard to disclosures of arm's length assertions, the guidance should be amended to indicate that it may be difficult for management to substantiate the assertions.
- The section on evaluation of related party disclosures should be expanded to include evaluation of the substance of related party transactions and their effects.
- With regard to evaluating the significance of related party transactions, it should be noted that the monetary amount of the transactions may not be the sole determinant of significance.
- The scope of the proposed requirement to discuss significant related party transactions and issues with those charged with governance should be clarified. In addition, the requirement to discuss with those charged with governance should be changed to a requirement to *communicate with* them.
- There should be a specific documentation requirement regarding the identity of the entity's related parties and the nature of the related party relationships, as well as the procedures

performed in relation to a party actively exerting dominant influence over the entity, and, if applicable, any parties identified as being related to the dominant party.

#### APPROVAL

The IAASB reviewed the revised draft of the proposed revised ISA 550, reflecting the changes agreed during the earlier discussions, and unanimously approved it for issue as an exposure draft. The closing date for comments was set as April 30, 2006.

#### 5. Group Audits

Mr Hansen explained that the task force had developed a revised draft of the proposed revised ISA for discussion based on the clarity drafting conventions. This differs from the approach to other projects in progress, which is to first agree on a final draft of a proposed ISA before proceeding to redrafting for clarity purposes. However, many respondents to the exposure draft had highlighted the structure of the proposed ISA as a significant issue. The task force felt it could only address these comments by redrafting the proposed ISA in the clarity style.

Mr Hansen led a review of the significant comments from respondents and the redrafted proposed revised ISA.

#### FULL VS. DIVIDED RESPONSIBILITY

Mr. Hansen noted that no new arguments arose on this issue from re-exposure. The task force therefore concluded that the IAASB's decision to eliminate the divided responsibility approach remained valid.

Some respondents argued that the divided responsibility approach might be practical in certain circumstances where access to information is restricted. The task force, however, concluded that an inability to obtain sufficient appropriate audit evidence in relation to a significant component would be a scope limitation that would give rise to a modified audit opinion. Such circumstances could be described in the basis for modified opinion paragraph in the auditor's report. This would provide information similar to the case where reference is made to another auditor in the group auditor's report under the divided responsibility approach.

The IAASB agreed that the proposed ISA should clarify that, although the group auditor alone is responsible for the audit opinion on the group financial statements, the other auditor remains responsible for his or her opinion on the component's financial information, i.e., the fact that the group auditor is responsible for the audit opinion on the group financial statements would not translate into the other auditor not being responsible for his or her opinion.

#### DEFINITIONS

The IAASB discussed the proposed definition of "group auditor," taking into account comments received from the CAG. It was agreed that the task force should clarify the meaning of "direct supervision" by reference to ISA 220. In addition, the task force should consider the definition of "group auditor" in the context of the definition of "auditor" in the Glossary, including the effect of moving from a definition that focuses on responsibility for the engagement and its performance to one that focuses on responsibility for signing the auditor's report. Further, the task force should

consider including the definitions of “group audit” and “group audit opinion,” which are reflected elsewhere in the proposed ISA, in the Definitions section.

Mr. Hansen reported that the CAG had expressed concern that the meanings ascribed to accounting terms in the proposed ISA were different from those in the International Financial Reporting Standards (IFRSs). In particular, the term “consolidation” in the proposed ISA included associated companies accounted for by the equity method, which was not the case for IFRSs. The IAASB asked the task force to consider this matter further.

#### ACCEPTANCE AND CONTINUANCE AS GROUP AUDITOR

The CAG supported the task force’s view that, in the case of significant components, access to information would be necessary to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. The IAASB, however, asked the task force to reconsider the PricewaterhouseCoopers comment letter, as more could have been drawn from that letter. The IAASB agreed that the guidance dealing with restrictions on access to information should be redrafted to reflect a more positive tone. The proposed revised ISA should also explain that the fundamental question is whether the group auditor will be able to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level, and that this could be achieved through involvement in the work of the other auditors, or by other means.

The IAASB asked the task force to consider emphasizing in the application material management’s responsibility to consent to access to information. In addition, the proposed ISA should recognize that law or regulation may prohibit the group auditor from accepting or resigning from an engagement. The guidance should also indicate that the group auditor obtains an understanding of group management’s rationale for appointing other auditors to audit the financial statements of components. The CAG had suggested deleting from the guidance the example of the percentage (10%) to be applied to a chosen benchmark in identifying components that are of individual financial significance. It was noted that the approach should be similar to that for the examples of percentages to be applied to chosen benchmarks in proposed revised ISA 320. The IAASB asked the task force to reconsider the appropriateness of its recommendation in light of the comments received, in particular, whether the percentage should be changed from 20% to 10% as recommended.

#### MATERIALITY

The IAASB questioned whether the task force had fully responded to the respondents’ comments in this area. Mr Hansen noted that the proposed revised ISA 320 formed the basis for the related requirements and guidance in the proposed revised ISA 600, and that the latter would be aligned with the former.

It was questioned whether three levels of materiality were intended, i.e., materiality for the group financial statements as a whole, materiality for the component communicated by the group auditor to the other auditor, and materiality determined by the other auditor for purposes of performing risk assessment and further audit procedures at the component level. Mr Hansen confirmed that this was the case. With regard to the proposed requirement for the auditor responsible for performing the work on a component’s financial information to determine an amount lower than component materiality for purposes of performing risk assessment and further audit procedures, the IAASB

asked the task force to consider explaining that this requirement would relate to cases where the other auditor is requested to perform a full scope audit. In addition, the task force should consider explaining that although component materiality may be communicated by the group auditor, the other auditor still has to apply the requirements and guidance in proposed ISA 320.

#### COMMUNICATIONS WITH THE OTHER AUDITORS

The CAG had asked whether the proposed revised ISA should address the other auditors' obligation to provide the group auditor with access to their audit documentation where such access is not prohibited by law or regulation. Although the task force felt that the matter had already been dealt with through the requirements in the proposed ISA, the IAASB agreed that the requirements should be explicit about the other auditors' cooperation with the group auditor.

It was questioned whether it would always be necessary for the other auditor's memorandum or report to contain all the information listed in paragraph 43. It was noted that, in the case of a significant component where the group auditor may decide to review relevant parts of the other auditor's audit documentation, it may be unnecessary to include all the information in the other auditor's memorandum or report. It was also unclear how the work performed by the other auditor should be described in the memorandum or report. The IAASB agreed that the task force should reconsider whether all the information in the list would always be necessary.

#### PUBLIC SECTOR PERSPECTIVE

Mr Hansen noted that IAASB staff will liaise with the Focus Group of the Financial Audit Guidelines Sub-committee of the INTOSAI Professional Standards Committee in finalizing the Public Sector Perspective.

#### APPLICATION OF THE CLARITY DRAFTING CONVENTIONS

Concern was expressed about the long lists of items, factors, examples, etc. in the application material and, to a limited extent, in the requirements section. Such lists could be regarded as audit programs. It was noted that some of the lists could be summarized. Although application material and appendices have the same authority, including some of the lists in appendices may aid presentation. The IAASB asked the task force to reconsider the extent of application material and how to present the requirements and application material more effectively.

#### OTHER CHANGES

In addition to editorial changes, the IAASB also agreed the following:

- The meaning of the word "additional" in the first paragraph in the introduction should be clarified. The guidance in this paragraph could be retained; however, the task force should consider whether the example could be deleted.
- The task force should consider explaining that a reason for obtaining an understanding of the other auditors is to evaluate the effect the other auditors may have on the work effort of the group auditor.
- The task force should consider deleting the reference to ISA 220 in the requirements section as the terms "group auditor" and "other auditor" are defined.

- The task force should consider indicating in the application material that it may be unnecessary for the group auditor to obtain an understanding of other auditors from network firms.
- The text within the requirements section dealing with confirmations from other auditors about external quality control reviews should be moved to the application material.
- The task force should consider revising the application material which lists factors that may affect the group auditor's ability to use the work of the other auditors, to indicate that these factors are inter-related and are not mutually exclusive. An example should be considered.
- The task force should reconsider the term "commonality" as the CAG had noted that it is not common and may be difficult to translate.
- With regard to assessing the risks of material misstatement of the group financial statements, the guidance should focus on the risks arising from frequent changes in other auditors rather than the risks arising from the fact that more than one auditor is engaged to audit the components.
- With regard to the group auditor's involvement in the work of other auditor, the proposed requirement in paragraph 29 should be moved to the application material as it does not in fact establish a requirement. The task force should also develop a requirement for the group auditor to determine his or her involvement based on the significance of the component, identified risks of material misstatement of the group financial statements, and the group auditor's understanding of the other auditor.
- The task force should clarify that the requirements dealing with the group auditor's involvement in the work of the other auditor in the case of a significant component or identified significant risks of material misstatement, also apply where the component is subject to audit by statute, regulation, or other reason.
- With regard to obtaining and reading the other auditor's memoranda or reports of work performed, the proposed requirement should be for the group auditor to evaluate the other auditor's memoranda or reports to determine whether matters reported have implications for the audit opinion on the group financial statements.
- With regard to the example of the modified opinion in Appendix 1, the task force should revise the Basis for Modified Opinion paragraph to indicate that the associated company's financial statements were audited, but that the auditor did not have access to information necessary to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Consideration should be given to specifying the information.

#### WAY FORWARD

The IAASB agreed that the task force should submit a revised draft of the proposed revised ISA for approval as a re-exposure draft at the next IAASB meeting. It was acknowledged that a trail from the previous exposure draft to the re-exposure draft would not be possible. The IAASB asked the task force to prepare a Basis for Conclusions, reflecting the IAASB's response to the significant comments on exposure. In addition, the task force should indicate which occurrences of the present tense have been elevated to requirements. This should accompany the re-exposure draft. When

approving the re-exposure draft, the IAASB should consider whether to permit comments on matters other than the application of the clarity drafting conventions.

## **6. Materiality**

Ms Esdon reported on the task force's consideration of the comments raised by the IAASB at the October 2005 meeting, and explained the task force's recommendations with regard to the significant exposure draft comments that were not discussed at that meeting. She then led a detailed review of the proposed ISA 320, "Materiality in Planning and Performing an Audit."

### MANAGEMENT'S MATERIALITY

Ms Esdon explained that the task force has reviewed proposed ISA 315 (Redrafted) and identified a number of paragraphs in the requirements and application material that contain implicit references to management's materiality. The Task Force remains of the view that a conforming amendment to ISA 315 is not necessary.

Ms Esdon reported that some IAASB CAG representatives were of the view that management's consideration of materiality is an integral part of designing and implementing internal control and preparing financial statements and that the auditor should consider management's materiality when determining materiality for planning and performing the audit. A CAG representative was of the view that the auditor should use management's materiality as the materiality level for the audit.

On balance, having subsequently reviewed Agenda Item 6-E, the IAASB was of the view that it is not necessary to include an explicit reference to management's materiality in ISA 315.

### TOLERABLE ERROR

Ms Esdon explained that respondents had expressed their confusion about the term "tolerable error" in the exposure draft and had requested additional guidance on the approach to be followed in determining tolerable error. In response, the task force had expanded the guidance to explain the concept in general terms, without referring to the term "tolerable error." The IAASB noted that it was important that the concept remained in the proposed revised ISA 320; however, it did not have to be explained beyond what the task force proposed. It was also noted that auditors would need additional guidance in this area. The IAASB agreed, however, that the proposed ISA was not the place to further explain the concept, and that the need for further research in this area should be considered by the Steering Committee.

### CATEGORIZATION OF MISSTATEMENTS

Ms Esdon noted that the task force had revised the categorization of misstatements, as most of the respondents were concerned about the misstatements involving subjective decisions as a subset of known misstatements. A CAG representative had suggested an additional category, i.e., improper application of an accounting policy that may become material in the future. The IAASB did not think that this suggestion would be practicable, as there are many matters that could become material in future, but are immaterial for the audit in question. Also see Accumulation of Identified Misstatements below.

#### PRIOR PERIOD UNCORRECTED MISSTATEMENTS

Ms Esdon noted the task force's view that the IAASB cannot mandate one method for the auditor to account for prior period uncorrected misstatements because of transitional provisions which could only be mandated by a regulator or equivalent authority. Proposed ISA XXX, "Evaluation of Misstatements Identified during the Audit" requires the auditor to request management to correct all misstatements. The incidence of prior period uncorrected misstatements should therefore diminish over time. To provide for the current situation, the proposed guidance had been revised to explain that the cumulative effect of immaterial uncorrected misstatements related to prior periods might have a material effect on the current period's financial statements. Therefore, the auditor considers both (i) the adjustment(s) necessary to correct misstatements in the ending balance sheet, even if they arose in whole or part in prior periods, and (ii) the adjustment(s) necessary to correct misstatements affecting the current income statement.

It was noted that the approach to dealing with prior period uncorrected misstatements would depend on the applicable financial reporting framework. Ms Esdon stated that the identification and evaluation of misstatements would be required irrespective of the applicable financial reporting framework.

Mr. Fogarty noted that the AICPA's Auditing Standards Board (ASB) had issued its audit risk standards without concluding on this matter since the U.S. SEC was developing guidance in this regard. As it was uncertain when the U.S. SEC would issue its guidance, the ASB was advised to issue the relevant standards allowing both methods. Mr Fogarty noted that it was not possible for an auditing standard setter to mandate a single method. A regulator, however, could provide transitional arrangements from which a single method could be mandated. Transitional arrangements developed by a regulator might, however, not apply to all entities, such as private companies. Accordingly, there was a responsibility for the accounting standard setter to address the matter.

Concern was expressed that the proposed ISA XXX provided for different outcomes under the same circumstances. Financial statements prepared under one method would be different from financial statements prepared under the other method.

It was questioned whether it was not a matter of an undisclosed accounting policy. Based on discussions with the client, the auditor and the client might agree on what would be material with regard to prior period uncorrected misstatements. One IAASB member viewed a change in the applied method as a change in accounting policy, while another viewed it as a change in estimate.

Ms Esdon proposed that the task force further consider the matter based on the IAASB's comments.

#### MATERIALITY IN THE CONTEXT OF AN AUDIT

Some CAG representatives had expressed the view that the auditor should use the definition of materiality in the applicable financial reporting framework to determine materiality for planning and performing the audit. They were of the view that the matter might be resolved by moving the reference to the auditor using the definition in the applicable financial reporting framework as a frame of reference when determining materiality (paragraph 8) to precede the description of materiality (paragraph 5). Some CAG representatives had also noted that, while the proposed revised

ISA 320 described the concept of materiality, it did not formally define materiality. The IAASB noted that a formal definition of materiality would provide a “hook” for the discussions that follow. The IAASB agreed that the text should be revised to state that most financial reporting frameworks define materiality as including the elements currently described in the proposed text (paragraph 5). This should be followed by the discussion of the various elements. The IAASB asked the task force to reconsider the relevance of paragraph 7 (which notes that materiality depends on the size and nature of the misstatement), and whether its meaning had changed when it was repositioned in the revised draft of the proposed ISA.

#### USE OF BENCHMARKS IN DETERMINING MATERIALITY

A CAG representative had expressed the view that the proposed ISA should not include examples of percentages that could be applied to chosen benchmarks. Another CAG representative also noted that examples of percentages, if any, should be in the application material of the redrafted ISA under Clarity. After discussing the task force’s consideration of the comments raised at the October 2005 IAASB meeting, the IAASB agreed that the examples should be retained, the text should be amended to be less prescriptive, and the guidance should be in the application material of the redrafted ISA. The task force should also consider clarifying how the size of the entity would affect the auditor’s identification of an appropriate benchmark.

#### CONSIDERATION AS THE AUDIT PROGRESSES

The IAASB asked the task force to consider expanding paragraph 23 (dealing with materiality level(s) that may need to be revised as a result of a change in circumstances, new information, etc) to include a reference to fraud. The IAASB agreed that the text in paragraph 25, which discusses communication with those charged with governance, should be amended to draw attention to the fact that proposed ISA 260 (Revised) contains related requirements and guidance.

During the discussion of the examples of percentages to be applied to chosen benchmarks, Mr Ikegami indicated that the minutes of the previous IAASB meeting showed that a small majority of IAASB members were in favor of deleting the examples. The revised draft of the proposed ISA presented to the IAASB, however, retained two such examples. Mr Ikegami was of the view that due process had not been followed. Ms Esdon explained that the task force had considered all the comments received at the October 2005 IAASB meeting, including the show of hands taken at that meeting to provide direction to the task force on whether to delete the examples, and that the revised draft reflected the task force’s best efforts to address the IAASB’s views as a whole. The IAASB was satisfied with how the task force had dealt with the comments from the previous IAASB meeting. Mr. Kellas also noted that a show of hands may occasionally be taken during the development of a standard to solicit views from the IAASB, but is not necessarily to be regarded as binding on a task force, as a final vote would be.

#### OTHER CHANGES

In addition to editorial changes, the IAASB also agreed the following:

- The phrase “the auditor should consider materiality” in paragraph 2 of the introduction should be clarified, as it was unclear whether the auditor should be required to take any action based on this consideration, and how this would be reflected in the objective of the redrafted ISA under Clarity.

- In respect of inherent uncertainties associated with the measurement of particular financial statement items, paragraph 16 of the exposure draft should be deleted.
- With regard to determining materiality when planning the audit, the task force should clarify that it is difficult to foresee qualitative aspects at the planning stage and, therefore, the auditor does not consider them when determining materiality for planning and performing the audit.
- The task force should reconsider the third factor in paragraph 18 dealing with materiality levels for particular classes of transactions, account balance or disclosures, and the auditor's consideration of whether attention is focused on the financial performance of a particular business segment that is separately disclosed in the financial statements.
- In relation to the determination of an amount lower than materiality for the purposes of assessing risks and designing further audit procedures, the task force should consider deleting the reference to ISA 530 in paragraph 21, and explaining the concept further by way of an example.

Ms Esdon next led a detailed review of the proposed ISA XXX.

#### MISSTATEMENTS

The IAASB asked the task force to reconsider the definition of misstatement in paragraph 3, and the remainder of the proposed ISA, to ensure that it was not limited to financial reporting frameworks designed to achieve fair presentation. The definition should apply to all financial reporting frameworks. The task force should also clarify the link between materiality determined for planning and performing the audit (proposed revised ISA 320) and materiality used to evaluate uncorrected misstatements (proposed ISA XXX). The split of the exposure draft into two documents might have created the impression that the auditor determines planning materiality and evaluation materiality.

#### ACCUMULATION OF IDENTIFIED MISSTATEMENTS

In relation to the categorization of misstatements in paragraph 7, the IAASB agreed that it should be clarified that projected misstatements are based on projections from reliable samples. Ms Esdon suggested that the task force consider the requirements of ISA 530 and, if appropriate, include a link in the proposed ISA to ISA 530. The IAASB also asked the task force to reconsider the guidance in paragraph 13, which discusses management's actions with regard to projected misstatements.

#### OTHER CHANGES

In addition to editorial changes, the IAASB also agreed the following:

- With regard to consideration as the audit progresses, the first part of the sentence in paragraph 8(b) should be deleted, as the auditor considers the effect of the aggregate of the misstatements accumulated during the audit on the overall audit strategy and audit plan as the audit progresses, and not only when the aggregate of the accumulated misstatements approaches the materiality level.
- In relation to documentation, the task force should consider including a requirement for the auditor to document the amount under which misstatements would be regarded as clearly trivial. In addition, guidance should be provided regarding paragraph 30(c) dealing with

documentation of misstatements to allow the auditor to evaluate the effect of uncorrected misstatements on significant groups of accounts, segment information, etc.

#### WAY FORWARD

Ms Esdon provided background to the paper on a new ISA on forming an opinion on the financial statements. As a first step, the task force had identified requirements and guidance in the ISAs that could be moved to such an ISA. She noted that the development of a new ISA could affect the finalization of the project to revise ISA 320. The IAASB supported the development of a new ISA, but agreed that the proposed ISAs 320 and XXX should be finalized within their planned timeframe.

The IAASB asked the task force to present the proposed ISAs 320 and XXX using the clarity drafting conventions at the March 2006 meeting. The proposed ISAs should be accompanied by a paper explaining how the task force has addressed the comments raised by the IAASB.

#### **7. Due Process**

Mr Kellas noted that the IAASB's due process was subject to the PIOB's approval. Mr Sylph provided some background to the project and indicated that the objective was to align the IAASB's due process with those of other IFAC Public Interest Activity Committees (PIACs). To date, conformity has been achieved with three other PIACs. The PIOB had reviewed the IAASB's due process document in September 2005 and proposed minor amendments. The latest version distinguishes due process paragraphs (normal type) and working procedures (italicized). The IAASB then reviewed the due process document.

#### APPROVAL

Subject to some minor editorial changes, the IAASB unanimously approved the due process document as presented.

#### **8. Project Proposal – Revision of ISA 505, “Confirmations”**

Mr Sylph noted that the project had arisen as a result of several developments, including a comment letter that the IAASB had received from the European Commission, the U.S. PCAOB's intention to revise its corresponding standard, and comments from IOSCO.

To ensure that the revised ISA provides appropriate guidance on, IAASB staff proposed that the IAASB liaised with the Basel Committee on Banking Supervision and the International Bar Association. Mr Sylph then led a review of the proposal.

It was noted that recent developments in Europe may lead to one or more countries introducing mandatory confirmations. Some IAASB members expressed concern that this project might give rise to unrealistic expectations that IAASB intended to mandate the use of confirmations. Mr Kellas pointed out that the possibility of mandatory confirmations was discussed at the last CAG meeting and that some CAG members believed confirmations should be mandated. There might, however, be rational reasons for not doing so, and those national standard-setters that wish to mandate confirmations could do so by adding to the ISA. The task force should be asked to research the issue of mandating confirmations and to propose a solution to the IAASB.

APPROVAL

The IAASB approved the project proposal, with fourteen votes for, three against, and one abstention. Mr Kellas indicated that Mr Crawford had expressed his willingness to chair the task force. Mr Kellas invited other IAASB members interested in participating on this task force to let him or Mr Sylph know.

**9. Next Meeting**

The next meeting of the IAASB has been scheduled for March 6-10, 2006 in Hong Kong.

**10. Closing Remarks**

Mr Kellas expressed his appreciation for the contribution of the five retiring IAASB members: Mowafak Al-Yafi (Lebanon), Philip Ashton (United Kingdom), Rogério Gollo (Brazil), Gen Ikegami (Japan) and Roger Simnett (Australia).

Mr Kellas thanked the South African Institute of Chartered Accountants for hosting the meeting, and its staff for the assistance offered with the meeting arrangements.

Mr. Kellas closed the meeting.

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