

Auditing Disclosures – Proposed Changes to the ISAs

This paper includes extracts of extant standards with mark-up for Disclosures—revisions for comments from December 2013 IAASB meeting have been highlighted in yellow. Where relevant, proposed changes to the standards arising from the Auditor Reporting exposure draft¹ are shown for reference and have been reflected as marked changes in black font. However, these proposed changes may change when the Auditor Reporting standards are finalized. The footnote numbering in this document does not necessarily correlate with the footnotes as currently included in the extant ISAs.

A. ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

Definitions

13. For purposes of the ISAs, the following terms have the meanings attributed below:

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- (f) Financial statements – A structured representation of historical financial information, including ~~related notes~~disclosures, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time. A complete set of financial statements is defined by the applicable in accordance with a financial reporting framework, and may, for example in the case of many general purpose frameworks, include a balance sheet, an income statement, a statement of changes in equity and a cash flow statement (primary financial statements), and related notes, which may include a summary of significant accounting policies and other explanatory material. Disclosures are ordinarily included in the related notes to the financial statements, but may also be found on the primary financial statements or incorporated by reference when permitted by the applicable financial reporting framework. ~~ordinarily comprise a summary of significant accounting policies and other explanatory information.~~ The term “financial statements” ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement and related notes.

B. ISA 210, *Agreeing the Terms of Audit Engagements*

Requirements

Preconditions for an Audit

6. In order to establish whether the preconditions for an audit are present, the auditor shall: **[NO CHANGE PROPOSED TO THE REQUIREMENT FOR DISCLOSURES]**
- (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2–A10)
 - (b) Obtain the agreement of management that it acknowledges and understands its

¹ See the IAASB's July 2013 Exposure Draft, [Reporting on Audited Financial Statements; Proposed New and Revised International Standards on Auditing \(ISAs\)](#)

responsibility: (Ref: Para. A11–A14, A20)

- (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A15)
- (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (Ref: Para. A16–A19)
- (iii) To provide the auditor with:
 - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - b. Additional information that the auditor may request from management for the purpose of the audit; and
 - c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

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Agreement on Audit Engagement Terms

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10. Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include: (Ref: Para. A22–A25) **[NO CHANGE PROPOSED TO THE REQUIREMENT FOR DISCLOSURES]**
- (a) The objective and scope of the audit of the financial statements;
 - (b) The responsibilities of the auditor;
 - (c) The responsibilities of management;
 - (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
 - (e) Reference to the expected form and content of any reports to be issued by the auditor, including, if the auditor is not required to communicate key audit matters but intends to do so, a statement that the auditor intends to communicate key audit matters; and (Ref: Para. A23a)
 - (f) A statement that there may be circumstances in which a report may differ from its expected form and content.

Application and Other Explanatory Material

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Preconditions for an Audit

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Agreement of the Responsibilities of Management (Ref: Para. 6(b))

- A11. An audit in accordance with ISAs is conducted on the premise that management has acknowledged and understands that it has the responsibilities set out in paragraph 6(b).² In certain jurisdictions, such responsibilities may be specified in law or regulation. In others, there may be little or no legal or regulatory definition of such responsibilities. ISAs do not override law or regulation in such matters. However, the concept of an independent audit requires that the auditor's role does not involve taking responsibility for the preparation of the financial statements or for the entity's related internal control, and that the auditor has a reasonable expectation of obtaining the information necessary for the audit (including from systems or processes that are not part of the general ledger system) in so far as management is able to provide or procure it. Accordingly, the premise is fundamental to the conduct of an independent audit. To avoid misunderstanding, agreement is reached with management that it acknowledges and understands that it has such responsibilities as part of agreeing and recording the terms of the audit engagement in paragraphs 9–12.
- A12. The way in which the responsibilities for financial reporting are divided between management and those charged with governance will vary according to the resources and structure of the entity and any relevant law or regulation, and the respective roles of management and those charged with governance within the entity. In most cases, management is responsible for execution while those charged with governance have oversight of management. In some cases, those charged with governance will have, or will assume, responsibility for approving the financial statements or monitoring the entity's internal control related to financial reporting. In larger or public entities, a subgroup of those charged with governance, such as an audit committee, may be charged with certain oversight responsibilities.
- A13. ISA 580 requires the auditor to request management to provide written representations that it has fulfilled certain of its responsibilities.³ It may therefore be appropriate to make management aware that receipt of such written representations will be expected, together with written representations required by other ISAs and, where necessary, written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.
- A14. Where management will not acknowledge its responsibilities, or agree to provide the written representations, the auditor will be unable to obtain sufficient appropriate audit evidence.⁴ In such circumstances, it would not be appropriate for the auditor to accept the audit engagement, unless law or regulation requires the auditor to do so. In cases where the auditor is required to accept the audit engagement, the auditor may need to explain to management the importance of these matters, and the implications for the auditor's report.

² ISA 200, paragraph A2

³ ISA 580, *Written Representations*, paragraphs 10–11

⁴ ISA 580, paragraph A26

...

Agreement on Audit Engagement Terms

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*Audit Engagement Letter or Other Form of Written Agreement*⁵ (Ref: Para. 10–11)

A22. It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some countries, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law, that is, they prescribe the matters described in paragraph 10. Although in these circumstances paragraph 11 permits the auditor to include in the engagement letter only reference to the fact that relevant law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b), the auditor may nevertheless consider it appropriate to include the matters described in paragraph 10 in an engagement letter for the information of management.

Form and Content of the Audit Engagement Letter

A23. The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor's responsibilities may be based on ISA 200.⁶ Paragraphs 6(b) and 12 of this ISA deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, ISAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.
- The form of any other communication of results of the audit engagement.
- The requirement for the auditor to communicate key audit matters in the auditor's report in accordance with proposed ISA 701.⁷
- The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.
- Arrangements regarding the planning and performance of the audit, including the composition of the engagement team.
- The expectation that management will provide written representations (see also paragraph A13).
- The expectation that management will provide the information necessary for the audit of the financial statements—support for the disclosures in the financial statements, including for

⁵ In the paragraphs that follow, any reference to an audit engagement letter is to be taken as a reference to an audit engagement letter or other suitable form of written agreement.

⁶ ISA 200, paragraphs 3–9

⁷ Proposed ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

~~those disclosures information~~ from systems or processes that are not a part of the general ledger system.

- The agreement of management to make available to the auditor draft financial statements, ~~including the related disclosures notes to the financial statements~~, and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable.
- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.

Appendix 1

(Ref: Paras. A23–A24)

Example of an Audit Engagement Letter

The following is an example of an audit engagement letter for an audit of general purpose financial statements prepared in accordance with International Financial Reporting Standards. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this ISA. It will need to be varied according to individual requirements and circumstances. It is drafted to refer to the audit of financial statements for a single reporting period and would require adaptation if intended or expected to apply to recurring audits (see paragraph 13 of this ISA). It may be appropriate to seek legal advice that any proposed letter is suitable.

To the appropriate representative of management or those charged with governance of ABC Company:⁸

[The objective and scope of the audit]

You⁹ have requested that we audit the financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and ~~the disclosures required by the financial reporting framework, including those in the related notes to the financial statements, including a summary of significant accounting policies and other explanatory information~~. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.

⁸ The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons – see paragraph A21.

⁹ Throughout this letter, references to “you,” “we,” “us,” “management,” “those charged with governance” and “auditor” would be used or amended as appropriate in the circumstances.

~~Our audit will be conducted with~~ The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our expressing an opinion on the financial statements. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

[The responsibilities of the auditor]

We will conduct our audit in accordance with ~~International Standards on Auditing (ISAs)~~. Those standards require that we comply with ethical requirements, ~~and As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the planning and performing of the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit also involves~~ We also:

- ~~performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of~~ Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- ~~In making our risk assessments, we~~ Obtain an understanding of ~~consider~~ internal control relevant to the entity's preparation of the financial statements ~~audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.¹⁰ However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.~~
- ~~An audit also includes evaluating~~ Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management, ~~as well as~~
- ~~evaluating~~ Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

[The responsibilities of management and identification of the applicable financial reporting framework (for purposes of this example it is assumed that the auditor has not determined that the law or regulation

¹⁰ This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

prescribes those responsibilities in appropriate terms; the descriptions in paragraph 6(b) of this ISA are therefore used).]

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance]¹¹ acknowledge and understand that they have responsibility:

- (a) For the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards;¹²
- (b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;
- (c) To provide us with:¹³
 - (i) Access to all information of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - ~~(ii) Appropriate support for the disclosures in the financial statements, including for those disclosures generated by systems or processes that are not part of the general ledger system;~~
 - ~~(iii)~~(ii) Additional information that we may request from [management] for the purpose of the audit; and
 - ~~(iv)~~(iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation from your staff during our audit.

[Other relevant information]

[Insert other information, such as fee arrangements, billings and other specific terms, as appropriate.]

[Reporting]

[Insert appropriate reference to the expected form and content of the auditor's report, including where applicable the intent of an auditor of financial statements of an entity other than a listed entity to communicate key audit matters if not otherwise required to do so. This section may also include reference to the auditor's required reporting responsibilities in relation to going concern, other information and key audit matters.]

The form and content of our report may need to be amended in the light of our audit findings.

¹¹ Use terminology as appropriate in the circumstances.

¹² Or, if appropriate, "For the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards"

¹³ See paragraph A23 for examples of other matters relating to management's responsibilities that may be included.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

XYZ & Co.

Acknowledged and agreed on behalf of ABC Company by

(signed)

.....

Name and Title

Date

C. ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

Requirements

Discussion among the Engagement Team

15. ISA 315 (Revised) requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion.¹⁴ This discussion shall place particular emphasis on how and where the entity’s financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10–A11) [NO CHANGE PROPOSED TO THE REQUIREMENT FOR DISCLOSURES]

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Application and Other Explanatory Material

Discussion among the Engagement Team (Ref: Para. 15)

- A10. Discussing the susceptibility of the entity’s financial statements to material misstatement due to fraud with the engagement team:
- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
 - Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
 - Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor’s attention.
- A11. The discussion may include such matters as:
- An exchange of ideas among engagement team members about how and where they believe the entity’s financial statements, including disclosures required by the applicable financial reporting framework, may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
 - A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
 - A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity

¹⁴ ISA 315 (Revised), paragraph 10

for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.

- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statements, including disclosures required by the applicable financial reporting framework, to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

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

Matters to Be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit

14. The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that: **[NO CHANGE PROPOSED TO THE REQUIREMENT FOR DISCLOSURES]**
- (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and
 - (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A9–A10)

Planned Scope and Timing of the Audit

15. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor. (Ref: Para. A11–A15) **[NO CHANGE PROPOSED TO THE REQUIREMENT FOR DISCLOSURES]**

...

Application and Other Explanatory Material

Planned Scope and Timing of the Audit (Ref: Para. 15)

A11. Communication regarding the planned scope and timing of the audit may:

- (a) Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures; and
- (b) Assist the auditor to understand better the entity and its environment.

A11a. Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they require special audit consideration. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.*

A12. Matters communicated may include:[^]

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- Assessed risks of material misstatement other than identified significant risks that are anticipated to have the greatest effect on the overall audit strategy or on the audit plan, including on the efforts of the engagement team.
- The auditor's approach to internal control relevant to the audit.
- The application of the concept of materiality in the context of an audit.¹⁵
- The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor's expert.¹⁶
- The impact on the audit of significant changes to the applicable financial reporting framework or changes in the activities of the entity, which may affect the required disclosures in the financial statements.

A13. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, how the external auditor and internal auditors can work in a constructive and complementary manner, including any planned use of the work of the internal audit function.¹⁷
- The views of those charged with governance of:

* When the final standard is issued, this paragraph will become paragraph A12 and all subsequent paragraphs will be renumbered accordingly.

[^] Conforming amendments to this paragraph also were proposed in the Exposure Draft, Proposed ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon*. The IAASB will consider feedback from that consultation in determining whether such changes continue to be appropriate as it finalizes both proposed ISA 260 (Revised) and proposed ISA 720 (Revised).

¹⁵ ISA 320, *Materiality in Planning and Performing an Audit*

¹⁶ See ISA 620, *Using the Work of an Auditor's Expert*.

¹⁷ ISA 610 (Revised), paragraph 18

- The appropriate person(s) in the entity's governance structure with whom to communicate.
 - The allocation of responsibilities between those charged with governance and management.
 - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
 - Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
 - The overall presentation, structure and content of the financial statements, including the relevance and understandability of disclosures.
 - Significant communications with regulators.
 - Other matters those charged with governance consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
 - The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.
 - The responses of those charged with governance to previous communications with the auditor.
- A14. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.
- A15. Care is necessary ~~required~~ when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

E. ISA 300, *Planning an Audit of Financial Statements*

Requirements

Planning Activities

9. The auditor shall develop an audit plan that shall include a description of:
- (a) The nature, timing and extent of planned risk assessment procedures, as determined under ISA 315.¹⁸

¹⁸ ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

- (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA 330.¹⁹
- (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs. (Ref: Para. A12–A12b) [NO CHANGE PROPOSED TO THE REQUIREMENT FOR DISCLOSURES]

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Application and Other Explanatory Material

Planning Activities

The Audit Plan (Ref: Para. 9)

A12. The audit plan is more detailed than the overall audit strategy in that it includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

A12a. Planning the nature, timing and extent of audit procedures to be performed on the disclosures in the financial statements is important in light of both the wide range of information and the level of detail that may be encompassed in those disclosures. Further, certain disclosures may be generated by contain information from systems or processes that are outside not part of the general ledger system, which may also affect the nature, timing and extent of audit procedures on them.*

A12b. Consideration early in the audit process of the audit procedures to be performed on the disclosures in the financial statements assists the auditor in giving appropriate attention to, and planning adequate time for, auditing disclosures in the same way as attention is given to auditing classes of transactions, events and account balances. It may also helps the auditor to identify the impact on the audit of:

- Significant ~~N~~ new or revised disclosures arising from changes in the activities of the entity (for example ~~e.g.~~, that result in a change in the way that segments that should be have been identified or if a significant new subsidiary has been acquired during the period);
- Significant new or revised disclosures arising from changes to the applicable financial reporting framework;
- The need for ~~an~~ the auditor's to engage an auditor's expert's involvement to assist with particular disclosures (for example ~~e.g.~~, disclosures related to pension or other retirement benefit funds).

¹⁹ ISA 330, *The Auditor's Responses to Assessed Risks*

* When the final standard is issued, this paragraph will become paragraph A13 and all subsequent paragraphs will be renumbered accordingly.

- Matters relating to disclosures that the auditor may wish to discuss with those charged with governance.²⁰

Appendix

(Ref: Para. 7–8, A8–A11)

Considerations in Establishing the Overall Audit Strategy

This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters will also influence the auditor's detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required by other ISAs, not all matters are relevant to every audit engagement and the list is not necessarily complete.

Characteristics of the Engagement

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

²⁰ ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph A12

Reporting Objectives, Timing of the Audit, and Nature of Communications

- The entity's timetable for reporting, such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of materiality in accordance with ISA 320²¹ and, where applicable:
 - The determination of materiality for components and communication thereof to component auditors in accordance with ISA 600.²²
 - The preliminary identification of significant components and material classes of transactions, account balances and disclosures.
- Preliminary identification of areas where there may be a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal control, including evidence of appropriate documentation of such internal control.

²¹ ISA 320, *Materiality in Planning and Performing an Audit*

²² ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraphs 21–23 and 40(c)

- Significant changes to the applicable financial reporting framework, such as changes in accounting standards, including which includes new or revised disclosure requirements.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- The process(es) management uses to identify and prepare the disclosures required by the applicable financial reporting framework, including the disclosures containing information from systems or processes that are not part of the general ledger system.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- ~~Significant changes in the financial reporting framework, such as changes in accounting standards.~~
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

Nature, Timing and Extent of Resources

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

F. ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

Requirements [NO CHANGES PROPOSED TO ANY REQUIREMENTS FOR DISCLOSURES]

Risk Assessment Procedures and Related Activities

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1–A5)

...

9. Where the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A19–A20)
10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable

financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A21–A23)

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

11. The auditor shall obtain an understanding of the following:

- (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A24–A29)
- (b) The nature of the entity, including:
 - (i) its operations;
 - (ii) its ownership and governance structures;
 - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - (iv) the way that the entity is structured and how it is financed,to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A30–A34)
- (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A35)
- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A36–A42)
- (e) The measurement and review of the entity's financial performance. (Ref: Para. A43–A48)

...

The Entity's Internal Control

Components of Internal Control

Control environment

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
 - (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A76–A86)

...

The information system, including the related business processes, relevant to financial reporting, and communication

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:
- (a) The classes of transactions in the entity's operations that are significant to the financial statements;
 - (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
 - (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
 - (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
 - (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and
 - (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A89–A93)

....

Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A96–A102)

...

Identifying and Assessing the Risks of Material Misstatement

25. The auditor shall identify and assess the risks of material misstatement at:
- (a) the financial statement level; and (Ref: Para. A118–A121)
 - (b) the assertion level for classes of transactions, account balances, and disclosures, (Ref: Para. A122–A126)
26. For this purpose, the auditor shall:
- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the

classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A127–A128)

- (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A129–A131)
- (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

...

Application and Other Explanatory Material

Risk Assessment Procedures and Related Activities (Ref: Para. 5)

A1. Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with ISA 320;²³
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- Identifying areas of the financial statements (including related disclosures) where special audit consideration may be necessary, for example, related party transactions (including information in the related notes), or the appropriateness of management's use of the going concern assumption; (including information in the related notes); or
- Considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

...

Information Obtained in Prior Periods (Ref: Para. 9)

²³ ISA 320, *Materiality in Planning and Performing an Audit*

A19. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.
- The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.
- Those particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures.

A20. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion among the Engagement Team (Ref: Para. 10)

A21. The discussion among the engagement team, which often occurs early in the audit process, about the susceptibility of the entity's financial statements to material misstatement:

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures.
- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

ISA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.²⁴

A21a. In addition, As part of the discussion among the engagement team, the discussion among the engagement team about consideration of the disclosure requirements of the applicable financial reporting framework, early in the audit process, assists in identifying where there is an increased

²⁴ ISA 240, paragraph 15

risk of material misstatement in relation to disclosures. Examples of matters the audit engagement team may discuss include:

- New financial reporting requirements that may result in significant new or revised disclosures;
- Changes in the activities of the entity that may result in significant new or revised disclosures, for example, a significant business combination in the period under audit; and
- Disclosures for which obtaining sufficient appropriate audit evidence may have been difficult in the past.*

...

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

Industry, Regulatory and Other External Factors (Ref: Para. 11(a))

...

Regulatory Factors

A26. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include:

- Accounting principles and industry-specific practices.
- Regulatory framework for a regulated industry, including requirements for disclosures in the financial statements.
- Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

...

Nature of the Entity (Ref: Para. 11(b))

A30. An understanding of the nature of an entity enables the auditor to understand such matters as:

- Whether the entity has a complex structure, for example, with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint

* When the final standard is issued, this paragraph will become paragraph A22 and all subsequent paragraphs will be renumbered accordingly.

ventures, investments, or special-purpose entities are accounted for appropriately, and whether adequate disclosure of such issues in the financial statements has been made.

- The ownership, and relationships between owners and other people or entities. This understanding assists in determining whether related party transactions have been appropriately identified, and accounted for, and adequately disclosed in the financial statements appropriately. ISA 550²⁵ establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

A31. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- Business operations such as:
...
- Investments and investment activities such as:
...
- Financing and financing activities such as:
...
- Financial reporting practices such as:
 - Accounting principles and industry-specific practices, including for industry-specific significant categories classes of transactions and events, account balances and related disclosures in the financial statements (for example, loans and investments for banks, or research and development for pharmaceuticals).
 - Revenue recognition practices.
 - Accounting for fair values.
 - Foreign currency assets, liabilities and transactions.
 - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A32. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

...

Components of Internal Control—Control Environment (Ref: Para. 14)

...

Effect of the Control Environment on the Assessment of the Risks of Material Misstatement

A80. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration

²⁵ ISA 550, *Related Parties*

schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

- Their independence from management and their ability to evaluate the actions of management.
- Whether they understand the entity's business transactions.
- The extent to which they evaluate whether the financial statements, including disclosures, are prepared in accordance with the applicable financial reporting framework.

...

Components of Internal Control—The Information System, Including Related Business Processes, Relevant to Financial Reporting, and Communication

The Information System, Including Related Business Processes, Relevant to Financial Reporting (Ref: Para. 18)

A89. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

- Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;
- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, support summarized and appropriately reported in the financial statements.

A89a. Information in the ~~notes to the~~ financial statements may ~~be contain information from generated by~~ systems or processes that are not part of the general ledger system. These systems or processes may include:

- An entity's risk management system.
- ~~Production of~~ A valuation reports by an experts ~~such as a valuation report~~ relating to support the disclosure of the fair value of an amount ~~that is~~ recorded on the balance sheet ~~at cost using a different measurement basis, for example cost.~~
- Models or other calculations used to develop estimates recognized or disclosed in the financial statements, including the underlying data and assumptions used in those models, for example, assumptions developed internally that may affect an asset's useful life, or that may be affected by factors outside the control of the entity, such as interest rate data.

- Sensitivity analyses derived from financial models to demonstrate that management has considered alternative assumptions.

Components of Internal Control—Control Activities Relevant to the Audit (Ref: Para. 20)

...

A98. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing. For example, control activities relevant to the audit may include those that management has established to ascertain that disclosures have been prepared in accordance with the applicable financial reporting framework.

...

Identifying and Assessing the Risks of Material Misstatement

Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 25(a))

A118. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A119. Risks at the financial statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as a management's lack of management competence or inadequate controls over the preparation of the information (including disclosures) in the financial statements or the omission of relevant information from the disclosures in the financial statements may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

...

The Use of Assertions

A123. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding ~~the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.~~

A124. Assertions used by the auditor ~~to in considering~~ the different types of potential misstatements that may occur may fall into the following three categories and may take the following forms:

- (a) Assertions about classes of transactions and events, and related disclosures, for the period under audit:
 - Occurrence—transactions and events that have been recorded have occurred, and such transactions and events and related disclosures pertain to the entity.

- Completeness—all transactions and events that should have been recorded have been recorded, and all related the relevant disclosures that should have been included in the financial statements have been included.
 - Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and the related disclosures have been appropriately presented and described.
 - Presentation—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable.
 - Cutoff—transactions and events have been recorded in the correct accounting period.
 - Classification—transactions and events have been recorded in the proper accounts.
- (b) Assertions about account balances, and related disclosures, at the period end:
- Existence—assets, liabilities, and equity interests exist.
 - Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related the relevant disclosures that should have been included in the financial statements have been included.
 - Accuracy, valuation and allocation—assets, liabilities, and equity interests are have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are have been appropriately recorded, and related disclosures have been appropriately presented and described.
 - Presentation—account balances are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable.
- (c) Assertions about presentation and other disclosures that are not directly related to recorded classes of transactions, events, and account balances, including non-quantitative disclosures—the assertions set out above may also be used, adapted as appropriate, for these such disclosures (see paragraph A125a). those disclosures that are not related to classes of transactions and events, or account balances.:
- (i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
 - (ii) Completeness—all disclosures that should have been included in the financial statements have been included.
 - (iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
 - (iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

A125. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine

the assertions about transactions and events, and related disclosures, with the assertions about account balances, and related disclosures.

A125a. ~~Some~~ Financial reporting frameworks may require disclosures that are not directly related to recorded classes of transactions, events, or account balances (for example, disclosure of a contingent liability), or may require disclosures to provide further explanation about amounts recorded in the balance sheet, income statement or cash flow statement. For example, the entity may be required to ~~describe~~ disclose its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks. In relation to these types of disclosures, ~~the~~ assertions described in paragraphs A124(a)–(b) may assist the auditor in considering the different types of misstatements that may occur. ~~However, not all of the assertions may be relevant to such disclosures.~~

...

Process of Identifying Risks of Material Misstatement (Ref: Para. 26(a))

A127. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing and extent of further audit procedures to be performed.

A128. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement, including risks of material misstatement relating to disclosures.

...

Appendix 2

(Ref: Para. A40, A128)

Conditions and Events That May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. A number of these examples may indicate apply to risks of material misstatement not only in relation to amounts included on the face of the financial statements, but also in relation to disclosures required by the applicable financial reporting framework. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete. The identification and assessment of the risks of material misstatement is a matter of the auditor's professional judgment.

- ~~Operations~~ Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.

- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.
- Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Deficiencies in internal control, especially those not addressed by management.
- Incentives for management and employees to engage in fraudulent financial reporting.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including accounting estimates, and their related disclosures.
- Omission of, or obscuring, of useful and relevant information in disclosures.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

G. ISA 320, *Materiality in Planning and Performing an Audit*

Introduction

Materiality in the Context of an Audit

...

6. In planning the audit, the auditor makes judgments about ~~the size of~~ misstatements that will be considered material. These judgments provide a basis for:
- (a) Determining the nature, timing and extent of risk assessment procedures;
 - (b) Identifying and assessing the risks of material misstatement; and
 - (c) Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. ~~Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, Thus~~ the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.²⁶

...

Requirements

Determining Materiality and Performance Materiality When Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2–A11)
11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

~~Consideration of Considering Non-Quantitative Disclosures When Planning the Audit~~

- 11a. ~~When planning the audit, The auditor shall make a preliminary assessment determination of those non-quantitative disclosures, the misstatement of which that could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole. (Ref: Para. A12a)~~*

...

²⁶ ISA 450, paragraph A16

* When the final standard is issued, this paragraph will become paragraph 12 and all subsequent paragraphs will be renumbered accordingly.

Application and Other Explanatory Material

Determining Materiality and Performance Materiality When Planning the Audit

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

A10. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

- Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, ~~and~~ the remuneration of management and those charged with governance, or sensitivity analysis for fair value accounting estimates with high estimation uncertainty).
- The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, the entity may have acquired a significant new subsidiary during the period and relevant disclosures about the acquisition would enhance users' understanding of changes in the financial position and financial performance of the entity ~~a newly acquired business~~).
- The significance of the information in relation to the financial statement amounts e.g. for example, segment information for a where a segment that has been identified as having a significant role in the operations or profitability of the entity).
- The extent of subjectivity involved in the calculation of a recorded amount or related disclosures ~~and how it may influence the users' understanding~~ e.g. for example, disclosure of a sensitivity analysis to enable users to understand the underlying measurement uncertainty of a recorded or disclosed amount. or description of risk factors underlying the calculation).

A11. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

...

Consideration of Materiality for Considering Non-Quantitative Disclosures When Planning the Audit (Ref: Para. 11a)

A12a. When planning the audit, understanding the information needs of the users of financial statements (in the context of the circumstances of the entity) may assist the auditor in making the preliminary determination of those non-quantitative misstatements that may be material. The auditor may also consider previous experience with the entity and other relevant information obtained when performing audit procedures to understand the entity (for example, changes in the activities of the entity). The auditor's assessment of non-quantitative disclosures that could be material takes into account the information needs of users of the financial statements and the entity's circumstances.

Depending on the circumstances of the entity, ~~Examples of material non-quantitative disclosures may include:~~

- ~~Disclosures about liquidity and debt covenants of an entity in financial distress.~~
- ~~Disclosure of the events or circumstances that have led to the recognition of an impairment loss.~~
- ~~Disclosures of the assumptions about the future, and other major sources of estimation uncertainty~~ about key sources of estimation uncertainty, including assumptions about the future.
- ~~The disclosure of the nature of a change in accounting policy, and other relevant disclosures required by the applicable financial reporting framework, where, for example, new financial reporting requirements are expected to have a significant impact on the financial position and financial performance of the entity.~~
- ~~Disclosure about share-based payment arrangements, including information about how any amounts recognized were determined, and other relevant disclosures.~~
- ~~Disclosure of information about related parties, and related party transactions.~~*

H. ISA 330, *The Auditor's Responses to Assessed Risks*

Requirements

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

6. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4–A8) [NO CHANGE PROPOSED TO THE REQUIREMENT FOR DISCLOSURES]
7. In designing the further audit procedures to be performed, the auditor shall: [NO CHANGE PROPOSED TO THE REQUIREMENT FOR DISCLOSURES]
 - (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
 - (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and
 - (ii) Whether the risk assessment takes account of relevant controls (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9–A18)
 - (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

* When the final standard is issued, this paragraph will become paragraph A13 and all subsequent paragraphs will be renumbered accordingly.

...

Substantive Procedures

Substantive Procedures Related to the Financial Statement Closing Process

20. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

- (a) Agreeing or reconciling the financial statements, including disclosures, with the underlying accounting records, ~~which may include~~ including information contained in systems or processes that are not part of the general ledger system; and
- (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)

...

Adequacy of Presentation and Disclosure

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. (Ref: Para. A59) [NO CHANGE PROPOSED TO THE REQUIREMENT FOR DISCLOSURES]

...

Application and Other Explanatory Material

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

The Nature, Timing and Extent of Further Audit Procedures (Ref: Para. 6)

...

Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))

...

Timing

...

A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten or procedures to be observed may occur only at certain times).

- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.
- The timing of the preparation of the financial statements, particularly for those disclosures that do not relate to specific line items in the balance sheet, income statement, cash flow statement or statement of changes in equity.

...

Substantive Procedures (Ref: Para. 18)

...

Substantive Procedures Related to the Financial Statement Closing Process (Ref: Para. 20**(b)**)

- A52. The nature, and also the extent, of the auditor's substantive procedures related to the financial statement closing process ~~examination of journal entries and other adjustments~~ depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

...

Adequacy of Presentation and Disclosure (Ref: Para. 24)

- A59. Evaluating the overall presentation of the financial statements, including the related disclosures, relates to whether the individual financial statements, including related disclosures, are presented in a manner that reflects:
- The appropriate classification and description of financial information and the underlying transactions and events; and
 - The appropriate form, arrangement, and content of the financial statements, and their appended notes. This includes, for example, the terminology used as required by the applicable financial reporting framework, the amount of detail given, provided, the aggregation and disaggregation of amounts, and the classification of items in the statements, and the bases of amounts set forth.

I. ISA 450, *Evaluation of Misstatements Identified during the Audit*

Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:

- (a) **Misstatement** – A difference between the reported amount, classification, presentation, or disclosure of a ~~reported~~ financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)

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

Requirements [NO CHANGE PROPOSED TO THE REQUIREMENTS FOR DISCLOSURES]

Accumulation of Identified Misstatements

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2–A3a)

...

Evaluating the Effect of Uncorrected Misstatements

10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with ISA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A11–A12)
11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:
- (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A13–A17, A19–A20)
 - (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A18)

...

Application and Other Explanatory Material

Definition of Misstatement (Ref: Para. 4(a))

- A1. Misstatements may result from:
- (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;
 - (b) An omission of an amount or disclosure, including non-quantitative disclosures and objective-based disclosures required by certain financial reporting frameworks²⁷ (for example International Financial Reporting Standards (IFRSs));
 - (c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts;
 - (d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate;
 - (e) Inappropriately classified or aggregated information; and
 - (f) For financial statements prepared in accordance with a fair presentation framework, the omission of additional information necessary for fair presentation, beyond that specifically

²⁷ For example, International Financial Reporting Standard 7, *Financial Instruments: Disclosures*, paragraph 42H states that "an entity shall disclose any additional information that it considers necessary to meet the disclosure objectives in paragraph..."

required by the applicable financial reporting framework. Information in the notes to the financial statements that is inappropriately presented or otherwise misleading (for example, because it obscures information necessary for a proper understanding of a matter).

Examples of misstatements arising from fraud are provided in ISA 240.²⁸

Accumulation of Identified Misstatements (Ref: Para. 5)

- A2. For misstatements in amounts ~~disclosed~~ included in the financial statements, the auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. An amount that would be “clearly trivial” is not another expression for an amount that is “not material.” Amounts that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with ISA 320, and will be amounts that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more amounts are clearly trivial, the matter is considered not to be clearly trivial.

A2a.- Misstatements in disclosures are also accumulated, and aggregated where appropriate, to assist the auditor in evaluating their effect on the disclosures and the financial statements as a whole. Although misstatements in non-quantitative disclosures cannot be aggregated in the same manner as misstatements of amounts, they are still individually and collectively assessed. Misstatements in non-quantitative disclosures, due to their nature, cannot be accumulated in the same way as misstatements of amounts. They may, however, individually, or collectively with other misstatements, affect the auditor’s evaluation of whether the financial statements as a whole are free from material misstatement.

- A3. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.
- Factual misstatements are misstatements about which there is no doubt.
 - Judgmental misstatements are differences arising from the judgments of management concerning accounting estimates, the selection or application of accounting policies, or disclosures, that the auditor considers unreasonable or inappropriate. ~~that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.~~
 - Projected misstatements are the auditor’s best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in ISA 530.²⁹

²⁸ ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs A1–A6

* When the final standard is issued, this paragraph will become paragraph A4 and all subsequent paragraphs will be renumbered accordingly.

²⁹ ISA 530, *Audit Sampling*, paragraphs 14–15

...

Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 10–11)

A11. The auditor's determination of materiality in accordance with ISA 320 is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with ISA 320 based on the actual financial results.

A12. ISA 320 explains that, as the audit progresses, materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.³⁰ Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with ISA 320 (see paragraph 10 of this ISA) gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.

A13. Each individual misstatement of an amount is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

A13a. The auditor's evaluation of whether misstatements in non-quantitative disclosures are material takes into account their effect on the relevant disclosure, as well as their overall effect on the financial statements as a whole. ~~and the combined effect of individual misstatements. For example, incorrect descriptions of information about the objectives, policies and processes for managing capital could, for example, be material for significant to users of financial statements of entities with insurance and banking activities.~~

A14. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.³¹

A14a. ~~Some misstatements may result from the omission of relevant information in disclosures. The applicable financial reporting framework sets out the requirements for disclosures, and may further explain when disclosures may not be material. The auditor's determination about whether uncorrected misstatements are material takes into account whether such misstatements individually, or in the aggregate, are material.~~

³⁰ ISA 320, paragraph 12

³¹ The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to reassess the risk of material misstatement for that account balance or class of transactions.

- A15. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.
- A16. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:
- Affects compliance with regulatory requirements;
 - Affects compliance with debt covenants or other contractual requirements;
 - Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
 - Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
 - Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
 - Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
 - Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
 - Is significant having regard to the auditor's understanding of known previous communications to users, for example, in relation to forecast earnings;
 - Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
 - Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
 - Affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. ISA 720³² deals

³² ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*

with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

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

A17. ISA 240³³ explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

A17a. For misstatements in disclosures, the auditor may also consider whether individual misstatements could be indicative of:

- Management bias such that it leads to misleading information; or
- A trend towards duplicative or uninformative disclosures that may obscure important financial information.

A18. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

J. ISA 700, *Forming an Opinion and Reporting on Financial Statements*

Requirements [NO CHANGE PROPOSED TO THE REQUIREMENTS FOR DISCLOSURES]

Forming an Opinion on the Financial Statements

10. The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.^{34, 35}
11. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:
 - (a) The auditor's conclusion, in accordance with ISA 330, whether sufficient appropriate audit evidence has been obtained;³⁶
 - (b) The auditor's conclusion, in accordance with ISA 450, whether uncorrected misstatements are material, individually or in aggregate;³⁷ and
 - (c) The evaluations required by paragraphs 12–15.
12. The auditor shall evaluate whether the financial statements are prepared, in all material respects, in

³³ ISA 240, paragraph 35

³⁴ ISA 200, paragraph 11

³⁵ Paragraphs 35–36 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

³⁶ ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 26

³⁷ ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. (Ref: Para. A1–A3)

13. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:
 - (a) The financial statements adequately disclose the significant accounting policies selected and applied; (Ref: Para. A3a)
 - (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
 - (c) The accounting estimates made by management are reasonable;
 - (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable; (Ref: Para. A3b)
 - (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A4)
 - (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.
14. When the financial statements are prepared in accordance with a fair presentation framework, the evaluation required by paragraphs 12–13 shall also include whether the financial statements achieve fair presentation. The auditor's evaluation as to whether the financial statements achieve fair presentation shall include consideration of: (Ref: Para A4a–A4c)
 - (a) The overall presentation, structure and content of the financial statements; and
 - (b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.
15. The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. (Ref: Para. A5–A10)

...

Application and Other Explanatory Material

Qualitative Aspects of the Entity's Accounting Practices (Ref: Para. 12)

- A1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
- A2. Proposed ISA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.³⁸ In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements,

³⁸ ISA 260, *Communication with Those Charged with Governance*, Appendix 2

causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor's evaluation of whether the financial statements as a whole are materially misstated include the following:

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

A3. ISA 540 addresses possible management bias in making accounting estimates.³⁹ Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

Accounting Policies Adequately Disclosed in the Financial Statements (Ref: Para. 13(a))

A3a. The relevance of the accounting policies to the entity, and the clarity with which they have been presented, are important considerations in the auditor's evaluation of whether the financial statements adequately disclose the significant accounting policies selected and applied.*

Information Presented in the Financial Statements is Relevant, Reliable, Comparable and Understandable (Ref: Para. 13(d))

A3b. Classifying, characterizing and presenting information clearly and concisely may assist users in understanding the financial statements in making it understandable to users of the financial statements. Matters the auditor may consider in evaluating the understandability of the financial statements include whether:

- The financial statements, including disclosures the related notes, are classified, characterized and presented in a clear and concise manner transparent and succinct way but do not omit important relevant information; and
- The disclosures notes do not overburden undermine the overall presentation of the financial statements with by including information that is not relevant or in a manner that may obscure a proper understanding of the matters disclosed.

In addition, the auditor may consider whether the financial statements are comparable to the entity's financial statements of previous periods.

Disclosure of the Effect of Material Transactions and Events on the Information Conveyed in the Financial Statements (Ref: Para. 13(e))

A4. It is common for financial statements prepared in accordance with a general purpose framework to present an entity's financial position, financial performance and cash flows. In such circumstances, the auditor evaluates whether the financial statements provide adequate disclosures, given the entity's facts and circumstances, to enable the intended users to understand the effect of material transactions and events on the entity's financial position, financial performance and cash flows, the

³⁹ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 21

* When the final standard is issued, this paragraph will become paragraph A4 and all subsequent paragraphs will be renumbered accordingly.

auditor considers the ~~Matters the auditor may consider in evaluating the adequacy of disclosures include the extent to which the information included in the financial statements is useful and entity-specific that may in order to enable~~ extent to which the information in the financial statements is useful and specific to the circumstances of the entity. For example, the auditor may consider whether the disclosures are adequate to assist the intended users to understand, ~~for example:~~

- ~~Significant transactions and events that occurred during the period under audit.~~
- The nature and extent of the ~~potential~~ assets and liabilities arising from those transactions or events that do not meet the criteria for recognition (or the criteria for derecognition) established by the applicable financial reporting framework.
- The nature and extent of risks arising from ~~the entity's assets and liabilities— material transactions and events.~~
- The methods ~~used and the~~ assumptions and judgments ~~made,~~ and changes to them, that affect amounts presented or otherwise disclosed, ~~including relevant sensitivity analyses.~~

~~In addition, the auditor may consider whether the financial statements are comparable to the entity's financial statements of previous periods.~~

Evaluating Whether the Financial Statements Achieves Fair Presentation (Ref: Para. 14)

A4a. ~~Some financial reporting frameworks explicitly address the concept of fair presentation. For example, International Financial Reporting Standards (IFRSs) note that fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses. As noted in paragraph 7(b), fair presentation⁴⁰ involves not only compliance with the requirements of the applicable financial reporting framework, but also the possibility that additional disclosures may be necessary, regardless of whether there is specific requirement for that information in the framework.~~

A4b. ~~The auditor's evaluation about whether the financial statements achieve fair presentation, both in respect of presentation and disclosure, is a matter of professional judgment. This evaluation ordinarily takes into account the facts and circumstances of the entity based on the auditor's knowledge of the entity, and the audit evidence obtained during the audit.~~

A4c. ~~As part of the auditor's evaluation about whether the financial statements achieve fair presentation, the auditor may discuss with management and those charged with governance, as appropriate, their views on why a particular presentation was chosen, as well as alternatives that may have been considered. The discussions may include, for example:~~

- ~~The degree to which the amounts in the financial statements are aggregated or disaggregated, and whether the presentation of amounts or disclosures obscures useful information, or results in misleading information.~~

⁴⁰ ~~IFRS notes the term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and: (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances. See ISA 200, paragraph 13(a).~~

- Consistency with ~~accepted~~ appropriate industry practice, or whether any departures are relevant to the entity's circumstances and therefore warranted.

Description of the Applicable Financial Reporting Framework (Ref: Para. 15)

- A5. As explained in ISA 200, the preparation of the financial statements by management and, where appropriate, those charged with governance requires the inclusion of an adequate description of the applicable financial reporting framework in the financial statements.⁴¹ That description is important because it advises users of the financial statements of the framework on which the financial statements are based.
- A6. A description that the financial statements are prepared in accordance with a particular applicable financial reporting framework is appropriate only if the financial statements comply with all the requirements of that framework that are effective during the period covered by the financial statements.
- A7. A description of the applicable financial reporting framework that contains imprecise qualifying or limiting language (for example, “the financial statements are in substantial compliance with International Financial Reporting Standards”) is not an adequate description of that framework as it may mislead users of the financial statements.

Reference to More than One Financial Reporting Framework

- A8. In some cases, the financial statements may represent that they are prepared in accordance with two financial reporting frameworks (for example, the national framework and ~~International Financial Reporting Standards~~IFRSs). This may be because management is required, or has chosen, to prepare the financial statements in accordance with both frameworks, in which case both are applicable financial reporting frameworks. Such description is appropriate only if the financial statements comply with each of the frameworks individually. To be regarded as being prepared in accordance with both frameworks, the financial statements need to comply with both frameworks simultaneously and without any need for reconciling statements. In practice, simultaneous compliance is unlikely unless the jurisdiction has adopted the other framework (for example, ~~International Financial Reporting Standards~~IFRSs) as its own national framework, or has eliminated all barriers to compliance with it.
- A9. Financial statements that are prepared in accordance with one financial reporting framework and that contain a note or supplementary statement reconciling the results to those that would be shown under another framework, are not prepared in accordance with that other framework. This is because the financial statements do not include all the information in the manner required by that other framework.
- A10. The financial statements may, however, be prepared in accordance with one applicable financial reporting framework and, in addition, describe in the notes to the financial statements the extent to which the financial statements comply with another framework (for example, financial statements prepared in accordance with the national framework that also describe the extent to which they comply with ~~International Financial Reporting Standards~~IFRSs). Such description is supplementary financial information and, as discussed in paragraph 4749, is considered an integral part of the financial statements and, accordingly, is covered by the auditor's opinion.

⁴¹ ISA 200, paragraphs A2–A3