

Auditing Disclosures – Proposed Changes to the ISAs

The following includes extracts of selective ISAs with mark-up for proposed revisions to the Exposure Draft (ED), [Proposed Changes to the International Standards on Auditing \(ISAs\): Addressing Disclosures in the Audit of Financial Statements](#). See **Agenda Item 7-A** for discussion about the relevant changes proposed in this document.

When relevant, proposed changes to the standards arising from the Auditor Reporting New and Revised Standards and ISA 720 (Revised)¹ are shown for reference, and have been highlighted in grey. However, the ISA 720 (Revised) proposed changes may change when the relevant standards are finalized.

The footnote numbering in this document does not necessarily correlate with the footnotes as currently included in the extant ISAs.

[Marked for Changes to the Exposure Draft]

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:

...

- (f) Financial statements – A structured representation of historical financial information, including disclosures, intended to communicate an entity’s economic resources, ~~or claims against the entity~~ obligations and equity interests at a point in time, or the changes therein for a period of time, in accordance with a financial reporting framework. 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. Disclosures comprise explanatory or descriptive information, set out as required, expressly permitted or otherwise allowed by the applicable financial reporting framework, on the face of ~~the~~ a financial statements, ~~information or~~ in the related notes, or ~~information~~ incorporated therein by cross-reference, ~~when permitted by the applicable financial reporting framework. 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.~~

Application and Other Explanatory Material

Definitions

Financial Statements (Ref: Para. 13(f))

A1. Where the applicable financial reporting framework does not expressly prohibit the cross-referencing of where explanatory or other descriptive information may be found, and the information has been appropriately cross-referenced, this will form part of the financial statements.

¹ Proposed ISA 720 (Revised), *The Auditor’s Responsibilities Relating to Other Information*, issued for re-exposure in April 2014

A1a. Explanatory or descriptive information required by the applicable financial reporting framework may be set out in another document, even when such incorporation is neither required nor expressly permitted by the applicable financial reporting framework. If appropriately cross-referenced, such information is part of the financial statements unless incorporation by cross-reference is expressly prohibited by the applicable financial reporting framework.*

An Audit of Financial Statements

Scope of the Audit (Ref: Para. 3)

A1**b.** The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some jurisdictions, however, applicable law or regulation may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the ISAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

* When the final standard is issued, this paragraph will become paragraph A2 and all subsequent paragraphs will be renumbered accordingly.

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

Requirements

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. This includes information from accounting records that are outside the general and subsidiary ledgers; and
 - (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. This include information from accounting records that are outside the general and subsidiary ledgers. (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)
- to provide a basis for designing and performing further audit procedures.
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^{be})
 - (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;²
- 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, or the appropriateness of management's use of the going concern assumption, including related disclosures; or when 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)

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, for example due to their complexity.

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 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.

² ISA 320, *Materiality in Planning and Performing an Audit*

- 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.³

A21a. As part of the discussion among the engagement team, required by paragraph 10, consideration of the disclosure requirements of the applicable financial reporting framework assists in identifying early in the audit where there may be risks of material misstatement in relation to disclosures. Examples of matters the engagement team may discuss include:

- New Changes in financial reporting requirements that may result in significant new or revised disclosures;
- Changes in the entity's environment, financial condition or activities 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.
- Complex disclosures where there is a risk that users may not understand the potential impact of the information provided.*

...

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))

...

³ ISA 240, paragraph 15

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

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.
- 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 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. ~~Where the applicable financial reporting framework establishes related party requirements, t~~his understanding assists the auditor in determining whether related party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial statements ~~in accordance with the framework~~. ISA 550⁴ 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:
...

⁴ ISA 550, *Related Parties*

- Financial reporting practices such as:
 - Accounting principles and industry-specific practices, including for industry-specific significant 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.
 - 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 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, including classes of transactions, account balances and 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, summarized and appropriately reported in the financial statements.

A89a. ~~Information in the financial statements may contain information from accounting records⁵ that are outside the general and subsidiary ledgers, from systems or processes that are not part of the general ledger system. Examples of such accounting records. These systems or processes may include:~~

- ~~Relevant information produced by an~~ entity's risk management system.
- ~~Production of valuation reports information produced by management's~~ experts relating to, ~~for example,~~ the disclosure of the fair value of an amount that is recorded on the balance sheet at 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.
- ~~An entity's underlying tax records and returns.~~
- ~~Analysis to support management's use of the going concern basis of accounting or management's assessment of the entity's ability to continue as a going concern.~~

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

...

A97. Control activities that are relevant to the audit are:

- Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30, respectively; or
- Those that are considered to be relevant in the judgment of the auditor.

⁵ ~~Paragraph 5(a) of ISA 500, *Audit Evidence*, defines accounting records.~~

- 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.
- A99. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.
- A99a. Control activities relevant to the audit may include controls established by management that address risks of material misstatement from disclosures not being prepared in accordance with the applicable financial reporting framework, in addition to controls that address risks related to account balances and transactions. This also includes those control activities that address risks of material misstatement relating to account balances, transactions and disclosures from the entity's accounting records that are outside the general and subsidiary ledgers.
- A100. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

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 lack of management competence or lack of oversight over the preparation of the financial statements (including disclosures) 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 recognition, measurement and; presentation of classes of transactions and events, account balances and disclosures.

A1253a. The auditor may use the assertions as described in paragraph A124(a)–(b) ~~above~~below or may express them differently provided all aspects described ~~above~~below 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. [Moved from paragraph A125]

Assertions about classes of transactions, account balances, and related disclosures

A124. Assertions used by the auditor in considering the different types of potential misstatements that may occur may fall into the following categories:

- (a) Assertions about classes of transactions and events, and related disclosures, for the period under audit:
 - (i) Occurrence—transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
 - (ii) Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
 - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
 - (iv) Presentation—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
 - (v) Cutoff—transactions and events have been recorded in the correct accounting period.
 - (vi) Classification—transactions and events have been recorded in the proper accounts.
- (b) Assertions about account balances, and related disclosures, at the period end:
 - (i) Existence—assets, liabilities, and equity interests exist.
 - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
 - (iv) Accuracy, valuation and allocation—assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
 - (v) Presentation—~~account balances~~ assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
 - (vi) Classification—assets, liabilities and equity interests have been recorded in the proper accounts.

Assertions about other disclosures

A124a. The assertions described in paragraph A124(a)–(b) above, adapted as appropriate, may also be used by the auditor in considering the different types of potential misstatements that may occur in disclosures not directly related to recorded classes of transactions, events, or account balances. As an example of such a disclosure, the entity may be required to describe 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.

~~A125. The auditor may use the assertions as described in paragraph A124(a)–(b) 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.~~ [Moved to paragraph A123a]

...

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. In identifying the risks of material misstatement in the financial statements, the auditor exercises professional skepticism.

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.

A128a. As explained in ISA 320,⁶ materiality and audit risk are considered when identifying and assessing the risks of material misstatement in classes of transactions, account balances and disclosures. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial reporting needs of users of the financial statements.⁷

A128b. The auditor's consideration of disclosures in the financial statements when identifying risks ~~in accordance with paragraph 25(a) of this ISA~~ includes non-quantitative qualitative disclosures, the misstatement of which could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole. Depending on the circumstances of the entity and the engagement, examples of such disclosures that may be relevant when assessing the risks of material misstatement include disclosures about:

- Liquidity and debt covenants of an entity in financial distress.
- Events or circumstances that have led to the recognition of an impairment loss.
- Key sources of estimation uncertainty, including assumptions about the future.
- 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

⁶ ISA 320, *Materiality in Planning and Performing an Audit*, paragraph A1

⁷ ISA 320, paragraph 4

requirements are expected to have a significant impact on the financial position and financial performance of the entity.

- Share-based payment arrangements, including information about how any amounts recognized were determined, and other relevant disclosures.
- Related parties, and related party transactions.
- Sensitivity analysis, including the effects of changes in assumptions used in the entity's valuation techniques, intended to enable users to understand the underlying measurement uncertainty of a recorded or disclosed amount.

[Paragraph A128c moved to A128b]

...

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 in the financial statements, ~~including in disclosures~~. 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.

- 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 related disclosures.
- Omission, or obscuring, of significant information in disclosures.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

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 quantitative and qualitative 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.

Determining a materiality level or levels for quantitative misstatements, and considering the nature of qualitative misstatements that would be material, are relevant to the design of audit procedures to address the risks of material misstatement. However, 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. It is not practicable to design audit procedures to detect all misstatements that could be material solely because of their nature. When evaluating the effect on the financial statements of uncorrected misstatements that have been detected, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence.⁸ The materiality level or levels determined and the considerations of qualitative misstatements when planning the audit ~~does~~ not necessarily establish a size or nature by reference to which an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial.— For example, tThe circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are not of that size or nature below materiality. ~~However, consideration of the nature of potential misstatements in non-quantitative disclosures is relevant to the design of audit procedures to address risks of material misstatement. In addition, when evaluating the effect on the financial statements of all uncorrected misstatements, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence.~~⁹

...

Requirements

Determining Materiality and Performance Materiality When Planning the Audit

10. When establishing the overall audit strategy, the auditor shall:
- (a) ~~d~~Determine a materiality level 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

⁸ ISA 450, paragraph A16

⁹ ISA 450, paragraph A16

balances or disclosures for which misstatements of lesser amounts than the materiality level 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)

(b) Make a preliminary determination of the nature of a qualitative misstatement of disclosures 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: A11a)

11. The auditor shall determine a level or levels for 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)

Revision as the Audit Progresses [New from the ED – Marked to Extant ISA 320]

12. In the event of becoming aware of information during the audit that would have caused the auditor to have determined either a different materiality level or levels, or made a different determination of the nature of a qualitative misstatement of disclosures, from that initially determined in accordance with paragraph 10, ~~the~~ the auditor shall:

(a) ~~+~~Revise the materiality level for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures), or

(b) Revise the auditor's determination of the nature of a qualitative misstatement of disclosures that could reasonably be expected to be material. ~~in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.~~ (Ref: Para. A13)

13. If the auditor concludes that a lower materiality level for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than ~~those~~ initially determined are appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate. The auditor shall also determine whether the nature, timing and extent of the further audit procedures remain appropriate if the auditor revises the determination of the nature of a qualitative misstatement of disclosures that could reasonably be expected to be material.

...

Documentation [New from the ED – Marked to Extant ISA 320]

14. The auditor shall include in the audit documentation the following amounts and other items and the factors considered in their determination:¹⁰
- (a) The mMateriality level for the financial statements as a whole (see paragraph 10(a));
- (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10(a));

¹⁰ ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

- (c) The nature of a qualitative misstatement of disclosures that the auditor determined could reasonably be expected to be material (see paragraph 10(b));
- (ed) Performance materiality level or levels (see paragraph 11); and
- (de) Any revision of (a)–(ed) as the audit progressed (see paragraphs 12–13).

Application and Other Explanatory Material

Determining Materiality and Performance Materiality When Planning the Audit

...

Considerations Specific to Public Sector Entities (Ref: Para. 10) [New from the ED – Marked to Extant ISA 320]

- A2. In the case of a public sector entity, legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of the materiality level for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of a public sector entity is therefore influenced by law, regulation or other authority, and by the financial information needs of legislators and the public in relation to public sector programs.

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole (Ref: Para. 10) [New from the ED – Marked to Extant ISA 320]

- A3. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining the materiality level for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following: ...

...

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, the remuneration of management and those charged with governance, and 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 company).

- Whether attention is focused on a particular aspect of the entity’s business that is separately disclosed in the financial statements (for example, disclosures about segments or the acquisition of a significant ~~new subsidiary~~business combination).

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.

A11a. [Still to be developed]

Revision as the Audit Progresses (Ref: Para. 12) [*New from the ED – Marked to Extant ISA 320*]

A13. The materiality level for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures), or the determination of the nature of qualitative misstatements of disclosures that could reasonably be expected to be material, may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity’s business), new information, or a change in the auditor’s understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period-end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

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)
7. In designing the further audit procedures to be performed, the auditor shall:
 - (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)

...

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 information, including classes of transactions, account balances and disclosures in the financial statements, ~~including disclosures,~~ with the underlying accounting records, including those relevant accounting records that are outside the general and subsidiary ledgers and information from 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. This includes whether the financial statements—including disclosures, are presented in a manner that reflects the appropriate:

- The appropriate cClassification and description of financial information and the underlying transactions and events, including in disclosures; and
- The appropriate fForm, arrangement, and content of the financial statements. (Ref: Para. A59)

...

Documentation

...

30. The auditor's documentation shall demonstrate that information, including classes of transactions, account balances and disclosures in the financial statements, ~~including disclosures,~~ agrees or reconciles with the underlying accounting records, including those relevant accounting records that are outside the general and subsidiary ledgers.

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 provide further explanation about amounts recorded in the ~~balance sheet, income statement or cash flow statement~~ statement of financial position, statement of financial performance, and statement of cash flows.

...

Substantive Procedures (Ref: Para. 18)

...

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

A52. The nature, and also the extent, of the auditor's substantive procedures related to the financial statement closing process, 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 appropriate form, arrangement, and content of the financial statements overall presentation of the financial statements relates to whether the financial statements, including 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.~~ This includes, for example, consideration of the terminology used as required by the applicable financial reporting framework, the level of detail provided, the aggregation and disaggregation of amounts, ~~and the classification of items in the financial statements~~ and the bases of amounts set forth.

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 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–A3)

...

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^a, 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~~ inadequate or incomplete qualitative disclosures, ~~and objective-based~~ and those disclosures required to meet disclosure objectives ~~by~~ of certain financial reporting frameworks as applicable;¹¹
- (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) An inappropriate classification, aggregation or disaggregation, of information; and
- (f) For financial statements prepared in accordance with a fair presentation framework, the omission of a ~~disclosures~~ beyond ~~these~~ what is specifically required by the framework that ~~are~~ is necessary for fair presentation.¹²

Examples of misstatements arising from fraud are provided in ISA 240.¹³

Accumulation of Identified Misstatements (Ref: Para. 5)

- A2. The auditor may designate an amount below which quantitative 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, individually or in aggregate, on the financial statements. “Clearly trivial” is not another expression for “not material.” ~~Matters Quantitative and qualitative misstatements~~ that are clearly trivial will be of a wholly different (smaller) order of magnitude or significance, as applicable, than materiality determined in accordance with ISA 320, and ~~would~~ be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances as applicable. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.
- A2a. Paragraph 5 of this ISA requires the auditor to accumulate misstatements identified during the audit, whether quantitative or qualitative, identified during the audit other than those that are clearly trivial. Misstatements in disclosures are therefore also accumulated, ~~and aggregated where appropriate,~~ to assist the auditor in evaluating their effect of such misstatements on the disclosures and the financial statements as a whole. Although misstatements in ~~non-quantitative~~ qualitative disclosures cannot be ~~aggregated~~ added together as is possible in the case of ~~in the same manner as~~ misstatements of amounts, they are still evaluated individually, and in aggregate (i.e., collectively, with other misstatements) as required by paragraph 11 of this ISA. Paragraph A13a of

¹¹ For example, International Financial Reporting Standard (IFRS) 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...”

¹² For example, IFRS requires an entity to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (International Accounting Standard 1, *Presentation of Financial Statements*, paragraph 17(c)).

¹³ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs A1–A6

this ISA provides considerations about when misstatements in qualitative disclosures may be material.*

- 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 including those concerning ~~the recognition, measurement, presentation and disclosure in the financial statements (including accounting estimates,~~ the selection or application of accounting policies), ~~or disclosures,~~ that the auditor considers unreasonable or 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 530.¹⁴

...

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 the materiality level(s) determined in accordance with ISA 320 based on the actual financial results ~~or to revise the preliminary determination of the nature of qualitative misstatements that could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole.~~
- A12. ISA 320 explains that, as the audit progresses, the materiality level for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures), ~~and the auditor's determination of the nature of qualitative misstatements that could reasonably be expected to be material, is-are~~ 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-level (or amounts/levels), ~~or additional types of such misstatements,~~ initially.¹⁵ 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 the materiality level ~~or levels~~ determined in accordance with ISA 320 (see paragraph 10 of this ISA) gives rise to a lower amount (or amounts), is reconsidered ~~then performance materiality~~ and, ~~in that case and if the auditor's revision of the preliminary determination of the nature of qualitative misstatements in disclosures that could reasonably be expected to be material gives rise to additional types of such misstatements,~~ the appropriateness of the nature, timing and extent of the further audit procedures

* When the final standard is issued, this paragraph will become paragraph A3 and all subsequent paragraphs will be renumbered accordingly.

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

¹⁵ ISA 320, paragraph 12

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. ~~Each individual misstatement of a qualitative disclosure is also considered to evaluate its effect on the relevant disclosure(s), as well as its overall effect on the financial statements as a whole. The auditor exercises professional judgment in determining whether a misstatement(s) in a qualitative disclosure is material, in the context of the applicable financial reporting framework and the specific circumstances of the entity. Examples where such misstatements could be material include: Evaluating whether misstatements in non-quantitative disclosures are material takes into account matters such as their effect on the relevant disclosure, as well as their overall effect on the financial statements as a whole.~~

- ~~Incorrect-Inaccurate or incomplete~~ descriptions of information about the objectives, policies and processes for managing capital ~~could, for example, be material~~ for entities with insurance and banking activities.
- ~~The omission of information about the events or circumstances that have led to an impairment loss (e.g., a significant long-term decline in the demand for a metal or commodity) in an entity with mining operations.~~
- ~~The incorrect description of an accounting policy relating to a significant item in the statement of financial position, statement of financial performance or the statement of cash flows.~~
- ~~The inadequate description of the sensitivity of an exchange rate in an entity that undertakes international trading activities.~~

~~A13b. The circumstances related to some misstatements in qualitative disclosures may also cause the auditor to evaluate them as material when considered together with qualitative misstatements accumulated during the audit. For example, the auditor may consider whether clerical errors in narrative disclosures could be persistent or pervasive where the misstatements of a number of qualitative disclosures are each related to the same matter, the auditor may consider whether collectively their impact would result in a material misstatement in the financial statements as a whole. This aggregation of misstatements in disclosures is also helpful when evaluating the financial statements in accordance with paragraph 13(d) of ISA 700,¹⁶ which requires the auditor to consider whether the disclosures undermine the overall presentation of the financial statements by including information that is not relevant or that is presented in a manner that may obscure a proper understanding of the matters disclosed.~~

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

¹⁶ [ISA 700, Forming an Opinion and Reporting on Financial Statements](#)

further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.¹⁷

- 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 the materiality level for the financial statements as a whole or are not of the nature of a qualitative misstatement in disclosures that the auditor has determined could be material. 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

¹⁷ 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.

- Affects other information that will be communicated in the annual report 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 720 (Revised) 18 deals with the auditor’s responsibilities relating to 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 240¹⁹ 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. The auditor exercises professional skepticism when considering indicators of fraud. Examples of

A17a. mMisstatements in disclosures that could be indicative of fraud may include; for example:

- Misleading disclosures that have resulted from bBias in management’s judgments that results in misleading disclosures; or
- Extensive duplicative or uninformative disclosures that are intended to obscure a proper understanding of matters in the financial statements. that may obscure significant information in the financial statements.

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.

¹⁸ Proposed ISA 720 (Revised), *The Auditor’s Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*

¹⁹ ISA 240, paragraph 35

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

Requirements

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.^{20, 21}
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;²²
 - (b) The auditor's conclusion, in accordance with ISA 450, whether uncorrected misstatements are material, individually or in aggregate;²³ 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 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 appropriately disclose the significant accounting policies selected and applied; ~~;~~ ~~(Ref: Para. A3a)~~ This includes consideration of the relevance to the entity, and the understandability of, these disclosures.
 - (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. This includes consideration of whether:
 - Information in the financial statements, including disclosures, are is appropriately classified, aggregated or disaggregated, and characterized; disclosed in an understandable manner; and presented in a clear and concise manner, but and does not omit relevant information that is relevant in view of the requirements of the applicable financial reporting framework.

²⁰ ISA 200, paragraph 11

²¹ 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.

²² ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 26

²³ ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

- The disclosures undermine the overall presentation of the financial statements by including information that is not relevant or that is presented in a manner that may obscure a proper understanding of the matters disclosed. (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.²⁴ 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, 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 making accounting estimates.
- A3. ISA 540 addresses possible management bias in making accounting estimates.²⁵ Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on

²⁴ ~~Proposed~~ ISA 260 (Revised), *Communication with Those Charged with Governance*, Appendix 2

²⁵ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 21

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 Appropriately Disclosed in the Financial Statements (Ref: Para. 13(a))~~

~~A3a. The auditor's evaluation of whether the financial statements appropriately disclose the significant accounting policies selected and applied includes consideration of matters such as the relevance of the accounting policies to the entity, and the clarity with which they have been presented.~~

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

A3~~ab~~. Evaluating the understandability ~~and relevance of the information presented in~~of the financial statements includes consideration of matters such as whether: ~~The financial statements, including disclosures, are appropriately classified and characterized, and presented in a clear and concise manner, but do not omit relevant information.~~

~~The disclosures undermine the overall presentation of the financial statements by including information that is not relevant or that is presented in a manner that may obscure a proper understanding of the matters disclosed.~~

- The information in the financial statements is presented in a clear and concise manner.
- The placement of significant disclosures gives appropriate prominence to them (for example, when there is perceived value of entity-specific information to users), and whether the disclosures are appropriately internally cross-referenced in a manner that would not give rise to significant challenges for users in identifying necessary information.~~to draw attention to related matters, where appropriate.~~*

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. Evaluating whether, in view of the applicable financial reporting framework, the financial statements provide adequate disclosures 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 includes consideration of such matters as:

- ~~—~~The extent to which the information in the financial statements is relevant and specific to the circumstances of the entity; and
- ~~w~~Whether the disclosures are adequate to assist the intended users to understand:
 - The nature and extent of the entity's potential assets and liabilities arising from transactions or events that do not meet the criteria for recognition (or the criteria for derecognition) established by the applicable financial reporting framework.

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

- The nature and extent of risks of material misstatement arising from 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.

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

- A4a. Some financial reporting frameworks acknowledge explicitly or implicitly the concept of fair presentation.²⁶ As noted in paragraph 7(b) of this ISA, a fair presentation²⁷ financial reporting framework not only requires compliance with the requirements of the framework, but also acknowledges explicitly or implicitly that it may be necessary for management to provide disclosures beyond those specifically required by the framework.²⁸
- 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 takes into account such matters ~~such~~ as the facts and circumstances of the entity, including changes thereto, based on the auditor's knowledge-understanding of the entity and the audit evidence obtained during the audit. The evaluation also includes consideration, for example, of the disclosures needed to achieve a fair presentation arising from matters that may be relevant to the economic decisions of the users of the financial statements, such as evolving financial reporting requirements or the changing economic environment.
- A4c. Evaluating whether the financial statements achieve fair presentation includes, for example and as appropriate, discussions with management and those charged with governance about 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.
 - Consistency with 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.²⁹ That description is

²⁶ 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.

²⁷ See ISA 200, paragraph 13(a).

²⁸ For example, IFRS requires an entity to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (International Accounting Standard 1, *Presentation of Financial Statements*, paragraph 17(c)).

²⁹ ISA 200, paragraphs A2–A3

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 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, 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 IFRSs. Such description is supplementary financial information and, as discussed in paragraph 53, is considered an integral part of the financial statements and, accordingly, is covered by the auditor’s opinion.