

DISCLOSURES—REVISED PROPOSED CHANGES TO THE ISAs

The following presents **mark-up from Exposure Draft (unless otherwise noted)** and incorporating further changes from the Auditor Reporting standards issues in January 2015 (where relevant).

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

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~~ assets, liabilities or equity against the entity 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~~ 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. (Ref: Para.A1a)

...

Application and Other Explanatory Material

Definitions [This section is new and is marked to extant ISA 200]

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

- A1. Where the applicable financial reporting framework does not expressly prohibit the cross-referencing of where explanatory or descriptive information may be found, and the information has been appropriately cross-referenced, this will form part of the financial statements.
- A1a. Incorporated therein by cross-reference means from the financial statements to some other statement, such as management report or risk report, that is available to users of the financial statements. 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)

A1b. 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 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:
- (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 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.

...

Agreement on Audit Engagement Terms

...

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)
- (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; 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

...

Preconditions for an Audit

...

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).¹ 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 information obtained from ~~systems or processes that are not part of the general ledger system~~outside the general and subsidiary ledgers) 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.² 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.³ 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

¹ ISA 200, paragraph A2

² ISA 580, *Written Representations*, paragraphs 10–11

³ ISA 580, paragraph A26

engagement, the auditor may need to explain to management the importance of these matters, and the implications for the auditor's report.

...

Agreement on Audit Engagement Terms

...

*Audit Engagement Letter or Other Form of Written Agreement*⁴ (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 200.⁵ 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 ISA 701.⁶
- 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.

⁴ 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.

⁵ ISA 200, paragraphs 3–9

⁶ ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

- The expectation that management will provide written representations (see also paragraph A13).
- The expectation that management will~~in~~ provide ing~~e~~ access to all information ~~{of which management is aware}~~ that is relevant to the preparation of the financial statements, also includes an expectation that management will provide access to information relevant to disclosures, recognizing that this includes information from systems or processes that are not part of the general ledger system.
- The agreement of management to make available to the auditor draft financial statements, including ~~related disclosures, and~~ all information ~~that is~~ relevant to their preparation (including all information relevant to the preparation of disclosures, whether obtained from within or outside the general and subsidiary ledgers), and the other information, of the financial statements 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: Para. 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:⁷

⁷ 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.

[The objective and scope of the audit]

You⁸ have requested that we audit the financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.

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 opinion. 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 ISAs. Those standards require that we comply with ethical requirements. As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- 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.
- Obtain an understanding of internal control relevant to the 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.⁹ 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.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our

⁸ 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.

⁹ 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.

auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- 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 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]¹⁰ 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;¹¹
- (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; and
- (c) To provide us with:¹²
 - (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) Additional information that we may request from [management] for the purpose of the audit; and
 - (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.]

¹⁰ Use terminology as appropriate in the circumstances.

¹¹ Or, if appropriate, "For the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards"

¹² See paragraph A23 for examples of other matters relating to management's responsibilities that may be included.

[Reporting]

[Insert appropriate reference to the expected form and content of the auditor's report, including, if applicable, the reporting on other information in accordance with ISA 720 (Revised).¹³]

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

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

¹³ Conforming amendment to ISA 210 (Revised) as a result of ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, approved by the IAASB in December 2014 subject to PIOB consideration of due process followed.

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)

...

Responses to the Assessed Risks of Material Misstatement Due to Fraud

...

Audit Procedures Responsive to Risks Related to Management Override of Controls

31. Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

...

Application and Other Explanatory Material

Characteristics of Fraud (Ref: Para. 3) [*These paragraphs (A3 and A4) are new from the Exposure Draft*]

...

- A3. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

- A4. Fraudulent financial reporting often involves management override of controls that otherwise may

¹⁴ ISA 315 (Revised), paragraph 10

appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Omitting, obscuring or misstating disclosures required by the applicable financial reporting framework or disclosures that are necessary to achieve fair presentation.
- Concealing, ~~or not disclosing~~, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

...

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, the individual statements and the disclosures) 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 risk that management may attempt to ~~obscure information by~~ presenting disclosures ~~that are not clear and understandable~~ in a manner that may obscure a proper

understanding of the matters disclosed (for example, by including too much immaterial information or by using unclear or ambiguous language).

- 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 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,~~ 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.

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:
- (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–A16)

...

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.

A12. 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.

A13. Matters communicated may include:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- How the auditor plans to address areas of higher assessed risks of material misstatement.
- 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
- When ISA 701 applies, the auditor's preliminary views about matters that may be areas of significant auditor attention in the audit and therefore may be key audit matters.
- How the auditor plans to address the effect on the audit (including the individual statements and the disclosures), of significant changes to within the applicable financial reporting framework or in the entity's environment, financial condition or activities. on the audit and financial statements, including disclosures.
- How the auditor will consider whether all relevant information that should have been included has been included, and that the overall presentation of the financial statements has not been undermined by including information that is not relevant or that obscures a proper understanding of the matters disclosed.

A14. 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, and the nature and extent of any planned use of internal auditors to provide direct assistance.¹⁷
- The views of those charged with governance about:
 - 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.
 - Significant communications between the entity and 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, and

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

~~how they affect~~ the effect of such developments on, for example, the overall presentation, structure and content of the financial statements, including the relevance, reliability, comparability and understandability of the information presented in the financial statements.

- The responses of those charged with governance to previous communications with the auditor.
- The documents comprising the other information (as defined in ISA 720 (Revised)) and the planned manner and timing of the issuance of such documents. When the auditor expects to obtain other information after the date of the auditor's report, the discussions with those charged with governance may also include the actions that may be appropriate or necessary if the auditor concludes that a material misstatement of the other information exists in other information obtained after the date of the auditor's report.¹⁸

A15. 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.

A16. Care is necessary 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.

Significant Findings from the Audit (Ref: Para. 16)

A17. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

A18. When ISA 701 applies, the communications with those charged with governance required by paragraph 16, as well as the communication about the significant risks identified by the auditor required by paragraph 15, are particularly relevant to the auditor's determination of matters that required significant auditor attention and which therefore may be key audit matters.¹⁹

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 16(a))

A19. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures, for example, in relation to the use of key assumptions in the development of accounting estimates for which there is significant measurement uncertainty. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to "critical accounting estimates" or "critical accounting policies and practices" to identify and provide additional information

¹⁸ Conforming amendment to ISA 260 (Revised) as a result of ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, approved by the IAASB in December 2014 subject to PIOB consideration of due process followed.

¹⁹ ISA 701, paragraphs 9–10

to users about the most difficult, subjective or complex judgments made by management in preparing the financial statements.

- A20. As a result, the auditor's views on the subjective aspects of the financial statements may be particularly relevant to those charged with governance in discharging their responsibilities for oversight of the financial reporting process. For example, in relation to the matters described in paragraph A19, those charged with governance may be interested in the auditor's evaluation of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks. Open and constructive communication about significant qualitative aspects of the entity's accounting practices also may include comment on the acceptability of significant accounting practices and the quality of the disclosures. Appendix 2 identifies matters that may be included in this communication.

ISA 300, *Planning an Audit of Financial Statements*

Requirements

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 (Revised).²⁰
 - (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA 330.²¹
 - (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs. (Ref: Para. A12–A12b)

...

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. Determining the nature, timing and extent of planned risk assessment procedures, and the further audit procedures, as they relate to disclosures 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 contain information from ~~systems or processes that are not part of the general ledger system~~ accounting records that are outside the general and subsidiary ledgers, which may also affect the assessed risks and the nature, timing and extent of audit procedures to address them.*

²⁰ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

²¹ 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.

A12b. Consideration of disclosures early in the audit assists the auditor in giving appropriate attention to, and planning adequate time for, addressing disclosures in the same way as classes of transactions, events and account balances. Early consideration may also help the auditor to determine the effects on the audit of:

- Significant new or revised disclosures required as a result of changes in the entity's environment, financial condition or activities (for example, a change in the required identification of segments and reporting of segment information arising from ~~the acquisition of~~ a significant ~~new subsidiary~~business combination);
- Significant new or revised disclosures arising from changes in the applicable financial reporting framework;
- The need for the involvement of an auditor's expert to assist with audit procedures related to particular disclosures (for example, disclosures related to pension or other retirement benefit obligations).
- Matters relating to disclosures that the auditor may wish to discuss with those charged with governance.²²

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.

²² ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph A12

- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- Whether the entity has an internal audit function and, if so, whether, in which areas and to what extent, the work of the function can be used, or internal auditors can be used to provide direct assistance, for purposes of the audit.
- 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.

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 320²³ and, where applicable:

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

- The determination of materiality for components and communication thereof to component auditors in accordance with ISA 600.²⁴
- 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.
- Changes to within the applicable financial reporting framework, such as changes in accounting standards, which may involve significant new or revised disclosures.
- 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 disclosures containing information from ~~systems or processes that are not part of the general ledger system~~ accounting records that are outside the general and subsidiary ledgers.
- 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.
- 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

²⁴ ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraphs 21–23 and 40(c)

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.

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. This shall include an understanding of the information system relevant to information disclosed in the financial statements, whether such information was obtained from within or outside of the general and subsidiary ledgers. This understanding shall also include the following areas: (Ref: Para. A89–A89a93)
- (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, and journal entries used to record other

information obtained from outside the general and subsidiary ledgers. (Ref: Para. A90–A93.
~~(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 (whether quantitative or qualitative) 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;²⁵
- 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.

²⁵ ISA 320, *Materiality in Planning and Performing an Audit*

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.
- 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.²⁶

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; ~~and~~-
- Disclosures about complex matters, including those involving significant management judgment as to what information to disclose, where misstatement of such matters could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole.*

...

²⁶ ISA 240, paragraph 15

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

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.
- 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~~²⁷~~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 550²⁷ 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:

²⁷ ISA 550, *Related Parties*

...

- 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 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,~~ are prepared in accordance with the applicable financial reporting framework, including whether the financial statements include adequate disclosures.

...

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 obtained from systems or processes that are not part of outside the general and subsidiary ledgers system. These systems or processes may~~ Examples of such information may include:

- ~~Information disclosed in the financial statements that is produced by a~~ An entity's risk management system.
- ~~Fair value information pProduction of valuation reports by management's experts and disclosed in the financial statements relating to the disclosure of the fair value of an amount that is recorded on the balance sheet at cost.~~
- ~~Information disclosed in the financial statements that has been obtained from Mmodels or from other calculations used to develop estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, for example, such as assumptions developed internally that may affect an asset's useful life, or data such as interest rates that may beare affected by factors outside the control of the entity, such as interest rate data.~~
- ~~Information disclosed in the financial statements about Ssensitivity analyses derived from financial models that to demonstrates that management has considered alternative assumptions.~~
- ~~Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records.~~

- Information disclosed in the financial statements that has been obtained from analyses prepared 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, as relevant.

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.

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 arising 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. Such control activities may relate to information included in the financial statements derived from 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.

A123a. 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:
 - Occurrence—transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
 - 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.
 - 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.~~
 - (iv) Cutoff—transactions and events have been recorded in the correct accounting period.
 - ~~(v)~~ Classification—transactions and events have been recorded in the proper accounts.
 - (vi) 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.
- (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—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.~~
- ~~(v) Classification—assets, liabilities and equity have been recorded in the proper accounts.~~
- ~~(vi) Presentation— assets, liabilities and equity account balances—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.~~

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 in accordance with ISA 200²⁸.

²⁸ ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, paragraph 15.

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 320,²⁹ 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.³⁰

A128b. The auditor's consideration of disclosures in the financial statements when identifying risks includes qualitative in accordance with paragraph 25(a) of this ISA includes non-quantitative 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.

~~A128c.~~ 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 requirements are expected to have a significant impact on the financial position and financial performance of the entity. [Paragraph A128c moved to A128b]
- 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.

...

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.

²⁹ ISA 320, *Materiality in Planning and Performing an Audit*, paragraph A1

³⁰ ISA 320, paragraph 4

- 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 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. It is not practicable to design audit procedures to detect all misstatements that could be material solely because of their nature. However, consideration of the nature of potential misstatements in ~~non-quantitative~~qualitative disclosures is relevant to the design of audit procedures to address risks of material misstatement³¹. 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.³² (Ref: Para.A1a)

...

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)

...

³¹ See ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, paragraphs A128a–A128b

³² ISA 450, paragraph A16

Application and Other Explanatory Material

Determining Materiality and Performance Materiality When Planning the Audit

...

Materiality in the Context of an Audit

A1a. Identifying and assessing the risk of material misstatement³³ involves the use of professional judgment to identify those items, including 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. When considering whether misstatements in qualitative disclosures could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole, the auditor may identify relevant factors such as:

- The circumstances of the entity for the period (for example, the entity may have undertaken a significant business combination during the period).
- The applicable financial reporting framework, including changes therein (for example, a new financial reporting standard may require new qualitative disclosures that are significant to the entity).
- Qualitative disclosures that are important to users of the financial statements because of the nature of an entity (for example, liquidity risk disclosures may be important to users of the financial statements for a financial institution).
- The way in which disclosures have been presented (for example, a misstatement in an individual qualitative disclosure may not be material, but when combined with other misstatements, results in inadequate information for users about a particular transaction undertaken by the entity in the period under audit).*

...

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, the remuneration of management and those charged with governance, and sensitivity analysis for fair value accounting estimates with high estimation uncertainty).

³³ ISA 315, paragraph 25, requires the auditor to identify and assess the risk of material misstatement at the financial statement and assertion level.

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

- 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.

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 in the financial statements, including classes of transactions, account balances and disclosures, with the underlying accounting records, including as applicable, those relevant accounting records that are outside and information from systems or processes that are not part of the general and subsidiary ledgers 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 is in accordance with the applicable financial reporting framework. In making this

evaluation, the auditor shall consider whether the financial statements are presented in a manner that reflects the appropriate:

- Classification and description of financial information and the underlying transactions, events and conditions; and
- Presentation, structure and content of the financial statements. (Ref: Para. A59)

...

Documentation [This paragraph is new from the Exposure Draft and is marked to extant ISA 330]

...

30. The auditor's documentation shall demonstrate that information in the financial statements, including classes of transaction, account balances and disclosures agrees or reconciles with the underlying accounting records, including, as applicable, 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

...

[Paragraph A13 is new from the Exposure Draft and is marked to extant ISA 330]

A13. In addition, certain audit procedures can be performed only at or after the period end, for example:

- Agreeing or reconciling information in the financial statements, including classes of transactions, account balances and disclosures, with the underlying accounting records including, as applicable, to the accounting records those relevant accounting records that are outside the general and subsidiary ledgers;
- Examining adjustments made during the course of preparing the financial statements;
- Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized

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 presentation, 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

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 inadequate or incomplete qualitative non-quantitative disclosures, and those disclosures required to meet disclosure objectives based on disclosures required by certain financial reporting frameworks as applicable.³⁴
- (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 necessary for the financial statements to achieve fair presentation s beyond disclosures those specifically required by the framework, that are necessary for fair presentation.³⁵

Examples of misstatements arising from fraud are provided in ISA 240.³⁶

Accumulation of Identified Misstatements (Ref: Para. 5)

- A2. 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. “Clearly trivial” is not another expression for “not material.” Matters 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 matters 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 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, other than those that are clearly trivial. Misstatements in quantitative and qualitative 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. Misstatements in qualitative disclosures that are clearly trivial will be misstatements that are clearly inconsequential, whether taken individually or in combination with other misstatements, and judged by any criteria of nature or circumstance. 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,

³⁴ 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...”

³⁵ 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)).

³⁶ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs A1–A6

with other misstatements) as required by paragraph 11 of this ISA. Paragraph A13a of this ISA provides examples of where such 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 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 530.³⁷
- ...

Communication and Correction of Misstatements (Ref: Para. 8–9) [Paragraphs A7–A10 are new from the Exposure Draft and are marked to extant ISA 450]

- A7. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.
- A7a. As part of the communication of misstatements to the appropriate level of management, the auditor may also consider whether the misstatements are indicative of a significant deficiency or deficiencies in internal control to be communicated to those charged with governance as required by ISA 265.³⁸
- A8. However, Law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.
- A9. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

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

³⁷ ISA 530, *Audit Sampling*, paragraphs 14–15

³⁸ ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraphs 7–9

- A10. ISA 700 (Revised) requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments,³⁹ which may be affected by the auditor's understanding of management's reasons for not making the corrections.

...

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.⁴⁰ 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. 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 determination of 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 is a matter that involves the exercise of professional judgment. Examples where such misstatements may 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.

³⁹ ISA 700 (Revised), paragraph 12

⁴⁰ ISA 320, paragraph 12

- 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. In determining whether uncorrected misstatements are material in accordance with paragraph 11(a) of this standard, the auditor considers uncorrected misstatements in amounts and qualitative disclosures. Misstatements in qualitative disclosures may be considered material either individually, or when taken in combination with other misstatements. For example, depending on the misstatements identified in qualitative disclosures the auditor may consider whether:

- (a) Identified errors in narrative disclosures are persistent or pervasive; or
- (b) A number of identified misstatements in qualitative disclosures are relevant to the same matter, and considered collectively may affect the users' understanding of that matter.

This consideration of accumulated misstatements, including misstatements in qualitative disclosures, is also helpful when evaluating the financial statements in accordance with paragraph 13(d) of ISA 700 (Revised),⁴¹ which requires the auditor to consider whether the overall presentation of the financial statements has not been undermined by including information that is not relevant or that obscures 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 further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.⁴²
- 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:

⁴¹ ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

⁴² 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 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 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 (Revise)⁴³ deals with the auditor's responsibilities relating to consideration of other information 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 240⁴⁴ 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. Depending on the circumstances,

A17a-m Misstatements in disclosures could also be indicative of fraud, and, for example, may arise from:

- Misleading disclosures that have resulted from B bias in management's judgments ~~that results in misleading disclosures~~; or

⁴³ Proposed ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

⁴⁴ ISA 240, paragraph 35

- Extensive ~~A trend towards~~ duplicative or uninformative disclosures that are intended to ~~may~~ obscure ~~significant information~~ a proper understanding of matters in the financial statements.

When considering the implications of misstatements in transactions, account balances and disclosures, the auditor exercises professional skepticism in accordance with ISA 200.⁴⁵

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.

⁴⁵ ISA 200, paragraph 15

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

Definitions [This paragraph is new from the Exposure Draft and is marked to ISA 700 (Revised)]

8. Reference to “financial statements” in this ISA means “a complete set of general purpose financial statements,⁴⁶ ~~including the related notes.” The related notes ordinarily comprise a summary of the significant accounting policies and other explanatory information.~~ The requirements of the applicable financial reporting framework determine the presentation, form and content of the financial statements, and what constitutes a complete set of 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.^{47, 48}
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;⁴⁹
 - (b) The auditor’s conclusion, in accordance with ISA 450, whether uncorrected misstatements are material, individually or in aggregate;⁵⁰ 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. In making this evaluation, the auditor shall consider the relevance of the accounting policies to the entity, and whether they have been presented in an understandable manner; (Ref: Para. A3a)

⁴⁶ ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, paragraph 13(f) sets out the content of financial statements.

⁴⁷ ISA 200, paragraph 11

⁴⁸ 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.

⁴⁹ ISA 330, *The Auditor’s Responses to Assessed Risks*, paragraph 26

⁵⁰ ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

- (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. In making this evaluation, the auditor shall consider whether:
 - All information that should have been included has been included, and whether such information is appropriately classified, aggregated or disaggregated, and characterized.
 - The overall presentation of the financial statements has not been undermined by including information that is not relevant or that obscures 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)

...

Auditor's Report [This section is new from the Exposure Draft and is marked to ISA 700 (Revised)]

...

Auditor's Report for Audits Conducted in Accordance with International Standards on Auditing

...

Auditor's Responsibilities for the Audit of the Financial Statements

...

Date of the Auditor's Report

48. The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that: (Ref: Para. A61–A64)
- (a) All the statements, and related disclosures, that comprise the financial statements, including the related notes, have been prepared; and
 - (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

...

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. ISA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.⁵¹ 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 e.g., 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.⁵² 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 Appropriately Disclosed in the Financial Statements (Ref: Para. 13(a))

- A3a. ~~The auditor's~~In evaluation ~~of~~ whether the financial statements appropriately disclose the significant accounting policies selected and applied, the auditor's includes consideration may include ~~of~~ matters such as:

⁵¹ ISA 260 (Revised), *Communication with Those Charged with Governance*, Appendix 2

⁵² ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 21

- Whether all disclosures related to the significant accounting policies that are required to be included by the applicable financial reporting framework have been disclosed;
- Whether the information that has been disclosed is relevant;
- The clarity with which the accounting policies have been presented.

The relevance of the accounting policies to the entity is a matter of professional judgment and takes into account whether the accounting policies reflect the application of the underlying recognition criteria and measurement bases for items included in the financial statements in the particular circumstances of the entity's operations and its environment, 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))

A3b. Evaluating the understandability ~~and relevance~~ of the ~~information presented in the~~ financial statements includes consideration of matters such as whether:

- The information in the financial statements ~~financial statements, including disclosures, are appropriately classified and characterized, and is~~ 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 placement of significant disclosures gives appropriate prominence to them (~~for example e.g.~~, when there is perceived value of entity-specific information to users), and whether the disclosures are appropriately 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

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

- ~~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.
 - 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.⁵³ As noted in paragraph 7(b) of this ISA, a fair presentation⁵⁴ 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.⁵⁵
- 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 ~~matters~~ such matters 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 could reasonably be expected to influence relevant to the economic decisions of the users taken on the basis of the financial statements as a whole, such as evolving financial reporting requirements or the changing economic environment.
- A4c. Evaluating whether the financial statements achieve fair presentation may 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.

⁵³ 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.

⁵⁴ See ISA 200, paragraph 13(a)

⁵⁵ 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)).

- 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.⁵⁶ 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 (~~e.g. 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 (~~e.g. 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 (~~e.g. 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 (~~e.g. 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.

⁵⁶ ISA 200, paragraphs A2–A3

...

Auditor's Report (Ref: Para. 20) [This section is new from the Exposure Draft and is marked to ISA 700 (Revised)]

...

Date of the Auditor's Report (Ref: Para. 48)

...

- A62. Since the auditor's opinion is provided on the financial statements and the financial statements are the responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until evidence is obtained that all the statements, and related disclosures, that comprise the financial statements, ~~including the related notes~~, have been prepared and management has accepted responsibility for them.
- A63. In some jurisdictions, law or regulation identifies the individuals or bodies (e.g., the directors) that are responsible for concluding that all the statements, and related disclosures, that comprise the financial statements, ~~including the related notes~~, have been prepared, and specifies the necessary approval process. In such cases, evidence is obtained of that approval before dating the report on the financial statements. In other jurisdictions, however, the approval process is not prescribed in law or regulation. In such cases, the procedures the entity follows in preparing and finalizing its financial statements in view of its management and governance structures are considered in order to identify the individuals or body with the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared. In some cases, law or regulation identifies the point in the financial statement reporting process at which the audit is expected to be complete.
- A64. In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of ISAs is the earlier date on which those with the recognized authority determine that all the statements, and related disclosures, that comprise the financial statements, ~~including the related notes~~, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.