

Potential Changes to the ISAs – Planning

The following illustrates potential changes to the ISAs to address issues identified by the respondents to the Discussion Paper, The Evolving Nature of Financial Reporting Disclosure and its Audit Implications. This has been presented for the relevant paragraphs in ISAs 300; and ISAs 315 (Revised), 320 and 260 (relevant to planning only).

ISA 300, *Planning an Audit of Financial Statements*

Application and Other Explanatory Material¹

The Role and Timing of Planning (Ref: Para.2)

A2. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- [Obtaining an understanding of the applicable financial reporting framework,² including requirements relating to disclosures.](#)
- The involvement of experts.
- The performance of other risk assessment procedures.

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.

¹ The Task Force had identified no gaps in requirements in ISA 300 – see Agenda Item 3-B from December 2012 IAASB Meeting.

A12.1 Planning the nature, timing and extent of audit procedures to be performed by the engagement team members includes planning procedures for the disclosures in the financial statements that are required by the applicable financial reporting framework.² Planning in this respect is important in light of the wide range of information that may be encompassed in disclosures. Consideration of the audit procedures for financial statement disclosures early in the audit process assists the auditor with making sure that appropriate attention is given to disclosures in the same way as attention is given to classes of transactions and account balances, and that adequate time has been planned.

Appendix (ISA 300)

(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.

- ...
- ...
- ...

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

- The determination of materiality in accordance with ISA 320³ and, where applicable:
 - The determination of materiality for components and communication thereof to component auditors in accordance with ISA 600.⁴
 - 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.

² Glossary of Terms: *Applicable Financial Reporting Framework*—The applicable financial reporting framework is that adopted by the management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

³ ISA 320, "Materiality in Planning and Performing an Audit"

⁴ ISA 600, "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors), paragraphs 21-23 and 40(c)

- 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.
- Significant changes in the applicable financial reporting framework, ~~such as changes in accounting standards~~ including new accounting standards or disclosure requirements.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- The process(es) management uses to identify and document the disclosures required by the applicable financial reporting framework
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- ~~Significant changes in the financial reporting framework, such as changes in accounting standards.~~
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

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

Application and Other Explanatory Material⁵

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.](#)
- [Disclosure requirements of the applicable financial reporting framework.](#)
- Regulatory framework for a regulated industry.
- 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.

A27. ISA 250 includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.⁶

[A27.1 Obtaining an understanding of the disclosure requirements relevant to the entity early in the planning process helps the auditor to identify:](#)

- [\(a\) The nature and extent of the disclosures that may be required or relevant taking into account the needs of users of the financial statements.](#)
- [\(b\) New disclosures, arising from changes in the entity \(e.g., a change in the way segments have been identified or a new significant subsidiary has been acquired\) or new financial reporting requirements, which may require auditor attention.](#)

⁵ The Task Force had identified no gaps in requirements in ISA 315 (Revised) – see Agenda Item 3-B from December 2012 IAASB Meeting.

⁶ ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 12

[\(c\) Disclosures for which experts' services may be required \(e.g., pension or other retirement benefit funds or disclosure of reserves in extractive entities\).](#)

[\(d\) Disclosures that the auditor may wish to discuss with those charged with governance.⁷](#)

The Entity's Internal Control (Ref: Para. 12)⁸

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 are prepared in accordance with the applicable financial reporting framework, [including relevant disclosure requirements](#).

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

⁷ [ISA 260, Communication with Those Charged with Governance, paragraph A13](#)

⁸ [In ISA 315 \(Revised\), Application and Other Explanatory Material regarding the entity's internal control is presented in paragraphs A49-A117](#)

- Ensure information required to be disclosed by the applicable financial reporting framework, including that which is not generated by the accounting system, is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

ISA 320, *Materiality in Planning and Performing the Audit*

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)

Application and Other Explanatory Material

Determining Materiality and Performance Materiality When Planning the Audit

Considerations Specific to Public Sector Entities (Ref: Para. 10)

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

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole (Ref: Para. 10)

- A3. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:
 - The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
 - Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
 - The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;

- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
 - The relative volatility of the benchmark.
- A4. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.
- A5. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.
- A6. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.
- A7. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances.

A7.1 In relation to financial statement disclosures, the absolute or relative size of a quantitative amount in a disclosure or the related financial statement amount, are not the only relevant factors in determining whether the disclosure is material. For example:

- The objective of the requirements of the applicable financial reporting framework (e.g., the requirement to disclose certain risk management policies, the omission of which may impair the users understanding of the risks embedded in the financial statements);

- The relevance of the information to the entity's current financial statements (e.g. disclosure of relevant calculations of items in the financial statements, such as possible ranges of values, discount rates, effective interest rates and growth rates);
- The significance of the information in relation to financial statement amounts (e.g. segment information where a segment has been identified as playing a significant role in the operations or profitability of the entity);
- The extent of subjectivity involved and how it may influence a user (disclosures to enable users to understand the underlying measurement variability of a recorded amount, such a sensitivity analysis); and
- Management's evaluation and reasoning for providing (or not providing) the disclosure, including considerations around potential bias (e.g. disclosure of material uncertainties in relation to the going concern assumption).

Considerations Specific to Small Entities

A8. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

Considerations Specific to Public Sector Entities

A9. In an audit of a public sector entity, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program activities. Where a public sector entity has custody of public assets, assets may be an appropriate benchmark.

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

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

- Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).
- 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, a newly acquired business).

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.

Performance Materiality (Ref: Para. 11)

A12. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

[A12.1 Disclosures are often in narrative form and qualitative in nature, and could be materially misstated, that is, the misstatement is such that the economic decisions of users would be affected. These material misstatements could occur in individual disclosures, or there may be individual immaterial misstatements within the disclosures that, in the aggregate, would be material to the financial statements. The concept underlying the definition of performance materiality applies to all types of disclosures, notwithstanding that the definition in the ISAs addresses quantitative items and therefore refers to "amount or amounts". The auditor reduces the risk of material misstatement in these qualitative disclosures by considering the nature and extent of the disclosures that may be required or relevant taking into account the needs of users of the financial statements.](#)

ISA 260, *Communication with Those Charged with Governance*

Application and Other Explanatory Material⁹

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. Care is required when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

A13. Matters communicated may include:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- The auditor's approach to internal control relevant to the audit.
- The application of the concept of materiality in the context of an audit.¹⁰
- Changes to the applicable financial reporting framework,¹¹ including those requirements related to disclosures that are relevant and material to the entity, and the implications of these on the planned approach.

⁹ The Task Force had not identified this standard as affecting disclosures. However, upon further reflection, to focus attention on disclosures a potential change to the application material has been included.

¹⁰ ISA 320, "Materiality in Planning and Performing an Audit."

¹¹ Glossary of Terms: *Applicable Financial Reporting Framework*-The applicable financial reporting framework is that adopted by the management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.