

Audit [Planning] Considerations Relating to Disclosures

The Task Force has developed this narrative educational guide to assist in developing the potential changes to the ISAs. This educational guide covers audit considerations and procedures for disclosures to the extent that they relate to planning the audit, and includes ISA 300 and ISAs 315, 320 and 260 as they relate to planning only. This educational guide has been presented for information purposes only and it is not intended that it will be discussed at the April 2013 IAASB meeting.

Introduction

The purpose of this document is to provide a summary of the broad [planning] requirements of the ISAs relating to auditing disclosures, with further audit considerations on the application of these requirements to different types of disclosures.

1. Under International Standards on Auditing (ISAs), auditors are required to address disclosures in planning and performing the audit, including identifying and assessing the risks of material misstatement for disclosures. Further, for financial statements prepared in accordance with a fair presentation framework, auditors are required to consider the overall presentation of the financial statements and whether the financial statements, including the related disclosures, represent the underlying transactions and events in a manner that achieves fair presentation or a true and fair view.¹
2. Auditing disclosures is an integral part of the audit, and should not be isolated from auditing the underlying numbers and other elements of the financial statements. It is important that procedures performed during all stages of the audit include considerations and work effort on these.
3. To integrate the audit of disclosures with the audit of other elements of the financial statements requires the auditor to pay particular attention to the following ISAs:
 - When planning the audit: ISA 300,² ISA 315 (Revised)³, ISA 260⁴ and ISA 320⁵ [*this document covers these standards only, including understanding the entity and its environment, communications with those charged with governance and materiality only as they relate to planning. The balance of the sections relating to risk assessment, materiality, obtaining sufficient appropriate audit evidence, evaluation of misstatements and reporting will be completed later in 2013*].
4. This material has been written in the context of a general purpose fair presentation financial reporting framework, but may also be useful for other financial reporting frameworks.

¹ Whether the phrase “present fairly, in all material respect”, or the phrase “give a true and fair view” is used in any particular jurisdiction is determined by the law or regulation governing the audit of financial statements in that jurisdiction, or by generally accepted accounting practice in that jurisdiction

² ISA 300, *Planning an Audit of Financial Statements*

³ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

⁴ ISA 260, *Communication with Those Charged with Governance*

⁵ ISA 320, *Materiality in Planning and Performing an Audit*

Background Information

5. The nature of financial reporting has evolved to meet the changing needs of users. Business and capital markets have become more challenging, with greater complexity in business models, sources of risk and uncertainty, as well as greater sophistication in how risk is managed. This evolution has led to a need for information that is more relevant to users, even if such information may be more subjective and less reliable.
6. Financial reporting disclosure requirements and practices have also had to respond to these changes by shifting from simply providing breakdowns of line items on the face of the financial statements to providing a broad variety of disclosures, some of which may not be derived from the accounting system, and may include forward looking information and disclosures of estimation uncertainty and models.
7. As financial reporting has grown more complex, financial statements are now more likely to include a variety of disclosures in addition to the traditional disclosure items, for example:
 - (a) **Significant accounting policies**—descriptions of the accounting policies adopted by the entity relevant to understanding the line items on the face of the financial statements and the basis of the accounting policies of the entity.
 - (b) **Components of line items**—such as breakdowns of line items into smaller categories, movement analyses or other related information about a line item.
 - (c) **Factual information about the entity**—such as addresses, names of group entities, composition of share capital and dividend payments.
 - (d) **Judgments and reasons**—judgments made in the process of applying accounting policies and management decisions and reasons for the policies/decisions selected/made. Examples include criteria developed by the entity to distinguish investment properties from owner occupied properties and from property held for sale in the ordinary course of business, and disclosures around why an entity's ownership interest does not constitute control in respect of an investee where more than half of its voting rights, or potential voting rights are owned directly or indirectly.
 - (e) **Assumptions/models/inputs**—includes disclosures of material information relevant to the calculation of items in the financial statements, such as possible ranges of values, and forward looking information to the extent that it is used for amounts recognized in the balance sheet such as for impairment testing, including discount rates, effective interest rates and growth rates.
 - (f) **Sources of estimation uncertainty/sensitivity analysis disclosures**—these are disclosures to enable users to understand the underlying measurement variability of an item in the financial statements. An example is value at risk disclosures or other types of sensitivity analyses.
 - (g) **Material uncertainties in relation to the going concern basis of accounting**—information about material uncertainties related to events or conditions that may cast doubt upon the entity's ability to continue as a going concern.

- (h) **Related party disclosures**—Descriptions of related party relationships and amounts of transactions, including key management compensation.
- (i) **Pro forma financial information**—disclosures are required, under some accounting frameworks, relating to business combinations which have occurred after the balance sheet date but before the financial statements are issued.
- (j) **Descriptions of internal processes**—disclosures such as risk management policies and practices. An example is the disclosure of the policies and procedures for managing financial instrument risks.
- (k) **Disclosure of the fair value of an amount recorded on the balance sheet using a different measurement basis**—such as a requirement to disclose fair values for items measured using another measurement basis such as historical cost or amortized cost.
- (l) **Objective-based disclosure requirements**—these are overarching requirements that set out the objectives of the disclosures to be provided rather than require specific disclosures. Thus, preparers are expected to provide additional disclosures when compliance with the specific disclosure requirements in a standard will be insufficient for users to be able to understand the impact of particular transactions, other events and conditions on the entity's financial position and performance.

Financial Reporting Considerations

8. The preparation of financial statements by management requires the identification of the applicable financial reporting framework in the context of the relevant laws and regulations. The applicable financial reporting framework often encompasses financial reporting standards established by an authorized or recognized standard setting organization (such as the International Accounting Standards Board (IASB) or Financial Accounting Standards Board in the US (FASB)), or legislative or regulatory requirements.
9. The requirements of the applicable financial framework determine the form and content of the financial statements. Although the conceptual framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.
10. The conceptual framework may also set out the concepts that underlie the preparation and presentation of the financial statements, including the objectives and the qualitative characteristics of financial reporting. These conceptual frameworks assist in the standard setting process, and also assist preparers in applying the relevant accounting standards, and auditors in assessing whether the financial statements comply with the financial reporting standards.
11. As accounting standards have continued to evolve with the changing business environment, in particular the increasing use of fair value, changes have also occurred in the conceptual frameworks of accounting standards. For example, 'reliability' was once a principal qualitative characteristic of financial information but has been superseded by other concepts, such as 'faithful representation', in recognition of the move towards fair value accounting.

12. Given the new emphasis on faithful representation it has been argued that, in some circumstances, the disclosures about the line item may become at least as important, if not more useful, to users as the number on the face of the financial statements. The disclosures are necessary to inform users about judgments and assumptions made in the measurement of the line item, reasons for the judgments, facts, circumstances and the measurement uncertainty related to that line item. In effect, the disclosures in these cases are being used to achieve the principles of relevance, faithful representation, or both.
13. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly, or explicitly, makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. Some conceptual frameworks call this the fundamental characteristics of useful information,⁶ and in contemporary accounting standards often includes 'relevance' and 'faithful representation',⁷ or similar characteristics.
14. 'Relevant information' is commonly accepted as having predictive value, confirmative value, or both, and is therefore capable of making a difference to decisions made by lenders, investors and creditors.⁸
15. 'Faithful representation' generally means information is:⁹
 - Complete—Information is complete if a user can understand the phenomenon being depicted;
 - Neutral—Information is neutral if it is without bias in its selection or presentation, i.e., it is not intentionally overstated, understated, emphasized or de-emphasized; and
 - Free from error—This does not mean perfectly accurate, but rather that there are no errors in the process used to produce information and no errors in its description.

Financial Reporting Materiality

16. Materiality depends on both quantitative and qualitative factors which is particularly relevant for disclosures where verbal descriptions are often included. Assessing whether to include a disclosure because it is considered material¹⁰ is a management decision, and requires the exercise of professional judgment on whether the information has the potential to make a difference in users' decisions about providing resources to the entity. It is important that balance is achieved between disclosures that are useful and relevant, and those that are provided without adding any value. A key consideration is finding the balance between competing needs such as understandability of disclosures, excessively lengthy financial statements, consistency and comparability.

⁶ The IASB has included fundamental characteristics of useful information in their Framework 2010.

⁷ Relevance and faithful representation are the fundamental qualitative characteristics of the IASB's Conceptual Framework, and are used as examples to represent the characteristics of accounting information included in disclosures. Other accounting frameworks may have similar terms, which should be considered in a similar way when assessing the accounting requirements of information to be included in disclosures.

⁸ IASB Conceptual Framework, paragraph QC6-QC7

⁹ IASB Conceptual Framework, paragraph QC12

¹⁰ In IFRS, IAS 1, paragraph 31 states that "an entity need not provide a specific disclosure required by an IFRS if the information is not material".

17. Notwithstanding that some financial reporting standards define materiality¹¹ they do not specify a uniform quantitative threshold or predetermine what could be material in a particular situation as materiality is entity-specific, and is to be judged in the context of the entity's circumstances.
18. ISA 320 notes that the financial reporting frameworks discuss materiality in different terms, including, for example, that:
 - Misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
 - Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
 - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effects on specific individual users, whose needs may vary widely, is not considered.¹²
19. Therefore, there is a presumption that the financial statement disclosures presented are relevant, faithfully represented and material.

Audit Planning Considerations Relating to Disclosures in an Audit of Financial Statements

Planning

20. At the planning stage of the audit, the auditor establishes an overall audit strategy and develops an audit plan so that appropriate attention is devoted to important areas of the audit, thereby performing audit procedures in an effective manner to reduce audit risk to an acceptably low level. Consequently, auditors are required to also address disclosures¹³ in planning and performing the audit. This section focusses on audit considerations for disclosures when planning the audit.
21. To develop an appropriate audit plan,¹⁴ the auditor:
 - Obtains an understanding of the entity and its environment, including relevant internal controls;
 - Determines materiality; and
 - Identifies the risks of material misstatement at the assertion level.

¹¹ As an example, the IASB's Conceptual Framework defines materiality as follows: "Information is material if omitting or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity".

¹² ISA 320, paragraph 2

¹³ This includes all disclosure requirements of the relevant financial reporting standards which are covered by the audit opinion. Disclosures, in this context, do not include other information that is presented in a financial report together with the audited financial statements.

¹⁴ ISA 300, paragraph A12 states "the audit plan...includes the nature, timing and extent of audit procedures to be performed by the 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 auditors risk assessment procedures occurs early in the audit process...."

22. It is important in the planning phase of the audit that proper consideration is given to planning the nature, timing, and extent of audit procedures specifically relating to disclosures, because of the wide range of information that may be encompassed in the disclosures.
23. ISA 300 covers the broad requirements for planning an audit. ISA 300, paragraph A2 notes that “planning includes the need to consider, prior to the identification and assessment of the risks of material misstatement, such matters as:
- ...
 - The determination of materiality.
 - Obtaining an understanding of the applicable financial reporting framework, including requirements relating to disclosures.¹⁵
 - ...”
24. As each element of the planning process to develop an appropriate audit plan is undertaken, consideration is given to disclosures in the same way that attention is given to classes of transactions and account balances. Considering the audit procedures for disclosures during planning will assist with allocating adequate time during the audit to obtain sufficient appropriate evidence in respect of disclosures.

Understanding the Disclosure Requirements

25. The objective of ISA 315 (Revised) is for the auditor to obtain an understanding of the entity and identify and assess the risks of material misstatement, whether due to fraud or error, both at the financial statement level, and the assertion level, to provide a basis for designing and performing further audit procedures.¹⁶
26. ISA 315 (Revised) requires the auditor to obtain an understanding of the applicable financial reporting framework relevant to disclosures.¹⁷ The disclosure requirements of the applicable financial reporting framework may themselves be complex and extensive. Obtaining a comprehensive understanding of the entity’s disclosures at an earlier stage of the audit helps the auditor to identify and address:
- The nature and extent of the disclosures that may be required or relevant taking into account the needs of users of the financial statements.
 - 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.
 - Disclosures for which experts’ services may be required (e.g., pension or other retirement benefit funds or disclosure of reserves in extractive entities).
 - Disclosures that the auditor may wish to discuss with to those charged with governance.¹⁸

¹⁵ This is not currently in ISA 300, but has been included in Agenda Item 5-B as a potential change

¹⁶ ISA 315 (Revised), paragraph 3

¹⁷ ISA 315 (Revised), paragraph 11(a)

¹⁸ This is not currently in ISA 260, but has been presented as a potential change to paragraph A13 in Agenda Item 5-B.

27. Obtaining this understanding early in the planning process also assists the auditor in assessing the availability of audit evidence to support the disclosures, in particular when there are significant disclosures required that are not generated by the entity's accounting system. For example when there is a need to disclose the fair value of an amount recorded on the balance sheet using a different basis, early identification can enable discussion with management to assist with timely preparation of this information.

Understanding How the Financial Statements are Compiled

28. Some disclosures may not be audited as part of the audit of classes of transactions or account balances, and an understanding of how the financial statements are compiled assists the auditor in determining the nature, timing and extent of audit procedures on disclosures. Information included in the financial statements could arise from various sources, including:
- Information generated by the accounting system, e.g., breakdowns of account balances on the balance sheet;
 - Descriptions of internal processes from risk management procedure manuals;
 - Fair value of an amount recorded on the balance sheet using a different measurement basis from a valuation expert;
 - Assumptions, models and inputs from calculations supporting amounts recorded in the general ledger;
 - Sensitivity analyses from financial models.

Understanding Internal Control

29. ISA 315 (Revised) establishes requirements for the auditor to understand internal control relevant to the audit.¹⁹
30. The control environment relevant to the preparation of the financial statements is also considered, including management's attitude to proper preparation of the financial statements, the knowledge and skills of the preparer of the financial statements, the level of importance placed on the process, adequate segregation of duties and the nature of the information included in the financial statements (i.e., automated or prepared manually). These factors will have an impact on the decision to plan to rely on controls over the preparation of the financial statements.
31. The complexity and volume of the financial statements impact the nature and extent of controls that may exist over the financial reporting process. It is important to understand the controls over:
- Data collection and processing of information used in the financial statements;
 - The financial reporting close process;
 - The preparation of information for those disclosures which are not generated by the financial reporting system;
 - The completeness of information in the financial statements;

¹⁹ ISA 315 (Revised), paragraph 12

- The preparation of the financial statements, including the review and approval process.
32. When a third party service organization is used to prepare the financial statements, an understanding is obtained of how the services of the service organization are used, including:
- The nature of the services provided by the service organization, including the effect thereof on the internal control relevant to the preparation of the financial statements;
 - The degree of interaction between the activities of the service organization and those of the entity relative to the preparation of the financial statements; and
 - The nature and the relationship between the entity and its service organization, including contractual terms for the activities undertaken by the service organization.

Identifying and Assessing the Risks of Material Misstatement

Overall Considerations

33. ISAs require auditors to 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,²⁰ including for disclosures. This necessitates the auditor identifying the disclosures to audit, and the relevant assertions that are applicable.

Material Disclosures for Audit Planning Purposes

34. The application of the concept of materiality is central to both the preparation and the audit of financial statements. As discussed above, it impacts the decisions of preparers when deciding how an entity should recognize, measure, present and disclose certain transactions and information in the financial statements. ISA 320 requires the auditor to determine materiality and performance materiality when planning the audit²¹ to:
- Determine the extent and nature of risk assessment procedures;
 - Identify and assess the risk of material misstatements; and
 - Determine the nature, timing and extent of further audit procedures.

Since the evaluation of whether particular information could influence users' decisions, an understanding of the users of the entity's financial statements, and the kinds of decisions they make, is necessary for both preparers and auditors.²²

When Planning Audit Procedures on Disclosures, are All Disclosures Material?

35. ISA 320 does not prescribe how to apply materiality to disclosures.
36. The auditor expresses an audit opinion on the financial statements as a whole and not on individual disclosures. Some financial reporting frameworks, including IFRS, states that specific disclosure requirements need not be complied with if the information is not material.²³ In light of this, the

²⁰ ISA 315 (Revised), paragraph 5

²¹ ISA 320, paragraphs 10-11

²² ISA 320, paragraph 4 states that "materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements."

²³ IAS 1, *Presentation of Financial Statements*, paragraph 31

auditor plans audit procedures for disclosures based on materiality judged in the context of the financial statements as a whole and the needs of the users of those financial statements, and not to all individual disclosures purely because the related financial statement item is quantitatively material.

37. When determining whether a disclosure is material for audit purposes, the absolute or relative size should not be the only influential factor. Information, including both verbal descriptions and quantitative amounts, may be relevant for users in their decisions, and may therefore be considered material. As quantitative materiality of a line item is not the sole determinant of the need for individual disclosures, qualitative factors also need to be considered when judging whether a disclosure is material. For example:

- 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),

are borne in mind when planning audit procedures for disclosures.

38. Further examples of information that could be considered relevant to users, and therefore material, include the following:

- Significant accounting policies—if there is a choice in accounting policy for the treatment of an item, or where there has been a change in accounting policy because, say, the financial reporting standard has changed;
- Components of line items—if the caption of the line item is not sufficient to understand the nature or characteristics of the underlying amounts, these should therefore be disaggregated to provide more useful information;
- Factual information about the entity—if the disclosure, say, provided information on the composition of the group, which may assist users in assessing the ability of the group to generate cash flows or move assets from one part of the group to another;

- Judgments and reasons—if an accounting standard allows for alternative recognition or measurement, it would be relevant to users to understand why the item has been accounted for in the selected way;
 - Assumptions/models/inputs—if the information explains the entity’s measurement of an amount where the measurement inputs could cover a large range and could change over time, which may affect future cash flows;
 - Sources of estimation uncertainty/sensitivity analysis disclosures—if a reasonable possible change in a measurement input would have a significant impact on the amount recorded;
 - Material uncertainties in relation to the going concern basis of accounting—if the information explains the entity’s exposure to a significant event or uncertainty which may impact the entity’s ability to continue as a going concern;
 - Related party disclosures—if information is important to users to assess the integrity of management and to ensure equal treatment of shareholders;
 - Pro-forma financial information—if the information is important to users because the timing of cash flows or exposure to unrecognized items may be significant going forward;
 - Descriptions of internal processes—if the standard sets a high-level principle which needs articulation by the entity to assist users with understanding how internal processes affect the entity’s operations or financial structure;
 - Disclosure of the fair value of an amount recorded on the balance sheet using a different measurement basis—if the amount recorded in the balance sheet does not convey adequate information about possible future cash flows relating to the item;
 - Objective-based disclosure requirements—if the information is required for the user to properly assess the prospects for future cash flows.
39. In light of the auditor’s knowledge of the entity and its environment, and in considering whether disclosures are material for the purposes of planning further audit procedures, some disclosures may not be judged to be material and therefore no further audit procedures planned. Some disclosures may be useful to investors even if they are not quantitatively material, and the auditor considers whether such matters may require further consideration as part of the planning process. For example:
- A disclosure that a financial institution has no material exposure to a particular class of assets, such as sovereign debt, could be considered of particular interest to investors.
 - An entity’s non-compliance with a particular law or regulation, such as competition law, may be relevant to users even if the resulting fine is immaterial.
 - Non-compliance with loan covenants, which may result in a reclassification of long term liabilities, may be of particular relevance to users of the financial statements.

How are the Concepts of Materiality and Performance Materiality Applied to Qualitative Disclosures?

40. As discussed, materiality has qualitative as well as quantitative aspects. The qualitative aspects take account of the specific facts and circumstances surrounding each item which requires professional judgment based on information relevant to the item.
41. ISA 320 defines performance materiality as “the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceed materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures”.²⁴ Therefore, performance materiality, as defined, does not apply to narrative disclosures as it refers to amounts.
42. 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 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 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.
43. For those disclosures which have not been judged material and therefore for which specific audit procedures have not been planned, the auditor considers the following factors when deciding whether to plan specific audit procedures:
- The strength of the system of internal control surrounding the preparation of the financial statements, and the likelihood that misstatements will be detected and corrected;
 - Changes in the process to prepare the financial statements, including changes to those responsible for preparation and approval of the financial statements;
 - The knowledge and experience of those preparing the financial statements, both of the entity and applicable financial reporting standards;
 - Areas where required disclosures have not been previously made or there were detected errors in prior periods; and
 - New financial reporting disclosure requirements affecting the entity.

In addition, consideration is given to members of the audit engagement team performing audit procedures on disclosures in light of the risk of an aggregated material misstatement in disclosures.

²⁴ ISA 320, paragraph 9

Assertions

44. ISA 315 (Revised) identifies the following assertions for presentation and disclosure that may be used by the auditor to consider the different types of potential misstatements:²⁵
- Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
 - Completeness—all disclosures that should have been included in the financial statements have been included.
 - Classification and understandability—relevant information is appropriately presented and described, and descriptions and related information have been clearly expressed.
 - Accuracy and valuation—financial information is disclosed at appropriate amounts, and descriptions, analyses and other related information is disclosed appropriately.
45. It is worth noting that, while many of the assertions above are also relevant for classes of transactions and account balances, there are some important differences. The explanations of the assertions have been tailored to presentation and disclosure and the assertion of understandability is unique to presentation and disclosure.
46. The assertions are directed towards individual disclosures, which are presumed to be included because they are relevant. However, the assertions above do not necessarily apply to every category of disclosure identified in paragraph 7.
47. As many disclosures relate to specific line items, consideration of the risks of material misstatement at the assertion level for disclosures may often be done at the same time as, and in conjunction with, the related line item and would not be different to the assertions used for testing that line item. Furthermore, audit evidence obtained in the process of performing procedures in response to the identified assessed risks of material misstatement for the related account balances or classes of transactions may be used for auditing the related disclosures.
48. The identification and assessment of the risk of material misstatement, including applicable assertions, for disclosures that are not directly related to a line item in the financial statements will necessitate a separate exercise.

Fraud Risk Factors²⁶

49. Fraudulent financial reporting can arise from:
- Manipulation, falsification or alteration of records or documents;
 - Misrepresentation or intentional omission from the financial statements of events, transactions, or other significant sources of financial information; or
 - Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

²⁵ ISA 315 (Revised), paragraph A124(c) – these incorporate the potential changes illustrated in Agenda Item 5-B.

²⁶ See ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* for requirements and guidance dealing with fraud risk factors.

50. When assessing the risks of material misstatement arising from fraudulent financial reporting, the audit team identifies areas in disclosures where fraud could occur and develops an appropriate response. The identification process includes considering the type, significance, pervasiveness, and likelihood of the risk of fraud. Examples of increased risks of fraudulent financial reporting include:
- Difficult financial market conditions may give rise to increased incentives for fraudulent financial reporting. For example, to avoid breaching loan covenants items on the face of the balance sheet may be misclassified, or disclosures about commitments may be omitted;
 - The more complex the underlying accounting, the higher the risk that inappropriate disclosures may exist or that disclosures may not be understandable;
 - The more subjective the recorded information, the higher the risk that the related disclosures do not properly explain the calculations and related sensitivities;
 - The less sophisticated the method with which the financial statements are compiled, the higher the risk for misapplication or omission of disclosures.
 - The higher the risk of the override of controls, the higher the risk for fraudulent financial reporting.
 - The more immaterial or irrelevant disclosures that are included, the higher the risk that the disclosures overall will not be understandable.

Other Considerations for the Auditor

51. To identify the risks of material misstatements in disclosures, the auditor considers the information gathered in obtaining an understanding of the entity and its environment to identify matters that could impact the financial statements. This provides a basis for considering the appropriate audit approach for designing and performing further audit procedures in accordance with ISA 330.²⁷
52. The evolving nature of disclosures, in particular those related to fair value information and other estimates involving judgment and complex measurements, may lead to an increased risk of material misstatement. Other matters affecting the risk of material misstatement include:
- Disclosures are often prepared late in the financial reporting process and may be less formal and less structured;
 - Different interpretations in applying the concept of materiality to disclosures. One result of this is that the financial statements may have excessive disclosures which may obscure important information.
 - The nature of some disclosures such as objective-based disclosures, where the assessment of meeting the objective of the disclosure requirements may be highly judgmental.
 - Omissions of disclosures which are significant to users of the financial statements, such as future committed cash flows.

²⁷ ISA 330, *The Auditor's Responses to Assessed Risks*

- The verifiability of some information included in disclosures, such as forward-looking information.
53. When assessing the risk of material misstatement in disclosures, in applying their professional judgment and identifying disclosures where further consideration may be warranted, the auditor considers:
- The effect on the users if the disclosure was not made, not understandable or poorly worded;
 - The completeness of the disclosures, including objective-based disclosures;
 - Relevant controls, and their operating effectiveness, relating to the financial reporting process.
 - Incentives for management or employees to engage in fraudulent financial reporting, to hide fraud or error, avoid breaching regulatory, liquidity or borrowing limits, avoid reporting losses or other information to the users of the financial statements or for personal gain.
54. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of an audit as additional information is obtained. Remaining alert during the audit, for example, when inspecting records or documents, may assist the auditor in identifying arrangements or other information that may indicate the existence of disclosures that management has not previously identified or disclosed to the auditor.
55. As financial statements are often prepared later in the financial reporting process, this may impact the timing of the availability of the evidence available for the audit for some disclosures and will therefore affect the timing of planned audit procedures.