

Disclosures in the Audit of Financial Statements – Conforming Amendments to Other ISAs

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

Requirements

The Entity's Internal Control

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Components of Internal Control

Control environment

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

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: (Ref: Para. A89–A89a)

- (a) The classes of transactions in the entity's operations that are significant to the financial statements;
- (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
- (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and
- (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A8990–A93)

This understanding of the information system relevant to financial reporting shall include relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers.

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Identifying and Assessing the Risks of Material Misstatement

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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 (including the quantitative or qualitative aspects of such disclosures) in the financial statements; (Ref: Para. A127–A128b)
- (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. (Ref: Para. A131a)

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;¹
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- Identifying areas relating to amounts or disclosures in the financial statements where special audit consideration may be necessary, for example: related party transactions, the appropriateness of or management's use of the assessment of the entity's ability to continue as a going concern assumption, 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.

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¹ ISA 320, *Materiality in Planning and Performing an Audit*

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.

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

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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:

- 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;
- 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.*

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* When the conforming amendments become effective, 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))

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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.

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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. This understanding assists the auditor in determining whether related party transactions have been appropriately identified, and accounted for, appropriately and adequately disclosed in the financial statements. ISA 550² 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:
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- Investments and investment activities such as:

² ISA 550, *Related Parties*

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- Financing and financing activities such as:

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

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

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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 whether the financial statements include adequate disclosures.

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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)

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A89a. Financial statements may contain information that is obtained from outside of the general and subsidiary ledgers. Examples of such information may include:

- Information obtained from lease agreements disclosed in the financial statements, such as renewal options or future lease payments.

- Information disclosed in the financial statements that is produced by an entity's risk management system.
- Fair value information produced by management's experts and disclosed in the financial statements.
- Information disclosed in the financial statements that has been obtained from models, 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, such as:
 - Assumptions developed internally that may affect an asset's useful life; or
 - Data such as interest rates that are affected by factors outside the control of the entity.
- Information disclosed in the financial statements about sensitivity analyses derived from financial models that 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 assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern.³

A89b. The understanding of the information system relevant to financial reporting required by paragraph 18 of this ISA (including the understanding of relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers) is a matter of the auditor's professional judgment. For example, certain amounts or disclosures in the entity's financial statements (such as disclosures about credit risk, liquidity risk, and market risk) may be based on information obtained from the entity's risk management system. However, the auditor is not required to understand all aspects of the risk management system, and uses professional judgment in determining the necessary understanding.

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Considerations specific to smaller entities

A93. The information systems, and related business processes, relevant to financial reporting in small entities, including relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers, are likely to be less sophisticated than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's information systems relevant to financial reporting and processes may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

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³ See paragraphs 19–20 of ISA 570 (Revised).

A99a. Control activities relevant to the audit may include controls established by management that address risks of material misstatement related to 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 that is obtained from outside of the general and subsidiary ledgers.

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Identifying and Assessing the Risks of Material Misstatement

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

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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 ~~management's~~ a lack of management competence or lack of oversight over the preparation of the financial statements may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

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The Use of Assertions

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

A123a. The auditor may use the assertions as described above in paragraph A124(a)-(b) 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 classes of transactions and events, and related disclosures, with the assertions about account balances, and related disclosures.

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

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

- (a) Assertions about classes of transactions and events, and related disclosures, for the period under audit:
 - (i) Occurrence—transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
 - (ii) Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
 - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
 - (iv) 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—financial and other information are disclosed fairly and at appropriate amounts 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) Classification—assets, liabilities and equity interests have been recorded in the proper accounts.
 - (vi) 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.
- ~~(c) —Assertions about presentation and disclosure:~~
 - ~~(i) —Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.~~
 - ~~(ii) —Completeness— all disclosures that should have been included in the financial statements have been included.~~
 - ~~(iii) —Classification and understandability— financial information is appropriately presented and described, and disclosures are clearly expressed.~~
 - ~~(iv) —Accuracy and valuation— financial and other information are disclosed fairly and at appropriate amounts.~~

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 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 with the assertions about account balances.~~ [Moved to paragraph A123a]

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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 200.⁴

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 320,⁵ 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.⁶

A128b. The auditor's consideration of disclosures in the financial statements when identifying risks includes quantitative and qualitative disclosures, the misstatement of which could be material (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole). Depending on the circumstances of the entity and the engagement, examples of disclosures that will have qualitative aspects and 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.
- 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.

⁴ ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, paragraph 15

⁵ ISA 320, Materiality in Planning and Performing an Audit, paragraph A1

⁶ ISA 320, paragraph 4

Considerations specific to smaller entities

A128c. Disclosures in the financial statements of smaller entities may be less detailed or less complex (e.g., some financial reporting frameworks allow smaller entities to provide fewer disclosures in the financial statements). However, this does not relieve the auditor of the responsibility to obtain an understanding of the entity and its environment, including internal control, as it relates to disclosures.

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Material Misstatements

A131a. Potential misstatements in individual statements and disclosures may be judged to be material due to size, nature or circumstances. (Ref: Para. 26(d))

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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. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.
- Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Deficiencies in internal control, especially those not addressed by management.

- Incentives for management and employees to engage in fraudulent financial reporting.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including accounting estimates, and related disclosures.
- Omission, or obscuring, of significant information in disclosures.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.