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AUDITING DISCLOSURES

WEIGHING OUR WORDS

Financial statement disclosures continue to expand and are increasingly qualitative and subjective. We examine the IAASB's recent amendments to the International Auditing Standards (ISAs), which are intended to support a more robust, consistent process of auditing disclosures. By ***Lindsay Croeser***

In order to drive improved focus on disclosures throughout the audit process and to clarify the audit work effort required on disclosures, the IAASB undertook a specific project to update the ISAs to enhance the requirements for auditors. The more significant new and amended requirements for auditors, and related guidance, are summarised below.

The definition of 'financial statements' in ISA 200, *Overall Objectives of the Independent Auditor,* and the Conduct of an Audit in Accordance with International Standards on Auditing says that financial statements are a 'structured representation of historical financial information, including disclosures'. This definition has been expanded through addition of the following clarification relating to disclosures: 'Disclosures comprise explanatory or descriptive information, set out as required, expressly permitted or otherwise allowed by the applicable financial reporting framework, on the face of a financial statement, or in the notes, or incorporated therein by cross-reference.' This serves to highlight that disclosures are an important element of financial reporting, whether presented within the financial statements or otherwise.

AUDITOR CONSIDERATIONS WHEN COMMENCING THE ENGAGEMENT

ISA 210, *Agreeing the Terms of Audit Engagements,* recommends that the engagement agreement requests that management provides the financial statement information early in the audit process, including information that is obtained from outside the general and subsidiary ledgers.

ISA 260 (Revised), *Communication with Those Charged with Governance,* focuses auditor attention on communicating an overview of the planned scope and timing of the audit. This may also include addressing the implications on disclosures of any significant changes within the applicable financial reporting framework, or in the entity's environment, financial condition or activities.

CONSIDERATIONS WHEN PERFORMING THE AUDIT RISK ASSESSMENT AND PLANNING THE AUDIT

ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements,* draws the auditor's attention to the possibility of fraudulent financial reporting through intentionally omitting, obscuring or misstating required disclosures. ISA 240 highlights that the audit team's discussion of the susceptibility of the entity's financial statements to material misstatement due to fraud needs to include assessment of this risk in relation to disclosures.

ISA 300, *Planning an Audit of Financial Statements,* focuses auditor attention on the need for the timely consideration of disclosures in developing the overall audit strategy. Given the wide range of information and the level of detail that may be encompassed in management's disclosures, determining the nature, timing and extent of planned risk assessment and audit procedures as they relate to disclosures is an important consideration at the start of the audit. Early consideration assists the auditor in planning adequate time for addressing disclosures in the same way as for classes of transactions and events, and account balances.

ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment,* includes some of the more fundamental changes. As part of understanding the business, the auditor is required to reflect on those disclosures where the risk of material misstatement is high. The auditor's consideration should include areas where there have been changes in the environment and areas over which it has been difficult to obtain sufficient appropriate audit evidence in the past. Auditors are reminded that disclosures may come from information systems outside the general and subsidiary ledgers. Useful examples help the auditor understand other possible sources of disclosures and highlight the importance of judgement in determining the level of understanding required over these additional information systems.

Most importantly, the amendments have introduced a new assertion for classes of transactions and events, and related disclosures, named 'presentation'. In addition to the existing assertions of occurrence, completeness, accuracy, cut-off and classification, the auditor must consider whether 'transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable'. When expressed in relation to account balances and related disclosures, the presentation assertion describes how 'assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable'. Auditors and preparers must ensure that their processes specifically address the new presentation assertion. This will establish a more consistent work effort for auditing disclosures.

The existing assertions on both classes of transactions and account balances have also been modified to make more specific reference to the disclosure aspect of each assertion. For example, the completeness assertion now contains 'all related disclosures that should have been included in the financial statements have been included'. The application guidance also highlights that those same assertions may be used to evaluate the risks related to disclosures that are not directly related to classes of transactions or account balances (that is, other disclosures), for example the risk management disclosures.

Auditors are comfortable in applying the concept of quantitative materiality to the audit of accounts and disclosures in the financial statements. The application of judgement in determining qualitative materiality is decidedly trickier. The amendments to ISA 320, *Materiality in Planning and Performing an Audit*, as well as changes to ISA 315, provide guidance on the application of materiality to qualitative disclosures to determine whether they are of such importance to the users as to potentially affect their decisions taken on the basis of the financial statements as a whole. For example, qualitative disclosures regarding liquidity or debt covenants, events that lead to impairment losses or key sources of estimation uncertainty if misstated or omitted may paint a fundamentally different picture of the entity. Amendments to ISA 450, *Evaluation of Misstatements Identified during the Audit,* explain that each misstatement of a qualitative disclosure, other than those that are clearly trivial, should be accumulated and evaluated. The new application guidance also reminds us that misleading disclosures resulting from management bias or extensive duplication or uninformative disclosures that may obscure a proper understanding of matters may also be considered a material misstatement.

CONSIDERATIONS FOR RESPONDING TO THE ASSESSED AUDIT RISKS

ISA 330, *The Auditor's Responses to Assessed Risks,* contains expanded requirements for substantive procedures on the financial statement closing process. The auditor is required to reconcile the information in the financial statements not only to the general and subsidiary ledgers, but also to any other sources from which the information contained in the disclosures is drawn. Further, procedures around assessing the adequacy of presentation of the financial statements require the auditor to assess and respond to the classification and presentation assertions for the financial statements.

CONSIDERATIONS WHEN FORMING AN OPINION AND REPORTING ON THE FINANCIAL STATEMENTS

Finally, the new requirements in ISA 700 (Revised), *Forming an Opinion and Reporting on the Financial Statements,* include evaluating whether the financial statements appropriately disclose the significant accounting policies selected and applied and whether they have been presented in an understandable manner. The new requirements also require that the auditor evaluate whether the information presented in the financial statements is relevant, reliable, comparable and understandable.

The effect of these changes will be most keenly felt in entities where the disclosure process is onerous and where historically this process has not been prioritised early on in the financial statement closing process. Preparers and auditors will need to engage, from an early stage, in effective dialogue around disclosures throughout the audit process. Users of the financial statements ought to rest assured knowing that not only the numbers, but also the words have been appropriately weighed.

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