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| --- | --- | --- |
| **Client:** | **${client}** | |
| **Period end date:** | **${start} - ${end}** | |
| **Ref. no.:** |  | |
| **Prepared by:** | ${user} | **Date:** |
| **Approved by Manager:** | ${manager} | **Date:** |
| **Approved by Partner:** | ${partner} | **Date:** |

Guidance (click to expand):

This template is designed to serve as a documentation template for an engagement team's understanding of the entity and its environment and the applicable financial reporting framework. Engagement team is required to document the risk assessment procedures performed and the sources of information from which the understanding was obtained/updated.

The auditor’s understanding provides a basis for identifying and assessing the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

This documentation template consists of different elements of understanding of the entity and its environment as per ISA 315 (Revised). The matters to consider column assists the auditor in understanding the stated element by providing the auditor with matters to think about when obtaining the understanding.

The auditor shall perform the following procedures to obtain/update this understanding (**ISA 315.14-17**):

1. Inquiries directed towards management and those charged with governance and others within the entity who in our judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. For example:
2. Inquiries directed towards those charged with governance may help the auditor understand the extent of oversight by those charged with governance over the preparation of the financial statements by management.
3. Inquiries of employees responsible for initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
4. Inquiries directed towards in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contractual terms.
5. Inquiries directed towards marketing or sales personnel may provide information about changes in the entity’s marketing strategies, sales trends, or contractual arrangements with its customers.
6. Inquiries directed towards the risk management function (or inquiries of those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
7. Inquiries directed towards IT personnel may provide information about system changes, system or control failures, or other IT-related risks.
8. Inspection to support, corroborate or contradict inquiries of management and others, and to provide information about the entity and its environment. For example inspection of documents, records, internal control manuals and reports prepared by management and those charged with governance as well as information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; regulatory or financial publications; or other external documents about the entity’s financial performance.
9. Observation to support, corroborate or contradict inquiries of management and others, and to provide information about the entity and its environment. For example observation of entity’s operations, premises and plant facilities and behaviours and actions of management and those charged with governance.
10. Analytical performed as risk assessment procedures to identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that indicate matters that may have audit implications including identifying risks of material misstatement, especially risks of material misstatement due to fraud. Analytical procedures may:
11. Include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold (non-financial); and
12. Use data aggregated at a high level. Accordingly, the results of those analytical procedures may provide a broad initial indication about the likelihood of a material misstatement.
13. Consider additional information obtained from other engagements performed for the entity.
14. Consider information obtained from previous audits and its relevance to the current period for example:
15. Past misstatements and whether they were corrected on a timely basis.
16. The nature of the entity and its environment, and the entity’s system of internal control (including control deficiencies).
17. Significant changes that the entity or its operations may have undergone since the prior financial period.
18. 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.
19. Discussions among engagement team.

This document also contains examples of events or conditions that may indicate the existence of risks of material misstatement at the assertion level. The risks identified and their impacts need to be reflected in the audit strategy. The purpose of this template is to document how we determine the impact of the risks identified.

Understanding the Entity and Its Environment and the Applicable Financial Reporting Framework

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| **Matters to consider** | **Documentation of the understanding, including how the understanding was obtained (ISA 315.38(b))** | | **Document risks identified** **and identify where their impact will be considered:** | |
| ISA requirement: The entity’s organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT (ISA 315.19(a)(i)) | | | | |
| **Organizational structure and ownership *(ISA 315.A56)***   * The complexity of the entity’s structure. For example, the entity may be a single entity or the entity’s structure may include subsidiaries, divisions or other components in multiple locations. Further, the legal structure may be different from the operating structure. Complex structures often introduce factors that may give rise to increased susceptibility 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, including related parties. This understanding may assist in determining whether related party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial statements. * The distinction between the owners, those charged with governance and management. For example, in less complex entities, owners of the entity may be involved in managing the entity, therefore there is little or no distinction. In contrast, such as in some listed entities, there may be a clear distinction between management, the owners of the entity, and those charged with governance. * The structure and complexity of the entity’s IT environment. For example an entity may: * Have multiple legacy IT systems in diverse businesses that are not well integrated resulting in a complex IT environment. * Be using external or internal service providers for aspects of its IT environment (e.g., outsourcing the hosting of its IT environment to a third party or using a shared service centre for central management of IT processes in a group). | **Organizational structure and ownership**  *[Text]* | | |  |  | | --- | --- | | **Inherent Risk Factor** | *[complexity; subjectivity; change; uncertainty; and/or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk]* | | **Risks Identified?** | *[include description of the risk identified]* | | **Impact on:** |  | | **FS Component** | *[specific account/disclosure or pervasive risk]* | | **Materiality** |  | | **Fraud Risk Assessment** |  | | **Risk Assessment Analytics** |  | | **Other:** |  |   For example:   * Organizational structures and ownership – The existence of a number of direct and/or indirect subsidiaries (complexity). * Business operations – The existence of complex alliances and joint ventures. * Business operations – Loss of significant customers.­ (change). * Business operations – Changes in key personnel including departure of key executives. * Business operations – Significant transactions with related parties (susceptibility to misstatement due to fraud risk factors). * Financing and financing activities – Use of off-balance sheet finance, special-purpose entities, and other complex financing arrangements. * Business risks – Changes in the industry in which the entity operates. * Business risks – Developing or offering new products or services, or moving into new lines of business (change). * Business risks – Changes in the supply chain. * Business risks – Entities or business segments likely to be sold (change). * Business risks – Changes in the entity such as large acquisitions or reorganizations or other unusual events. * Business risks – Expanding into new locations (change). * Business risks – Inception of investigations into the entity’s operations or financial results by regulatory or government bodies (change). * Business risks – Impact of new legislation related to environmental protection (change). * Business risks – New constraints on the availability of capital and credit (change). * Business risks – Changes in the IT environment. * Business risks – Installation of significant new IT systems related to financial reporting (change). | |
| **Governance *(ISA 315.A60)***   * Whether any or all of those charged with governance are involved in managing the entity. * The existence (and separation) of a non-executive Board, if any, from executive management. * Whether those charged with governance hold positions that are an integral part of the entity’s legal structure, for example as directors. * The existence of sub-groups of those charged with governance, such as an audit committee, and the responsibilities of such a group. * The responsibilities of those charged with governance for oversight of financial reporting, including approval of the financial statements. | **Governance**  *[Text]* | |
| **Business operations (ISA 315 (Appendix 1)(5)(a)):**   * Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities. * Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks). * Alliances, joint ventures, and outsourcing activities. * Geographic dispersion and industry segmentation. * Location of production facilities, warehouses, and offices, and location and quantities of inventories. * Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post- employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters). * Research and development activities and expenditures. * Transactions with related parties. | **Business operations**  *[Text]* | |
| **Investments and investment activities (ISA 315 (Appendix 1)(5)(b)):**   * Planned or recently executed acquisitions or divestitures. * Investments and dispositions of securities and loans. * Capital investment activities. * Investments in non-consolidated entities, including non-controlled partnerships, joint ventures and non-controlled special-purpose entities. | **Investments and investment activities**  *[Text]* | |
| **Financing and financing activities (ISA 315 (Appendix 1)(5)(c)):**   * Ownership structure of major subsidiaries and associated entities, including consolidated and non-consolidated structures. * Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements. * Beneficial owners (for example, local, foreign, business reputation and experience) and related parties. * Use of derivative financial instruments. | **Financing and financing activities**  *[Text]* | |
| **Objectives and strategies and related business risks**  Examples of matters that the auditor may consider when obtaining an understanding of the entity’s business model, objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include ***(ISA 315.A64)***:   * Industry developments, such as the lack of personnel or expertise to deal with the changes in the industry; * New products and services that may lead to increased product liability; * Expansion of the entity’s business, and demand has not been accurately estimated; * New accounting requirements where there has been incomplete or improper implementation; * Regulatory requirements resulting in increased legal exposure; * Current and prospective financing requirements, such as loss of financing due to the entity’s inability to meet requirements; * Use of IT, such as the implementation of a new IT system that will affect both operations and financial reporting; or * The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements. | **Objectives and strategies and related business risks**  *[Text]* | |
| ISA requirement: Relevant industry, regulatory, and other external factors (ISA 315.19(a)(ii)) | | | | |
| **Industry factors**  Industry conditions such as the competitive environment, supplier and customer relationships, and technological developments **(*ISA 315.A68*)**:   * The market and competition, including demand, capacity, and price competition * Cyclical or seasonal activity * Product technology relating to the entity’s products * Energy supply and cost   The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience **(ISA 315.A69).** | **Industry factors**  *[Text]* | | |  |  | | --- | --- | | **Inherent Risk Factor** | *[complexity; subjectivity; change; uncertainty; and/or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk]* | | **Risks Identified?** | *[include description of the risk identified]* | | **Impact on:** |  | | **FS Component** | *[specific account/disclosure or pervasive risk]* | | **Materiality** |  | | **Fraud Risk Assessment** |  | | **Risk Assessment Analytics** |  | | **Other:** |  |   For example:   * Regulatory – Operations that are subject to a high degree of complex regulation (complexity). * Other external factors – Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies (change). | |
| **Regulatory factors**  Those laws and regulations to which an entity is subject constitute the legal and regulatory framework **(*ISA 250.2*)**:   * The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity’s financial statements. * Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity’s financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health, and equal employment opportunity). Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.   Auditor shall obtain an understanding as mentioned below.  Applicable financial reporting framework and the legal and political environment and any changes thereto, such as **(*ISA 315.A70*)**:   * Regulatory framework for a regulated industry, for example, prudential requirements, including related disclosures. * Legislation and regulation that significantly affect the entity’s operations, for example, labor laws and regulations. * Taxation legislation and regulations. * 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 restriction policies. * Environmental requirements affecting the industry and the entity’s business.   How the entity complies with that framework, for example **(*ISA 250.A11*)**:   * Use the auditor’s existing understanding of the entity’s industry, regulatory and other external factors; * Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements; * Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity; * Inquire of management concerning the entity’s policies and procedures regarding compliance with laws and regulations; and * Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims. * Or review of relevant documents, reports and correspondence with licensing and regulatory authorities. | **Regulatory factors**  *[Text]* | |
| **Other external factors**  Other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation ***(ISA 315.A73).*** | **Other external factors**  *[Text]* | |
| **ISA requirement: The measures used, internally and externally, to assess the entity’s financial performance (ISA 315.19(a)(iii))** | | | | |
| Key indicators used for evaluating financial performance may include ***(ISA 315.A77)***:   * Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics. * Period-on-period financial performance analyses. * Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports. * Employee performance measures and incentive compensation policies. * Comparisons of an entity’s performance with that of competitors.   External parties may also review and analyze the entity’s financial performance, in particular for entities where financial information is publicly available. The auditor may also consider publicly available information to help the auditor further understand the business or identify contradictory information such as ***(ISA 315.A79)***:   * Information from analysts or credit agencies, news and other media, including social media * Taxation authorities. * Regulators. * Trade unions. * Providers of finance.   Such financial information can often be obtained from the entity being audited. | *[Text]* | | |  |  | | --- | --- | | **Inherent Risk Factor** | *[complexity; subjectivity; change; uncertainty; and/or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk]* | | **Risks Identified?** | *[include description of the risk identified]* | | **Impact on:** |  | | **FS Component** | *[specific account/disclosure or pervasive risk]* | | **Materiality** |  | | **Fraud Risk Assessment** |  | | **Risk Assessment Analytics** |  | | **Other:** |  | | |
| ISA requirement: The applicable financial reporting framework, and the entity’s accounting policies and the reasons for any changes thereto (ISA 315.19(b)) | | | | |
| **Financial reporting practices in terms of the applicable financial reporting framework *(ISA 315.A82)***   * Accounting principles and industry-specific practices, including for industry-specific significant 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. * Accounting for financial instruments, including related credit losses. * Foreign currency assets, liabilities and transactions. * Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for cryptocurrency). | | **Financial reporting practices in terms of the applicable financial reporting framework**  *[Text]* | | |  |  | | --- | --- | | **Inherent Risk Factor** | *[complexity; subjectivity; change; uncertainty; and/or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk]* | | **Risks Identified?** | *[include description of the risk identified]* | | **Impact on:** |  | | **FS Component** | *[specific account/disclosure or pervasive risk]* | | **Materiality** |  | | **Fraud Risk Assessment** |  | | **Risk Assessment Analytics** |  | | **Other:** |  |   For example:   * Events or transactions that involve significant measurement uncertainty, including accounting estimates, and related disclosures. * Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation (uncertainty). * Opportunities for management and employees to engage in fraudulent financial reporting, including omission, or obscuring, of significant information in disclosures (susceptibility to misstatement due to fraud risk). * Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end (susceptibility to misstatement due to fraud risk). * Transactions that are recorded based on management’s intent, for example, debt refinancing, assets to be sold and classification of marketable securities (susceptibility to misstatement due to management bias or other fraud risk). * Accounting measurements that involve complex processes. * A wide range of possible measurement criteria of an accounting estimate. For example, management’s recognition of depreciation or construction income and expenses (subjectivity). * Management’s selection of a valuation technique or model for a non-current asset, such as investment properties (subjectivity). * Application of new accounting pronouncements (change). * Lack of personnel with appropriate accounting and financial reporting skills. * Past misstatements, history of errors or a significant amount of adjustments at period end. |
| **The entity’s selection and application of accounting policies, including the reasons for changes thereto *(ISA 315.A82):***   * The methods the entity uses to recognize, measure, present and disclose significant and unusual transactions. * The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. * Changes in the environment, such as changes in the applicable financial reporting framework or tax reforms that may necessitate a change in the entity’s accounting policies. * Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt, or comply with, such requirements.   The auditor shall evaluate whether the entity’s accounting policies are appropriate and consistent with the applicable financial reporting framework ***(ISA 315.20).*** | | **The entity’s selection and application of accounting policies, including the reasons for changes thereto**  *[Text]* | |