Audit Risk – Significant Changes

This agenda paper highlights the significant changes made by the Joint Risk Assessments Task Force (TF) to the Audit Risk exposure drafts. The Audit Risk documents presented to the IAASB for approval as final ISAs are:

1. Revision of ISA 200, “Objective and Principles Governing an Audit of Financial Statements”;
2. ISA, “Audit Evidence”;
3. ISA, “Understanding the Entity and Assessing the Risks of Material Misstatement” (ISA Assessing Risks); and

The significant issues raised by respondents through the exposure draft process and the TF’s initial reaction to the issues was presented and discussed with the IAASB at its July 2003 meeting. In reviewing the final drafts for approval, IAASB Members may find it helpful to refer to the Significant Issues paper presented in July 2003.

General Matters

1. **Structure and Length.** The exposure drafts were edited to eliminate unnecessary repetition and to delete or move guidance of a purely explanatory nature into appendices where appropriate. Much of the guidance on internal control was, however, considered to be necessary to provide context for what is required of the auditor and, consequently, much of the guidance has been retained within the body of the ISA. Some respondents expressed concern that the extent of internal control guidance may divert attention away from other important areas where obtaining audit evidence through substantive procedures may be of particular importance. Subject matter specific ISAs such as ISA 540, “Audit of Accounting Estimates,” and ISA 550, “Related Parties,” are structured to provide additional requirements and guidance on the audit of such matters. An appropriate understanding of internal control remains an important aspect of the analysis and assessment of risk.

2. The inclusion of new guidance (for example, smaller entity considerations) and further clarification of principles and essential procedures (for example, the required understanding of internal control) has increased the overall length of the documents.

3. **Effective Date.** At the July 2003 IAASB meeting, the TF proposed an effective date for audits for periods beginning on or after January 1, 2005. The TF recognizes that in some jurisdictions, entities may finalize their financial periods a few days before or after their statutory yearend. An effective date of periods beginning on or after December 15, 2004 has been proposed in the ISAs.

4. **Preface Text Box.** Revisions to the template Preface text box are currently being considered by IAASB Staff. The Preface text will incorporate the revised text once it is finalized.

5. **Numbering of the ISAs.** The ISAs will be numbered according to recommendations by the IAASB Staff.
Smaller Entity Considerations

6. **Additional Guidance.** Paragraphs 16 and 17 of exposure draft ISA Assessing Risks tried to highlight the way in which the auditor’s procedures may vary for smaller and larger entities. In response to comments, the TF has included further guidance on specific areas where smaller entity considerations are relevant. The approach taken is also consistent with the TF’s understanding of the IAASB’s decision to begin the process of adopting smaller entity considerations within ISAs.

7. The smaller entity considerations that have been added relate primarily to the aspects of understanding of the entity, its environment and its internal control. The Appendix to this paper provides a summary of the key paragraphs relating to smaller entity considerations.

Revisions to ISA 200 Objective and General Principles Governing an Audit of Financial Statements

8. The revisions to the exposure draft relate primarily to clarifying the description of “risk of material misstatement”. As it was not within the TF’s scope to revise the whole of ISA 200, there are only certain minor conforming revisions to ISA 200 other than the proposed paragraphs relating to audit risk.

9. The TF is aware that the ISA 700 Task Force is also proposing changes to ISA 200. The version included in this section of the agenda deals only with those matters arising from the audit risk project. The TF has assumed that, when the proposed audit risk revisions are approved, it will be issued in its revised form. The ISA 700 Task Force has included in its section of the agenda a version of ISA 200 showing as revisions only the further changes it proposes, based on the draft submitted by the TF in this part of the agenda.

ISA Audit Evidence

10. **Extent of Bold Statements.** The primary purpose of ISA Audit Evidence is to describe and define what constitutes audit evidence in an audit of financial statements. The exposure draft was structured around the basic principle requiring the auditor to obtain sufficient appropriate audit evidence to be able to draw conclusions on which to base the audit opinion. Two bold statements relating to audit evidence have been added as their requirements assist in clarifying the concept of “sufficient appropriate audit evidence” and the use of assertions:

    (a) The need to ensure information produced by the entity and used by the auditor is accurate and complete is emphasized by the following bold statement:

    11. **When information used by the auditor to perform audit procedures is produced by the entity’s information system, the auditor should obtain audit evidence about the accuracy and completeness of the information.** (This requirement was included as guidance in paragraph 13 of the exposure draft ISA Auditor’s Procedures.)

    (b) The Audit Risk ISAs and other ISAs discuss specific situations in which the auditor is required to obtain audit evidence at the assertion level. A requirement to use assertions in assessing risks and in the design and performance of audit procedures has been added to reinforce the importance of the assertions described in ISA Audit Evidence. The requirement states:
15. The auditor should use assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of audit procedures.

The addition of the above bold statements also responds to comments that it was unusual for an ISA to have only one bold statement.

11. Presentation and Expression of Assertions. Some respondents suggested condensing the presentation of the assertions as well as proposing other assertions. The TF has retained the presentation in the three categories (classes of transactions, account balances, and presentation and disclosure) as the TF considers the more detailed presentation provides a clearer link between the assertions and the financial statement elements, and supports the requirement to use assertions in “sufficient detail”.

12. The assertion “accuracy” was not changed to “measurement” as some had proposed. The TF believed this to be right, having regard in particular to non-financial and other qualitative aspects. However, a reference to measurement has been added as part of the guidance added to relate management’s assertions to the more detailed assertions used by the auditor (see paragraph 16 of Audit Evidence).

ISA Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

13. Understanding the Entity’s Objectives, Strategies and Business Risks (Paragraphs 30 to 34). The relationship between business risk and the risk of material misstatement is further discussed in paragraph 32 on the consequences a business risk may have for the financial statements.

14. Measurement and Review of the Entity’s Financial Performance. This section has been edited to describe more clearly the entity’s performance measures and the relevance of understanding such measures. There was some misunderstanding about how this aspect differs from the internal control component “Monitoring of Control”. Paragraph 36 has been added to clarify the overlap between these two aspects of understanding and their differences.

15. Internal Control Relevant to the Audit and Control Activities. As internal control is a wide-ranging topic relating to the entity’s objectives regarding financial reporting, operations and compliance, the guidance in the “Controls Relevant to the Audit” section was intended to clarify what was relevant to the auditor’s work. Some respondents did not find this guidance sufficient and the following changes have been made to clarify the scope of understanding required:

- Emphasizing the auditor’s understanding of internal control as those “relevant to the audit” by adding this phrase to the overall requirement to understand internal control (paragraph 41).
- Emphasizing that controls relevant to the audit vary depending on the specific circumstances and the need, therefore, to exercise professional judgment (paragraph 48).
- Emphasizing the relationship between controls relevant to the audit and the auditor’s considerations in assessing risks of material misstatement and designing and performing further procedures in response to the risks (paragraph 48).
• Placing the guidance relating to controls relevant to the audit immediately after the description of internal control and also to add reference to the specific discussion of controls relevant to the audit within the guidance relating to each of the internal control component (paragraph 53).

16. **Control Activities.** Some respondents also expressed concern that the required scope of understanding of control activities may be too extensive given many controls may be interpreted as being relevant to financial reporting and consequently to the auditor’s risk assessment. The above revisions assist in focusing the auditor’s understanding of control activities on those controls relevant to assessing risks of material misstatement and designing and performing further procedures in response to the risks. The following revisions to the specific discussion of control activities have been made to further clarify the relationship to the auditor’s work:

- The bold statement (paragraph 90) has been changed to “**The auditor should obtain a sufficient understanding of those control activities to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks.**”
- Paragraph 91 emphasizes that the auditor’s primary consideration is whether and how a specific control activity prevents or detects misstatements.
- Paragraph 91 (last sentence) reiterates that control activities are relevant to the audit where the auditor considers it necessary to obtain an understanding in order to assess risks of material misstatement and to design further procedures.

17. **Internal Control and Application of “Understanding” for Each Component.** “Understanding” internal control is defined as evaluating the design of a control and determining whether it is implemented. Some respondents questioned whether this definition was suitable for the internal control components that are more of a supervisory nature, such as the control environment and the entity’s risk assessment process, as there may be less information available to determine whether the control has been implemented.

18. Although the nature of such components may differ from control activities, the TF believes the definition of “understanding” can apply to controls of a supervisory nature. To clarify how the definition of “understanding” can be applied to such controls, the guidance within each internal control component has been revised.

19. **Internal Control – Information System, Including the Related Business Processes, Relevant to Financial Reporting.** Paragraph 80 of the exposure draft (deleted text in marked draft), which dealt with certain IT aspects of information systems, has been changed from bold lettering to guidance because it was unnecessary in the light of the revised description of manual and automated elements of internal control (paragraphs 57 to 63). However, much of the guidance in exposure draft paragraph 80 is relevant to an understanding of the entity’s information system, whether manual or automated. It has therefore been revised and included in paragraphs 82 to 86.

20. **Significant Risks – Determining Significant Risks.** Many respondents were unclear as to how the requirement to assess risks of material misstatement related to the requirement to determine significant risks. Some comments suggest respondents may have interpreted ISA Assessing Risks as requiring an assessment of risks of material misstatement and also a separate exercise for the assessment of significant risks. This is not the intention; the auditor’s
determination of significant risks is an integral part of the assessment of risks. Paragraph 107 requires that—

“As part of the risk assessment as described in paragraph 99, the auditor should determine which of the risks identified are, in the auditor’s judgment, significant risks that require special audit consideration.” [Emphasis added.]

21. Certain assessed risks are of greater significance to the auditor’s risk assessment and the auditor’s procedures to obtain sufficient appropriate audit evidence because:
   - Not all assessed risks are as likely to occur or have the same effect to the financial statements if the risk occurs;
   - The nature of certain risks may make their audit of more significance: for example, assessed risks relating to non-routine transactions or those involving significant judgment.

22. **Significant Risks – Effect of Controls.** As the presence of controls affects the likelihood of occurrence and magnitude of a risk of misstatement, the auditor’s determination of significant risks excludes the effect of related controls. However, because the risk of material misstatement may be greater for significant risks, the auditor is required to evaluate the related controls (to the extent the controls have not been evaluated as part of the auditor’s risk assessment procedures). A number of respondents highlighted that the nature of non-routine transactions or matters involving significant judgment or measurement uncertainty is such that they may not be subject to the entity’s routine controls. Whether and how management has responded to risks that are not subject to routine controls is nevertheless an important part of the auditor’s risk assessment. Guidance has been added to paragraph 112 to emphasize the auditor’s consideration of whether and how management has responded to such risks including the importance of controls such as those of a supervisory or risk assessment nature.

23. **Documentation.** The overarching requirement relating to documentation is set out by ISA 230.02 which states: “The auditor should document matters which are important in providing evidence to support the audit opinion and evidence that the audit was carried out in accordance with ISAs.” Some respondents questioned whether ISA Assessing Risks needs to have the level of detail proposed in the exposure draft relating to the documentation requirements. The TF believes the level of detail is an appropriate expression of ISA 230.02’s requirement and is appropriate given the importance of understanding of the entity, the way in which the auditor uses the understanding and the importance of the auditor’s risk assessment. Therefore, the TF has retained the proposed documentation requirements modified as follows:
   - Paragraph 121(a): Documentation of the “significant decisions reached” at the engagement team discussion replaces “subject matter discussed” to focus on the results of the discussion and;
   - Paragraph 121(c): To clarify that the auditor’s documentation includes the identified and assessed risks.
   - Paragraph 121(d): To clarify that the auditor’s documentation as a result of the requirements of 112 and 114 includes the risks identified and the related controls.

24. Some respondents questioned whether auditors might interpret the details as a requirement to document every risk of misstatement for every assertion and consequently to produce extensive documentation for all assessed risks. The documentation requirements relate only to
identified and assessed risks of material misstatement: not every assertion or risk may be relevant. ISA Assessing Risks also recognizes that the manner in which the auditor documents the identified risks differs according to the auditor’s specific methodology. However, common tools such as audit programs and questionnaire are often used in practice to assist in assessing and documenting whether there is a risk of material misstatement.

ISA The Auditor’s Procedures in Response to Assessed Risks

25. **Primarily Performing Substantive Procedures.** As discussed in the Significant Issues paper presented to the IAASB in July 2003, the TF believes it is rare for an entity, even a small entity, to be devoid of internal control. Consequently, the TF believes it would be rare for an auditor’s whole audit approach to be performed by substantive procedures alone without some consideration of controls in assessing risk and influencing the auditor’s decision about further audit procedures. (Refer paragraphs 39 to 42 of the July 2003 Significant Issues paper.)

26. The TF considers that only in the case of an audit of a very small entity could the auditor adopt a primarily substantive approach. In an audit of very small entities, the auditor may determine that there are so few controls for them to be taken into account in assessing the risks of material misstatement. Paragraph 9 has been added to provide this guidance.

27. **Requirement to Perform Tests of Controls.** ISA Auditor’s Procedures requires the auditor to perform tests of controls in two specific circumstances:

   (a) When the auditor’s risk assessment is based on an expectation that controls are operating effectively, the auditor is required to perform tests of controls (paragraph 23). The auditor performs test of controls to obtain audit evidence to support the auditor’s reliance on their operating effectiveness; and

   (b) When substantive procedures alone do not provide sufficient appropriate audit evidence to reduce the risks of material misstatement to an acceptably low level (paragraph 25).

Some respondents suggested that ISA Auditor’s Responses should be clearer as to when the auditor is required to perform tests of controls. Guidance has been added to paragraphs 22, 24 and 25 to support the above requirements.

28. **Operating Effectiveness of Controls: Inquiry in Combination With Other Procedures.** The nature of inquiry is such that performing inquiry alone is not sufficient to obtain audit evidence about the operating effectiveness of controls. The following changes have been made in order to strengthen and more clearly express this principle.

   (a) Paragraph 29. A bold statement and guidance have been added to require the auditor to perform inquiry in combination with other audit procedures to test the operating effectiveness of controls;

   (b) Paragraph 39. The auditor is required to perform inquiry in combination with observation or inspection to confirm the auditor’s understanding of the effectiveness of controls obtained in prior audits.

29. **Testing Controls At Least Once Every Third Audit.** For controls that the auditor plans to rely on but which have not changed since they were last tested, ISA Auditor’s Response has retained the requirement for the auditor to test the control at least every third audit. The following changes have been made to clarify this requirement:
• The bold statement (paragraph 41) clarifies that the auditor tests the controls at least “once in every third audit”.

• The last sentence of paragraph 41 describes that the period between retesting cannot exceed two years. The last sentence of paragraph 43 further describes that the auditor plans to test a sufficient portion of controls in each audit period and at a minimum, each control is tested at least every third audit.

• To assist the auditor in determining whether to use audit evidence obtained in prior audits, additional guidance has been added to paragraph 42.

30. Requirement to Perform Substantive Procedures. Some respondents thought the extent of requirements and guidance related to tests of controls may reduce the emphasis on the need to perform substantive procedures. Performing substantive procedures in order to detect material misstatements at the assertion level continues to be an important response by the auditor, and there is no intention to downplay this. ISA Auditor’s Response establishes the general requirement to perform substantive procedures for each material class of transaction, account balance, and disclosure (paragraph 49) and for significant risks (paragraph 51).

31. Additional requirements to perform substantive procedures are contained in other subject matter specific ISAs. However, the following two bold statements have been added to emphasis the importance of performing audit procedures about the entity’s financial reporting process and the adequacy of the presentation of the financial statement including the related disclosures:

50. The auditor’s substantive procedures should include the following audit procedures related to the financial statement closing process:

(a) Agreeing the financial statements to the underlying accounting records;

(b) Examining material journal entries and other adjustments made during the course of preparing the financial statements; and

(c) Other procedures relating to the preparation of the financial statements as considered necessary.

65. The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with the applicable financial reporting framework.

32. Timing of Substantive Procedures. Additional guidance has been added on the use of substantive procedures in the remaining period where testing has been carried out to an interim date. In particular, guidance has been added relating to:

• Whether using substantive procedures only for the remaining period is appropriate based on the result of the auditor’s tests of controls or other substantive procedures performed at interim (paragraph 58).

• Considerations on the use of substantive analytical procedures during the remaining period (paragraph 60).

33. Documentation. A requirement to document the auditor’s conclusions on the use of audit evidence about the operating effectiveness of controls obtained in prior audits has been added (paragraph 73). This documentation requirement reflects the importance of this decision.
Appendix: Smaller Entity Considerations

This appendix presents the key paragraphs relating to smaller entity considerations in ISA “Understanding the Entity and Assessing the Risks of Material Misstatement.”

34. Smaller entities often do not set their objectives and strategies, or manage the related business risks, through formal plans or processes. In many cases there may be no documentation of such matters. In such entities, the auditor’s understanding is ordinarily obtained through inquiries of management and observation of how the entity responds to such matters.

40. Smaller entities ordinarily do not have formal processes to measure and review the entity’s financial performance. Management nevertheless often rely on certain key indicators which knowledge and experience of the business suggest are reliable bases for evaluating financial performance and taking appropriate action.

45. The way in which internal control is designed and implemented varies with an entity’s size and complexity. Specifically, smaller entities may use less formal means and simpler processes and procedures to achieve their objectives. For example, smaller entities with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures or detailed written policies. For some entities, in particular very small entities, the owner-manager may perform functions which in a larger entity would be regarded as belonging to several of the components of internal control. Therefore, the components of internal control may not be clearly distinguished within smaller entities, but their underlying purposes are equally valid.

66. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, for key areas, even in a very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. The potential for override of controls by the owner-manager depends to a great extent on the control environment and in particular, the owner-manager’s attitudes and awareness towards internal control.

71. Audit evidence for elements of the control environment may not be available in documentary form, in particular for smaller entities where communication between management and other personnel may be informal, yet effective. For example, management’s commitment to ethical values and competence are often implemented through the behavior and attitude they demonstrate in managing the entity’s business instead of in a written code of conduct. Consequently, management’s attitudes, awareness and actions are of particular importance in the design of a smaller entity’s control environment. In addition, the role of those charged with governance is often undertaken by the owner-manager where there are no other owners.

79. In a smaller entity, management may not have a formal “risk assessment process” as described in paragraph 76. For such entities, the auditor discusses with management how risks to the business are identified by management and how they are managed.

---

1 This ISA uses the term “owner-manager” to indicate the proprietors of entities who are involved in the running of the entity on a day-to-day basis.
[Next Section Begins at Page 1563]