

**Exposure Draft**  
**July 2018**

*Comments due: November 2, 2018*

*International Standard on Auditing*

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## Proposed International Standard on Auditing 315 (Revised)

Identifying and Assessing the  
Risks of Material Misstatement  
and

Proposed Consequential and  
Conforming Amendments to  
Other ISAs



International Auditing  
and Assurance  
Standards Board

## **About the IAASB**

This Exposure Draft was developed and approved by the International Auditing and Assurance Standards Board (IAASB).

The objective of the IAASB is to serve the public interest by setting high-quality auditing, assurance, and other related standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by the International Federation of Accountants (IFAC).

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## REQUEST FOR COMMENTS

This Exposure Draft, proposed ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement*, and conforming and consequential amendments, was developed and approved by the International Auditing and Assurance Standards Board® (IAASB®).

The proposals in this Exposure Draft may be modified in light of comments received before being issued in final form. **Comments are requested by November 2, 2018.**

Respondents are asked to submit their comments electronically through the IAASB website, using the "[Submit a Comment](#)" link. Please submit comments in both a PDF and Word file. First-time users must register to use this feature. All comments will be considered a matter of public record and will ultimately be posted on the website.

This publication may be downloaded from the IAASB website: [www.iaasb.org](http://www.iaasb.org). The approved text is published in the English language.

## EXPLANATORY MEMORANDUM

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## Executive Summary

A strategic objective identified as part of the IAASB's [Strategy for 2015–2019](#) is to ensure that the ISAs continue to form the basis for high-quality, valuable and relevant audits conducted worldwide by responding on a timely basis to issues noted in practice and emerging developments. In this regard, and in light of the findings from the IAASB's post-implementation review of the clarified ISAs and related outreach with its stakeholders, the IAASB undertook a global consultation on a number of interrelated topics, to obtain further insight to the challenges and issues that had been identified. The input from the IAASB's Invitation to Comment, [Enhancing Audit Quality in the Public Interest – A Focus on Professional Skepticism, Quality Control and Group Audits](#), helped inform its Work Plans and led to the commencement of a number of important standard-setting projects with the overarching objective of improving audit quality.

The approval in June 2018 of International Standard on Auditing (ISA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, signifies the first revised standard to be completed as part of the IAASB's work program 'Addressing the Fundamental Elements of an Audit,' which, subject to approval of due process by the Public Interest Oversight Board, is expected to be published in October 2018. This exposure draft (ED) of proposed ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement* (ED-315) is the second significant standard to be exposed as part of the IAASB's commitment to advancing audit quality globally. Exposure drafts of revisions to the IAASB's quality control standards that address the management of quality both at the firm level and the engagement level are expected to be approved at the end of 2018. The topic of professional skepticism is being considered as part of each project.

ISA 315 (Revised) sets out the risk assessment procedures that form the foundation for an audit of financial statements. The IAASB has proposed essential enhancements to the auditor's risk assessment process, with the objective of establishing more robust requirements and appropriately detailed guidance to drive auditors to perform consistent and effective identification and assessment of the risks of material misstatement. A more robust risk assessment process enhances the basis upon which auditors design and perform audit procedures that are responsive to the risks of material misstatement. Through the performance of audit procedures, the auditor obtains sufficient appropriate audit evidence to provide a basis for the audit opinion.

The IAASB has also focused on the ability of ED-315 to be applied to audits of entities with a wide range of circumstances and of different complexity. In considering how the standard is scalable, the IAASB has innovatively embedded scalability considerations within the application and other explanatory material of ED-315, and through illustrations of simple matters or circumstances contrasted to those that are more complex to help demonstrate the scalability of the standard. To assist with understanding how the standard should be implemented, IAASB Staff has developed three flowcharts, which have been published as supplements to the Exposure Draft. The IAASB will give further consideration to the development of non-authoritative guidance as the standard is finalized.

Importantly, to modernize the proposed standard for changes in a continually evolving environment, revisions in particular have been made to:

- Promote a deeper understanding of the entity's business model and the risks that may arise from the application of the applicable financial reporting framework in the nature and circumstances of the entity and its environment;
- Explicitly acknowledge how auditors may use automated tools and techniques, including data analytics, to perform risk assessment procedures; and

- Enhance the auditor's required understanding of the entity's use of information technology (IT) relevant to financial reporting.

The organization, structure and workflow of ISA 315 (Revised) has also been a focus of the improvements in ED-315. ED-315 separately highlights the importance of, and provides enhanced requirements for, the auditor's understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control to provide a robust basis for the identification and assessment of the risks of material misstatement. Without seeking to change the fundamentals of the audit risk model, new concepts have however been introduced to better facilitate and focus the risk identification and assessment process, including to promote greater consistency in the determination of significant risks.

Professional skepticism plays a central role in any audit and ED-315 contains several key provisions that are designed to enhance the auditor's exercise of professional skepticism throughout the risk assessment process. In addition, specific focus has been placed on the auditor's understanding of the entity and its environment and its central role in the auditor's ability to effectively exercise professional skepticism throughout the audit.

In proposing the changes to ISA 315 (Revised), the IAASB has proposed numerous changes to various other ISAs to conform the other standards to proposed changes in ED-315, in particular, conforming and consequential changes have been proposed to ISA 330,<sup>1</sup> which includes requirements for the auditor's responses to the risks of material misstatement identified and assessed in accordance with ISA 315 (Revised). Conforming amendments to ISA 540 (Revised) will be published separately later in July 2018.

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<sup>1</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

## Section 1 Introduction

1. This memorandum provides background to, and an explanation of, the exposure draft of ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement* (ED-315), which was approved for exposure by the IAASB in June 2018.

### Section 1-1 – Background

2. In March 2009, the IAASB completed its Clarity Project, designed to improve the clarity and understandability of the International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC) 1<sup>2</sup>, thereby facilitating their consistent application.<sup>3</sup> One of the initiatives in the IAASB's Strategy and Work Program 2009–2011 was the development of a process for assessing the effectiveness of the implementation of the clarified ISAs.
3. The post-implementation review of the clarified ISAs was completed in 2013, and the [findings](#) from this review formed the basis for the IAASB's Strategy and Work Plans in 2015–2019. Findings with regard to ISA 315 (Revised) (extant ISA 315) suggested that reconsideration of the standard was needed as the comments received indicated that several aspects of the standard were not being understood or implemented in a consistent manner. Accordingly, the Board included planned work on extant ISA 315 in its Strategy and Work Plans for 2015–2019.
4. The ISA 315 Working Group commenced work in early March 2016 and undertook outreach with a wide group of stakeholders to further inform preliminary thinking on the issues identified by the ISA Implementation Monitoring Project related to ISA 315 (Revised). Auditors of small- and medium-sized entities (SMEs) noted specific challenges from a scalability perspective in effectively and efficiently applying extant ISA 315. One of the more significant challenges related to the extent to which understanding an entity's internal control is necessary when the auditor does not intend to rely on the operating effectiveness of the entity's controls. Inspection findings by audit regulatory and oversight bodies consistently highlighted issues related to auditor risk assessments, including the work performed to understand internal control, identify significant risks and consider and respond to information technology (IT) risks. The IAASB approved a [project](#) to revise extant ISA 315 in September 2016.
5. The IAASB has recently completed a [project to revise ISA 540 \(Revised\)](#),<sup>4</sup> another important building block to enhancing audit quality in the public interest. In the process of revising extant ISA 315, the IAASB recognized the significant interaction between ISA 540 (Revised) and extant (and proposed) ISA 315 because the auditor's risk assessment procedures in relation to accounting estimates build on the principles of and the procedures required by ISA 315 (Revised). Close coordination between the Task Forces working on these projects was therefore necessary throughout the process of making the revisions to the respective standards. Because ISA 540 (Revised) introduces revisions to the risk assessment process for accounting estimates that are also relevant to ED-315 more broadly, the revisions to ED-315 were progressed as efficiently as possible in order to reduce the

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<sup>2</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*

<sup>3</sup> The clarified ISAs became effective for audits of financial statements for periods beginning on or after December 15, 2009.

<sup>4</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, was approved in June 2018 and is subject to Public Interest Oversight Board approval of the due process in September 2018

amount of time between when ISA 540 (Revised) becomes effective and the proposed revisions to extant ISA 315 are finalized.

## Section 2 Guide for Respondents

The IAASB welcomes comments on all matters addressed in ED-315, but especially those identified in the Request for Comments section. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and make specific suggestions for any proposed changes to wording. Respondents are free to address only questions relevant to them from the Request for Comments section. When a respondent agrees with proposals in ED-315 (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view as this cannot always be inferred when not stated.

## Section 3 Significant Matters

### Section 3A – Public Interest Issues Addressed in ED-315

6. Although all the proposed revisions in ED-315 are made with the public interest in the forefront, revisions that are most important in supporting the public interest are set out below.
7. A robust identification and assessment of the risks of material misstatement drives the performance of a quality audit because robust risk assessment is the basis on which the auditor plans and performs audit procedures and gathers audit evidence to support the audit opinion on the financial statements.
8. ISA 315 (Revised) builds on the foundational concepts relating to an audit of financial statements in ISA 200<sup>5</sup> (such as audit risk, identifying risks at the financial statement and assertion levels, and the definitions of inherent risk and control risk). In undertaking the revision of extant ISA 315, the IAASB did not seek to fundamentally change the key concepts underpinning audit risk<sup>6</sup> as the IAASB continues to have the view that the audit risk model is fundamentally sound. Rather, the IAASB has spent the last two years deliberating how certain aspects of the identification and assessment of the risks of material misstatement can be clarified and improved in order to drive better risk assessments and therefore enhance audit quality.
9. As a result of the IAASB's deliberations, minimal changes have been proposed to ISA 200 with the exception of a conforming amendment to explain that ED-315 requires a separate assessment of inherent and control risk.<sup>7</sup> (ISA 200 currently provides for such assessments to be made on a combined basis or separately, however, the revisions to ISA 540 (Revised) also include requiring separate assessments as explained further in paragraph 53 of this Explanatory Memorandum). In addition, the linkage between ED-315 and the foundational audit concepts introduced in ISA 200 is explained in the new introductory paragraphs to ED-315.

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<sup>5</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

<sup>6</sup> Audit risk is a function of the risks of material misstatement (i.e., inherent risk and control risk) and detection risk.

<sup>7</sup> Separate assessments of inherent and control risk have been introduced in the project to revise ISA 540 (Revised). As part of the ISA 540 project, conforming changes were made to ISA 200 to acknowledge the required separate assessments). A further consequential amendment is being proposed to ISA 200 to explain that the requirement for a separate assessment of inherent and control risk is required by ISA 315 (Revised).



10. The sub-sections that follow describe the overarching themes of the revisions proposed. In addition to these overarching themes, proposed revisions also address specific challenges and issues. Explanation supporting these revisions can be found in Section 3-B–3-D:
- Understanding the entity’s system of internal control, in particular relating to the auditor’s work effort to obtain the necessary understanding and to identify ‘controls relevant to the audit’ (see paragraphs 37–40 of this Explanatory Memorandum).
  - Modernizing the standard in relation to IT considerations, including addressing risks arising from IT (see paragraphs 41–45 of this Explanatory Memorandum).
  - Determining significant risks (see paragraphs 54–57 of this Explanatory Memorandum).

#### *Complexity and Iterative Nature of the Standard*

11. Notwithstanding that the ISAs are written in a linear manner, many aspects of ED-315 are interconnected in nature and are often in practice performed in an iterative manner. The IAASB recognizes the importance and also the complexity of the auditor’s risk assessment process and the proposed requirements are therefore correspondingly robust, but principles-based. Introductory paragraphs have been included in ED-315 to provide a summary of the flow of the auditor’s risk assessment process, providing overall context for the structure of the standard. These introductory paragraphs highlight the iterative nature of the auditor’s risk assessment process.
12. In addition to the explanatory information in the introductory paragraphs of ED-315, the IAASB has developed three flowcharts (that accompany this explanatory memorandum) that provide visual representations of how the entire standard should be applied:
- ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement—illustrating the overall flow of the standard.
  - Obtaining an Understanding of the Entity’s System of Internal Control—illustrating how to apply paragraphs 25 to 44 of ED-315.
  - The Auditor’s Understanding of the IT Environment and the Identification of General IT Controls Relevant to the Audit.

These flowcharts also illustrate the iterative nature of the standard, and how the various sections of ED-315 interconnect.

#### *Scalability*

13. In proposing revisions to extant ISA 315, the IAASB recognizes that the auditor’s ability to serve the public interest includes the ability to apply the standard to the audits of financial statements for all entities, ranging from small, simple, non-complex entities to large, complex, multinational entities.
14. The IAASB is of the view that although size of the entity matters, the level of complexity in the nature of an entity and its financial reporting also drives scalability in the application of ED-315. Many small entities have complexities in their business model and their financial reporting processes and therefore auditors may be required to perform more robust or detailed risk assessments.
15. The IAASB has debated how to describe scalability considerations in ED-315. The IAASB agreed to include in the application material considerations for audits of entities that are both smaller and less complex, which are those audits that would typically require simpler risk assessment procedures. Some of these considerations are contrasted with considerations for audits of larger, complex entities (e.g., in

relation to the understanding of an entity's use of IT). This approach is intended to demonstrate scalability in both directions, in relation to the nature, timing and extent of the auditor's risk assessment procedures.

16. The IAASB recognizes that the considerations for audits of smaller and less complex entities may also be relevant to audits of larger entities that have simple business models or financial reporting processes and where the auditor's risk assessment may also be simpler. The introductory paragraphs therefore note that some of the considerations for entities that are both smaller and less complex may be applicable in audits of larger and less complex entities.
17. In making the proposed revisions with regard to scalability, the IAASB has removed the extant "considerations specific to smaller entities" sections throughout the standard. However, most of the matters previously included in these sections have been retained and built into the text of ED-315 as appropriate, together with further proposed revisions to promote scalability. In some cases the content of the extant "considerations specific to smaller entities" sections is not unique to audits of smaller and less complex entities. The IAASB has also considered the placement of guidance related to scalability, in many cases, placing guidance relating to audits of smaller and less complex entities at the start of the relevant sections, so that auditors of such entities are able to more appropriately consider the material that follows in context.

#### *Modernizing and Updating the ISA for an Evolving Business Environment*

18. Significant changes in, and the evolution and increasingly complex nature of, the economic, technological and regulatory aspects of the markets and environment in which entities and audit firms operate, and recent developments relating to internal control<sup>8</sup> and other relevant frameworks, have necessitated proposed revisions to extant ISA 315.
19. The IAASB has also recognized the increasing use of the ISAs by auditors of public sector entities, and has proposed revisions to enhance the specific considerations relevant to audits of public sector entities.

#### *Data Analytics*

20. Auditors increasingly use automated tools and techniques when performing risk assessment procedures. The IAASB acknowledges the importance of explicitly recognizing the usage of such tools and techniques, but also understands the need to not require the use of tools and techniques that might not be available to all auditors, and which might, in the judgment of the auditor, not be necessary or appropriate in the circumstances.
21. In 2015, the IAASB set up a working group (the Data Analytics Working Group (DAWG)) to explore developments in the use of technology by auditors, including data analytics, and how the IAASB could effectively respond. The proposed revisions in ED-315 have been informed by the work to date of the DAWG.
22. The IAASB was firmly of the view that the focus of ED-315 should be on gathering sufficient appropriate audit evidence, and not on being prescriptive or limiting in terms of how audit evidence is obtained. However, the IAASB recognizes the importance of guidance that demonstrates how audit evidence is obtained to address the requirements in its standards.

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<sup>8</sup> For example, the IAASB considered changes that had been made to the Committee of Sponsoring Organizations (COSO) Internal Control – Integrated Framework 2013 (COSO Integrated Framework – 2013)

23. Accordingly, application material has been developed in ED-315, with input from the DAWG, to provide examples of how the automated tools and techniques are being used (relevant references to ED-315 can be found in Appendix 1). In developing this application material, the IAASB has been mindful about how these tools and techniques have been described. Although the term ‘data analytics’ is sometimes used to refer to such tools and techniques, the term does not have a uniform definition or description. The IAASB has the view that the term ‘data analytics’ is potentially too narrow because it may not encompass all of the emerging technologies that are being used when performing risk assessment or other audit procedures today and the technologies and related audit applications that will continue to evolve in the future, such as artificial intelligence applications, robotics automation processes and the use of drones. The IAASB therefore decided to use the broader term *automated tools and techniques* in ED-315. The IAASB also notes that the use of automated tools and techniques have implications for other ISAs, such as ISA 500,<sup>9</sup> ISA 330, ISA 520<sup>10</sup> and ISA 530.<sup>11</sup> Therefore the IAASB continues to have the view that such tools and techniques should not be described definitively by the work on this project alone.<sup>12</sup>

### Information Technology

24. As IT becomes the medium through which a significant amount of audit evidence is obtained, it becomes increasingly important for auditors to understand an entity’s IT environment with particular focus on those aspects that are relevant to financial reporting, including how the integrity of the information is maintained. As part of the modernization of the standard, the IAASB recognized that changes and enhancements were needed with regard to an entity’s use of IT. Accordingly, the IAASB has proposed significant clarifications and enhancements to the requirements in ED-315 such that the auditor is required to understand the entity’s use of IT in its business and system of internal control. This understanding forms the basis for the auditor’s identification of risks of material misstatement arising from the entity’s use of IT and the identification of any relevant general IT controls that the entity has put in place to address those risks of material misstatement.
25. The application material has been significantly enhanced to appropriately support the proposed enhanced requirements. However, in making these proposed revisions, the IAASB has been mindful to introduce additional material relating to IT in a principles-based manner, recognizing that rapid changes in IT and the terms in which it is described could ‘date’ the standard within a short space of time. Specific changes made in relation to IT are described below in the section on “Understanding the Entity’s System of Internal Control” (see paragraphs 29–46 of this Explanatory Memorandum)

### *Fostering Independence of Mind and Professional Skepticism*

26. The IAASB recognizes the central role that professional skepticism plays in an audit. ED-315 contains several key provisions that are designed to enhance the auditor’s exercise of professional skepticism, including:

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<sup>9</sup> ISA 500, *Audit Evidence*

<sup>10</sup> ISA 520, *Analytical Procedures*

<sup>11</sup> ISA 530, *Audit Sampling*

<sup>12</sup> The IAASB has indicated in its online [Strategy Survey](#) an openness to explore a new possible project on audit evidence, which is expected to include considerations in relation to the types of audit procedures and nature of the audit evidence from those procedures, and which may result in future revisions to several ISAs.

- Emphasizing the importance of exercising professional skepticism in the introductory paragraphs.
- Clarifying that a thorough and robust understanding of the entity and its environment, and the applicable financial reporting framework, provides a foundation for being able to exercise professional skepticism throughout the rest of the audit.
- Highlighting the benefits of exercising professional skepticism during the required engagement team discussion.
- Highlighting that contradictory evidence may be obtained as part of the auditor's risk assessment procedures.

Appendix 1 sets out relevant paragraphs where professional skepticism has been highlighted.

27. In addition, the IAASB has explained that the purpose of performing risk assessment procedures is to obtain *sufficient appropriate audit evidence* as the basis for the identification and assessment of the risks of material misstatement.<sup>13</sup> This makes it clear that performing risk assessment procedures provides audit evidence, but linking the risk assessment procedures performed to sufficient appropriate audit evidence, emphasizes the need for professional skepticism in obtaining and evaluating this audit evidence as the basis for the identification and assessment of the risks of material misstatement.

#### *The Auditor's Considerations Relating to Fraud*

28. ED-315 contains a number of other proposals in the public interest, including the introduction of the inherent risk factors (described further in Section 3D below). As part of the new concept of inherent risk factors, intended to assist with the identification and assessment of the susceptibility of assertions to misstatement, a link has been made to the auditor's consideration of susceptibility of misstatement due to fraud.<sup>14</sup> The IAASB has further considered whether more needs to be enhanced in ED-315 in relation to the auditor's consideration of the risks of fraud. On balance the IAASB believes that there are sufficient references within ED-315 to ISA 240,<sup>15</sup> but has highlighted in the introductory paragraphs the need to also apply ISA 240 when identifying and assessing the risks of material misstatement due to fraud.

### **Section 3B – Understanding the Entity and Its Environment**

#### *Focusing on the Applicable Financial Reporting Framework in Identifying Risks of Material Misstatement*

29. The IAASB has restructured the requirement that focuses on the auditor's understanding of the entity and its environment and has elevated the importance of the auditor's required understanding of the applicable financial reporting framework, because it is the application of the framework in the context of the nature and circumstances of the entity that gives rise to potential risks of misstatement. This revision is intended to clarify the context of the understanding of the framework, and includes enhancements requiring the auditor to focus on the reasons for changes to the entity's accounting policies. The IAASB's new concept of 'inherent risk factors' is also introduced as the auditor contemplates potential risks arising from the

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<sup>13</sup> ED-315, paragraph 17

<sup>14</sup> ISA 540 (Revised) also includes references to an inherent risk factor 'susceptibility to management bias and fraud,' which is consistent with the way it is described in ED-315.

<sup>15</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

application of the applicable financial reporting framework (the concept of 'inherent risk factors' is further described in Section 3D below).

### Section 3C – Understanding the Entity's System of Internal Control

30. In the ISA Implementation Monitoring Project, and subsequent outreach, significant concerns were highlighted relating to obtaining an understanding of the entity's system of internal control. In particular it was highlighted that it was not always clear:

- Why the understanding was required to be obtained (for example when a primarily substantive approach to the audit was planned) and how the information obtained was to be used;
- What procedures are required in order to 'obtain the necessary understanding' for certain components of internal control;
- Whether all components of internal control as set out in the standard needed to be understood; and
- When controls are considered 'relevant to the audit.'

In addition, it was noted that it was confusing when there was inconsistent terminology used when describing internal control and controls.

31. The IAASB believes that understanding the entity's system of internal control is integral to the auditor's identification and assessment of the risks of material misstatement. In particular, the understanding informs the auditor's expectations about the operating effectiveness of controls and the auditor's intentions to test controls in designing and performing further audit procedures, and is therefore the foundation for the auditor's assessment of control risk. It is important to be clear about the work effort necessary in obtaining the required understanding, and the IAASB has proposed revisions, as explained below, in this regard.

32. ED-315 also makes it clear that the overall requirement for understanding the entity's system of internal control is achieved through the requirements that address understanding each of the components of the system of internal control. The order in which the components are presented has also been changed as a result of the clarification described below related to the nature of each component, such that the three components that consist primarily of 'indirect controls' are presented before the two components that consist of primarily 'direct controls' (the 'indirect' and 'direct' controls are described below in paragraph 33).

#### *Terms Used to Describe Aspects of the Entity's System of Internal Control*

33. The IAASB has considered the various terms used to describe an entity's system of internal control or aspects thereof, and has made amendments to the descriptions of terms used, as well as revisions throughout ED-315 to apply the revised terms consistently. These changes, made throughout the proposed standard, include the following:

- The entity's *internal control*, as it is used in extant ISA 315, has been revised to the entity's system of internal control, and the definition has been updated to reflect that it is comprised of five inter-related components. The scope of the auditor's understanding of internal control has been clarified to be an understanding of the entity's system of internal control relevant to financial reporting, which is the system relevant to the preparation of the financial statements in accordance with the

requirements of the applicable financial reporting framework.<sup>16</sup> This change recognizes that the entity's system of internal control encompasses more than achieving financial reporting objectives (i.e., would generally also include achieving operational and compliance objectives when those objectives are relevant to financial reporting).

- The use of the term *controls* has been clarified by instituting the following definition:

“Controls are...Policies or procedures that are embedded within the components of the system of internal control to achieve the control objectives of management or those charged with governance. Within this context, policies are statements of what should or should not, be done within the entity to effect internal control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions. Procedures are actions to implement policies.”<sup>17</sup>

The IAASB also agreed that ‘policies and procedures’ should be broadly defined and may include aspects of governance, for example tone at the top, and other aspects of the entity's systems, such as the risk assessment process in some entities, which are established, but are not formally documented policies or procedures. Accordingly, proposed revisions have been made to the application material to recognize that some aspects of the entity's system of internal control may be less formalized but still functioning. The IAASB believes that this acknowledges that controls may also be less formalized, thereby contributing to the scalability of the definition, and the way it is interpreted within each of the components.

- *Components of internal control* for the purposes of the ISAs include the control environment, the entity's risk assessment process, the entity's process to monitor the system of internal control, the information system (including related business processes) and communication, and control activities. Within each of these components, individual controls are embedded (i.e., each component is comprised of a collection of controls). The proposed revisions to the requirements for each component have specified the necessary matters for which an understanding is required.
- *Control activities* refers to the component of the entity's system of internal control that typically includes controls over the flows of information within the information system. Understanding this component is achieved through the auditor's identification and understanding of controls relevant to the audit (see paragraphs 37–40 below about controls that are relevant to the audit).

#### *Understanding Internal Control through Understanding the Five Components of Internal Control*

34. The IAASB continues to believe that the five components of internal control as described above, comprising the entity's system of internal control, remain an appropriate framework for the auditor's understanding of the system of internal control required to be obtained for the purposes of the ISAs. In its deliberations, the IAASB agreed that the auditor needs to obtain an understanding of all of the components, to the extent that they have been implemented by the entity, and has revised the requirements for each of the components to be clear about the specific matters relating to that component that need to be understood.
35. In its deliberations about obtaining an understanding about the components of the system of internal control, the IAASB agreed that differentiating the nature of each of the components would help the

<sup>16</sup> ED-315, paragraph A95

<sup>17</sup> The IAASB specifically considered the explanation of controls in the COSO Integrated Framework – 2013 in developing this definition and its supporting application material.

auditor recognize how the understanding provides the basis for the auditor's identification and assessment of the risks of material misstatement. In the view of the IAASB, controls within the:

- *Control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control* components have controls that are typically more 'indirect' in nature (i.e., they are controls that generally do not directly address the risks of material misstatement at the assertion level). Such indirect controls are more likely to be relevant to the auditor's identification and assessment of risks of material misstatement at the financial statement level. For example, if the entity's control environment is not functioning as expected given the size and complexity of the entity, this could affect the operating effectiveness of controls in the other components of the system of internal control and are more likely to give rise to financial statement level risks (i.e., risks that have a pervasive effect on the financial statements).
- *Information system and communication, and control activities components* are comprised primarily of controls that directly address the risks of material misstatement at the assertion level ('direct controls'). The design of the information system is established in the policies and procedures that define the nature, timing and extent of the entity's financial reporting processes, and how the entity's personnel, IT and other resources are deployed in applying them. Such controls are referred to as 'information system controls relevant to financial reporting'. The auditor is required to evaluate the design of the information system controls relevant to financial reporting and determine that they have been implemented, which assists in identifying risks of material misstatement at the assertion level.<sup>18</sup> Controls in the control activities component are controls over the flows of information and the financial reporting processes within the entity's information system. Controls relevant to the audit include primarily controls in the control activities component. (See Controls Relevant to the Audit section below).

#### *Work Effort for Understanding Each of the Components of Internal Control*

36. Clarifying the requirements related to the understanding of each component of the system of internal control is an important aspect of the proposed enhancements to the standard. Within each component, the IAASB has set out the matters that need to be understood, as well as providing further guidance about the extent and scalability of related procedures, as appropriate. However, the nature, timing and extent of risk assessment procedures that the auditor performs to obtain the required understanding are matters of the auditor's professional judgment and are based on the auditor's determination as to what will provide sufficient appropriate audit evidence for the basis for the identification and assessment of the risks of material misstatement.

#### *Controls Relevant to the Audit*

37. The IAASB agreed to maintain the concept of a control being 'relevant to the audit,' and agreed to use the term consistently (extant ISA 315 sometimes refers to 'relevant controls'). To assist with determining which controls are relevant to the audit, the related requirement has been clarified to create a consolidated list of the controls that the IAASB is of the view are always relevant to the audit. In addition, recognizing that entities have a wide variety of circumstances, auditors are required to use professional judgment to determine if there are any other controls that are relevant to the audit.<sup>19</sup>

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<sup>18</sup> ED-315, paragraph 36

<sup>19</sup> ED-315, paragraph 39(e)

It has also been clarified that controls relevant to the audit are primarily direct controls and controls in the control activities component. However, the auditor may identify certain controls in the control environment, the entity's risk assessment process or the entity's process to monitor controls as relevant to the audit because they address risks of material misstatement at the assertion level.

38. The Controls Relevant to the Audit section of ED-315 also includes enhanced requirements to identify general IT controls relevant to the audit. These enhanced requirements are discussed in the next section.
39. The auditor is required to evaluate the design of each control relevant to the audit, including general IT controls, and determine whether it has been implemented (this is referred to as "D&I"). The related requirement and application material have been clarified and enhanced. In particular, new guidance has been included about the benefits of the auditor's D&I procedures to the design and performance of further audit procedures.<sup>20</sup> Based on D&I, the auditor may plan to test the operating effectiveness of these controls, which then provides the basis for the auditor's assessment of control risk at the assertion level to be assessed at less than maximum (refer to paragraph 50).
40. Application material provides further details to distinguish the differences between understanding and evaluating information system controls relevant to financial reporting and controls relevant to the audit. Nevertheless, the application material acknowledges that the auditor may perform the D&I procedures for the respective controls in a combined manner.<sup>21</sup>

#### *Enhanced Guidance Related to IT*

41. As IT becomes the medium through which a significant amount of audit evidence is obtained, it becomes increasingly important for auditors to understand an entity's IT system, including how the integrity of the information is maintained. This is also the case when such audit evidence is produced by, or available from sources external to, the audited entity. Accordingly, the IAASB has proposed significant enhancements to the auditor's consideration of IT when obtaining an understanding of the entity's system of internal control, including:
  - Examples of matters to be understood in relation to the IT environment, including the IT applications, IT infrastructure and IT processes.
  - Examples of matters within the IT environment that would likely be relevant to determining the IT applications and other aspects of the IT environment that are relevant the audit.
  - Contrasting examples of the auditor's considerations in situations in which the entity's IT system consists of commercial software and the entity does not have access to the source code, and situations in which the entity has highly-customized or highly-integrated IT applications.

The IAASB has also elevated definitions from the Glossary of Terms and updated them in respect of application controls, general IT controls and the IT environment to help provide greater clarity on these IT-related concepts. A Supplement to ED-315 presents a flowchart to illustrate the new requirements and guidance.

42. The most significant proposed enhancements to ED-315 addressing the entity's use of IT are in the requirements for the information system and communication component, and for the identification of

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<sup>20</sup> ED-315, paragraph A200

<sup>21</sup> ED-315, paragraphs A151–A157, and paragraphs A166–A175



controls relevant to the audit. In understanding the information system relevant to financial reporting, the auditor is required to understand the related IT environment in order to gain a high-level understanding of the nature and complexity of the environment and its supporting processes. Using the basis of the auditor's understanding of the IT environment as well as the identification of controls relevant to the audit (see previous section), the IAASB is of the view that the auditor uses four criteria to determine which IT applications and other aspects of the IT environment are 'relevant to the audit'.<sup>22</sup> These criteria help the auditor identify IT applications for which risks arising from the entity's use of IT may exist, and that may affect the design, implementation or operating effectiveness of automated controls or other controls over the integrity of information.

43. For the IT applications and other aspects of the IT environment determined to be 'relevant to the audit,' the auditor identifies the risks arising from the entity's use of IT and identifies general IT controls that address those risks as general IT controls relevant to the audit. The application material to these requirements has been enhanced to explain the possible risks and controls that the auditor may consider, as well as explaining that the extent to which general IT controls are relevant to the audit will vary, based on the circumstances of the engagement and planned audit approach or strategy. A new Appendix 4 has also been added to ED-315 to provide further considerations related to general IT controls.
44. The IAASB believes that this approach will assist the auditor's decision-making in determining the extent of general IT controls relevant to the audit. In particular, the IAASB is of the view that it is not necessary for the auditor to identify risks arising from the entity's use of IT or general IT controls unless there are IT applications that are determined to be relevant to the audit (taking into account the four specific criteria).<sup>22</sup>
45. When an entity's IT environment consists only of commercial software for which the entity does not have access to the underlying source code such that no program changes can be made (which may be the case for many smaller and less complex entities), the auditor may determine that none of the entity's IT applications meet the four criteria for different reasons, including the fact that the auditor plans to substantively test all reports and other information produced by the entity's information system that are used as audit evidence. In contrast, for larger, more complex entities or for audits where the auditor plans to test the operating effectiveness of automated controls, the auditor may determine that there are several IT applications relevant to the audit. This may drive a greater extent of general IT controls being identified as relevant to the audit.

#### *Other Matters Relevant to Understanding the Entity's System of Internal Control*

46. Deficiencies in internal control are described and addressed in ISA 265.<sup>23</sup> Extant ISA 315 required the auditor to explicitly consider whether deficiencies in internal control exist only in the context of the auditor's understanding of the entity's risk assessment process. The IAASB has recognized that a deficiency in internal control may arise within any of the components of the entity's system of internal control, and that these deficiencies may be identified when the auditor is obtaining an understanding of the system of internal control. As any identified deficiencies may have implications for the audit, including informing the auditor's identification of risks of material misstatement, as well as reporting requirements in terms of ISA 265, the IAASB has added overarching requirements for the auditor to

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<sup>22</sup> ED-315, paragraph 40

<sup>23</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph 6

determine, on the basis of the work performed under this standard (i.e., for all the components of the system of internal control), whether any control deficiencies have been identified and to evaluate the implications on the audit when any such deficiencies have been identified.<sup>24</sup>

### Section 3D – Identifying and Assessing the Risks of Material Misstatement

#### *Identifying and Assessing the Risks of Material Misstatement*

47. The IAASB has noted continuing concerns related to the implementation of the requirements for the identification and assessment of risks of material misstatement. In addition, the IAASB has noted that inspection findings commonly refer to an apparent lack of consistency in the determination of significant risks (see section entitled ‘Significant Risks’ below for proposed revisions).
48. To assist with the robustness and consistency of the identification and assessment of risks of material misstatement, the IAASB had the view that a more explicit and systematic risk identification and assessment process would help drive a more consistent and focused approach. To facilitate this, the IAASB has introduced new concepts and definitions, and significantly enhanced the related requirements:
  - *Inherent risk factors*<sup>25</sup> (new definition)—characteristics that affect susceptibility to misstatement of an assertion about a class of transactions, account balance or disclosure, and that may be quantitative or qualitative in nature. Such factors include *complexity, subjectivity, change, uncertainty and susceptibility to misstatement due to management bias or fraud*. Inherent risk factors are intended to assist the auditor in focusing on those aspects of events or conditions that affect an assertion’s susceptibility to misstatement, which in turn facilitates a more focused identification of risks of material misstatement. Taking into account the degree to which the inherent risk factors affect susceptibility to misstatement assists in the assessment of inherent risk (see the explanation of ‘spectrum of inherent risk’ below).
  - *Relevant assertions* (new definition)—have been introduced to focus auditors on those assertions relevant to a class of transactions, account balance or disclosure when the nature or circumstances are such that there is a reasonable possibility<sup>26</sup> of occurrence of misstatement with respect to an assertion, that is material, either individually or in combination with other misstatements. Application material to the definition explains that there will be one or more risks of material misstatement that relate to a relevant assertion. The introduction of the concept of ‘relevant assertion’ is viewed by the IAASB to have the benefit of enhancing the completeness of the auditor’s identification of the risks of material misstatement by requiring the auditor to identify those assertions where risks of material misstatement exist (i.e., are reasonably possible) and therefore need to be identified.

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<sup>24</sup> ED-315, paragraphs 43–44

<sup>25</sup> The concept of inherent risk factors is included in ISA 540 (Revised). A supplement to ED-315 will be issued to explain the interaction of ED-315 and ISA 540 (Revised) and the conforming amendments to ISA 540 (Revised) arising from ED-315.

<sup>26</sup> In its deliberations, the IAASB had the view that it was important to explain the level of likelihood that should be taken into account when identifying relevant assertions and risks of material misstatement. The IAASB selected ‘reasonably possible’ (also with recognition that this term is used in the US Public Company Accounting Oversight Board (PCAOB) standards in a similar context). The definition explains that ‘reasonably possibly’ equates to ‘more than remote.’ However, some concerns were raised that these appear to be different thresholds and may be subject to misinterpretation. However, on balance, the IAASB is of the view that the two terms are synonymous.

- *Significant class of transactions, account balance or disclosure* (new definition)—a class of transactions, account balance or disclosure where there is one or more relevant assertion. The introduction of the concept of a significant class of transactions, account balance, or disclosure is viewed by the IAASB to have the benefit of clarifying the scope of the auditor's understanding of the information system,<sup>27</sup> as well as the scope for the auditor's responses to the assessed risks of material misstatement,<sup>28</sup> and the related requirements in ISA 540 (Revised) that address these topics.<sup>29</sup>
  - *Spectrum of inherent risk*<sup>30</sup>—a concept included in the introductory paragraphs and application material recognizing that inherent risk factors individually or in combination increase inherent risk to varying degrees and that inherent risk will be higher for some assertions than for others. The degree to which inherent risk varies is referred to as the spectrum of inherent risk. The relative degrees of the likelihood and magnitude of a possible misstatement determine where on the spectrum of inherent risk the risk of misstatement is assessed. The IAASB is of the view that the introduction of the spectrum of inherent risk will facilitate greater consistency in the auditor's identification and assessment of risks of material misstatement by providing a frame of reference for the auditor's consideration of the likelihood and magnitude of possible misstatements and the influence of the inherent risk factors.
49. The IAASB acknowledges that the order in which the requirements related to the identification of the risks of material misstatement are to be applied should not be prescribed. For example, firms may have different approaches in their methodologies regarding the order in which the risks of material misstatement, and the significant classes of transactions, account balances and disclosures and the relevant assertions to which they relate, are identified. The process is iterative and is likely to be applied differently in an initial audit engagement versus a recurring engagement. What matters most is that each of the relevant requirements is complied with and that the auditor's understanding of the system of internal control is appropriate based on the identification and assessment of the risks of material misstatement. For example, the auditor is required to identify controls relevant to the audit based on the determination of significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence. As another example, the auditor forms an initial expectation of the significant classes of transactions, account balances and disclosures when understanding the entity and its environment and the applicable financial reporting framework. The auditor uses this expectation in understanding the information system, and then determines the significant classes of transactions, account balances and disclosures when identifying the risks of material misstatement.
50. The IAASB has also made a stronger link to the work performed on the D&I of controls relevant to the audit, with enhanced application material to further explain how the D&I work interacts with the auditor's assessment of control risk. The IAASB has made it clear that if the auditor does not contemplate testing the operating effectiveness of controls, or is not required to test controls, control risk is assessed at maximum. This means that control risk cannot be reduced for the effective operation of controls unless the auditor intends to test them. This allows auditors who intend to perform a primarily substantive audit

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<sup>27</sup> ED-315, paragraph 35(a)

<sup>28</sup> ISA 330, paragraph 7 (see conforming amendment)

<sup>29</sup> Conforming amendments to ISA 540 (Revised) will be distributed as a supplement to ED-315

<sup>30</sup> The concept of inherent risk factors is included in ISA 540 (Revised). A supplement to ED-315 will be issued to explain the interaction of ED-315 and ISA 540 (Revised) and the conforming amendments to ISA 540 (Revised) arising from ED-315.

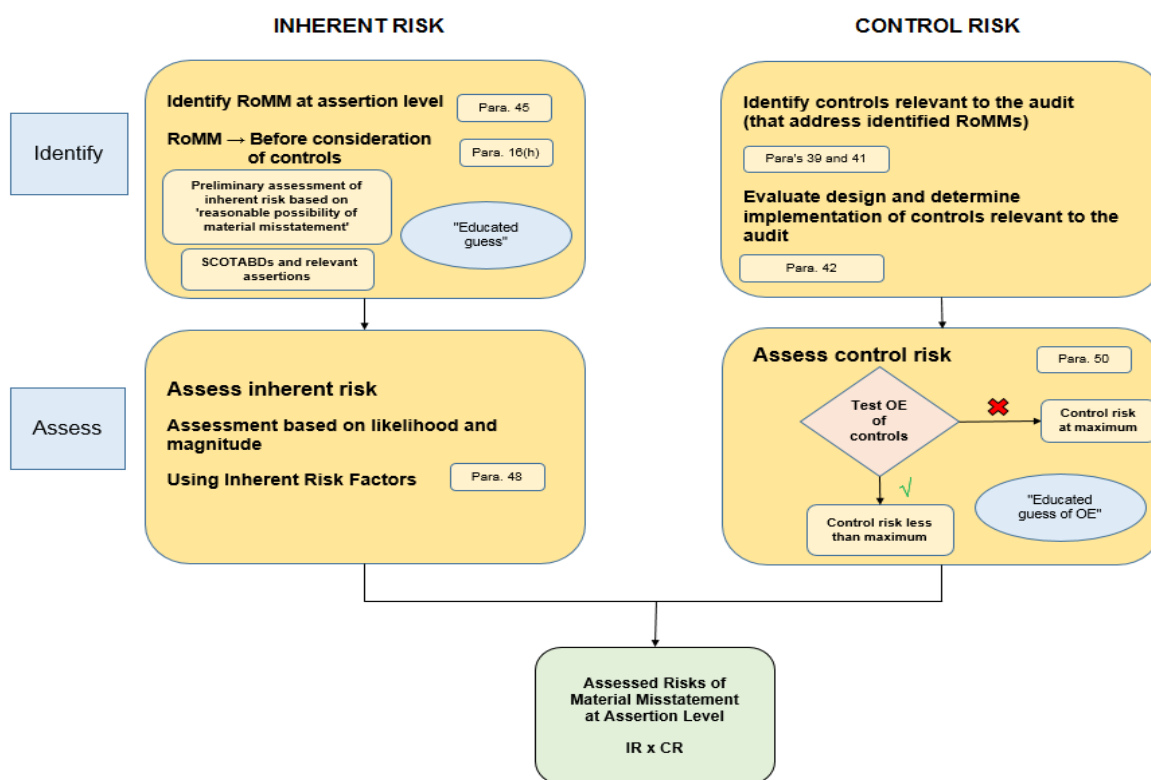
to not have to do anything further in relation to controls, although work on the D&I of controls is likely to affect the nature and extent of substantive procedures to be performed.

51. In making these revisions, the IAASB has focused on how the more robust and explicit requirements will help auditors make more consistent and effective assessments of identified risks of material misstatement, thereby providing an enhanced basis for the design and performance of further audit procedures, as well as overall responses to risks of material misstatement at the financial statement level (as required by ISA 330).

#### Relationship of Concepts with ISA 540 (Revised)

52. As noted, there has been close coordination between the ISA 315 and ISA 540 project Task Forces in the development of proposed revisions to both standards. Some of the new concepts in ED-315 have already been approved in the revised ISA 540, including inherent risk factors, spectrum of inherent risk and the separate assessments of inherent risk and control risk. The IAASB has also agreed that these concepts are appropriately proposed in ED-315 as they are applicable to all classes of transactions, account balances and disclosures, and not only accounting estimates. The IAASB has also worked towards addressing the use of these concepts consistently between the standards, although the inherent risk factors in ISA 540 (Revised) are those specifically relevant to accounting estimates and do not encompass all of the inherent risk factors in ISA 315 (Revised), which are intended to be more broadly applied.

### Separate Assessment of Inherent Risk and Control Risk



The illustration above presents the separate assessment of inherent and control risk at the assertion level.

53. Questions have arisen in both the ISA 540 and ISA 315 projects about the 'combined' assessment of inherent risk and control risk as permitted by extant ISA 200.<sup>31</sup> Noting the requirements in ISA 330, paragraph 7 that require the auditor to consider inherent risk and control risk separately in order to respond appropriately to assessed risks of material misstatement, the IAASB agreed, on balance, that a separate assessment of inherent risk and control risk should also be required, and that this change would initially be made in ISA 540 (Revised). ED-315 extends the requirement for the separate assessments of inherent and control risk in relation to all risks of material misstatement at the assertion level. New requirements have been included in ED-315 that address these separate assessments of inherent risk and control risk.

### Significant Risks

54. One of the key findings of the ISA Implementation Monitoring Project related to the consistency with which significant risks are determined. The IAASB believes that one of the main reasons for this inconsistency lies in the definition of significant risk. The current definition focuses the auditor on the response to the risk rather than the nature of the risk. In extant 315, significant risks are those that require 'special audit consideration.'

<sup>31</sup> ISA 200, paragraph A42 (Note: Consequential amendments to A42 have been made as a result of the required separate assessments of inherent risk and control risk in accordance with ISA 540 (Revised))

55. In its deliberations, the IAASB specifically considered the introduction of the spectrum of inherent risk and whether the spectrum alone might provide a framework sufficiently robust to properly assess all risks, or whether the auditor should still be required to separately determine significant risks. On balance, the IAASB believed that it was important to retain the concept of, and requirement to, determine significant risks because of the focused work effort in other ISAs on these types of risks.
56. To promote a more consistent approach to determining significant risks, the IAASB revised the definition to focus not on the response, but on those risks for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk. This update to the definition also incorporates the extant requirement for significant risks to be determined excluding the effects of identified controls related to the risks (i.e., based on inherent risk alone). Further, by defining the significant risks as “close to the upper end” of the spectrum, it suggests there may be one or more risks that could be determined to be ‘significant risks.’
57. In revising the definition of significant risk, the IAASB also deliberated whether these risks are represented on the spectrum of inherent risk by a high likelihood of occurrence AND a high magnitude of potential misstatement should the risk occur, or whether a significant risk could also be present when there is a high magnitude of potential misstatement but a low expectation of the risk occurring. On balance, the IAASB agreed that there could be risks potentially low in likelihood, but for which the magnitude could be very high if it occurred, and that it was probably not appropriate to explicitly exclude these risks from the auditor’s determination of significant risks. The definition therefore acknowledges that a significant risk could result from the degree of likelihood of misstatement OR magnitude of potential misstatement. It was agreed to consult specifically on this matter (see Question 6c).

*Identified and Assessed Risks of Material Misstatement at the Financial Statement Level*

58. Extant ISA 315 requires identification and assessment of the risks of material misstatement at the financial statement level but does not explain how to do this, or explain how this interacts with the identification and assessment of the risks of material misstatement at the assertion level. The IAASB considered the nature of risks of material misstatement at the financial statement level, reflecting on how they are described in ISA 200, in order to better describe and address them in ED-315.
59. Under ISA 200, every identified risk of material misstatement either relates specifically to an individual assertion, or to a number of assertions, which could be in one or more classes of transactions, account balances or disclosures. However, when the risk relates to a number of assertions (i.e., is more pervasive), the risk is considered to exist at the financial statement level. The assessment of risks of material misstatement at the financial statement level involves determining the effect of such risks on the assessment of risks of material misstatement at the assertion level. Because of the pervasive nature of the risks at the financial statement level, it may be difficult however to identify specific assertions that are affected (e.g., fraud risks such as risk of management override of controls). For that reason, assessment of risks at the financial statement level also involves evaluating the nature and extent of their pervasive effect on the financial statements to provide the basis for designing and implementing overall responses to the risks. Proposed revisions have been made to the requirements and application material to better reflect the relationship of these risks to the risks of material misstatement at the assertion level.
60. The IAASB is also of the view that risks at the financial statement level will often arise from deficiencies in the components of the entity’s system of internal control that consist primarily of ‘indirect controls,’ in particular the control environment, which will likely have a more pervasive effect on a number of, or all,

classes of transactions, account balances and disclosures, in the financial statements. Accordingly, the application material has been enhanced to link the auditor's understanding of the relevant components of the system of internal control, including the required evaluations thereof and the effect of any identified deficiencies, to the auditor's identification and assessment of the risks of material misstatement at the financial statement level.

#### *Stand-Back and Paragraph 18 of ISA 330*

61. In considering the risk identification and assessment process, the IAASB has also proposed a new 'stand-back' requirement (paragraph 52),<sup>32</sup> which is intended to drive an evaluation of the completeness of the significant classes of transactions, account balances and disclosures identified by the auditor. In turn, this helps drive the completeness of the identification of the risks of material misstatement (refer to paragraph 49 of this Explanatory Memorandum for further explanation of the process that the auditor may follow to determine the significant classes of transactions, account balances and disclosures).
62. The stand-back is intended to focus on *material* classes of transactions, account balances or disclosures (that have *not been determined to be significant* (i.e., the auditor has not identified any risks of material misstatement that are reasonably possible and therefore for which there are no relevant assertions). The description of 'material' has been expanded to be 'quantitatively or qualitatively material' with supporting application material to describe its meaning in this context. After identifying the classes of transactions, account balances and disclosures that are quantitatively or qualitatively material, the auditor is required to reconsider, for such classes of transactions, account balances or disclosures, whether there could be one or more risks of material misstatement at the assertion level.
63. Paragraph 18 of ISA 330 is also targeted at 'material' classes of transactions, account balances and disclosures,<sup>33</sup> and requires substantive procedures for all such classes of transactions, account balances and disclosures. In developing the scope of work for the project to revise ISA 315 (Revised), paragraph 18 of ISA 330 was included because of the inconsistent interpretation about how the requirement should be applied. The IAASB agreed to further consider the interaction of paragraph 18 of ISA 330 with the revisions proposed to extant ISA 315, including whether this paragraph is still needed.
64. The IAASB has proposed revisions to paragraph 18 of ISA 330 to apply to classes of transactions, account balances or disclosures that are 'quantitatively or qualitatively material' to align with the scope of the proposed stand-back in ED-315 and has also updated the related application material to explain the interaction of the requirement with the new concept of significant classes of transactions, account balances and disclosures. Specifically, many classes of transactions, account balances or disclosures that are quantitatively or qualitatively material will also be identified as significant under ED-315. Further audit procedures to address the risks of material misstatement related to significant classes of transactions, account balances or disclosures are performed in accordance with paragraph 6 of ISA 330. Provided the further audit procedures include substantive procedures, no further action is necessary to address the requirement in ISA 330, paragraph 18, in respect of the significant classes of transactions, account balances or disclosures. However, if the further audit procedures include only tests of controls, then substantive procedures are required to address the requirement in ISA 330, paragraph 18.

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<sup>32</sup> Proposed paragraph 52 of ED-315 requires the auditor to reconsider whether all significant classes of transactions, account balances and disclosures have been identified once the initial risk identification and assessment has been completed.

<sup>33</sup> "Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure."

65. Additionally, ISA 330, paragraph 18 (and its related application material in paragraph A42), applies to those classes of transactions, account balances or disclosures that are quantitatively or qualitatively material but not significant (i.e., for which there are no risks of material misstatement have been identified) and which have been identified in accordance with ISA 315 (Revised), paragraph 52 (i.e., substantive procedures on such classes of transactions, account balances and disclosures are required).
66. Despite the agreement of the IAASB to add the stand-back to ED-315 and align paragraph 18 of ISA 330, the IAASB recognized that both of these paragraphs serve a similar purpose to safeguard against imperfect risk identification and assessment, although paragraph 18 of ISA 330 has an additional purpose to safeguard against an approach to further audit procedures that includes only test of controls. Some members had the view that paragraph 18 should no longer be necessary as the more robust risk assessment, including the 'stand-back' would adequately cover all material classes of transactions, account balances and disclosures. Others had the view that paragraph 18 is necessary to prevent situations in which further audit procedures for a material class of transaction, account balance or disclosure would only include tests of controls. Furthermore, some members took the view that the stand-back in ED-315 should not be necessary, as the enhanced risk assessment requirements in ED-315 were sufficiently robust, and ISA 330 paragraph 18 could still serve its current purpose as an appropriate safeguard.
67. On balance, the IAASB agreed to seek respondents' views about the value of the stand-back in ED-315 and paragraph 18 of ISA 330 to determine whether one or both should be retained as proposed (see Question 8).

### Section 3E – Other Matters

#### *Documentation*

68. The IAASB considered expanding the specific documentation requirement in ED-315, but in light of the overall documentation requirements in ISA 230,<sup>34</sup> agreed that it was unnecessary for more detailed documentation requirements to be included in the standard (except as detailed below). The IAASB also noted that by requiring more explicit, robust procedures for obtaining the necessary understanding of the entity and its environment, the applicable financial reporting framework and the system of internal control, as well as for identifying and assessing the risks of material misstatement, enhanced documentation of these matters would result through an appropriate application of ISA 230.
69. However, based on the clarifications and enhancements made regarding controls that are relevant to the audit, the IAASB agreed that a more explicit requirement for the documentation of the controls identified to be relevant to the audit would be beneficial. In addition, the IAASB also agreed that it is important to capture the significant judgments made by the auditor in identifying and assessing the risk of material misstatement, including in relation to the determination of significant risks, and has therefore enhanced the documentation requirement in this regard.

#### *Appendices*

70. In considering changes to the standard, in particular the flow and structure, the IAASB considered what should remain in application material as guidance to applying the requirements, versus information that was useful and informative but not essential to understanding how the requirement

<sup>34</sup> ISA 230, *Audit Documentation*, paragraph 8



should be implemented. Accordingly, in some instances the IAASB has moved material from the application material to the Appendices (for example, Appendix 1 of ED-315 includes examples of matters that auditor may consider when understanding the entity and its business model).

71. The IAASB has also made other proposed revisions to the extant Appendices, as relevant, for changes:
- Proposed within ED-315 (for example, Appendix 2 of ED-315 is presented to relate to the new concept of inherent risk factors introduced); and
  - Made to other internal control frameworks (see Appendix 3 of ED-315, which has been updated for changes made to COSO's 2013 Framework).
72. A new Appendix has also been added to provide further context when understanding general IT controls, to further support proposed revisions made within the standard in relation to the identification of general IT controls relevant to the audit (see Appendix 4 in ED-315).

### **Section 3E - Conforming and Consequential Amendments**

#### *ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures*

73. ISA 540 (Revised) was only approved by the IAASB at its June 2018 meeting. Therefore the Board did not contemplate the total population of conforming changes arising from the ISA 315 (Revised) project at that meeting but will do so on an IAASB teleconference in mid-July 2018.<sup>35</sup> Proposed Conforming and Consequential Amendments to ISA 540 (Revised) are therefore not included in this Exposure Draft, rather these will be published later in July 2018 once they are approved by the IAASB and issued as a supplement to this Exposure Draft.

#### *Other Conforming and Consequential Amendments*

74. The proposed conforming and consequential changes to ISA 200, ISA 240 and ISA 330 have been presented in marked text to the relevant paragraphs. For ISA 200 and ISA 240, only the paragraphs that have amendments, or provide context to the amendments, are provided. For ISA 330, the full text of the standard has been provided for reference recognizing that many ISA 330 paragraphs are referred to in ED-315 and the supporting flowcharts. However, any paragraphs that are not relevant to the conforming amendments are greyed.
75. In relation to conforming amendments in the other ISAs that are not presented in the text of the related standards, a *description of the changes*, explaining the details of the amendments that will be made with relevant examples, has been provided in Appendix 2. As there are numerous changes throughout the ISAs, and as these changes are, in the IAASB's view, generally straightforward, the IAASB believes that this presentation is the most pragmatic approach for the purpose of ED-315.

#### **ISA 200**

76. ISA 200 explains the overall concepts used in the ISAs, including in relation to audit risk and risks of material misstatement. In revising extant ISA 315, new concepts and terms relating to the 'spectrum of inherent risk', 'inherent risk factors', 'relevant assertions' and 'significant classes of transactions, account balances and disclosures' have been introduced in enhancing the requirements and guidance to support the auditor's risk assessment process. Accordingly, the IAASB has proposed that amendments are made

<sup>35</sup> See explanation in paragraphs 5 and 52 of this Explanatory Memorandum

in ISA 200 to introduce these new concepts—see paragraph A40. In addition, a new paragraph A43a has been proposed to help explain that the purpose of the auditor's identification and assessment of risks of material misstatement at the assertion level is to provide a basis for the design and performance of further audit procedures to address those risks in accordance with ISA 330.

77. No further changes have been made to paragraph A42 at this time as this paragraph has also been amended by the ISA 540 project. As noted above, the IAASB will address final changes to this paragraph together with the other conforming and consequential changes to ISA 540 (Revised) later in July 2018.

#### ISA 240

78. As noted, the IAASB has been mindful of making a clear link to the auditor's considerations relating to fraud in identifying and assessing the risks of material misstatement, in particular through the inherent risk factors. Changes have been proposed to paragraph A25 of ISA 240, and Appendix 1, to explain the intended relationship between the fraud risk factors and the inherent risk factors in ED-315.
79. In revising extant ISA 315, significant effort has been made to clarify the work effort related to obtaining an understanding of the components of the entity's system of internal control, and relating to 'controls relevant to the audit.' As fraud very often is related to control aspects, some of the paragraphs in ISA 240 have been conformed to be consistent with the changes being proposed in ED-315:
- Paragraph 27—more explicitly stating that controls over fraud risks are controls relevant to the audit, (a footnote to paragraph 39(b) in ED-315 has been added)—and accordingly, the auditor is required to evaluate the design of those controls and determine whether they have been implemented in accordance with paragraph 42 of ED-315.
  - Paragraph 44(c)—this is a new requirement to specifically document controls relevant to the audit that are related to assessed risks of material misstatement due to fraud; this requirement is to conform to the proposed new requirement in paragraph 54(c) of ED-315 to document controls relevant to the audit.
  - Paragraphs A7 and A32—focusing on controls relevant to the audit when considering the controls over the information to be used as audit evidence and in understanding the controls that management has implemented to prevent and detect fraud .
  - Paragraph A43 (last bullet)—'level of internal control' is not a term used in ED-315, this has been changed to 'nature and extent of controls' which is consistent with the way control risk has been described in ISA 315 (Revised) for the purpose of determining an appropriate response to identified risks of material misstatement.
80. A new footnote reference has been added to paragraph A42, to explicitly link this paragraph to the requirement relating to controls relevant to the audit related to journal entries (paragraph 39(c) in ED-315), as this paragraph further explains more about the override of controls by way of journal entries.

#### ISA 330

81. In considering the conforming amendments to ISA 330, the IAASB has been mindful of maintaining the balance between conforming (or consequential) amendments, and more substantial changes that would not be within the scope of the ISA 315 (Revised) project. The IAASB is of the view that the more robust (and specific) process to identify and assess risks of material misstatement will result in auditors developing responses that are more targeted and responsive to the assessed risks of material misstatement in accordance with the extant requirements of ISA 330, specifically paragraphs 6 and 7.

82. Several changes are being proposed to ISA 330 to better align the required responses with the enhancements made in ED-315, including the introduction of general IT controls relevant to the audit and the effect on the auditor's tests of indirect controls (see paragraphs A29a–A29b).
83. Conforming amendments are also proposed in ISA 330 to reflect the new concepts introduced in ED-315 as follows:
- Paragraphs 7 and 27—introducing the new concept of 'significant' classes of transactions, account balances and disclosures to align with ISA 315 (Revised). Paragraph 27 has also been further aligned to changes proposed to paragraph 18 relating to classes of transactions, account balances or disclosures that are quantitatively or qualitatively material, but for which no risks of material misstatement have been identified.
  - In assessing the risks of material misstatement, ED-315 explains that the likelihood and magnitude of such risks are taken into account in order to assess where a risk of material misstatement is positioned on the spectrum of inherent risk. Likelihood was already identified in paragraph 7 of ISA 330, but this requirement has been conformed to ED-315 by also including magnitude. Paragraph A9 (which is the application material to paragraph 7) has also been enhanced to explain that the auditor's assessment of the identified risks of material misstatement is determined by the likelihood and magnitude of possible misstatement, and also impacted by the inherent risk factors.
  - Paragraph A18—changes have been proposed to recognize that materiality relates to both quantitative and qualitative aspects.
  - Paragraphs A4—conforming changes proposed to paragraph 18 have been reflected in relation to classes of transactions, account balances and disclosures that are quantitatively or qualitatively material.
  - Paragraph A15—the Task Force considered whether to include a more explicit reference to 'spectrum of inherent risk' (now included more explicitly in ED-315), but agreed that on balance this change was not necessary. This paragraph refers to assessed risk, i.e., starts with the output of the risk identification and assessment process performed in accordance with ED-315 which will result in risks having been assessed along the spectrum of inherent risk.
  - Paragraph A42—as explained in the discussion included in paragraphs 61–67 above, clarifying changes have been made to paragraph A42 and the guidance related to substantive procedures in paragraphs A42–A52 has been linked to paragraph 6 of ISA 330. In addition, paragraph A42a has been added to provide further guidance about the substantive procedures to be performed (i.e., in order to appropriately address the requirement, the procedures need to be designed taking into account how risks of misstatement could exist that have increased likelihood of giving rise to material misstatement). These proposed conforming and consequential amendments have been presented on the basis that both paragraph 30B of ISA 315 (Revised) and paragraph 18 of ISA 330 remain.
  - Paragraph A60—conforming to the new concepts introduced in ED-315 relating to 'relevant assertions' and 'significant classes of transactions, account balances and disclosures.'

#### *Other Conforming Amendments*

84. The IAASB agreed to propose conforming amendments to the other ISAs as presented in Appendix 2.

## Section 4 Request for Comments

Respondents are asked to comment on the clarity, understandability and practicality of application of the requirements and related application material of ED-315. In this regard, comments will be most helpful if they are identified with specific aspects of ED-315 and include the reasons for any concern about clarity, understandability and practicality of application, along with suggestions for improvement.

### Overall Questions

- 1) Has ED-315 been appropriately restructured, clarified and modernized in order to promote a more consistent and robust process for the identification and assessment of the risks of material misstatement. In particular:
  - (a) Do the proposed changes help with the understandability of the risk identification and assessment process? Are the flowcharts helpful in understanding the flow of the standard (i.e., how the requirements interact and how they are iterative in nature)?
  - (b) Will the revisions promote a more robust process for the identification and assessment of the risks of material misstatement and do they appropriately address the public interest issues outlined in paragraphs 6–28?
  - (c) Are the new introductory paragraphs helpful?
- 2) Are the requirements and application material of ED-315 sufficiently scalable, including the ability to apply ED-315 to the audits of entities with a wide range of sizes, complexities and circumstances?
- 3) Do respondents agree with the approach taken to enhancing ED-315 in relation to automated tools and techniques, including data analytics, through the use of examples to illustrate how these are used in an audit (see Appendix 1 for references to the relevant paragraphs in ED-315)? Are there other areas within ED-315 where further guidance is needed in relation to automated tools and techniques, and what is the nature of the necessary guidance?
- 4) Do the proposals sufficiently support the appropriate exercise of professional skepticism throughout the risk identification and assessment process? Do you support the proposed change for the auditor to obtain 'sufficient appropriate audit evidence'<sup>36</sup> through the performance of risk assessment procedures to provide the basis for the identification and assessment of the risks of material misstatement, and do you believe this clarification will further encourage professional skepticism?

### Specific Questions

- 5) Do the proposals made relating to the auditor's understanding of the entity's system of internal control<sup>37</sup> assist with understanding the nature and extent of the work effort required and the relationship of the work effort to the identification and assessment of the risks or material misstatement? Specifically:
  - a) Have the requirements related to the auditor's understanding of each component of the entity's system of internal control been appropriately enhanced and clarified? Is it clear why the understanding is obtained and how this informs the risk identification and assessment process?

<sup>36</sup> See paragraph 27 of this Explanatory Memorandum and paragraph 17 of ED-315

<sup>37</sup> Paragraphs 25–44 and A89–A200 of ED-315

- b) Have the requirements related to the auditor's identification of controls relevant to the audit<sup>38</sup> been appropriately enhanced and clarified? Is it clear how controls relevant to the audit are identified, particularly for audits of smaller and less complex entities?
  - c) Do you support the introduction of the new IT-related concepts and definitions? Are the enhanced requirements and application material related to the auditor's understanding of the IT environment, the identification of the risks arising from IT and the identification of general IT controls sufficient to support the auditor's consideration of the effects of the entity's use of IT on the identification and assessment of the risks of material misstatement?
- 6) Will the proposed enhanced framework for the identification and assessment of the risks of material misstatement result in a more robust risk assessment? Specifically:
- a) Do you support separate assessments of inherent and control risk at the assertion level, and are the revised requirements and guidance appropriate to support the separate assessments'?<sup>39</sup>
  - b) Do you support the introduction of the concepts and definitions of 'inherent risk factors'<sup>40</sup> to help identify risks of material misstatement and assess inherent risk? Is there sufficient guidance to explain how these risk factors are used in the auditor's risk assessment process?
  - c) In your view, will the introduction of the 'spectrum of inherent risk' (and the related concepts of assessing the likelihood of occurrence, and magnitude, of a possible misstatement) assist in achieving greater consistency in the identification and assessment of the risks of material misstatement, including significant risks?
  - d) Do you support the introduction of the new concepts and related definitions of significant classes of transactions, account balances and disclosures, and their relevant assertions? Is there sufficient guidance to explain how they are determined (i.e., an assertion is relevant when there is a reasonable possibility of occurrence of a misstatement that is material with respect to that assertion),<sup>41</sup> and how they assist the auditor in identifying where risks of material misstatement exist?
  - e) Do you support the revised definition,<sup>42</sup> and related material, on the determination of 'significant risks'? What are your views on the matters presented in paragraph 57 of the Explanatory Memorandum relating to how significant risks are determined on the spectrum of inherent risk?
- 7) Do you support the additional guidance in relation to the auditor's assessment of risks of material misstatement at the financial statement level,<sup>43</sup> including the determination about how, and the degree to which, such risks may affect the assessment of risks at the assertion level?

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<sup>38</sup> ED-315, paragraphs 39–40 and paragraphs 37–40 of this Explanatory Memorandum

<sup>39</sup> Paragraphs 45–50 and A201–A235 of ED-315

<sup>40</sup> See paragraph 48 of this Explanatory Memorandum and paragraphs 16(f), A5–A6 and A83–A88 of ED-315

<sup>41</sup> See footnote 26 of this Explanatory Memorandum

<sup>42</sup> Paragraphs 16(k) and A10, and A229–A231, of ED-315

<sup>43</sup> ED-315, paragraphs 47 and A215–A220

- 8) What are your views about the proposed stand-back requirement in paragraph 52 of ED-315 and the revisions made to paragraph 18 of ISA 330 and its supporting application material? Should either or both requirements be retained? Why or why not?

### **Conforming and Consequential Amendments**

- 9) With respect to the proposed conforming and consequential amendments to:
- a) ISA 200<sup>44</sup> and ISA 240, are these appropriate to reflect the corresponding changes made in ISA 315 (Revised)?
  - b) ISA 330, are the changes appropriate in light of the enhancements that have been made in ISA 315 (Revised), in particular as a consequence of the introduction of the concept of general IT controls relevant to the audit?
  - c) The other ISAs as presented in Appendix 2, are these appropriate and complete?
  - d) ISA 540 (Revised) and related conforming amendments (as presented in the Supplement to this exposure draft),<sup>45</sup> are these appropriate and complete?
- 10) Do you support the proposed revisions to paragraph 18 of ISA 330 to apply to classes of transactions, account balances or disclosures that are 'quantitatively or qualitatively material' to align with the scope of the proposed stand-back in ED-315?

### **Request for General Comments**

- 11) In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:
- (a) Translations—recognizing that many respondents may intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues respondents note in reviewing the ED-315.
  - (b) Effective Date—Recognizing that ED-315 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods beginning at least 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.

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<sup>44</sup> Conforming amendments to ISA 200, paragraph A42 will be presented with the conforming amendments to ISA 540 (Revised)

<sup>45</sup> To be published in late July 2018

**Appendix 1**

**Scalability** – refer paragraphs 13–17

<b>Paragraph reference in ED-315 and summary of content (Application material)</b>	
Para. 13	Introducing the concept of scalability and explaining how it has been presented within ISA 315 (Revised)
Para. A16	Explaining that the risk assessment procedures to obtain the overall understanding may be less extensive in the audits of smaller and less complex entities.
Para. A32–A33	Explaining how analytical procedures as a risk assessment tool are scalable: <ul style="list-style-type: none"> <li>- The auditor may perform a simple comparison of actual recorded to budgeted amounts.</li> <li>- Alternatively, the auditor may perform a more advanced procedure by extracting data from the entity's information system, and further analyze this data by using visualization techniques.</li> </ul>
Para. A41	Providing guidance where an engagement team discussion may not be possible, for example, where an engagement is carried out by a sole practitioner.
Para. A43	Clarifying that during the engagement team discussion, the consideration of disclosure requirements are considered even where the financial reporting framework may only require simplified disclosures.
Para. A47	Describing the depth of the auditor's required understanding of the entity and its environment – this will vary according to the nature, size and complexity of the entity.
Para. A49	Explaining that the auditor's understanding of the entity's organizational structure and ownership is dependent on the particular circumstances, such as complexity.
Para. A70	Emphasizing that the procedures to measure the performance of an entity may vary depending on the size or complexity of the entity, as well as the involvement of management and those charged with governance in the management of the entity.
Para. A81	Explaining that disclosures in financial statements of smaller and less complex entities may be simpler and less detailed, but this does not relieve auditor of obtaining understanding of the applicable financial reporting framework
Para. A88	Highlighting an increased susceptibility to risks of material misstatement due to fraud in owner–managed entities.

Para. A90	Explaining that the nature, timing and extent of the auditor's risk assessment procedures will vary and depend on matters such as the size and complexity of the entity.
Para. A93	Clarifying that the way in which internal control is designed, implemented and maintained, varies with an entity's size and complexity.
Para. A106 - A107	<ul style="list-style-type: none"> <li>• Highlighting that the control environment relating to smaller and less complex entities is likely to vary from larger or more complex entities. And therefore, some considerations about the entity's control environment may not be applicable or less relevant.</li> <li>• Clarifying that audit evidence for elements of the control environment in smaller and less complex entities may not be available in documentary form.</li> </ul> <p>In both instances, examples are also provided.</p>
Para. A110	Explaining that the auditor's consideration of the entity's use of IT, as it relates to the control environment, is commensurate with the nature and size of the entity and its business operations, including the complexity or maturity of the entity's technology platform or architecture.
Para. A113	Clarifying that domination of management by a single individual in a smaller and less complex entity does not generally indicate a failure by management to display and communicate an appropriate attitude regarding the entity's system of internal control and the financial reporting process.
Para. A116	Explaining that some smaller and less complex entities, and particularly owner-managed entities, may not have established a formal risk assessment process, or the risk assessment process may not be documented or performed on regular basis, but there may be relevant matters the auditor may still obtain an understanding of.
Para. A120	Highlighting that for some smaller and less complex entities, and particularly owner-managed entities, an appropriate risk assessment may be performed through the direct involvement of management or the owner-manager.
Para. A123	Clarifying that in smaller and less complex entities, and particularly owner-managed entities, management's monitoring of control is often accomplished by the owner-manager's direct involvement in operations and there may not be any other monitoring activities.
Para. A124	Providing guidance to the auditor where an entity may not have a distinct process for monitoring the system of internal control.
Para. A139	Explaining that the auditor's understanding of the entity's information system relevant to financial reporting may require less effort in an audit of smaller or less complex entities, and may be more dependent on inquiry than on review of documentation.



Para. A148	Clarifying that the auditor's understanding of the entity's IT environment may be simpler for a smaller and less complex entity that uses commercial software and the entity does not have access to the source code to make any program changes.
Para. A159	Clarifying that the communication of financial reporting roles and responsibilities within smaller and less complex entities may be less structured and less formal.
Para. A161	Explaining the nature or type of controls in smaller and less complex entities.
Para. A164	Explaining that smaller entities may be limited in the extent to which segregation of duties is practicable, and the consequences thereof.
Para. A167	Explaining that controls relevant to the audit are expected to include, at a minimum, controls over journal entries, and that in audits of smaller and less complex entities with a non-complex information system, there may not be any other controls relevant to the audit (if no significant risks and no intention to test the operating effectiveness of controls)
Para. A181	Providing guidance where an entity uses commercial software and management does not have access to the source code to make any program changes. And consequently, there may be circumstances where no IT applications are relevant to the audit or when understanding program change controls are not required (because the program can't be changed).
Para. A188	Explaining that when there are no IT applications relevant to the audit, other aspects of the entity's IT environment are also not relevant.
Para. A224	Acknowledging that, in relation to audits of smaller and less complex entities, a greater proportion of assessed inherent risks are likely to be at the lower end of the spectrum of inherent risk.
Para. A233	A reminder that the control risk assessment remains at the maximum level when the auditor does not intend to test the operating effectiveness of controls that address the assessed inherent risks.
Para. A244 - A246	Emphasizing that the form and extent of audit documentation may be simple in form and relatively brief for audits of smaller and less complex entities, and may be incorporated in the documentation of the overall strategy and audit plan.

**Data Analytics** – refer paragraphs 20–23

<b>Paragraph reference in ED-315 and summary of content (Application material)</b>	
Para. A15	Emphasizing that technology may be used on large volumes of data, which may result in audit evidence that informs the identification and assessment of risks of material misstatement.

Para. A18	Clarifying that the auditor may use automated tools and techniques to perform risk assessment procedures, including for analysis, recalculations, re-performance or reconciliations.
Para. A33	Describing that: <ul style="list-style-type: none"> <li>• Risk assessment analytical procedures may be automated, for example by using visualization techniques to analyze data to identify more specific areas of possible misstatement.</li> <li>• The application of automated analytical procedures to data may be referred to as data analytics.</li> </ul>
Para. A48	Highlighting that the auditor may be able to enhance the understanding of the entity and its environment by using automated tools and techniques, and providing an example.
Para. A155	Explaining the option to use automated techniques to assist in confirming that the information system has been implemented.
Para. A175	Describing that automated tools may be used to understand the nature and extent of controls over journal entries.
Para. A213	Clarifying that automated techniques may be used to confirm whether all significant classes of transactions and account balances have been identified by, for example, analyzing types of transactions and their volume.

**Professional Skepticism – refer paragraphs 26–27**

<b>Paragraph reference in ED-315 and summary of content (Application material)</b>	
Para. A19	Explaining that the various sources of information may provide potentially contradictory information which may assist the auditor in exercising effective professional skepticism in identifying and assessing the risks of material misstatement.
Para. A42	Describes the benefits of the engagement team discussion, and in particular, assisting engagement team members in further considering inconsistent information based on each member's own understanding of the nature and circumstances of the entity.
Para. A44	Explicitly explaining that when performing risk assessment procedures, the engagement team has the opportunity to exercise professional skepticism through identifying and discussing inconsistent or contradictory information obtained in performing those procedures, as well as considering whether there are indicators of possible management bias (both intentional and unintentional).

Para. A47	Clarifying that the ability of the engagement team to effectively exercise professional skepticism throughout the audit is enhanced through obtaining a thorough understanding of the entity and its environment and the applicable financial reporting framework.
Para. A135	Emphasizing that the auditor's communications with the internal audit function may provide opportunities for the auditor to obtain information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Contradictory information enables the auditor to exercise professional skepticism.
Para. A201	Reminding the auditor that in identifying and assessing the risks of material misstatement, the auditor exercises professional skepticism in accordance with ISA 200. <sup>46</sup>

**Fraud** – refer paragraph 28

<b>ED-315 Requirements</b>	
Introductory Para. 8	Explaining that risks to be identified and assessed by the auditor in accordance with ISA 315 (Revised) include both those due to error and fraud. Due to the significance of fraud, further reference to ISA 240 is required.
Para. 15	Stating the objective of the standard, i.e. the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
Para. 16(i)	Risk assessment procedures – The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
<b>ED-315 Application Material</b>	
Para. A5	Explanatory material on the 'susceptibility to misstatement due to management bias or fraud' inherent risk factor.
Para. A13	Confirming that the risks of material misstatement are identified and assessed due to both error and fraud. However, due to the significance of fraud, further reference to ISA 240 is required.
Para. A14	Explaining that the understanding of the auditor, as required by ISA 315 (Revised), establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, including during the auditor's consideration of fraud in accordance with ISA 240.
Para. A22	Clarifying that inquiries, as part of risk assessment procedures, may provide information about matters such as fraud or suspected fraud affecting the entity.

<sup>46</sup> ISA 200 paragraph 15

Para. A27	Reminding the auditor of ISA 240 para. 19: If internal audit function provides information regarding fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.
Para. A31	Explaining that analytical procedures may help identify unusual or unexpected relationships that may assist the auditor in identifying risks of material misstatement due to fraud.
Para. A42	<p>Emphasizing that:</p> <ul style="list-style-type: none"> <li>• The engagement team discussion allows the engagement team to exchange information about how the financial statements might be susceptible to material misstatement due to fraud and error.</li> <li>• ISA 240 requires that the discussion place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud.</li> </ul>
Para. A52	Explaining that the understanding of the business model may assist the auditor in identifying incentives or pressures on management that may result in intentional or unintentional bias.
Para. A71	Explaining that an understanding of the entity's performance measures may assist the auditor in identifying performance targets that increase the susceptibility to misstatement due to management bias or fraud.
Para. A84–A85	<ul style="list-style-type: none"> <li>• Emphasizing that when the auditor obtains an understanding of the entity, the auditor may identify events or conditions that are indicative of risks of material misstatement due to fraud.</li> <li>• If so, the auditor is required to consider whether one or more fraud risk factors are present in accordance with ISA 240 para. 24.</li> </ul>
Para. A88	Highlighting an increased susceptibility to risks of material misstatement due to fraud in owner–managed entities.
Para. A114	Clarifying that although the control environment may help reduce the risk of fraud, it is not an absolute deterrent to fraud.
Para. A117	Explaining that an understanding of the entity's risk assessment process may include how management or those charged with governance consider the potential for fraud.
Para. A164	Explaining that domination of management by a single individual (and when segregation of duties doesn't exist) is an opportunity for management override of controls.
Para. A172	Reminding the auditor of the importance to obtain an understanding of the controls management has implemented to prevent and detect fraud, as well as referring to the fraud risk factors included in ISA 240.
Para. A231	Emphasizing that ISA 240 provides requirements and guidance in relation to the identification and assessment of risks of material misstatement due to fraud when a significant risk has been identified.

EXPLANATORY MEMORANDUM TO ED-315 (REVISED)

Appendix 2	An example of events and conditions relating to the 'susceptibility to misstatement due to management bias or fraud' – Fraudulent financial reporting.
Appendix 3	Explaining that the segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

## Appendix 2

## Explanation of Conforming Amendments Proposed Not Presented

Table 1		
Extant Term in the ISAs	Change Made in Proposed ISA 315 (Revised)	Relevant Paragraph(s) Where Change is Proposed
<b>Changes to Names of Components of the System of Internal Control</b>		
Monitoring of controls (extant ISA 315 (Revised), para's 22–24)	The entity's process to monitor the system of internal control (ED-315, para's 32–34)	<u>ISA 210</u> : <sup>47</sup> <ul style="list-style-type: none"> <li>Para. A18 (refer to <b>Table 2</b>)</li> </ul> <u>ISA 402</u> : <sup>48</sup> <ul style="list-style-type: none"> <li>Para. A33 – last bullet</li> <li>Para. A34</li> </ul>
The information system, including the related business processes, relevant to financial reporting, and communication (extant ISA 315 (Revised), para. 18)	The information system, and communication (ED-315, para. 35)	<u>ISA 210</u> : <ul style="list-style-type: none"> <li>Para. A18 (refer to <b>Table 2</b>)</li> </ul>
<b>Other Changes</b>		
Monitoring of controls <sup>49</sup> (extant ISA 315 (Revised), para's 22–24)	Controls within the entity's process to monitor the system of internal control (ED-315, para's 32–34)	<u>ISA 402</u> : <ul style="list-style-type: none"> <li>A39 – first bullet</li> </ul> <u>ISA 600</u> : <sup>50</sup> <ul style="list-style-type: none"> <li>Appendix 2, para. 1, 8<sup>th</sup> bullet (refer to <b>Table 2</b>)</li> </ul>

<sup>47</sup> ISA 210, *Agreeing the Terms of Audit Engagements*

<sup>48</sup> ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

<sup>49</sup> Where this is used to describe what the entity does, as opposed to the name of the component

<sup>50</sup> ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

Table 1		
Extant Term in the ISAs	Change Made in Proposed ISA 315 (Revised)	Relevant Paragraph(s) Where Change is Proposed
Control activities (extant ISA 315 (Revised), para. 20)	Controls (ED-315, para. 38)	<u>ISA 250 (Revised):</u> <sup>51</sup> <ul style="list-style-type: none"> <li>• Para. A23</li> </ul> <u>ISA 265:</u> <ul style="list-style-type: none"> <li>• Para A3 (2<sup>nd</sup> and 3<sup>rd</sup> sentences) (refer to <b>Table 2</b>)</li> </ul> <u>ISA 500:</u> <ul style="list-style-type: none"> <li>• Para. A17</li> </ul> <u>ISA 501:</u> <sup>52</sup> <ul style="list-style-type: none"> <li>• Para. A4</li> </ul> <u>ISA 550:</u> <sup>53</sup> <ul style="list-style-type: none"> <li>• Para. A20</li> </ul> <u>ISA 600:</u> <ul style="list-style-type: none"> <li>• Appendix 2, para. 1 (7<sup>th</sup> bullet)</li> <li>• Appendix 5, Matters that are relevant to the conduct of the work of the component auditor (1<sup>st</sup> bullet)</li> </ul> <u>ISA 610:</u> <sup>54</sup> <ul style="list-style-type: none"> <li>• Para. A3</li> <li>• Para. A10</li> </ul>
Control activities <sup>55</sup> (extant ISA 315 (Revised), para. 20)	Controls in the control activities component (ED-315, para. 38)	<u>ISA 265:</u> <ul style="list-style-type: none"> <li>• Para. A3 (first sentence) (refer to <b>Table 2</b>)</li> </ul>
Relevant control activities (extant ISA 315 (Revised), para. 20)	Controls relevant to the audit (ED-315, para. 38)	<u>ISA 300:</u> <sup>56</sup> <ul style="list-style-type: none"> <li>• Para. A21</li> </ul>

<sup>51</sup> ISA 250 (Revised), *Consideration of laws and Regulations in an Audit of Financial Statements*

<sup>52</sup> ISA 501, *Audit Evidence – Specific Considerations for Selected Items*

<sup>53</sup> ISA 550, *Related Parties*

<sup>54</sup> ISA 610, *Using the Work of Internal Auditors*

<sup>55</sup> The proposed change in respect of this reference to ‘control activities’ is slightly different when compared to the proposed change in the previous row. This is due to the particular construction of the first sentence of ISA 265 paragraph A3; however, the meaning of ‘controls’ remains the same. Also refer to Table 2.

<sup>56</sup> ISA 300, *Planning an Audit of Financial Statements*

Table 1		
Extant Term in the ISAs	Change Made in Proposed ISA 315 (Revised)	Relevant Paragraph(s) Where Change is Proposed
The auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (extant ISA 315 (Revised), para. 9)	The auditor shall evaluate whether such information remains relevant and reliable as audit evidence for the current audit. (ED-315, para. 21)	<u>ISA 500:</u> <ul style="list-style-type: none"> <li>• Para. A1</li> </ul>
Internal control (extant ISA 315 (Revised), para. 4(c))	The system of internal control (ED-315, para. 16(l))	<u>ISA 210:</u> <ul style="list-style-type: none"> <li>• Para. A18 (refer to <b>Table 2</b>)</li> </ul> <u>ISA 265:</u> <ul style="list-style-type: none"> <li>• Para. 1 (second sentence)</li> <li>• Para. 2 (first sentence)</li> </ul> <u>ISA 620:</u> <sup>57</sup> <ul style="list-style-type: none"> <li>• Para. A4 (first bullet)</li> </ul>
Internal control relevant to the audit (extant ISA 315 (Revised), para. 12)	Controls relevant to the audit (ED-315, para. 26)	<u>ISA 402:</u> <ul style="list-style-type: none"> <li>• Para 14(b)</li> </ul>
Internal control relevant to the audit. (extant ISA 315 (Revised), para. 12)	System of internal control relevant to financial reporting (ED-315, para. 25)	<u>ISA 260 (Revised):</u> <sup>58</sup> <ul style="list-style-type: none"> <li>• Para A13, 3<sup>rd</sup> bullet</li> </ul> <u>ISA 265:</u> <ul style="list-style-type: none"> <li>• Para 2 (first sentence)</li> </ul> <u>ISA 402:</u> <ul style="list-style-type: none"> <li>• Para. 1</li> <li>• Para. 7(a)</li> <li>• Para. 10 (refer to <b>Table 2</b>)</li> </ul>
Extant elements of the auditor's understanding of the 'entity and its environment' Extant ISA 315 (Revised), para. 11 (refer to <b>Table 3</b> )	Revised elements of the auditor's understanding of the 'entity and its environment' (ED-315, para. 23 (refer to <b>Table 3</b> ))	All the changes in this section are presented in <b>Table 3</b> <u>ISA 550:</u> <ul style="list-style-type: none"> <li>• Para. A12</li> </ul> <u>ISA 600:</u> <ul style="list-style-type: none"> <li>• Para. A23</li> </ul> <u>ISA 720 (Revised):</u> <sup>59</sup> <ul style="list-style-type: none"> <li>• Para. A31</li> </ul>

<sup>57</sup> ISA 620, *Using the Work of an Auditor's Expert*

<sup>58</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

<sup>59</sup> ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*



Table 1		
Extant Term in the ISAs	Change Made in Proposed ISA 315 (Revised)	Relevant Paragraph(s) Where Change is Proposed
Understanding the entity and its environment <sup>60</sup> (extant ISA 315 (Revised), para. 11)	Understanding the entity and its environment, the applicable financial reporting framework and the system of internal control (ED-315, para. 17)	<u>ISA 230:</u> <ul style="list-style-type: none"> <li>Para. A17 (refer <b>Table 2</b>)</li> </ul> <u>ISA 600:</u> <ul style="list-style-type: none"> <li>Para. 17</li> </ul> <u>ISA 620:</u> <ul style="list-style-type: none"> <li>Para. A4 (first bullet)</li> </ul> <u>ISA 720 (Revised):</u> <ul style="list-style-type: none"> <li>Para. A31 (refer <b>Table 3</b>)</li> </ul>
Require special audit consideration (in context of significant risks) (extant ISA 315 (Revised), para. 4(e))	<i>Change as appropriate or delete</i> (ED-315, para. 16(k) and A10)	All the changes in this section are presented in <b>Table 2</b> <u>ISA 260 (Revised):</u> <ul style="list-style-type: none"> <li>Para. A12</li> </ul> <u>ISA 550:</u> <ul style="list-style-type: none"> <li>Para. A28</li> </ul> <u>ISA 600:</u> <ul style="list-style-type: none"> <li>Para. A6</li> </ul> <u>ISA 610:</u> <ul style="list-style-type: none"> <li>Para. A21</li> </ul> <u>ISA 701:</u> <ul style="list-style-type: none"> <li>Para. A20</li> </ul>
Relevant controls (extant ISA 315 (Revised), para 13 – heading)	Controls relevant to the audit (ED-315, para. 26)	<u>ISA 402:</u> <ul style="list-style-type: none"> <li>Para. 10 (refer <b>Table 2</b>)</li> <li>Para. 12 (c) and (d)</li> <li>Para. A19</li> <li>Para. A22 (hanging paragraph)</li> <li>Para. A29</li> <li>Para. A30 (1<sup>st</sup> and 2<sup>nd</sup> sentences)</li> <li>Para. A33</li> </ul>

<sup>60</sup> When reference is made to the auditor's understanding of the entity and its environment, and in the specific context used, are intended to be inclusive of the auditor's understanding of internal control

Table 1		
Extant Term in the ISAs	Change Made in Proposed ISA 315 (Revised)	Relevant Paragraph(s) Where Change is Proposed
Relevant controls (extant ISA 315 (Revised), para 13 – heading)	<i>Change as appropriate</i>	<u>ISA 530:</u> <sup>61</sup> <ul style="list-style-type: none"> <li>Appendix 2, factor 1 (refer <b>Table 2</b>)</li> </ul> <u>ISA 550:</u> <ul style="list-style-type: none"> <li>Para. A34 – last sentence (refer <b>Table 2</b>)</li> </ul>
Identifying and assessing the risks of material misstatement through understanding the entity and its environment (name of standard)	Identifying and assessing the risks of material misstatement	<u>ISA 210:</u> <ul style="list-style-type: none"> <li>Footnote 14</li> </ul> <u>ISA 220:</u> <sup>62</sup> <ul style="list-style-type: none"> <li>Footnote 13</li> </ul> <u>ISA 230:</u> <ul style="list-style-type: none"> <li>Footnote 5</li> <li>Appendix</li> </ul> <u>ISA 250:</u> <sup>63</sup> <ul style="list-style-type: none"> <li>Footnote 4</li> </ul> <u>ISA 260 (Revised):</u> <ul style="list-style-type: none"> <li>Footnote 4</li> </ul> <u>ISA 265:</u> <ul style="list-style-type: none"> <li>Footnote 1</li> </ul> <u>ISA 300:</u> <ul style="list-style-type: none"> <li>Footnote 4</li> </ul> <u>ISA 320:</u> <sup>64</sup> <ul style="list-style-type: none"> <li>Footnote 3</li> </ul> <u>ISA 402:</u> <ul style="list-style-type: none"> <li>Footnote 1</li> </ul> <u>ISA 500:</u> <ul style="list-style-type: none"> <li>Footnote 1</li> </ul>

<sup>61</sup> ISA 530, *Audit Sampling*

<sup>62</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

<sup>63</sup> ISA 250, (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*

<sup>64</sup> ISA 320, *Materiality in Planning and Performing an Audit*

Table 1		
Extant Term in the ISAs	Change Made in Proposed ISA 315 (Revised)	Relevant Paragraph(s) Where Change is Proposed
Identifying and assessing the risks of material misstatement through understanding the entity and its environment (name of standard)	Identifying and assessing the risks of material misstatement	<u>ISA 505:</u> <sup>65</sup> <ul style="list-style-type: none"><li>Footnote 14</li></ul> <u>ISA 510:</u> <sup>66</sup> <ul style="list-style-type: none"><li>Footnote 4</li></ul> <u>ISA 520:</u> <sup>67</sup> <ul style="list-style-type: none"><li>Footnote 1</li></ul> <u>ISA 550:</u> <ul style="list-style-type: none"><li>Footnote 1</li></ul> <u>ISA 570:</u> <sup>68</sup> <ul style="list-style-type: none"><li>Footnote 3</li></ul> <u>ISA 600:</u> <ul style="list-style-type: none"><li>Footnote 7</li></ul> <u>ISA 610:</u> <ul style="list-style-type: none"><li>Footnote 1</li></ul> <u>ISA 700 (Revised):</u> <ul style="list-style-type: none"><li>Footnote 35</li></ul> <u>ISA 701:</u> <ul style="list-style-type: none"><li>Footnote 5</li></ul> <u>ISA 720 (Revised):</u> <ul style="list-style-type: none"><li>Footnote 11</li></ul> <u>ISA 800:</u> <ul style="list-style-type: none"><li>Footnote 5</li></ul>
Relevant assertion (this is now a defined term)	<i>As appropriate</i>	Refer to <b>Table 2</b> : <ul style="list-style-type: none"><li>ISA 265 para. A8</li></ul>
<i>Aspects of the entity's</i> information system (ISA 315 (Revised), para. 18)	Alignment to the requirements to understanding the information system. (ED-315, para. 35)	<u>ISA 402:</u> Para. 3 (refer to <b>Table 2</b> )

<sup>65</sup> ISA 505, *External Confirmations*

<sup>66</sup> ISA 510, *Opening Balances*

<sup>67</sup> ISA 520, *Analytical Procedures*

<sup>68</sup> ISA 570 (Revised), *Going Concern*

Table 2

**Description of components of the system of internal control****1. ISA 210, para. A18**

It is for management to determine what internal control is necessary to enable the preparation of the financial statements. The term “internal control” encompasses a wide range of activities within components of the system of internal control that may be described as the control environment; the entity’s risk assessment process; the entity’s process to monitor the system of internal control, the information system, ~~including the related business processes relevant to financial reporting~~, and communication; and control activities; ~~and monitoring of controls~~. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component.<sup>69</sup> An entity’s internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.

**Controls within the entity’s process to monitor the system of internal control****2. ISA 600, Appendix 2, paragraph 1 (8<sup>th</sup> bullet)****Group-Wide Controls**

1. Group-wide controls may include a combination of the following:
  - Regular meetings between group and component management to discuss business developments and to review performance.
  - ...
  - Controls within the group’s process to monitor ~~Monitoring the system of internal~~ controls, including activities of the internal audit function and self-assessment programs.

**Control activities****3. ISA 265, para. A3**

While the concepts underlying controls in the control activities component in smaller entities are likely to be similar to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of controls ~~activities~~ are not necessary because of controls applied by management. For example, management’s sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed controls ~~activities~~.

<sup>69</sup> ED 315, ISA 315 (Revised), proposed paragraph A9959 and Appendix 31

Table 2

**'Controls relevant to the audit', and the 'system of internal control'****4. ISA 402, para. 10**

When obtaining an understanding of the system of internal control relevant to the audit financial reporting in accordance with ISA 315 (Revised),<sup>70</sup> the user auditor shall evaluate the design and implementation of ~~relevant~~ controls relevant to the audit at the user entity that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization. (Ref: Para. A12–A14)

**Describing aspects of the entity and its environment in extant ISA 315 (Revised):****5. ISA 230, para. A17**

When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control, the overall audit strategy and audit plan, materiality determined in accordance with ISA 320,<sup>71</sup> assessed risks, significant matters noted during the audit, and conclusions reached.

**References to risks that 'require special audit consideration'****6. ISA 260 (Revised), para. A12**

Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they were determined to be significant risks ~~require special audit consideration~~. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

**7. ISA 550, para. A28**

*Sharing Related Party Information with the Engagement Team* (Ref: Para. 17)

Relevant related party information that may be shared among the engagement team members includes, for example:

- The identity of the entity's related parties.
- The nature of the related party relationships and transactions.
- Significant or complex related party relationships or transactions that may be determined to be significant risks ~~require special audit consideration~~, in particular transactions in which management or those charged with governance are financially involved.

<sup>70</sup> ~~ED-315, ISA 315 (Revised)~~, paragraph ~~25~~<sup>42</sup>

<sup>71</sup> ISA 320, *Materiality in Planning and Performing an Audit*

Table 2

8. **ISA 600, para. A6**

The group engagement team may also identify a component as likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, ~~(that is, risks that require special audit consideration<sup>72</sup>)~~. For example, a component could be responsible for foreign exchange trading and thus expose the group to a significant risk of material misstatement, even though the component is not otherwise of individual financial significance to the group.

9. **ISA 610, para. A21**

As explained in ISA 315 (Revised),<sup>73</sup> significant risks ~~require special audit consideration~~ are risks assessed close to the upper end of the spectrum of inherent risk and therefore the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, where the risks of material misstatement is other than low, the use of the work of the internal audit function alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.

10. **ISA 701, para. A20**

ISA 315 (Revised) defines a significant risk as an identified ~~and assessed~~ risk of material misstatement:

- For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which one or a combination of the inherent risk factors affect the likelihood of a misstatement occurring or the magnitude of potential misstatement should that misstatement occur; or
- That is to be treated as a significant risk in accordance with the requirement of other ISAs.<sup>74</sup>  
~~that, in the auditor's judgment, requires special audit consideration. Areas of significant management judgment and significant unusual transactions may often be identified as significant risks. Significant risks are therefore often areas that require significant auditor attention.~~

**Extant references to relevant controls**11. **ISA 530****Appendix 2, factor 1**

1. An increase in the extent to which the auditor's risk assessment takes into account ~~relevant~~ controls that address the risk of material misstatement.

<sup>72</sup> ~~ISA 315 (Revised), paragraphs 27–29~~

<sup>73</sup> ~~ED-315, ISA 315 (Revised), paragraph 4(k)(e)~~

<sup>74</sup> ~~ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 27 and ISA 550, *Related Parties*, paragraph 18~~

Table 2

12. **ISA 550, para. A34**

Depending upon the results of the auditor's risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone in relation to the risks of material misstatement associated with related party relationships and transactions. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the ISA 330 requirement to obtain sufficient appropriate audit evidence as to the operating effectiveness of ~~relevant~~ controls,<sup>75</sup> the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.

**Extant references to 'relevant assertion'**13. **ISA 265, para. A8**

A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account balance or disclosure, ~~relevant~~ assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

**Alignment to the requirements to understanding the information system**14. **ISA 402, para. 3**

Services provided by a service organization are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organization are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. A service organization's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:

- (a) How information relating to significant classes of transactions, account balances and disclosures flows through the user entity's information system, whether manually or using IT, and whether obtained from within or outside the general ledger and subsidiary ledgers. The classes of transactions in the user entity's operations that are significant to the user entity's financial statements; This includes when the service organization's services affect how:
  - (i) ~~(b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements; Transactions of the user entity are initiated, and how information about them is recorded,~~

<sup>75</sup> ISA 330, paragraph 8(b)

Table 2

	<p><u>processed, corrected as necessary, and incorporated in the general ledger and reported in the financial statements; and</u></p> <p>(ii) <u>Information about events and conditions, other than transactions, is captured, processed and disclosed by the user entity in the financial statements.</u></p> <p>(b) <del>(c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements and other supporting records relating to the flows of information in paragraph 3(a) that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;</del></p> <p><del>(d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;</del></p> <p><u>(ce) The financial reporting process used to prepare the user entity's financial statements from the records described in paragraph 3(b), including as it relates to disclosures and to accounting estimates relating to significant classes of transactions, account balances and disclosures accounting estimates and disclosures; and</u></p> <p><u>(d) The entity's IT environment relevant to (a) to (c) above.</u></p> <p><del>(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.</del></p>
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Table 3

**Describing aspects of the entity and its environment in extant ISA 315 (Revised)** (*changes to the description of the entity and its environment are described below*):

**1. ISA 550, para. A12**

However, where the framework does not establish related party requirements, the entity may not have such information systems in place. Under such circumstances, it is possible that management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by paragraph 13 still applies because management may be aware of parties that meet the related party definition set out in this ISA. In such a case, however, the auditor's inquiries regarding the identity of the entity's related parties are likely to form part of the auditor's risk assessment procedures and related activities performed in accordance with ISA 315 (Revised) to obtain information regarding the entity's organizational structure, ownership, governance and business model.:

- ~~The entity's ownership and governance structures;~~
- ~~The types of investments that the entity is making and plans to make; and~~
- ~~The way the entity is structured and how it is financed.~~

In the particular case of common control relationships, as management is more likely to be aware of such relationships if they have economic significance to the entity, the auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or shares resources to a significant degree, are related parties.

**2. ISA 600, para. A23**

*Matters about Which the Group Engagement Team Obtains an Understanding* (Ref: Para. 17)

ISA 315 (Revised) contains guidance on matters the auditor may consider when obtaining an understanding of the entity and its environment, including:

- 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;
- Relevant industry, regulatory, and other external factors that affect the entity;<sup>76</sup>
- The relevant measures~~ment~~ used, internally and externally, to assess and review of the entity's financial performance; and
- The including the applicable financial reporting framework; the nature of the entity; objectives and strategies and related business risks; and.<sup>76</sup>

Appendix 2 of this ISA contains guidance on matters specific to a group including the consolidation process

<sup>76</sup> ED-315, ISA 315 (Revised), proposed paragraphs A4925–A8849

Table 3

**3. ISA 720 (Revised), para. A31**

The auditor's knowledge obtained in the audit includes the auditor's understanding of the entity and its environment, the applicable financial reporting framework, and including the entity's system of internal control, obtained in accordance with ISA 315 (Revised).<sup>77</sup> ISA 315 (Revised) sets out the auditor's required understanding, which includes such matters as obtaining an understanding of:

- (a) 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;
- (b) ~~The r~~Relevant industry, regulatory, and other external factors;  
~~The nature of the entity;~~  
~~The entity's selection and application of accounting policies;~~  
~~The entity's objectives and strategies;~~
- (c) The relevant measures used, internally and externally, to assess measurement and review of the entity's financial performance; ~~and~~
- (d) The applicable financial reporting framework; and
- (e) The entity's system of internal control.

**Proposed amendments to the auditor's required understanding of 'the entity and its environment'**

The following describes extant elements of the auditor's understanding of the 'entity and its environment' – ISA 315 (Revised) paragraph 11:

*The Entity and Its Environment*

The auditor shall obtain an understanding of the following:

- (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A25–A30)
- (b) The nature of the entity, including:
  - (i) its operations;
  - (ii) its ownership and governance structures;
  - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
  - (iv) the way that the entity is structured and how it is financed,  
to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A31–A35)
- (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A36)

<sup>77</sup> ED-315 ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraphs 2311–2512

**Table 3**

- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A37–A43)
- (e) The measurement and review of the entity's financial performance. (Ref: Para. A44–A49)

The following describes the revised elements of the auditor's understanding of the 'entity and environment' – ED 315 paragraph 23:

The auditor shall perform risk assessment procedures to obtain an understanding of the entity and its environment and the applicable financial reporting framework. In doing so, the auditor shall obtain an understanding of the following matters to provide an appropriate basis for understanding the classes of transactions, account balances and disclosures to be expected in the entity's financial statements:

- (a) The entity and its environment, including:
  - (i) 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; (Ref: Para A49–A63)
  - (ii) Relevant industry, regulatory and other external factors; and (Ref: Para. A64–A69)
  - (iii) The relevant measures used, internally and externally, to assess the entity's financial performance. (Ref: Para. A70–A78)
- (b) The applicable financial reporting framework, including: (Ref: Para.A79–A82)
  - (i) How it applies in the context of the nature and circumstances of the entity and its environment, including how events or conditions are subject to, or affected by, the inherent risk factors; and (Ref: Para.A83–A88)
  - (ii) The entity's accounting policies and any changes thereto, including the reasons for any changes to the entity's accounting policies.

**Changes will also be made to the *Glossary of Terms* as needed.**

# PROPOSED INTERNATIONAL STANDARD ON AUDITING 315 (REVISED) IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2020)

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PROPOSED INTERNATIONAL STANDARD ON AUDITING 315 (REVISED)  
IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing The Risks of Material Misstatement*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements

### Key Concepts in this ISA

2. ISA 200 deals with the overall objectives of the auditor in conducting an audit of the financial statements,<sup>78</sup> including to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.<sup>79</sup> Audit risk is a function of the risks of material misstatement and detection risk. ISA 200 explains that the risks of material misstatement may exist at two levels:<sup>80</sup> the overall financial statement level; and the assertion level for classes of transactions, account balances and disclosures. ISA 200 further requires the auditor to exercise professional judgment in planning and performing an audit, and to plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.<sup>81</sup>
3. Risks at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level consist of two components, inherent and control risk:
  - Inherent risk is described as the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - Control risk is described as the risk that a misstatement that could occur in an assertion about a class of transactions, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's controls.
4. The required understanding of the entity and the environment, the applicable financial reporting framework, and the system of internal control forms the basis for the auditor's identification of risks of material misstatement. The identification of risks of material misstatement at the assertion level is performed before consideration of any controls. The auditor does so based on a preliminary assessment of inherent risk that involves identifying those risks for which there is a reasonable possibility of material misstatement. In this ISA the assertions to which such risks of material misstatement relate are referred to as 'relevant assertions,' and the classes of transactions, account balances and disclosures to which the relevant assertions relate are referred to as 'significant classes of transactions, account balances and disclosures.'

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<sup>78</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

<sup>79</sup> ISA 200, paragraph 17

<sup>80</sup> ISA 200, paragraphs 13(c) and 13(n)

<sup>81</sup> ISA 200, paragraphs 15–16

5. For the identified risks of material misstatement at the assertion level, a separate assessment of inherent risk and control risk is required by this ISA. The auditor assesses the inherent risk by assessing the likelihood and magnitude of material misstatement, and by taking into account inherent risk factors. Inherent risk factors individually or in combination increase inherent risk to varying degrees. As explained in ISA 200, inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. The degree to which inherent risk varies, is referred to in this ISA as the 'spectrum of inherent risk.'
6. In assessing control risk, the auditor takes into account whether the auditor's further audit procedures contemplate planned reliance on the operating effectiveness of controls (that is, control risk is assessed as less than maximum). The auditor's understanding of the system of internal control forms the basis for the auditor's intentions about whether to place reliance on the operating effectiveness of controls. That is, the auditor may identify specific controls that address the identified risks of material misstatement and for which the auditor intends to test operating effectiveness. If the auditor does not intend to test the operating effectiveness of controls related to certain identified risks of material misstatement,, the auditor's assessment of control risk cannot be reduced for the effective operation of controls with respect to the particular assertion (that is, control risk is assessed at maximum).
7. The auditor's assessment of the risks of material misstatement at the assertion level is based on the auditor's assessments of inherent risk and control risk at the assertion level. The auditor designs and performs further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement at the assertion level. The auditor also identifies and assesses the risks of material misstatement at the financial statement level in accordance with this ISA in order to design and implement overall responses to address such risks.
8. Risks of material misstatement identified and assessed by the auditor include both those due to error and those due to fraud. Although both are addressed by this ISA, the significance of fraud is such that further requirements and guidance are included in ISA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify, assess and respond to the risks of material misstatement due to fraud.

The iterative nature of the auditor's risk assessment process

9. The auditor's risk assessment process is iterative and dynamic. The auditor develops initial expectations about the potential risks of material misstatement and the potential significant classes of transactions, account balances and disclosures based on the auditor's understanding of the entity and its environment and the applicable financial reporting framework. The auditor's understanding of the system of the internal control, and in particular the information system component, provides further information to assist the auditor in developing those expectations.
10. After identifying the risks of material misstatement, the auditor determines the significant classes of transactions, account balances and disclosures. The auditor is also required to perform a stand-back to confirm that this identification is appropriate.
11. The auditor's process of assessing the identified risks of material misstatement at the assertion level also results in the auditor's determination of any significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence.

12. This ISA requires the auditor to revise the risk assessments and modify further overall responses and further audit procedures based on audit evidence obtained from performing further audit procedures, or if new information is obtained.

#### Scalability

13. ISA 200 states that the ISAs include considerations specific to smaller entities within the application and explanatory material.<sup>82</sup> This ISA is intended for audits of all entities, regardless of size or complexity. However, the application material of this ISA incorporates considerations specific to audits of smaller entities when such entities are also less complex. Accordingly, in this context, this ISA refers to 'smaller and less complex entities.' While the size of an entity may be an indicator of its complexity, some smaller entities may be complex and some larger entities may be less complex. Some of the considerations however may be useful in audits of larger and less complex entities.

#### Effective Date

14. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2020.

#### Objective

15. The objective of the auditor is to identify and assess 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.

#### Definitions

16. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Application controls – Controls of a preventative or detective nature that support the initiation, recording, processing and reporting of transactions or other information in the entity's information system, the objectives of which are to maintain the reliability of such transactions and other information. Such controls may rely on information, or other controls that maintain the integrity of information, or may rely on the operation of other controls.
  - (b) Assertions – Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and in responding to the risks of material misstatement. (Ref. Para: A1–A2).
  - (c) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

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<sup>82</sup> ISA 200, paragraphs 66 - 68



- (d) Controls – Policies or procedures that are embedded within the components of the system of internal control to achieve the control objectives of management or those charged with governance. In this context:
- Policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.
  - Procedures are actions to implement policies. (Ref: Para. A3–A4)
- (e) General information technology (IT) controls – Controls related to the IT environment that support the effective functioning of application controls or the integrity of information by helping to maintain the continued operation, as designed, of the entity's information system. General IT controls include controls over the entity's IT processes. Also see the definition of *IT environment*
- (f) Inherent Risk Factors – Characteristics of events or conditions that affect susceptibility to misstatement of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be qualitative or quantitative, and include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to management bias or fraud. (Ref: Para A5–A6)
- (g) IT environment – The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies. For the purposes of this ISA:
- An IT application is a program or a set of programs that is used in the initiation, processing, recording and reporting of transactions or information.
  - The IT infrastructure is comprised of the network, operating systems, and databases and their related hardware and software.
  - The IT processes are the entity's processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations, which includes monitoring the IT environment. (Ref: Para: A7–A8)
- (h) Relevant assertions – An assertion is relevant to a class of transactions, account balance or disclosure when the nature or circumstances of that item are such that there is a reasonable possibility of occurrence of a misstatement with respect to that assertion that is material, individually or in combination with other misstatements. There is such possibility when the likelihood of a material misstatement is more than remote. The determination of whether an assertion is a relevant assertion is made before consideration of controls. (Ref: Para. A9)
- (i) Risk assessment procedures – The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
- (j) Significant class of transactions, account balance or disclosure – A class of transactions, account balance or disclosure for which there is one or more relevant assertions.

- (k) Significant risk – An identified risk of material misstatement:
- For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which one or a combination of the inherent risk factors affect the likelihood of a misstatement occurring or the magnitude of potential misstatement should that misstatement occur; or
  - That is to be treated as a significant risk in accordance with the requirements of other ISAs.<sup>83</sup> (Ref: Para. A10)
- (l) System of Internal Control – The system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. For the purposes of the ISAs, the system of internal control consists of five inter-related components: (Ref: Para. A11)
- Control environment.
  - The entity's risk assessment process.
  - The entity's process to monitor the system of internal control.
  - The information system and communication.
  - Control activities.

## Requirements

### Risk Assessment Procedures and Related Activities

17. The auditor shall design and perform risk assessment procedures to obtain an understanding of:
- (a) The entity and its environment in accordance with paragraph 23(a);
  - (b) The applicable financial reporting framework in accordance with paragraph 23(b); and
  - (c) The entity's system of internal control in accordance with paragraphs 25–44
- to obtain sufficient appropriate audit evidence as the basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A12–A16)
18. The risk assessment procedures shall include the following: (Ref: Para A17–A20)
- (a) Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A21–A29)
  - (b) Analytical procedures. (Ref: Para. A30–A34)

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<sup>83</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 27 and ISA 550, *Related Parties*, paragraph 18

- (c) Observation and inspection. (Ref: Para A35–A36)
- 19. The auditor, in identifying and assessing the risks of material misstatement, shall take into account information obtained from the auditor's acceptance or continuance of the client relationship or the audit engagement. (Ref: Para. A37)
- 20. If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying and assessing risks of material misstatement. (Ref: Para. A38)
- 21. Where the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall evaluate whether such information remains relevant and reliable as audit evidence for the current audit. (Ref: Para. A39–A40)
- 22. The engagement partner and other key engagement team members shall discuss the application of the applicable financial reporting framework in the context of the nature and circumstances of the entity and its environment, and the susceptibility of the entity's financial statements to material misstatement. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A41–A46)

**Obtaining an Understanding of the Entity and Its Environment and the Applicable Financial Reporting Framework** (Ref: Para. A47–A48)

- 23. The auditor shall perform risk assessment procedures to obtain an understanding of the entity and its environment and the applicable financial reporting framework. In doing so, the auditor shall obtain an understanding of the following matters to provide an appropriate basis for understanding the classes of transactions, account balances and disclosures to be expected in the entity's financial statements:
  - (a) The entity and its environment, including:
    - (i) 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; (Ref: Para A49–A63)
    - (ii) Relevant industry, regulatory and other external factors; and (Ref: Para. A64–A69)
    - (iii) The relevant measures used, internally and externally, to assess the entity's financial performance. (Ref: Para. A70–A78)
  - (b) The applicable financial reporting framework, including: (Ref: Para.A79–A82)
    - (i) How it applies in the context of the nature and circumstances of the entity and its environment, including how events or conditions are subject to, or affected by, the inherent risk factors; and (Ref: Para.A83–A88)
    - (ii) The entity's accounting policies and any changes thereto, including the reasons for any such changes.
- 24. The auditor shall evaluate whether the entity's accounting policies, and any changes thereto, are appropriate in the context of the nature and circumstances of the entity and its environment, and consistent with the applicable financial reporting framework.

### **Obtaining an Understanding of the Entity's System of Internal Control**

25. The auditor shall perform risk assessment procedures to obtain an understanding of the entity's system of internal control relevant to financial reporting, including the entity's use of IT, by understanding each of the components of internal control. For this purpose, the auditor shall address the requirements set out in paragraphs 27 to 38 of this ISA. (Ref: Para. A89–A103)
26. The auditor shall identify controls relevant to the audit, and shall evaluate the design of such controls and determine whether the controls have been implemented in accordance with the requirements set out in paragraphs 39 to 42. (Ref. Para. A104)

#### **Components of the Entity's System of Internal Control**

##### **Control Environment**

27. The auditor shall obtain an understanding of the control environment relevant to financial reporting, including understanding how the entity: (Ref: Para. A105–A110)
  - (a) Demonstrates a commitment to integrity and ethical values;
  - (b) When those charged with governance are separate from management, demonstrates that those charged with governance are independent of management and exercise oversight of the entity's system of internal control;
  - (c) Establishes, with the oversight of those charged with governance, structures, reporting lines, and appropriate authorities and responsibilities, in pursuit of its objectives;
  - (d) Demonstrates a commitment to attract, develop, and retain competent individuals in alignment with its objectives; and
  - (e) Holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control.
28. Based on the auditor's understanding of the control environment in accordance with paragraph 27, the auditor shall evaluate whether: (Ref: Para. A111–A114)
  - (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
  - (b) The strengths in those areas of the entity's control environment addressed in paragraphs 27(a) to (e) collectively provide an appropriate foundation for the other components of the system of internal control, or whether those other components are undermined by control deficiencies in the control environment component.

##### **The Entity's Risk Assessment Process (Ref: Para. A115–A116)**

29. The auditor shall obtain an understanding of the entity's risk assessment process, including the extent to which it is formalized, by understanding: (Ref: Para. A117–A119)
  - (a) Whether, and if so, how, the entity's process:
    - (i) Identifies business risks relevant to financial reporting objectives;
    - (ii) Assesses the significance of those risks, including the likelihood of their occurrence; and
    - (iii) Addresses those risks.

- (b) The results of the entity's process.
30. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether any such risks are of a kind that the auditor expects would have been identified by the entity's risk assessment process. If so, the auditor shall obtain an understanding of why the entity's risk assessment process failed to identify such risks of material misstatement, and consider the implications for the auditor's evaluation required by paragraph 31.
31. Based on the auditor's understanding of the entity's risk assessment process in accordance with paragraph 29, and if applicable, paragraph 30, the auditor shall: (Ref: Para. A120–A121)
- (a) Evaluate whether the nature of the entity's risk assessment process, including its formality, is appropriate to the entity's circumstances considering the nature and size of the entity; and
  - (b) If not, determine whether the lack of an appropriate risk assessment process represents one or more control deficiencies.

The entity's process to monitor the system of internal control (Ref: Para. A122–A125)

32. The auditor shall obtain an understanding of the entity's process to monitor the system of internal control, including the extent to which it is formalized, by understanding how the entity's process: (Ref: Para. A126–A128)
- (a) Monitors the effectiveness of controls; and
  - (b) Addresses the identification and remediation of control deficiencies, including those related to the entity's risk assessment process.
33. The auditor shall obtain an understanding of the sources of the information used in the entity's process to monitor the system of internal control, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A129–A130)
34. If the entity has an internal audit function,<sup>84</sup> the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed, or to be performed. (Ref: Para. A131–A135)

#### The Information System and Communication

35. The auditor shall obtain an understanding of the information system relevant to financial reporting, including the related business processes, through understanding: (Ref: Para. A136–A141)
- (a) How information relating to significant classes of transactions, account balances and disclosures flows through the entity's information system, whether manually or using IT, and whether obtained from within or outside of the general ledger and subsidiary ledgers. This understanding shall include how: (Ref: Para. A142–A143)
    - (i) Transactions are initiated, and how information about them is recorded, processed, corrected as necessary, and incorporated in the general ledger and reported in the financial statements; and

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<sup>84</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 14(a), defines the term "internal audit function" for purposes of the ISA.

- (ii) Information about events and conditions, other than transactions, is captured, processed and disclosed in the financial statements.
  - (b) The accounting records, specific accounts in the financial statements and other supporting records relating to the flows of information in paragraph 35(a);
  - (c) The financial reporting process used to prepare the entity's financial statements from the records described in paragraph 35(b), including as it relates to disclosures and to accounting estimates relating to significant classes of transactions, account balances and disclosures;
  - (d) The entity's IT environment relevant to (a) through (c) above. (Ref: Para. A144–A150 and Para. A180–A182)
36. The auditor shall evaluate the design of the information system controls relevant to financial reporting, by understanding how the matters in paragraph 35(a)–(d) are addressed by the entity, and implemented. (Ref: Para. A151–A157)
37. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relevant to financial reporting, including: (Ref: Para. A158–A159)
- (a) Communications between management and those charged with governance; and
  - (b) External communications, such as those with regulatory authorities.

#### Control Activities

38. The auditor shall obtain an understanding of the control activities component by identifying the controls relevant to the audit in the control activities component in accordance with the requirements of paragraphs 39 through 41, and by evaluating their design and determining whether they have been implemented in accordance with paragraph 42. (Ref: Para. A160–A165)

#### Controls relevant to the audit

39. The auditor shall identify controls relevant to the audit, being those: (Ref: Para. A166–A167)
- (a) That address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; (Ref: Para. A168)
  - (b) That address risks that are identified as a significant risk; (Ref: Para. A169–A173)
  - (c) Over journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments; (Ref: Para. A174–A175)
  - (d) Controls for which the auditor plans to test the operating effectiveness in determining the nature, timing and extent of substantive testing; or (Ref: Para. A176–A178)
  - (e) That, in the auditor's professional judgment, are appropriate to evaluate their design and determine whether they have been implemented to enable the auditor to: (Ref: Para. A179)
    - (i) Identify and assess the risks of material misstatement at the assertion level; or
    - (ii) Design further audit procedures responsive to assessed risks.

Not all controls that are relevant to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment as to whether a control, individually or in combination with other controls, is identified as being relevant to the audit.

40. Based on the understanding obtained in accordance with paragraph 35(d), and the identification of the controls relevant to the audit in accordance with paragraph 39, the auditor shall identify the IT applications and the other aspects of the entity's IT environment that are relevant to the audit. In doing so, the auditor shall take into account whether the IT applications include or address: (Ref: Para. A180–A188)
- (a) Automated controls that management is relying on and that the auditor has determined to be relevant to the audit;
  - (b) Maintenance of the integrity of information stored and processed in the information system that relates to significant classes of transactions, account balances or disclosures;
  - (c) System-generated reports on which the auditor intends to rely on without directly testing the inputs and outputs of such reports; or
  - (d) Controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.
41. For the IT applications and other aspects of the IT environment that are relevant to the audit, the auditor shall identify: (Ref: Para. A189–A193)
- (a) The risks arising from the use of IT; and
  - (b) The general IT controls relevant to the audit.
42. For each control identified as relevant to the audit in accordance with paragraphs 39 and 41, the auditor shall: (Ref: Para. A194–A200)
- (a) Evaluate whether the control is designed effectively to address the risk of material misstatement at the assertion level, or effectively designed to support the operation of other controls; and
  - (b) Determine whether the control has been implemented by performing procedures in addition to inquiry of the entity's personnel.

*Control Deficiencies Within the System of Internal Control*

43. The auditor shall, in accordance with ISA 265,<sup>85</sup> determine on the basis of the work performed in accordance with this ISA:
- (a) Whether one or more control deficiencies within the system of internal control have been identified; and
  - (b) If so, whether the control deficiencies, individually or in combination, constitute significant control deficiencies.
44. The auditor shall consider the implications for the audit of one or more control deficiencies in the system of internal control, including for:

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<sup>85</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraphs 7–8

- (a) The assessment of control risk for risks of material misstatement at the assertion level in accordance with paragraph 50; and
- (b) Designing and implementing overall responses to address the assessed risks of material misstatement as required by ISA 330.<sup>86</sup>

### **Identifying and Assessing the Risks of Material Misstatement**

45. The auditor shall identify the risks of material misstatement and determine whether they exist at: (Ref: Para. A201–A210)
- (a) The financial statement level, by evaluating whether the identified risks relate more pervasively to the financial statements as a whole, including potentially affecting many assertions; or (Ref: Para. A207)
  - (b) The assertion level for classes of transactions, account balances, and disclosures, taking into account the inherent risk factors. (Ref. Para. A208)
46. The auditor shall determine significant classes of transactions, account balances and disclosures, and their relevant assertions, based on the identified risks of material misstatement. (Ref. Para. A211 – A214)

### *Assessing Risks of Material Misstatement at the Financial Statement Level*

47. The auditor shall assess the identified risks of material misstatement at the financial statement level by: (Ref: Para. A215–A220)
- (a) Determining how, and the degree to which, such risks affect the assessment of risks of material misstatement at the assertion level (Ref: Para. A227), and
  - (b) Evaluating the nature and extent of their pervasive effect on the financial statements to provide the basis for designing and implementing overall responses to the identified risk of material misstatement at the financial statement level in accordance with ISA 330.<sup>87</sup> (Ref: Para A216)

### *Assessing Risks of Material Misstatement at the Assertion Level*

#### **Assessing Inherent Risk**

48. For identified risks of material misstatement at the assertion level, the auditor shall assess inherent risk by assessing the likelihood and magnitude of material misstatement. In doing so, the auditor shall take into account how, and the degree to which:
- (a) Identified events and conditions relating to significant classes of transactions, account balances and disclosures are subject to, or affected by, the inherent risk factors. (Ref: Para. A221–A228)
  - (b) The risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level. (Ref. Para. A216 and A227)

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<sup>86</sup> ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 5

<sup>87</sup> ISA 330, paragraph 5



49. The auditor shall determine, based on the auditor's assessment of inherent risk, whether any of the assessed risks of material misstatement are significant risks. (Ref: Para. A229–A231)

*Assessing Control Risk*

50. For identified risks of material misstatement at the assertion level, the auditor shall assess control risk as follows: (Ref: Para. A232–A235)
- (a) When the auditor plans to test the operating effectiveness of controls in designing further audit procedures to be performed to respond to a risk of material misstatement at the assertion level, the auditor shall assess control risk at less than maximum. In doing so, the auditor shall take into account whether the design, implementation and expected operating effectiveness of such controls support the auditor's intended reliance thereon.
  - (b) When the auditor does not plan to test the operating effectiveness of controls in designing further audit procedures to be performed to respond to a risk of material misstatement at the assertion level, the auditor shall assess control risk at the maximum.

*Risks for Which Substantive Procedures Alone Cannot Provide Sufficient Appropriate Audit Evidence*

51. The auditor shall determine, for any of the risks of material misstatement at the assertion level, whether substantive procedures alone cannot provide sufficient appropriate audit evidence (Ref: Para. A236–A239)

*Classes of Transactions, Account Balances and Disclosures that are Not Significant, but which are Material*

52. The auditor shall: (Ref: Para. A240–A242)
- (a) Identify the classes of transactions, account balances and disclosures that are quantitatively or qualitatively material, and that have not been identified as significant classes of transactions, account balances or disclosures in accordance with paragraph 46; and
  - (b) Evaluate whether the auditor's conclusion that there are no relevant assertions (that is, no related risks of material misstatement) for these classes of transactions, account balances and disclosures remains appropriate.

*Revision of Risk Assessment*

53. The auditor's assessments of the risks of material misstatement at the financial statement level and assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the identification and assessments of the risks of material misstatement, the auditor shall revise the assessment and modify the planned overall responses or further audit procedures accordingly. (Ref: Para. A243)

## Documentation

54. The auditor shall include in the audit documentation:<sup>88</sup> (Ref: Para. A244–A247)

- (a) The discussion among the engagement team, where required in accordance with paragraph 22, and the significant decisions reached;
- (b) Key aspects of the auditor's understanding obtained regarding the entity and its environment specified in paragraph 23 and of each of the components of the system of internal control specified in paragraphs 27, 29, 32 through 38; the sources of information from which the auditor's understanding was obtained; and the risk assessment procedures performed;
- (c) The controls identified to be relevant to the audit in accordance with the requirements in paragraphs 39 and 41.
- (d) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 45 through 51, including significant risks, and the rationale for the significant judgments made in identifying and assessing the risks of material misstatement. (Ref: Para A245)

## Application and Other Explanatory Material

### Definitions

*Assertions* (Ref: Para. 16(b))

- A1. Representations by management with respect to the recognition, measurement, presentation and disclosure of information in the financial statements of classes of transactions, account balances and disclosures differ from written representations provided to the auditor by management, as required by ISA 580,<sup>89</sup> to confirm certain matters or support other audit evidence.
- A2. Assertions that the auditor may use in addressing the requirements of this ISA are further described in paragraph A204.

*Controls* (Ref: Para. 16(d))

- A3. Policies are implemented through the actions of personnel within the entity, or through their restraint from taking actions that would conflict with such policies.
- A4. Procedures may be mandated, through formal documentation or other communication by management or those charged with governance, or may result from behaviors that are not mandated but are rather conditioned by the entity's culture. Procedures may be enforced through the actions permitted by the IT applications used by the entity or other aspects of the entity's IT environment.

*Inherent Risk Factors* (Ref: Para. 16(f))

- A5. Inherent risk factors may be qualitative or quantitative and affect the susceptibility to misstatement of financial statement items. Qualitative inherent risk factors relating to the preparation of information required by the applicable financial reporting framework (referred to in this paragraph as "required information") include:

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<sup>88</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6–A7

<sup>89</sup> ISA 580, *Written Representations*

- *Complexity*—arises either from the nature of the information or in the way that the required information is prepared, including when such preparation processes are more inherently difficult to apply. For example, complexity may arise:
  - In calculating supplier rebate provisions because it may be necessary to take into account different commercial terms with many different suppliers, or many interrelated commercial terms that are all relevant in calculating the rebates due; or
  - When there are many potential data sources, with different characteristics used in making an accounting estimate, the processing of that data involves many inter-related steps, and the data is therefore inherently more difficult to identify, capture, access, understand or process.
- *Subjectivity*—arises from inherent limitations in the ability to prepare required information in an objective manner, due to limitations in the availability of knowledge or information, such that management may need to make an election or subjective judgment about the appropriate approach to take and about the resulting information to include in the financial statements. Because of different approaches to preparing the required information, different outcomes could result from appropriately applying the requirements of the applicable financial reporting framework. As limitations in knowledge or data increase, the subjectivity in the judgments that could be made by reasonably knowledgeable and independent individuals, and the diversity in possible outcomes of those judgments will also increase.
- *Change*—results from events or conditions that, over time, affect the entity's business or the economic, accounting, regulatory, industry or other aspects of the environment in which it operates, when the effects of those events or conditions are reflected in the required information. Such events or conditions may occur during, or between, financial reporting periods. For example, change may result from developments in the requirements of the applicable financial reporting framework, or in the entity and its business model, or in the environment in which the entity operates. Such change may affect management's assumptions and judgments, including as they relate to management's selection of accounting policies or how accounting estimates are made or related disclosures are determined.
- *Uncertainty*—arises when the required information cannot be prepared based only on sufficiently precise and comprehensive data that is verifiable through direct observation. In these circumstances, an approach may need to be taken that applies the best available knowledge to prepare the information using sufficiently precise and comprehensive observable data, to the extent available, and reasonable assumptions supported by the best available data, when it is not. Constraints on the availability of knowledge or data, which are not within the control of management (subject to cost constraints where applicable) are sources of uncertainty and their effect on the preparation of the required information cannot be eliminated. For example, estimation uncertainty arises when the required monetary amount cannot be determined with precision and the outcome of the estimate is not known before the date the financial statements are finalized.
- *Susceptibility to misstatement due to management bias or fraud*— results from conditions that create susceptibility to intentional or unintentional failure by management to maintain neutrality in preparing the information. Management bias is often associated with certain conditions that have the potential to give rise to management not maintaining neutrality in exercising judgment

(indicators of potential management bias), which could lead to a material misstatement of the information that would be fraudulent if intentional. Such indicators include inherent incentives or pressures (for example, as a result of motivation to achieve a desired result, such as a desired profit target or capital ratio), and opportunity, not to maintain neutrality. Factors relevant to the susceptibility to misstatement due to fraud for assertions about classes of transactions, account balances and disclosures are described in paragraphs A1 to A5 of ISA 240.

- A6. Other inherent risk factors, that affect susceptibility to misstatement of an assertion about a class of transactions, account balance or disclosure include:
- The quantitative or qualitative significance of the class of transactions, account balance or disclosure, and of the items in relation to performance materiality;
  - The composition of the class of transactions, account balance or disclosure, including whether the items are subject to differing risks;
  - The volume of activity and homogeneity of the individual transactions processed through the class of transactions or account balance or class of transactions, or reflected in the disclosure; or
  - The existence of related party transactions in the class of transaction or account balance, or that are relevant to the disclosure.

*IT Environment (Ref: Para 16(g))*

- A7. IT applications may include data warehouses or report writers. A data warehouse is a central repository of integrated data from one or more disparate sources (such as multiple databases) from which reports may be generated or that may be used by the entity for other data analysis activities. A report-writer is an IT application that is used to extract data from one or more sources (such as a data warehouse, a database or an IT application) and present the data in a specified format.
- A8. A network is used in the IT infrastructure to transmit data and to share information, resources and services through a common communications link. The network also typically establishes a layer of logical security (enabled through the operating system) for access to the underlying resources. The operating system is responsible for managing communications between hardware, IT applications, and other software used in the network. Databases store the data used by IT applications and may consist of many interrelated data tables. Data in databases may also be accessed directly through database management systems by IT or other personnel with database administration privileges.

*Relevant Assertions (Ref: Para. 16(h))*

- A9. There will be one or more risks of material misstatement that relate to a relevant assertion. A risk of material misstatement may relate to more than one assertion, in which case all the assertions to which such a risk relates would be relevant assertions

*Significant Risk (Ref: Para. 16(k))*

- A10. Significance can be described as the relative importance of a matter, taken in context. The significance of a matter is judged by the auditor in the context in which the matter is being considered. The significance of a risk of material misstatement at the assertion level is considered in the context of the implications of the assessment of its inherent risk for the performance of the audit, including

the nature, timing and extent of the auditor's further audit procedures and the persuasiveness of the audit evidence that will be required to reduce audit risk to an acceptable level. Significance can be considered in the context of how, and the degree to which, the susceptibility to misstatement is subject to, or affected by, the inherent risk factors, which affect the likelihood that a misstatement will occur, as well as the potential magnitude of the misstatement were that misstatement to occur.

*System of Internal Control* (Ref: Para. 16(l))

A11. The entity's system of internal control may be reflected in policy and procedures manuals, systems and forms, and the information embedded therein, and is effected by people. The system of internal control is implemented by management, those charged with governance, and other personnel based on the structure of the entity. The system of internal control can be applied, based on the decisions of management, those charged with governance and other personnel and in the context of legal or regulatory requirements, to the operating model of the entity, the legal entity structure, or a combination of these.

**Risk Assessment Procedures and Related Activities (Ref: Para. 17–22)**

*Risk Assessment Procedures* (Ref: Para. 17)

A12. Obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control is a dynamic and iterative process of gathering, updating and analyzing information and continues throughout the audit. As the auditor performs audit procedures, the audit evidence obtained may cause the auditor to update the understanding on which the risk assessment was based and the nature, timing or extent of other planned audit procedures in accordance with ISA 330. For example, information gathered in understanding the entity's system of internal control assists the auditor in assessing control risk at the assertion level, such that control risk may be assessed at less than maximum based on an expectation about the operating effectiveness of the control(s) and the planned testing of such control(s). Information gathered when testing the operation of the control(s) as part of performing further audit procedures may indicate that the control(s) are not effective, and as a result the auditor's original assessment is updated in accordance with paragraph 53.

A13. The risks of material misstatement to be identified and assessed include both those due to fraud and those due to error, and both are covered by this ISA. However, the significance of fraud is such that further requirements and guidance are included in ISA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.<sup>90</sup> In addition, the following ISAs provide further requirements and guidance on identifying and assessing risks of material misstatement in regard to specific matters or circumstances:

- ISA 540 (Revised)<sup>91</sup> in regard to accounting estimates;
- ISA 550<sup>92</sup> in regard to related party relationships and transactions;

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<sup>90</sup> ISA 240, paragraphs 12–24

<sup>91</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

<sup>92</sup> ISA 550, *Related Parties*

- ISA 570 (Revised)<sup>93</sup> in regard to going concern; and
  - ISA 600<sup>94</sup> in regard to group financial statements.
- A14. The understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control also establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:
- Identifying and assessing risks of material misstatement of the financial statements (e.g., relating to risks of fraud in accordance with ISA 240 or when identifying or assessing risks related to accounting estimates in accordance with ISA 540 (Revised));
  - Determining materiality or performance materiality in accordance with ISA 320;<sup>95</sup>
  - Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
  - Developing expectations for use when performing analytical procedures in accordance with ISA 520;<sup>96</sup>
  - Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence in accordance with ISA 330;<sup>97</sup> and
  - Evaluating the sufficiency and appropriateness of audit evidence obtained (e.g., relating to assumptions or management's oral and written representations).
- A15. Information obtained by performing risk assessment procedures and related activities in accordance with paragraphs 17 to 22 of this ISA is audit evidence that supports the identification and assessment of the risks of material misstatement. In addition, the auditor may obtain some audit evidence about classes of transactions, account balances, or disclosures, and related assertions, and about the operating effectiveness of controls, even though such risk assessment procedures were not specifically planned as substantive procedures or as tests of controls. The auditor may also perform designed substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so. For example, through the use of technology the auditor may perform procedures on large volumes of data, and audit evidence may be obtained that provides information that is useful for the identification and assessment of risks of material misstatement, as well as providing sufficient appropriate audit evidence to support the conclusion that the possibility of a material misstatement is remote.
- A16. The auditor uses professional judgment to determine the nature and extent of the required understanding. The auditor's primary consideration is whether the understanding that has been obtained meets the objective stated in this ISA. The auditor's risk assessment procedures to obtain the overall understanding may be less extensive in audits of smaller and less complex entities. The

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<sup>93</sup> ISA 570 (Revised), *Going Concern*

<sup>94</sup> ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

<sup>95</sup> ISA 320, *Materiality in Planning and Performing an Audit*, paragraphs 10–11

<sup>96</sup> ISA 520, *Analytical Procedures*, paragraph 5

<sup>97</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

*Types of Risk Assessment Procedures and Sources of Information (Ref: Para. 18)*

- A17. ISA 500<sup>98</sup> explains the types of audit procedures that may be performed in obtaining audit evidence from risk assessment procedures and further audit procedures. The nature and timing of the audit procedures may be affected by the fact that some of the accounting data and other information may only be available in electronic form or only at certain points in time.<sup>99</sup>
- A18. Some of the information used by the auditor when performing risk assessment procedures may be electronic data available from the entity's information system, for example the general ledger, sub-ledgers or other operational data. In performing risk assessment procedures, the auditor may use automated tools and techniques in performing the risk assessment procedures, including for analysis, recalculations, reperformance or reconciliations.
- A19. Sources of information available to the auditor may include:
- Information obtained through interactions with management, those charged with governance, and other key entity personnel, such as internal auditors.
  - Information obtained directly or indirectly from certain external parties such as regulators.
  - Information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, updated as appropriate.
  - Publicly available information about the entity, for example entity-issued press releases, and materials for analysts or investor group meetings, analysts' reports or information about trading activity.

These sources may provide potentially contradictory information, which may assist the auditor in exercising professional skepticism in identifying and assessing the risks of material misstatement. Regardless of the source of information, the auditor considers the relevance and reliability of the information to be used as audit evidence in accordance with ISA 500.<sup>100</sup>

- A20. Although the auditor is required to perform all the risk assessment procedures described in paragraph 18 in the course of obtaining the required understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control (see paragraphs 23–44), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures may include making inquiries of the entity's external legal counsel or external supervisors, or of valuation experts that the entity has used.

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<sup>98</sup> ISA 500, *Audit Evidence*, paragraphs A14–A17 and A21–A25.

<sup>99</sup> ISA 500, paragraph A12

<sup>100</sup> ISA 500, paragraph 7

*Inquiries of Management, the Internal Audit Function and Others within the Entity* (Ref: Para. 18(a))

A21. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries of the internal audit function, if the entity has such a function, and others within the entity.

A22. The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. ISA 260 (Revised)<sup>101</sup> identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
- Inquiries of employees involved in 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.
- 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.
- 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.
- Inquiries directed towards the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed towards information system personnel may provide information about system changes, system or control failures, or other information system-related risks.

A23. As obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's inquiries may occur throughout the audit engagement.

*Considerations Specific to Public Sector Entities*

A24. When making inquiries of those who may have information that is likely to assist in identifying risks of material misstatement, auditors of public sector entities may obtain information from additional sources such as from the auditors that are involved in performance or other audits related to the entity.

*Inquiries of the Internal Audit Function*

A25. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control, and in identifying and assessing risks of material misstatement at the financial statement and

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<sup>101</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 4(b)



assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity and its environment, the applicable financial reporting framework and the system of internal control, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.<sup>102</sup> Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.

- A26. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.
- A27. In addition, in accordance with ISA 240,<sup>103</sup> if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.
- A28. Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

#### Considerations specific to public sector entities

- A29. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of control deficiencies related to financial reporting.

#### *Analytical Procedures (Ref: Para. 18(b))*

- A30. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in identifying and assessing the risks of material misstatement. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.
- A31. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

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<sup>102</sup> The relevant requirements are contained in ISA 610 (Revised 2013).

<sup>103</sup> ISA 240, paragraph 19

- A32. Analytical procedures performed as risk assessment procedures may use data aggregated at a high level and accordingly the results of those analytical procedures may provide a broad initial indication about the likelihood of a material misstatement. For example, in the audit of many entities, including those with less complex business models and processes, and a less complex information system, the auditor may perform a simple comparison of information, such as the change in account balances from interim or monthly reporting with balances from prior periods, to obtain an indication of potentially higher risk areas.
- A33. Analytical procedures can be performed using a number of tools or techniques, which may be automated. Applying automated analytical procedures to the data may be referred to as data analytics. For example, the auditor may use a spreadsheet to perform a comparison of actual recorded amounts to budgeted amounts, or may perform a more advanced procedure by extracting data from the entity's information system, and further analyzing this data using visualization techniques to identify more specific areas of possible misstatement.
- A34. This ISA deals with the auditor's use of analytical procedures as risk assessment procedures. ISA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"). Accordingly, analytical procedures performed as risk assessment procedures are not required to be performed in accordance with the requirements of ISA 520. However, the requirements and application material in ISA 520 may provide useful guidance to the auditor when performing analytical procedures as part of the risk assessment procedures.

*Observation and Inspection (Ref: Para. 18(c))*

- A35. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such risk assessment procedures include observation or inspection of the following:
- The entity's operations.
  - Internal documents (such as business plans and strategies), records, and internal control manuals.
  - Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
  - The entity's premises and plant facilities.
  - Information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications; or other external documents about the entity's financial performance (such as those referred to in paragraph A74).
  - The behaviors and actions of management or those charged with governance (such as the observation of an audit committee meeting).

*Considerations specific to public sector entities*

- A36. Risk assessment procedures performed by auditors of public sector entities may also include observation and inspection of documents prepared by management for the legislature, for example as documents related to mandatory performance reporting.

*Information from the Acceptance or Continuance of the Client Relationship or the Audit Engagement* (Ref: Para. 19)

A37. In accordance with ISA 220, the engagement partner is required to be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and to determine that conclusions reached in this regard are appropriate.<sup>104</sup> Information obtained in the client and engagement acceptance or continuance process may be relevant to the identification and assessment of the risks of material misstatement. Examples may include:

- Information about the nature of the entity and its business risks.
- Information about the integrity and ethical values of management and those charged with governance, which may be relevant to the auditor's understanding of the control environment, and may also affect the auditor's identification and assessment of the risks of material misstatement at the financial statement level.
- The applicable financial reporting framework and information about its application to the nature and circumstances of the entity.

*Information from Other Engagements Performed for the Entity* (Ref: Para. 20)

A38. The engagement partner may have performed other engagements for the entity and may thereby have obtained knowledge relevant to the audit, including about the entity and its environment. Such engagements may include agreed-upon procedures engagements (e.g., agreed-upon procedures relating to an entity's debt covenant compliance) or other audit or assurance engagements (e.g., audits of special purpose financial statements or reviews of interim financial information).

*Information Obtained in Prior Periods* (Ref: Para. 21)

A39. 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 system of internal control (including control deficiencies).
- 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.

A40. The auditor is required to determine whether information obtained in prior periods remains relevant and reliable, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the entity's system of internal control, for example, may affect the relevance and reliability of information obtained in the prior period. In evaluating whether such information

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<sup>104</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 12

remains relevant and reliable for the current audit, the auditor may consider whether changes have occurred that may affect the relevance or reliability of such information. For example, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

*Discussion Among the Engagement Team* (Ref: Para. 22)

A41. Paragraph 22 requires the engagement partner and other key engagement team members to discuss the application of the applicable financial reporting framework in the context of the nature and circumstances of the entity and its environment, and the susceptibility of the entity's financial statements to material misstatement. When the engagement is carried out by a single individual (such as a sole practitioner) i.e., where an engagement team discussion would not be possible, consideration of the matters referred to in paragraphs A42 and A43 nonetheless may assist the auditor in identifying where there may be risks of material misstatement.

A42. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity. Sharing information contributes to an enhanced understanding by all engagement team members.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject, how the inherent risk factors may affect the classes of transactions, account balances and disclosures, and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures. In particular, the discussion assists engagement team members in further considering contradictory information based on each member's own understanding of the nature and circumstances of the entity.
- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

ISA 240 requires the engagement team discussion to place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud may occur.<sup>105</sup>

A43. As part of the discussion among the engagement team required by paragraph 22, 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, even in circumstances where the applicable financial reporting framework only requires simplified disclosures. Examples of matters the engagement team may discuss include:

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<sup>105</sup> ISA 240, paragraph 15

- 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.

A44. In addition to the intended benefits of the engagement team discussion included in paragraph A42, the engagement team may also have an opportunity to exercise professional skepticism while performing risk assessment procedures, such as through identifying and discussing contradictory information obtained in performing those procedures, as well as in considering whether there are indicators of possible management bias (both intentional and unintentional). Professional skepticism is necessary for the critical assessment of audit evidence, and a robust and open engagement team discussion, including for recurring audits, may lead to improved identification and assessment of the risks of material misstatement. Another outcome from the discussion may be that the auditor identifies specific areas of the audit for which exercising professional skepticism may be particularly important, which may in turn drive the consideration of those engagement team members who are appropriately skilled to be involved in the performance of audit procedures related to those areas.

A45. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, while taking into account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

#### Considerations Specific to Public Sector Entities

A46. As part of the discussion among the engagement team, as required by paragraph 22, by auditors of public sector entities, consideration may also be given to any additional broader objectives, and related risks, arising from the audit mandate or obligations for public sector entities.

#### **Obtaining an Understanding of the Entity and Its Environment and the Applicable Financial Reporting Framework (Ref: Para. 23–24)**

A47. The auditor's understanding of the entity and its environment, and the applicable financial reporting framework, establishes a frame of reference within which the auditor identifies and assesses risks of material misstatement, and plans and performs audit procedures. Specifically, the auditor applies professional judgment in determining whether the understanding required by paragraph 23 is sufficient to provide an appropriate basis for the auditor to understand the classes of transactions, account balances and disclosures to be expected in the entity's financial statements. This understanding assists the auditor in identifying areas in the financial statements where material

misstatements may be more likely to arise and assists the auditor in exercising professional skepticism throughout the audit. The nature and extent of the understanding required will likely depend on the nature, size and complexity of the entity.

*The Entity and Its Environment* (Ref: Para 23(a))

A48. In obtaining an understanding of the entity and its environment, the auditor may be able to enhance the understanding by using automated tools and techniques. For example, the auditor may use automated techniques to understand flows of transactions and processing as part of the auditor's procedures to understand the information system. An outcome of these procedures may be that the auditor obtains information about the entity's organizational structure or those with whom the entity conducts business (e.g., vendors, customers, related parties).

*The Entity's Organizational Structure, Ownership and Governance, and Business Model* (Ref: Para. 23(a)(i))

*The entity's organizational structure and ownership*

A49. An understanding of the entity's organizational structure and ownership may enable the auditor to understand such matters as:

- 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 have 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.<sup>106</sup>
- The distinction between the owners, those charged with governance and management. In some entities, particularly smaller and less complex entities, owners of the entity may be involved in managing the entity, or those charged with governance may be involved in managing the entity.<sup>107</sup>
- The entity's IT environment. For example, an entity's IT environment may be relatively simple because it consists only of commercial software for which the entity does not have access to the underlying source code to which no changes have been made. Alternatively, an entity may have grown through extensive merger and acquisition activity and have multiple legacy IT systems in diverse businesses that are not well integrated resulting in a complex IT environment.

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<sup>106</sup> ISA 550 establishes requirements and provide guidance on the auditor's considerations relevant to related parties.

<sup>107</sup> ISA 260 (Revised), paragraphs A1 and A2, provides guidance on the identification of those charged with governance and explains that in some cases, some or all of those charged with governance are involved in managing the entity.

### Considerations specific to public sector entities

A50. In obtaining an understanding of the entity's organizational structure and ownership, auditors of public sector entities may consider the relevance of ownership of a public sector entity (i.e., ownership of a public sector entity may not have the same relevance as in the private sector because decisions related to the entity may be initiated outside of the entity as a result of political processes and therefore management may not have control over decisions that are made). Matters related to the understanding of the organizational structure, governance and business model of a public sector entity may include understanding the ability of the entity to make unilateral decisions, and the ability of other public sector entities to control or influence the entity mandate and strategic direction. For example, the public sector entity may be subject to laws or other directives from authorities that require it to obtain approval from parties external to the entity of its strategy and objectives prior to it implementing them. Matters related to understanding the legal structure of the entity may include applicable laws and regulations, and the classification of the entity (i.e. whether the entity is a ministry, department, agency or other type of entity).

### Governance

A51. Responsibilities of management and those charged with governance are broader than responsibilities for the oversight of the system of internal control, but are generally prerequisites for an effective system of internal control. The responsibilities of those charged with governance in relation to the control environment are further discussed in Appendix 3. Deficient governance processes may limit an entity's ability to provide appropriate oversight of its system of internal control, which may increase the entity's susceptibility to risks of material misstatement. Matters that may be relevant for the auditor to consider in obtaining an understanding of the governance of the entity include:

- 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.

### The Entity's Business Model

A52. The auditor's understanding of the entity's business model, and how it is affected by its business strategy and business objectives, may assist the auditor in identifying business risks that are relevant in the context of the audit. Furthermore, this may assist the auditor in identifying risks of material misstatement. For example, incentives and pressures on management may result in intentional or unintentional management bias, which may affect the reasonableness of significant assumptions and expectations of management or those charged with governance thereby increasing the susceptibility to risks of material misstatement. (See also paragraph A59).

A53. An entity's business model describes how an entity considers, for example its organizational structure, operations or scope of activities, business lines (including competitors and customers

thereof), processes, growth opportunities, globalization, regulatory requirements and technologies. The entity's business model describes how the entity creates, preserves and captures financial or broader value, such as public benefits, for its stakeholders.

A54. Strategies are the approaches by which management plans to achieve the entity's objectives, including how the entity plans to address the risks and opportunities that it faces. An entity's strategies are changed over time by management, to respond to changes in its objectives and in the internal and external circumstances in which it operates.

A55. A description of a business model typically includes:

- The scope of the entity's activities, and why it does them.
- The entity's structure and scale of its operations.
- The markets or geographical or demographic spheres, and parts of the value chain, in which it operates, how it engages with those markets or spheres (main products, customer segments and distribution methods), and the basis on which it competes.
- The entity's business or operating processes (e.g., investment, financing and operating processes) employed in performing its activities, focusing on those parts of the business processes that are important in creating, preserving or capturing value.
- The resources (e.g., financial, human, intellectual, environmental and technological) and other inputs and relationships (e.g., customers, competitors, suppliers and employees) that are necessary or important to its success.
- How the entity's business model integrates the use of IT in its interactions with customers, suppliers, lenders and other stakeholders through IT interfaces and other technologies.

A56. Understanding the entity's objectives, strategy and business model helps the auditor to understand the entity at a strategic level and to understand the business risks the entity takes and faces. Not all aspects of the business model are relevant for the auditor's understanding, but those aspects that give rise to business risks, which are relevant to the identification and assessment of risks of material misstatement, are likely to be more relevant for the auditor's understanding.

A57. Appendix 1 provides examples of matters that may be considered when obtaining an understanding of the activities of the entity, as well as other matters that may be considered when auditing financial statements of special purpose entities.

Considerations specific to public sector entities

A58. Entities operating in the public sector may create and deliver value in different ways to those creating wealth for owners, but will still have a 'business model' to promote value in the public interest. Matters public sector auditors may obtain an understanding of that are relevant to the business model of the entity, include:

- Knowledge of relevant government activities, including related programs.
- Program objectives and strategies, including public policy elements.

Business risks in the context of the entity's business model



A59. An understanding of the business risks that have an effect on the financial statements assists the auditor in identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. Business risks are broader than the risks of material misstatement of the financial statements, although business risks includes the latter. The auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement. Business risk may arise from, among other matters, inappropriate objectives or strategies, ineffective execution of strategies, or change or complexity. A failure to recognize the need for change may also give rise to business risk, for example, from:

- The development of new products or services that may fail;
- A market which, even if successfully developed, is inadequate to support a product or service; or
- Flaws in a product or service that may result in legal liability and reputational risk.

A60. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a significant fall in real estate market values may increase the risk of material misstatement associated with the valuation assertion for a lender of medium-term real estate backed loans. However, the same risk, particularly in combination with a severe economic downturn that concurrently increases the underlying risk of lifetime credit losses on its loans, may also have a longer-term consequence. The resulting net exposure to credit losses may cast significant doubt on the entity's ability to continue as a going concern. If so, this could have implications for management's and the auditor's conclusion as to the appropriateness of the entity's use of the going concern basis of accounting and determination as to whether a material uncertainty exists. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of events and conditions that may indicate risks of material misstatement are indicated in Appendix 2.

A61. 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:

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).

- Use of IT (a potential related business risk might be, for example, that the entity is implementing a new IT system that will affect both operations and financial reporting).
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A62. Ordinarily, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of the entity's system of internal control and is discussed in paragraph 29–31 and paragraphs A115–A121.

#### Considerations Specific to Public Sector Entities

A63. For the audits of public sector entities, “management objectives” may be influenced by requirements to demonstrate public accountability and may include objectives which have their source in law, regulation or other authority.

#### Relevant Industry, Regulatory and Other External Factors (Ref: Para. 23(a)(ii))

##### Industry factors

A64. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include:

- 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.

A65. 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.<sup>108</sup>

##### Regulatory Factors

A66. 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 and any changes thereto. Examples of matters the auditor may consider include:

- Regulatory framework for a regulated industry, for example, medical or retirement funds, including requirements for disclosures.
- Legislation and regulation that significantly affect the entity's operations, for example, labor laws and regulations.
- Taxation legislation and regulations.

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<sup>108</sup> ISA 220, paragraph 14

- 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.

A67. ISA 250 (Revised) includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.<sup>109</sup>

#### Considerations specific to public sector entities

A68. For the audits of public sector entities, there may be particular laws or regulations that affect the entity's operations. Such elements may be an essential consideration when obtaining an understanding of the entity and its environment.

#### Other External Factors

A69. Examples of 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.

#### Relevant Measures Used to Assess the Entity's Financial Performance (Ref: Para. 23(a)(iii))

A70. Management and others ordinarily measure and review those matters they regard as important. The procedures undertaken to measure the relevant performance of the entity may vary depending on the size or complexity of the entity, as well as the involvement of owners or those charged with governance in the management of the entity.

A71. Performance measures, whether used externally or internally, may create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to intentionally misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the susceptibility to misstatement due to management bias or fraud. For example, the auditor may identify incentives or pressures that may increase the risk of management override of controls. See ISA 240 for requirements and guidance in relation to the risks of fraud.

A72. The measurement and review of financial performance is not the same as the monitoring of the system of internal control (discussed as a component of the system of internal control in paragraphs A122–A135), though their purposes may overlap:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- In contrast, monitoring of the system of internal control is concerned with monitoring the effectiveness of controls including those related to management's measurement and review of financial performance.

In some cases, however, performance indicators also provide information that enables management to identify control deficiencies.

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<sup>109</sup> ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 13

A73. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:

- 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.

A74. External parties may also review and analyze the entity's financial performance, in particular for entities where financial information is publicly available. For example, publicly available financial information may be issued by:

- Analysts or credit agencies.
- Revenue authorities.
- Regulators.
- Trade unions.
- Providers of finance.

Such financial information can often be obtained from the entity being audited

A75. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor the likelihood with which risks of misstatement of related financial statement information exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry.

A76. Performance measures and targets, whether imposed internally or externally, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate an increased susceptibility to misstatement due to management bias or fraud in the preparation of the financial statements.

A77. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. In such cases, the auditor may identify relevant performance measures, whether internal or external, by considering the information that the entity uses to manage its business. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

Considerations specific to public sector entities

A78. In addition to considering relevant measures used by a public sector entity to assess the entity's financial performance, auditors of public sector entities may also consider non-financial information such as achievement of public benefit outcomes (for example, the number of people assisted by a specific program).

*The Applicable Financial Reporting Framework* (Ref: Para. 23(b))

A79. Examples of matters that the auditor may consider when obtaining an understanding of the entity's applicable financial reporting framework, and how it applies in the context of the nature and circumstances of the entity and its environment include:

- The entity's financial reporting practices in terms of the applicable financial reporting framework, such as:
  - 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 share-based payments).
- An understanding of the entity's selection and application of accounting policies, including any changes thereto as well as the reasons therefore, may encompass such matters as:
  - 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.

A80. Obtaining an understanding of the entity and its environment assists the auditor in considering where changes in the entity's financial reporting (e.g., from prior periods) may be expected. For example, if the entity has had a significant business combination during the period, the auditor would likely expect changes in classes of transactions, account balances and disclosures associated with that business combination. Alternatively, if there were no significant changes in the financial reporting framework during the period the auditor's understanding may help confirm that the understanding obtained in the prior period remains applicable.

A81. Disclosures in the financial statements of smaller and less complex entities may be simpler and less detailed (e.g., some financial reporting frameworks allow smaller entities to provide simpler and less detailed 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, the applicable financial reporting framework as it applies to the entity, and its related system of internal control.

Considerations specific to public sector entities

- A82. The applicable financial reporting framework in a public sector entity is determined by the legislative and regulatory frameworks relevant to each jurisdiction or within each geographical area. Matters that may be considered in the entity's application of the applicable financial reporting requirements, and how it applies in the context of the nature and circumstances of the entity and its environment, include whether the entity applies a full accrual-basis of accounting (such as the International Public Sector Accounting Standards), a cash-basis of accounting, or a hybrid. The financial reporting applied by a public sector entity further impacts the ability to assess the accountability for all assets and liabilities of the entity, as well as the entity's system of internal control.

How Events or Conditions are Subject To, or Affected By, the Inherent Risk Factors

- A83. The auditor is required to consider events or conditions in understanding how the applicable financial reporting framework applies in the context of the nature and circumstances of the entity. In doing so, the auditor identifies how events or conditions are subject to, or affected by, the inherent risk factors, which may assist the auditor in understanding which classes of transactions, account balances and disclosures may be affected. Understanding whether, and the relative degree to which the inherent risk factors affect the events and conditions may assist the auditor in identifying and assessing the risks of material misstatement at the assertion level. Appendix 2 provides examples of events and conditions that may indicate susceptibility to risks of material misstatement, categorized by inherent risk factor.
- A84. The extent to which a class of transactions, account balance or disclosure is subject to, or affected by, complexity or subjectivity, is often closely related to the extent to which it is subject to change or uncertainty. Further, when a class of transactions, account balance or disclosure is subject to, or affected by, complexity, subjectivity, change or uncertainty, these inherent risk factors may create opportunity for management bias, whether unintentional or intentional, and affect susceptibility to misstatement due to management bias or fraud. Accordingly, the auditor's identification of risks of material misstatement, and assessment of inherent risk at the assertion level, are also affected by the interrelationships among the inherent risk factors.
- A85. Events or conditions that may be affected by, or subject to, the susceptibility of misstatement due to management bias or fraud may be indicative of increased risks of material misstatement due to fraud. Accordingly, this may be relevant information for use in accordance with paragraph 24 of ISA 240, which requires the auditor to evaluate whether the information obtained from the other risk assessment procedures and related activities indicates that one or more fraud risk factors are present.
- A86. When complexity is an inherent risk factor, there may be an inherent need for more complex processes in preparing the information, and such processes may be inherently more difficult to apply. As a result, applying them may require specialized skills or knowledge, and may require the use of a management's expert. For example, when there are many potential data sources, with different characteristics, and the processing of that data involves many interrelated steps, the data may be inherently more difficult to identify, capture, access, understand or process.
- A87. When management judgment is more subjective, the susceptibility to misstatement due to management bias, whether unintentional or intentional, may also increase. For example, significant management judgment may be involved in making accounting estimates that have been identified as

having high estimation uncertainty, and conclusions regarding methods, models and assumptions may reflect unintentional or intentional management bias.

A88. Where there are increased opportunities for intentional management bias or fraud (e.g., owner-managed entities where there is an increased opportunity for management override of controls), the auditor may identify an increased susceptibility to misstatement due to management bias or fraud.

**Obtaining an Understanding of the Entity's System of Internal Control** (Ref: Para. 25–26)

A89. Obtaining an understanding of the components of the entity's system of internal control:

- Assists the auditor in identifying and assessing the risks of material misstatement at the financial statement level and the assertion level; and
- Provides a basis for the auditor's determination of the extent to which the auditor plans to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures in accordance with ISA 330.

A90. The auditor is required to perform risk assessment procedures to obtain an understanding of each component of internal control relevant to financial reporting. Paragraphs 27–38 address the matters the auditor is required to understand in relation to the components of the system of internal control. The nature, timing, and extent of risk assessment procedures that the auditor performs to obtain this understanding are matters of the auditor's professional judgment and are based on the auditor's determination as to what will provide sufficient and appropriate audit evidence for the auditor's identification and assessment of risks of material misstatement. Accordingly, the nature, timing and extent of procedures to understand the entity's system of internal control will vary from entity to entity, and may depend on matters such as:

- The size and complexity of the entity, including its IT environment.
- Previous experience with the entity.
- The nature of each component<sup>110</sup> of the entity's system of internal control.
- The nature and form of the entity's documentation, including as it relates to specific controls.

A91. The entity's use of IT and the nature and extent of changes in the IT environment may also affect the specialized skills that are needed to assist with obtaining the required understanding.

A92. Appendix 3 further describes the nature of the entity's system of internal control and inherent limitations of internal control, respectively. Appendix 3 also provides further explanation of the components of a system of internal control for the purposes of the ISAs.

*System of Internal Control Relevant to Financial Reporting*

A93. The entity's system of internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- The reliability of the entity's financial reporting;
- The effectiveness and efficiency of its operations; and
- Its compliance with applicable laws and regulations.

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<sup>110</sup> See paragraph 102

The way in which the system of internal control is designed, implemented and maintained varies with an entity's size and complexity. For example, smaller and less complex entities may use less structured and simpler controls (i.e., policies and procedures) to achieve their objectives.

- A94. The entity's system of internal control relevant to financial reporting will include aspects of the system of internal control that relate to the entity's reporting objectives, including its financial reporting objectives, but may also include aspects that relate to its operations or compliance objectives, when such aspects are relevant to financial reporting. For example, controls over compliance with laws and regulations may be relevant to financial reporting when such controls are relevant to the entity's preparation of contingency disclosures in the financial statements. In particular, the auditor is required by paragraph 35 to understand how the entity initiates transactions and captures information relevant to financial reporting as part of the auditor's understanding of the information system. Such information may include information from the entity's systems and controls designed to address compliance and operations objectives. Further, some entities may have information systems that are highly integrated such that controls may be designed in a manner to simultaneously achieve financial reporting, compliance and operational objectives, and combinations thereof.
- A95. For the purposes of this ISA, the system of internal control relevant to financial reporting means the system of internal control relevant to the preparation of the financial statements in accordance with the requirements of the applicable financial reporting framework.

#### Considerations Specific to Public Sector Entities

- A96. Auditors of public sector entities often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice or reporting on spending against budget. Auditors of public sector entities may also have responsibilities to report on compliance with law, regulation or other authority. As a result, their considerations about the system of internal control may be broader and more detailed.

#### *Understanding the Entity's Use of Information Technology in the Components of the System of Internal Control*

- A97. An entity's system of internal control contains manual elements and automated elements. An entity's mix of manual and automated elements in the entity's system of internal control varies with the nature and complexity of the entity's use of IT. The overall objective and scope of an audit does not differ whether an entity operates in a mainly manual environment, a completely automated environment, or an environment involving some combination of manual and automated elements. An entity's use of IT affects the manner in which the information relevant to financial reporting is processed, stored and communicated, and therefore affects the manner in which the system of internal control relevant to financial reporting is designed and implemented. Each component of the system of internal control may involve some extent of automation. The auditor's understanding of the system of internal control relevant to financial reporting involves understanding the entity's use of IT for each component.
- A98. The characteristics of manual or automated elements are relevant to the auditor's identification and assessment of the risks of material misstatement, and further audit procedures based thereon. Automated controls may be more reliable than manual controls because they cannot be as easily bypassed, ignored, or overridden, and they are also less prone to simple errors and mistakes. Automated controls may be more effective than manual controls in the following circumstances:



- High volume of recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- Controls where the specific ways to perform the control can be adequately designed and automated.

*Components of the Entity's System of Internal Control*

A99. The components of the entity's system of internal control for the purpose of this ISA do not necessarily reflect how an entity designs, implements and maintains its system of internal control, or how it may classify any particular component. Entities may use different terminology or frameworks to describe the various aspects of the system of internal control. For the purpose of an audit, auditors may also use different terminology or frameworks provided all the components described in this ISA are addressed.

A100. The entity's system of internal control relevant to financial reporting addresses the prevention, detection and correction of misstatements in the entity's financial statements; however, the manner in which the individual components operate in this respect differs. The control environment provides the overall foundation for the operation of the other components of the system of internal control. Similarly, the entity's risk assessment process and its process for monitoring the system of internal control are designed to operate in a manner that also supports the entire system of internal control. Therefore these components support the controls within the other components of the entity's system of internal control. Due to the manner in which the controls within these components are designed to operate, they are typically not precise enough to prevent, or detect and correct, misstatements at the assertion level and instead may have an indirect effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls may be referred to as "indirect controls."

A101. In contrast, the information system and communication component, as well as the control activities component, typically include controls that are designed to prevent, or to detect and correct, misstatements at the assertion level for the classes of transactions, account balances and disclosures in the entity's financial statements. Such controls may be referred to as "direct controls."

A102. The nature of each of the components of the entity's system of internal control may also affect the auditor's identification and assessment of the risks of material misstatement as follows:

- The auditor's understanding of the entity's control environment, risk assessment process, and the entity's process to monitor controls are more likely to affect the identification and assessment of risks of material misstatement at the financial statement level.
- The auditor's understanding of the information system and communication component, and the control activities component, are more likely to affect the identification and assessment of risks of material misstatement at the assertion level.

A103. Notwithstanding the types of controls that are typically within each component of the entity's system of internal control, direct or indirect controls may exist in any of the components. In particular, the control activities component includes general IT controls, which may include 'indirect controls.' For example, controls that address the continued functioning of automated controls over the processing of transactions, such as controls over the integrity of information in the entity's information system, may also include 'direct controls.'

**Controls Relevant to the Audit (Ref: Para. 26)**

A104. The auditor identifies controls relevant to the audit in accordance with paragraphs 39 through 41. Controls relevant to the audit are likely to include mainly controls that address potential risks of misstatement at the assertion level (i.e., controls in the control activities component). However, controls relevant to the audit may also include controls in other components of the system of internal control, i.e., the control environment, the risk assessment process and the process to monitor controls components that address the risks of material misstatement at the assertion level. The auditor evaluates the design of each control relevant to the audit and determines whether it has been implemented in accordance with paragraph 42.

**Understanding the Components of the Entity's System of Internal Control (Ref: Para. 27–38)**

*Control Environment (Ref: Para. 27)*

A105. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's system of internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A106. The control environment relating to smaller and less complex entities is likely to vary from larger or more complex entities. For example, the organizational structure may be simpler and include a small number of employees involved in roles related to financial reporting. Further, those charged with governance in smaller and less complex entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. Accordingly, some considerations about the entity's control environment may be inapplicable or less relevant. For example, if the role of governance is undertaken directly by the owner-manager, the auditor may determine that the independence of those charged with governance is not relevant.

A107. In addition, audit evidence for elements of the control environment in smaller and less complex entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, but is still effective. For example, such entities may not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller and less complex entity's control environment.

**Understanding the Control Environment**

A108. Audit evidence for the auditor's understanding of the control environment may be obtained through a combination of inquiries and other risk assessment procedures (i.e., corroborating inquiries through observation or inspection of documents). The nature, timing and extent of the auditor's procedures to obtain the understanding of the control environment may vary to the extent necessary, to provide an appropriate basis for the required evaluation in paragraph 28. For example, in considering the extent to which management demonstrates a commitment to integrity and ethical values, the auditor may obtain an understanding through inquiries of management and employees about how management communicates to employees its views on business practices and ethical behavior and

inspecting management's written code of conduct and observing whether management acts in a manner that supports that code.

A109. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified control deficiencies relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

A110. The auditor's consideration of the entity's use of IT as it relates to the control environment may include such matters as:

- Whether governance over IT is commensurate with the nature and size of the entity and its business operations enabled by IT, including the complexity or maturity of the entity's technology platform or architecture and the extent to which the entity relies on IT applications to support its financial reporting.
- The management organizational structure regarding IT and the resources allocated (for example, whether the entity has invested in an appropriate IT environment and necessary enhancements, or whether a sufficient number of appropriately skilled individuals have been employed including when the entity uses commercial software (with no or limited modifications)).

#### Evaluating the Control Environment (Ref: Para. 28)

A111. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific controls in the control activities component) and thereby, the auditor's identification and assessment of the risks of material misstatement. As further explained in paragraph A218–A219, control deficiencies in the control environment may lead to risks of material misstatement at the financial statement level, which may have implications for the audit, including, as explained in ISA 330, an influence on the nature, timing and extent of the auditor's further procedures.<sup>111</sup>

A112. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. An entity's control consciousness is influenced 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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<sup>111</sup> ISA 330, paragraphs A2–A3

A113. Some entities may be dominated by a single individual who may exercise a great deal of discretion. The actions and attitudes of that individual may have a pervasive effect on the culture of the entity, which in turn may have a pervasive effect on the control environment. Such an effect may be positive or negative. For example, direct involvement by this single individual may be key to enabling the entity to meet its growth and other objectives, and can also contribute significantly to an effective system of internal control. On the other hand, such concentration of knowledge and authority can also lead to an increased susceptibility to misstatement through management override of controls.

A114. Active involvement by those charged with governance, who are also independent, may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings. Overall, although a control environment that provides an appropriate foundation for the system of internal control may help reduce the risk of fraud, an appropriate control environment is not necessarily an effective deterrent to fraud.

*The Entity's Risk Assessment Process (Ref: Para. 29–31)*

A115. The entity's risk assessment process is an iterative process for identifying and analyzing risks to achieving the entity's objectives, and forms the basis for how management or those charged with governance determine the risks to be managed.

A116. The extent to which an entity's risk assessment process is formalized may vary. Some entities, including smaller and less complex entities, and particularly owner-managed entities, may not have established a structured risk assessment process, or the risk assessment process may not be documented or performed on regular basis. Irrespective whether the risk assessment process is formally established or not, the auditor may still obtain the understanding required by paragraph 29 about how the entity identifies risks relevant to financial reporting and how these risks are addressed through observation and inquiry.

*Understanding the Entity's Risk Assessment Process (Ref: Para. 29)*

A117. In order to understand how management and those charged with governance have identified business risks relevant to financial reporting objectives, and have decided about actions to address those risks, matters the auditor may consider include how management or, as appropriate, those charged with governance have:

- Specified objectives with sufficient clarity to enable the identification and assessment of the risks relating to the objectives;
- Identified the risks to achieving the entity's objectives and analyzed the risks as a basis for determining how the risks should be managed;
- Considered the potential for fraud when considering the risks to achieving the entity's objectives; and
- Identified and evaluated changes that could significantly affect the entity's system of internal control.

As explained in paragraph A59, not all business risks give rise to risks of material misstatement.

A118. The nature, timing and extent of the auditor's risk assessment procedures to obtain the understanding of the entity's risk assessment process may vary to the extent necessary, to provide an appropriate basis for the required evaluation in paragraph 31.

A119. Understanding the risks arising from the entity's use of IT identified by the entity, as well as how these risks have been addressed, is an important input to the auditor's identification of risks arising from the use of IT in accordance with paragraph 41. It may also help the auditor understand the nature and extent of automated processes, and the data, used in controls that may be relevant to the audit.

*Evaluating the Appropriateness of the Entity's Risk Assessment Process (Ref: Para. 31)*

A120. Whether the entity's risk assessment process is appropriate to the circumstances of the entity, including its nature, size, and complexity, is a matter of the auditor's professional judgment. For example, in some smaller and less complex entities, and particularly owner-managed entities, an appropriate risk assessment may be performed through the direct involvement of management or the owner-manager (e.g., the manager or owner-manager may routinely devote time to monitoring the activities of competitors and other developments in the market place to identify emerging risks that may affect how the entity applies the requirements of the applicable financial reporting framework related to the entity's ability to continue as a going concern).

A121. When the auditor determines, in accordance with paragraph 31(b), that a control deficiency exists related to the entity's risk assessment process, the auditor is required to determine, in accordance with paragraph 43, whether any such deficiency constitutes a significant control deficiency. Whether the absence of an appropriate risk assessment process represents a significant control deficiency is a matter of the auditor's professional judgment. Circumstances that may indicate a significant control deficiency exists include matters such as:

- The absence of a risk assessment process when such a process would ordinarily be expected to have been established; or
- Evidence of an ineffective risk assessment process, which may be the case when the process has failed to identify a risk of material misstatement when it would be expected the risk assessment process would have identified the risk.

*The Entity's Process to Monitor the System of Internal Control (Ref: Para. 32–34)*

A122. The entity's process to monitor the system of internal control is a continuous process to evaluate the effectiveness of the system of internal control and to take necessary remedial actions on a timely basis. The entity's process to monitor the system of internal controls may consist of ongoing activities, separate evaluations (conducted periodically), or some combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities. The entity's process will likely vary in scope and frequency depending on the assessment of the risks by the entity.

A123. In smaller and less complex entities, and in particular owner-manager entities, the entity's process to monitor the system of internal control is often accomplished by management's or the owner-manager's direct involvement in operations, and there may not be any other monitoring activities. For example, this is the case when significant variances from expectations and inaccuracies in financial data are identified through the owner-manager's direct involvement. The owner-manager's actions and follow-up may also be how remedial actions are implemented. In such cases, the auditor's

understanding of the process to monitor the system of internal control may be accomplished through inquiry of the owner-manager and employees about these activities, and may also involve inspection or observation of related communications or other evidence of remedial actions.

A124. For entities where there is no distinct process for monitoring the system of internal control, it may be difficult to distinguish between controls in the control activities component and activities related to monitoring. For example, a supervisory review may not be considered a monitoring activity by the entity, but the review may have a role in monitoring the effectiveness of underlying controls. For such entities, understanding the process to monitor the system of internal control may include understanding periodic reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

A125. Controls in the entity's process to monitor the system of internal control are likely to consist of primarily indirect controls. However, monitoring activities, such as management or supervisory reviews, may be precise enough to address risks of material misstatement at the assertion level (i.e., direct controls). Such controls may also include certain activities performed by the internal audit function. The auditor may determine certain direct controls to be controls relevant to the audit in accordance with paragraph 39–41.

Understanding the Entity's Process to Monitor the System of Internal Control (Ref: Para. 32)

A126. In order to understand how the entity monitors its system of internal control, matters that may be relevant for the auditor to consider include:

- The design of the monitoring activities, for example whether it is periodic or ongoing monitoring;
- The performance and frequency of the monitoring activities;
- The evaluation of the results of the monitoring activities, on a timely basis, to determine whether the controls have been effective; and
- How identified deficiencies have been addressed through appropriate remedial actions, including timely communication of such deficiencies to those responsible for taking remedial action.

A127. The entity's process to monitor the system of internal control includes monitoring underlying controls that involve the use of IT, and may include, for example:

- Controls to monitor complex IT environments that:
  - Evaluate the continuing design effectiveness of underlying controls and modify them, as appropriate, for changes in conditions; or
  - Evaluate the operating effectiveness of underlying controls.
- Controls that monitor the permissions applied in automated application controls that enforce the segregation of duties.
- Controls that monitor how errors or control deficiencies related to the automation of financial reporting are identified and addressed.

A128. Controls within the entity's process to monitor the system of internal control, including those that monitor underlying automated controls, may be automated or manual, or a combination of both. For

example, an entity may use automated monitoring controls over access to certain technology with automated reports of unusual activity to management, who manually investigate identified anomalies.

Sources of Information (Ref: Para. 33)

A129. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that information used for monitoring is accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

- The sources of the information related to the entity's monitoring activities; and
- The basis upon which management considers the information to be sufficiently reliable for the purpose of the monitoring activities

is required to provide a basis for the auditor's understanding of the entity's process to monitor the system of internal control.

A130. Management's monitoring activities may use information in communications from external parties such as customer complaints or regulator comments that may indicate problems or highlight areas in need of improvement.

The Entity's Internal Audit Function (Ref: Para. 34)

A131. If the entity has an internal audit function, the auditor's understanding of the entity's process to monitor the system of internal control involves obtaining an understanding of the role that the internal audit function plays in that process. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 18(a) of this ISA help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function. This understanding, together with the information obtained from the auditor's inquiries in paragraph 18(a) of this ISA, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.

A132. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.

A133. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, ISA 610 (Revised 2013) applies.

A134. As is further discussed in ISA 610 (Revised 2013), the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of

management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

A135. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. ISA 200<sup>112</sup> discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

#### *The Information System and Communication*

The Information System Relevant to Financial Reporting (Ref: Para. 35)

A136. The information system relevant to financial reporting consists of the policies or procedures, and records, designed and established to:

- Initiate, record, process, and report entity transactions (as well as to capture, process and disclose information about events and conditions other than transactions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Incorporate information from transaction processing in the general ledger (e.g., transferring of accumulated transactions from a subsidiary ledger);
- Capture and process information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of assets; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

A137. An entity's business processes include the activities designed to:

- Develop, purchase, produce, sell and distribute an entity's products and services;
- Ensure compliance with laws and regulations; and
- Record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, which include

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<sup>112</sup> ISA 200, paragraph 15



how transactions are originated, assists the auditor in obtaining an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

A138. The entity's information system relevant to financial reporting may include the use of manual and automated elements, which also affect the manner in which transactions are initiated, recorded, processed, and reported. In particular, procedures to initiate, record, process, and report transactions may be enforced through the IT applications used by the entity, and how the entity has configured those applications. In addition, records in the form of digital information may replace or supplement records in the form of paper documents.

A139. The information system, and related business processes relevant to financial reporting in smaller and less complex entities is likely to be less sophisticated than in larger entities and involve a less complex IT environment, but the role of the information system is just as important. Regardless of the size or nature of the entity, the information system includes 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. Smaller and less complex entities with direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's information system relevant to financial reporting may therefore require less effort in an audit of smaller and less complex entity, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important to identify risks of material misstatement.

A140. The auditor's understanding of the information system relevant to financial reporting required by paragraph 35 includes understanding the flows of information relating to the entity's significant classes of transactions, account balances, and disclosures in the financial statements. The auditor's understanding of the information system relevant to financial reporting is not required to include an understanding of the flows of information related to classes of transactions, account balances or disclosures that are not significant classes of transactions, account balances or disclosures.

A141. Risk identification and assessment is an iterative process. The auditor's expectations formed in paragraph 23 about the classes of transactions, account balances and disclosures may assist the auditor in determining the significant classes of transactions, account balances and disclosures in accordance with paragraph 46, which are those that need to be understood when obtaining an understanding of the information system in accordance with paragraph 35. For example, the auditor may have an expectation that certain significant classes of transactions related to revenue exist, but in obtaining the understanding about the flows of information in the information system, the auditor may identify additional classes of transactions related to revenue that may be significant.

#### Information Obtained from Outside of the General and Subsidiary Ledgers

A142. 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 accounting 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.<sup>113</sup>

A143. 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.

Understanding the Entity's Use of Information Technology in the Information System (Ref: Para. 35(d))

A144. The auditor is required to understand the IT environment relevant to the entity's information system because the entity's use of IT applications or other aspects in the IT environment may give rise to risks arising from the use of IT. The nature and significance of these risks vary based on whether, and the extent to which, the entity relies on IT, including automated controls, to support the processes in its information system and to maintain the completeness and accuracy of the underlying data and information. The entity may implement general IT controls in response to these risks. General IT controls may be relevant to the audit and may need to be taken into account in the auditor's assessment of control risk at the assertion level.

A145. Examples of risks arising from the use of IT include:

- Inappropriate reliance on IT applications that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.

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<sup>113</sup> See paragraphs 19–20 of ISA 570 (Revised), *Going Concern*

- Unauthorized changes to data in master files.
- Unauthorized changes to IT applications or other aspects of the IT environment.
- Failure to make necessary changes to IT applications or other aspects of the IT environment.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

A146. The auditor may take an approach to obtaining the understanding the IT environment that involves identifying the IT applications and supporting IT infrastructure concurrently with the auditor's understanding of how information relating to significant classes of transactions, account balances and disclosures flows through the entity's information system.

A147. In obtaining the understanding of the IT environment, the auditor may also obtain a high-level understanding of the IT processes and the personnel involved in maintaining the IT environment (e.g., the number and skill level of the IT support resources that manage security and changes to the environment), which assists the auditor in understanding the complexity of the IT environment. This understanding may include identifying significant changes in the IT environment, which may be revealed through significant changes in the flows of transactions or information through the entity's information system.

A148. Obtaining the auditor's understanding of the IT environment in accordance with paragraph 35(d), and the auditor's identification of IT applications and other aspects of the IT environment relevant to the audit in accordance with paragraph 40, may involve an iterative process or may be performed concurrently. Matters that may be relevant to the auditor's understanding of the IT environment, or the determination of the aspects that are relevant to the audit, include matters such as:

- The extent of automated procedures for processing, and the complexity of those procedures, including, whether there is highly automated, paperless processing.
- The extent of the entity's reliance on system-generated reports in the processing of information.
- How data is input (i.e., manual input, customer or vendor input, or file load).
- How IT facilitates communication between applications, databases or other aspects of the IT environment, internally and externally, as appropriate, through system interfaces.
- The volume and complexity of data in digital form being processed by the system, including whether accounting records or other information are stored in digital form.
- Matters related to the individual aspects of the IT environment, for example:
  - The type of application (e.g., a commercial application with little or no customization, or a highly-customized or highly-integrated application that may have been purchased and customized, or developed in-house).
  - The complexity of the nature of the IT applications and the underlying IT infrastructure.
  - The complexity of the security over the IT environment, including vulnerability of the IT applications, databases, and other aspects of the IT environment to cyber security risks, particularly when there are web-based transactions or transactions involving external interfaces.

- The extent of change within the IT environment (e.g., new aspects of the IT environment or significant changes in the IT applications or the underlying IT infrastructure)
- Whether there is third-party hosting or outsourcing of IT.
- Whether the entity is using emerging technologies that affect its financial reporting.
- Whether there was a major data conversion during the period and, if so, the nature and significance of the changes made, and how the conversion was undertaken.
- Whether program changes have been made to the manner in which information is processed, and the extent of such changes during the period

A149. Obtaining an understanding of the entity's IT environment may be more easily accomplished for a smaller and less complex entity that uses commercial software and when the entity does not have access to the source code to make any program changes. Such entities may not have dedicated IT resources but may have a person assigned in an administrator role for the purpose of granting employee access or installing vendor-provided updates to the IT applications. Specific matters that the auditor may consider in understanding the nature of a commercial accounting software package, which may be the single IT application used by a smaller and less complex entity in its information system, may include:

- The extent to which the software is well established and has a reputation for reliability;
- The extent to which it is possible for the entity to modify the source code of the software; and
- The nature and extent of modifications that have been made to the software. Many software packages allow for configuration (e.g., setting or amending reporting parameters). These do not usually involve modifications to source code; however, the auditor may consider the extent to which the entity is able to configure the software when considering the completeness and accuracy of information produced by the software that is used as audit evidence.

A150. Complex IT environments may include highly-customized or highly-integrated IT applications and may therefore require more effort to understand. Financial reporting processes or IT applications may be integrated with other IT applications. Such integration may involve IT applications that are used in the entity's business operations and that provide information to the financial reporting IT applications. In such circumstances, certain IT applications used in the entity's business operations may be relevant to financial reporting. Complex IT environments also may require dedicated IT departments that have structured IT processes supported by personnel that have software development and IT environment maintenance skills. In other cases, an entity may use third-party service providers to manage certain aspects of, or IT processes within, its IT environment.

Evaluating the Design of the Information System Controls Relevant to Financial Reporting (Ref: Para. 36)

A151. The information system relevant to financial reporting comprises the entity's financial reporting processes, and the entity's personnel, IT and other resources, deployed in applying those processes. The objective of those processes is to capture, store and process data from internal and external sources, and to produce the entity's accounting records and the information that the entity needs to include in its financial statements. The objective of those processes is also to comply with the requirements and principles in the applicable financial reporting framework, and in other applicable laws or regulations. Paragraphs 10–12 of Appendix 3 sets out further matters for consideration relating to the information system.)

A152. The design of the information system is established in the policies and procedures that define the nature, timing and extent of the entity's financial reporting processes, and how the entity's personnel, IT and other resources are deployed in applying them. Such controls are referred to in this ISA as information system controls relevant to financial reporting. Such policies and procedures may be formally documented, for example in a financial reporting manual, or may be less formally established through communication by management.

A153. The auditor's understanding of the information system may be obtained in various ways. The auditor's risk assessment procedures to obtain such understanding may include, for example, a combination of:

- Inspection of policy or process manuals or other documentation of the entity's information system;
- Inquiries of relevant personnel about the procedures used to initiate, record, process and report transactions or about the entity's financial reporting process; or
- Observation of the performance of the policies or procedures by entity's personnel.
- Selecting transactions and tracing them through the applicable process in the information system.

Inquiry alone, however, is not sufficient for such purposes.

A154. The audit evidence obtained by these risk assessment procedures is used by the auditor to evaluate the design of the information system controls relevant to the financial reporting and determine whether they have been implemented. In evaluating the design of the entity's information system controls relevant to financial reporting, the auditor considers whether such controls would meet their financial reporting objectives, if implemented as designed and operating effectively.

A155. The auditor may also use automated techniques by obtaining direct access to, or a digital download from, the databases in the entity's information system that store the accounting records of transactions. By using this information, the auditor may confirm the understanding obtained about how transactions flow through the information system by tracing journal entries, or other digital records related to a particular transaction, or an entire population of transactions, from initiation in the accounting records through to recording in the general ledger. Analysis of complete or large sets of transactions may also result in the identification of variations from the normal, or expected, processing procedures for these transactions, which may result in the identification of additional risks of material misstatement related to non-standard procedures.

A156. Regardless of the techniques used to evaluate the design of the information system and determine whether it has been implemented, the auditor's understanding of the sources of data, and the IT applications involved in processing that data, may also assist the auditor in understanding the IT environment.

A157. The entity also establishes controls that are designed to support the operating effectiveness of the controls within the information system. For purposes of the ISAs, controls over the information system are treated as controls in the control activities component and may be identified as controls relevant to the audit. The objectives of such controls may include, for example, maintaining the integrity or security of the data captured, stored or processed, and of the accounting records and information produced by the information system. The auditor is required to evaluate the design of those controls

and determine whether they have been implemented, in accordance with paragraph 42. These procedures may be performed together with the procedures performed to evaluate the design of the information system controls relevant to financial reporting. For example, the auditor may perform a walk-through of a transaction to confirm the flow of transactions relevant to the transaction and at the same time, evaluate the design and implementation of controls relevant to the audit that relate to that class of transactions, such as those related to approvals or reconciliations.

*Communication (Ref: Para. 37)*

A158. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to the system of internal control relevant to financial reporting. It may include such matters as the extent to which personnel understand how their activities in the information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals, particularly in larger entities.

A159. Communication may be less structured (e.g., formal manuals may not be used) and easier to achieve in a smaller and less complex entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability. Regardless of the size of the entity, open communication channels help ensure that exceptions are reported and acted on.

*Control Activities (Ref: Para. 38)*

A160. Controls in the control activities component include those controls over the flows of information within the information system relating to significant classes of transactions, account balances and disclosures and the financial reporting process used to prepare the financial statements. Such controls consist of application controls and general IT controls, both of which could be manual or automated. Regardless of whether controls are within the IT environment or manual systems, controls may have various objectives and may be applied at various organizational and functional levels. Examples of controls in the control activities component include authorizations and approvals, reconciliations, verifications (such as edit and validation checks or automated calculations), segregation of duties, and physical or logical controls, including those addressing safeguarding of assets.

A161. Controls in smaller and less complex entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, in smaller and less complex entities, more controls may be directly applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions.

A162. Some individual controls may consist of both automated and manual aspects, such as controls that may use information produced by IT (e.g., an exception report) that is subject to manual procedures (e.g., review and follow-up). For many entities, most controls may be automated controls or involve a combination of automated and manual aspects because of the extent of use of IT applications for financial reporting purposes. In some cases, authorizations, approvals and the preparation of reconciliations may involve the use of technology enabled workflow or use of supporting records in digital form.

A163. The greater the extent of automated controls, or controls involving automated aspects, that management uses and relies on in relation to its financial reporting, the more important it may become for the entity to implement general IT controls that address the continued functioning of the automated aspects of application controls.

A164. It may be less practicable to establish segregation of duties in smaller and less complex entities that have fewer employees. However, in an owner-managed entity, the owner-manager may be able to exercise more effective oversight through direct involvement than in a larger entity, which may compensate for the generally more limited opportunities for segregation of duties. Although, as also explained in ISA 240, domination of management by a single individual can be a potential control deficiency since there is an opportunity for management override of controls.<sup>114</sup>

A165. Controls in the control activities component 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. Such controls may relate to information included in the financial statements that is obtained from outside of the general and subsidiary ledgers.

#### Controls Relevant to the Audit (Ref: Para. 39–41)

##### Determining controls relevant to the audit (Ref: Para. 39)

A166. Controls relevant to the audit are primarily direct controls and are primarily controls in the control activities component because such controls typically are controls over the entity's information system and address risks of material misstatement at the assertion level. However, there may be direct controls that exist in the control environment, the entity's risk assessment process or the entity's process to monitor the system of internal control components. Controls are required to be relevant to the audit when such controls meet one or more of the criteria included in paragraph 39. However, when multiple controls each achieve the same objective, it is unnecessary to identify each of the control related to such objective.

A167. Controls relevant to the audit are required to include controls over journal entries because the manner in which an entity incorporates information from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or non-standard, or automated or manual. The extent to which other controls are relevant to the audit may vary based on the nature of the entity and the auditor's planned approach to further audit procedures. For example, in an audit of a smaller and less complex entity, the entity's information system may not be complex and the auditor may not be required to, or plan to, rely on the operating effectiveness of any controls. Further, the auditor may not have identified any significant risks or any other risks of material misstatement for which it is necessary for the auditor to evaluate the design of controls and determine that they have been implemented. In such an audit, the auditor may determine that there are no controls relevant to the audit other than the entity's controls over journal entries.

##### Controls that address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence (Ref: Para. 39(a))

A168. The auditor determines whether there are any risks of material misstatement at the assertion level for which it is not possible or practicable to obtain sufficient appropriate audit evidence through

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<sup>114</sup> ISA 240, paragraph A27

substantive procedures alone as described in paragraph 51. The auditor is required, in accordance with ISA 330,<sup>115</sup> to design and perform tests of relevant controls that address such risks of material misstatement when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. As a result, when such controls exist that address these risks, they are relevant to the audit.

Controls that address significant risks (Ref: Para. 39(b))

A169. The auditor determines whether any assessed risks of material misstatement at the assertion level are significant risks in accordance with paragraph 49. Significant risks are those that exist close to the upper end of the spectrum of inherent risk and therefore are those risks of material misstatement that require the most persuasive audit evidence in accordance with ISA 330.<sup>116</sup> Paragraph 39 requires that the auditor identify controls that address significant risks to be controls relevant to the audit. The risk assessment procedures performed to understand these controls in accordance with paragraph 42 contribute to the audit evidence related to the significant risk.

A170. Regardless of whether the auditor intends to test the operating effectiveness of controls that address significant risks, the understanding obtained about management's approach to addressing those risks may inform the design and performance of substantive procedures responsive to significant risks as required by ISA 330.<sup>117</sup> Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

- Controls such as a review of assumptions by senior management or experts.
- Documented processes for accounting estimations.
- Approval by those charged with governance.

A171. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A172. ISA 240<sup>118</sup> requires the auditor to identify the controls that address risks of material misstatement due to fraud as controls relevant to the audit and explains that it is important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In identifying the controls relevant to the audit that address the risks of material misstatement due to fraud, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties.

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<sup>115</sup> ISA 330, paragraph 8

<sup>116</sup> ISA 330, paragraph 7(b)

<sup>117</sup> ISA 330, paragraph 21

<sup>118</sup> ISA 240, paragraphs 27 and A32.



A173. In some cases, management may not have appropriately responded to significant risks by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant control deficiency.<sup>119</sup>

Controls over journal entries (Ref: Para. 39(c))

A174. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general or a subsidiary ledger, or to record accounting estimates that are periodically made by management, such as changes in the accounting estimate of uncollectible accounts receivable.

A175. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidation adjustments, entries for a business combination or disposal, or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of automated techniques. For example, applying automated techniques to analyze an entire population of journal entries within a general ledger may assist in understanding the nature and extent of journal entries made, which account balances are subject to standard or non-standard journal entries, and which entity personnel made or authorized the journal entries. These techniques can be accompanied by inquiries of management or inspection of supporting documentation for journal entries to identify the controls the entity has implemented over journal entries.

Testing of operating effectiveness of controls (Ref: Para. 39(d))

A176. When the auditor determines that a risk(s) for which substantive procedures alone cannot provide sufficient appropriate audit evidence exists, the auditor is required to, in accordance with ISA 330,<sup>120</sup> design and perform tests of relevant controls. Further, when the auditor voluntarily intends to take into account the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures, such controls are required to be identified as relevant to the audit because ISA 330<sup>121</sup> requires the auditor to design and perform tests of those controls. For example, the auditor may plan to test controls over routine classes of transactions because such testing may be more effective or efficient for large volumes of homogenous transactions.

A177. The auditor's intentions to test the operating effectiveness of controls may also be influenced by the identified risks of material misstatement at the financial statement level. For example, if deficiencies are identified related to the control environment, this may affect the auditor's overall expectations about the operating effectiveness of direct controls.

A178. The auditor may plan to test the operating effectiveness of controls over the completeness and accuracy of information produced by the entity when the auditor intends to take into account the operating effectiveness of those controls in designing and performing further audit procedures to

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<sup>119</sup> ISA 265, paragraph A7

<sup>120</sup> ISA 330, paragraph 8

<sup>121</sup> ISA 330, paragraph 8(a)

determine the reliability of that information for its use as audit evidence. The auditor may also plan to test the operating effectiveness of controls relating to operations and compliance objectives when they relate to data the auditor evaluates or uses in applying audit procedures.

Other controls relevant to the audit (Ref: Para. 39(e))

A179. The extent to which other controls are identified as relevant to the audit is a matter of the auditor's professional judgment. The auditor's judgment about whether it is appropriate to devote additional attention to evaluating the design of controls and determining whether they have been implemented in order to provide a basis for the design and performance of further audit procedures is influenced by:

- The auditor's knowledge about the presence or absence of controls obtained from the understanding of the components of the system of internal control. For example, when an engagement is new or the entity has made significant changes to its information system, the auditor may determine that more information about the entity's controls is needed to provide a basis for the design of the auditor's further audit procedures, including to assist the auditor in deciding whether to test the operating effectiveness of such controls; and
- The identification of risks of material misstatement and the related assessments of inherent risk at the assertion level because ISA 330 requires more persuasive audit evidence the higher the auditor's assessment of risk.<sup>122</sup> For risks that are assessed as higher, but are not significant risks, the auditor may identify controls over those risks to be relevant to the audit. Similar to controls over significant risks, the auditor's evaluation of the design of these controls and determination of whether they have been implemented contributes to the audit evidence related to the higher risk. This understanding of controls may also assist the auditor in designing further audit procedures responsive to the risk.

IT Applications and Other Aspects of the IT Environment Relevant to the Audit (Ref: Para 35(d) and 40)

A180. An entity may be using and relying upon IT to accurately process and maintain the integrity of information in the entity's information system relevant to financial reporting. In obtaining the understanding of the IT environment in accordance with paragraph 35(d), the auditor may have obtained information about the nature and number of the IT applications and the complexity of the IT processes in the entity's IT environment. Obtaining a high-level understanding of the extent to which the entity's IT processes include the implementation of general IT controls may assist the auditor in identifying whether there are IT applications on which management is relying for the purposes of financial reporting and that therefore may be IT applications relevant to the audit. In addition, the auditor is required to take into account the matters included in paragraph 39 because these matters may further assist the auditor in identifying those IT applications for which the entity's general IT controls may be relevant to the audit.

A181. In smaller and less complex entities that use commercial software and that do not have access to the source code to make any program changes, the entity may not have any IT processes other than, for example, to process updates to the software received from the vendor. Also, in smaller and less complex entities, management may not be relying on the IT applications, and the controls within them, to maintain the integrity of information. For example, management may instead be relying on

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<sup>122</sup> ISA 330, paragraph 7(b)

reconciliations of information about transactions processed by the IT application to hard copy records or external documents (e.g., reconciliation of cash sales to deposits reported on a bank statement). When an entity uses an IT application that is reputable, widely-used and considered reliable, is unable to change its programming, and maintains hard-copy accounting records, the auditor may determine that there are no IT applications relevant to the audit. In such a case, the auditor is also likely to be able to obtain audit evidence about the completeness and accuracy of the information produced by the entity used as audit evidence through substantive testing without the need to test controls over its production.

A182. In larger entities, the entity may be relying on IT to a greater extent and the IT environment may involve multiple IT applications and the IT processes to manage the IT environment may be complex. When an entity has greater complexity in its IT environment, determining the IT applications and other aspects of the IT environment that are relevant to the audit is likely to require the involvement of team members with specialized skills in IT.

Matters taken into account in identifying IT applications relevant to the audit

A183. Automated controls that may be determined to be relevant to the audit in accordance with paragraph 40 may include, for example, automated calculations or input, processing and output controls, such as a three-way match of a purchase order, shipping document, and vendor invoice. System-generated reports that the auditor may intend to use as audit evidence may include, for example, a trade receivable aging report or an inventory valuation report.

A184. In considering whether the IT applications in which automated controls exist and reports are generated are relevant to the audit, the auditor is likely to consider whether, and the extent to which, the entity may have access to source code that enables management to make program changes to such controls or the IT applications. For system-generated reports to be used as audit evidence, the auditor may obtain audit evidence about the completeness and accuracy of the reports by substantively testing the inputs and outputs of the report. In other cases, the auditor may plan to test the operating effectiveness of the controls over the preparation and maintenance of the report, in which case the IT application from which it is produced is likely to be relevant to the audit.

A185. Some IT applications may include report-writing functionality within them while some entities may also utilize separate report-writing applications (i.e., report-writers). In such cases, the auditor may need to determine the sources of system-generated reports (i.e., the application that prepares the report and the data sources used by the report) to determine the IT applications relevant to the audit. The data sources used by IT applications may be databases that, for example, can only be accessed through the IT application or by IT personnel with database administration privileges. In other cases, the data source may be a data warehouse that may itself be considered to be an IT application relevant to the audit.

A186. The entity's ability to maintain the integrity of information stored and processed in the information system may vary based on the complexity and volume of the related transactions and other information. The greater the complexity and volume of data that supports a significant class of transactions, account balance or disclosure, the less likely it may become for the entity to maintain integrity of that information through application controls alone (e.g., input and output controls or review controls). It also becomes less likely that the auditor will be able to obtain audit evidence about the completeness and accuracy of such information through substantive testing alone when such information is used as audit evidence. In some circumstances, when volume and complexity of

transactions are lower, management may have an application control that is sufficient to verify the accuracy and completeness of the data (e.g., individual sales orders processed and billed may be reconciled to the hard copy originally entered into the IT application). When the entity relies on general IT controls to maintain the integrity of certain information used by IT applications, the auditor may determine that the IT applications that maintain that information are relevant to the audit.

A187. The auditor may have identified a risk for which substantive procedures alone are not sufficient because of the entity's use of highly-automated and paperless processing of transactions, which may involve multiple integrated IT applications. In such circumstances, the controls relevant to the audit are likely to include automated controls. Further, the entity may be relying on general IT controls to maintain the integrity of the transactions processed and other information used in processing. In such cases, the IT applications involved in the processing and the storage of the information are likely relevant to the audit.

Identifying other aspects of the IT environment that are relevant to the audit

A188. The other aspects of the IT environment that may be relevant to the audit include the network, operating system and databases, and in certain circumstances interfaces between IT applications. When there are no IT applications relevant to the audit, other aspects of the IT environment are also not relevant. When there are IT applications relevant to the audit, the other aspects of the IT environment that are relevant to the audit varies based on the extent to which such aspects support and interact with the IT applications determined to be relevant to the audit. The database(s) that stores the data processed by an IT application relevant to the audit is also relevant to the audit. Similarly, because an IT application's ability to operate is often dependent on the operating system, the operating system is typically relevant to the audit. The network may be relevant to the audit, for example, when an IT application interacts with vendors or external parties through the internet.

Risks Arising from the Use of IT and General IT Controls Relevant to the Audit (Ref: Para. 41)

A189. The extent and nature of the risks arising from the use of IT vary depending on the nature and characteristics of the IT applications and other aspects of the IT environment relevant to the audit. Specific IT risks may result when the entity uses third-party hosting for relevant aspects of its IT environment. It is more likely that there will be more IT risks arising from the use of IT when the volume or complexity of automated application controls is higher and management is placing greater reliance on those controls for effective processing of transactions or the effective maintenance of the integrity of underlying information. Examples of risks arising from the use of IT are included in paragraph A145.

A190. General IT controls are implemented to address risks arising from the use of IT. Accordingly, the auditor uses the understanding obtained about the IT applications and other aspects of the IT environment that are relevant to the audit and the related risks arising from the use of IT in determining the general IT controls relevant to the audit. In doing so, the auditor may take an approach of understanding the general IT controls that the entity has established over its IT processes for management of access, program change and IT operations for each IT application or other aspect of the IT environment that is relevant to the audit. In some cases, an entity may use common IT processes across its IT environment or across certain IT applications, in which case common risks arising from the use of IT and common general IT controls may be identified.

- A191. In identifying the risks arising from the use of IT, the auditor may also consider the nature of the IT application or other aspect of the IT environment and the reasons for it being determined to be relevant to the audit. For some IT applications or other aspects of the IT environment, the risks identified may relate primarily to unauthorized access or unauthorized program changes. In the case of databases or data warehouses, the auditor may be focused on the risk of inappropriate changes to the data through direct database access and the ability to directly manipulate information.
- A192. In general, a greater number of general IT controls related to IT applications and databases are likely to be relevant to the audit than for other aspects of the IT environment. This is because these aspects are the most closely concerned with the processing and storage of information and most subject to automated controls used in the entity's information system. In identifying general IT controls, the auditor may consider controls over actions of both end users and of the entity's IT personnel or IT service providers.
- A193. Identifying the risks arising from the use of IT and the general IT controls relevant to the audit is likely to require the involvement of team members with specialized skills in IT, other than for the simplest of IT environments. Such involvement is likely to be essential, and may need to be extensive, for complex IT environments. Appendix 4 provides further explanation of the nature of the general IT controls typically implemented for different aspects of the IT environment. In addition, examples of general IT controls for different IT processes are provided.

Evaluating the Design, and Determining Implementation of, Controls Relevant to the Audit (Ref: Para 42)

- A194. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements (i.e., the control objective). Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not designed effectively, and so the design of a control is considered first. An improperly designed control may represent a significant control deficiency.
- A195. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to risks of material misstatement in the context of processes and, when applicable, IT applications in which they exist. The relationship to IT applications assists with relating the general IT controls relevant to the audit to the controls that they support. In many cases, an individual control may not in itself adequately address a risk of material misstatement. Often, only multiple controls, together with other components of the system of internal control, will be sufficient to address a risk of material misstatement.
- A196. Conversely, some controls may have a specific effect on an individual risk of material misstatement at the assertion level embodied in a particular significant class of transactions or account balance. For example, the controls that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the risks of material misstatement relevant to the existence and completeness assertions for the inventory account balance.
- A197. Controls that support other controls are indirect controls. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements related to the risk of material misstatement. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the risks of material misstatement

relevant to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing those risks than controls more directly related thereto, such as matching shipping documents with billing documents. Similarly, a general IT control alone is typically not sufficient to address a risk of material misstatement at the assertion level.

A198. Risk assessment procedures to obtain audit evidence about the design and implementation of controls relevant to the audit may include:

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.

Inquiry alone, however, is not sufficient for such purposes.

A199. Evaluating the design and determining the implementation of controls relevant to the audit is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, the auditor may evaluate the design and determine whether the control has been implemented concurrently with the testing of its operating effectiveness, when, for example, there is some automation that provides for consistent operation of the control and the relevant risks arising from the use of IT have been addressed (e.g., when general IT controls are operating effectively). Tests of the operating effectiveness of controls, including tests of indirect controls, are further described in ISA 330.<sup>123</sup>

A200. Notwithstanding that the risk assessment procedures to obtain audit evidence about the design and implementation of controls relevant to the audit are not sufficient to test the operating effectiveness of controls (and thus assess control risk below the maximum), these procedures provide information important to the auditor's identification and assessment of the risks of material misstatement, and to the design of further audit procedures. In addition to contributing toward the auditor's understanding of the components of the entity's system of internal control, the results of these risk assessment procedures may:

- Influence the auditor's plans to test the operating effectiveness of the controls. When a control is not designed or implemented effectively, there is no benefit in testing it. Conversely, the auditor may conclude that a control, which is effectively designed and implemented, may be appropriate to test in order to take its operating effectiveness into account in designing substantive procedures. When the auditor plans to test a control, the information obtained about the extent to which the control addresses the risk(s) of material misstatement is an input to the auditor's control risk assessment at the assertion level.
- Provide the auditor with a greater understanding of the risks of material misstatement, including the identification of additional risks of material misstatement. This understanding is used in designing the nature, timing and extent of substantive audit procedures that are responsive to the risks of material misstatement, including when the auditor does not plan to test the operating effectiveness of the controls. For example, the results of these procedures may

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<sup>123</sup> ISA 330, paragraphs 8–11

inform the auditor's consideration of possible deviations in a population when designing audit samples.

- Result in the identification of risks of material misstatement at the financial statement level when the results of the auditor's procedures are inconsistent with expectations about the entity's system of internal control that may have been set based on information obtained during the engagement acceptance or continuance process.

### **Identifying and Assessing the Risks of Material Misstatement**

A201. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls relevant to the audit 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 accordance with ISA 330. In identifying and assessing the risks of material misstatement in the financial statements, the auditor exercises professional skepticism in accordance with ISA 200.<sup>124</sup>

A202. The auditor's understanding required by paragraphs 23 to 25, and the identification and assessment of the risks of material misstatement, is an iterative process. For example, the auditor may form initial expectations about the significant classes of transactions, account balances and disclosures based on the understanding of the entity and its environment and the applicable financial reporting framework obtained in accordance with paragraph 23. These expectations may be confirmed or updated as the auditor performs further risk assessment procedures to address the requirements in paragraphs 24 and 25, in particular relating to the auditor's understanding of the entity's information system. Specifically, the auditor may identify additional risks of material misstatement related to the classes of transactions, account balances or disclosures that were expected to be significant, thus confirming their significance. The auditor may also identify risks of material misstatement at the assertion level that are related to classes of transactions, account balances or disclosures not previously considered significant and which may therefore give rise to the identification of additional significant classes of transactions, account balances, or disclosures. (Ref: Para. 45(b) and 46)

### *The Use of Assertions*

A203. In identifying and assessing the risks of material misstatement, the auditor may use the assertions as described in paragraph A204(a)–(b) below or may express them differently provided all aspects described 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.

A204. Assertions used by the auditor in considering the different types of potential misstatements that may occur may fall into the following categories:

- (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.

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<sup>124</sup> ISA 200, paragraph 15

- (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—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.

A205. The assertions described in paragraph A204(a)–(b) above, adapted as appropriate, may also be used by the auditor in considering the different types of 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.

#### Considerations Specific to Public Sector Entities

A206. When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A204(a)–(b), management may often assert that transactions and events have been carried out in accordance with law, regulation or other authority. Such assertions may fall within the scope of the financial statement audit.



*Identifying Risks of Material Misstatement* (Ref: Para. 45)

- A207. The required understanding of the entity and the environment, the applicable financial reporting framework, and the system of internal control forms the basis for the auditor's identification of risks of material misstatement. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level.
- A208. Risks of material misstatements that do not relate pervasively to the financial statements are risks of material misstatement at the assertion level. The identification of risks of material misstatement at the assertion level is performed before consideration of any controls. The auditor does so based on a preliminary assessment of inherent risk that involves identifying those risks for which there is a reasonable possibility of material misstatement. The assertions to which such risks of material misstatement relate are relevant assertions, and the classes of transactions, account balances and disclosures to which the relevant assertions relate are significant classes of transactions, account balances and disclosures.
- A209. While obtaining the understanding as required by paragraph 23, the auditor takes into account the inherent risk factors. Appendix 2 sets out examples, in the context of the inherent risk factors, of events and conditions that may indicate susceptibility to misstatement that may be material.

Considerations Specific to Public Sector Entities

- A210. For public sector entities, the identification of risks at the financial statement level may include consideration of matters related to the political climate, public interest and program sensitivity.

Significant Classes of Transactions, Account Balances and Disclosures, and their Relevant Assertions (Ref: Para. 46)

- A211. The auditor determines the significant classes of transactions, account balances and disclosures by considering whether there are one or more risks of material misstatement related to the assertions for classes of transactions, account balances and disclosures expected in the financial statements (i.e., whether there is a reasonable possibility of being subject to a misstatement that is material, individually or in combination with other misstatements). When there is a remote possibility of a material misstatement with respect to an assertion, there are no identified risks of material misstatement and the assertion is not relevant. In determining the relevant assertions, the auditor considers the information gathered from the auditor's risk assessment procedures about the identified risks of material misstatement and the assertions that they may affect.
- A212. In determining significant classes of transactions, account balances and disclosures from the identified risks of material misstatement, understanding how the inherent risk factors affect the classes of transactions, account balances and disclosures enables the auditor to consider which related assertions may be subject to risks of material misstatement (see paragraph A83).
- A213. The auditor may also use automated techniques to confirm whether all significant classes of transactions and account balances have been identified by, for example, analyzing an entire population of transactions to identify their nature, source, size and volume. By applying automated techniques, the auditor may, for example identify that an account with a zero balance at period end

actually was comprised of numerous offsetting transactions and journal entries occurring during the period thus indicating that the account balance or class of transactions may be significant (e.g., a “loan processing suspense” account in a financial institution entity).

#### Identifying Significant Disclosures

A214. Significant disclosures include both quantitative and qualitative disclosures for which there is one or more relevant assertions. Examples of significant disclosures that have qualitative aspects 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.

#### *Assessing Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 47)*

A215. Because risks of material misstatement at the financial statement level have a pervasive effect on the financial statements, it may not be possible to identify the specific assertions that are more susceptible to the risk (e.g., risk of management override of controls). In other cases, a number of assertions may be identified as susceptible to the risk, and which may therefore affect the auditor's risk identification and assessment of risks of material misstatement at the assertion level.

A216. The evaluation of whether risks identified relate pervasively to the financial statements as required by paragraph 45(a) supports the auditor's ability to perform the assessment of the risks of material misstatement at the financial statement level as required by paragraph 47. The determination of the effect of the risks of material misstatement at the financial statement level on the risks of material misstatement at the assertion level as required by paragraph 47(a) is taken into account in the auditor's assessment of inherent risk at the assertion level in accordance with paragraph 48(b).

A217. Risks of material misstatement due to fraud may be particularly relevant to the auditor's consideration of the risks of material misstatement at the financial statement level. For example, the risk of management override of controls may pervasively affect the risks of material misstatement at the assertion level, although the auditor may consider particular assertions to have a greater potential for misstatement based on greater susceptibility to management bias or fraud.

A218. The auditor's identification and assessment of risks of material misstatement at the financial statement level is influenced by the auditor's understanding of the entity's system of internal control,

including the outcome of the evaluations required by paragraphs 28 and 31(b) and any control deficiencies identified in accordance with paragraph 43. In particular, risks at the financial statement level may arise from deficiencies in the control environment or from external events or conditions, such as declining economic conditions.

A219. The auditor's understanding of the control environment and other components of the system of internal control may raise doubts about the auditability of an entity's financial statements, such that it may affect the auditor's opinion or be cause for withdrawal from the engagement. For example:

- Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
- Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

A220. ISA 705 (Revised)<sup>125</sup> establishes requirements and provides guidance in determining whether there is a need for the auditor to express a qualified opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement where withdrawal is possible under applicable law or regulation.

#### *Assessing Risks of Material Misstatement at the Assertion Level*

Assessing Inherent Risk (Ref: Para. 48)

Assessing the Likelihood and Magnitude of the Risks of Material Misstatement at the Assertion Level (Ref: Para: 48(a))

A221. The degree to which events or conditions relating to significant classes of transactions, account balances and disclosures are subject to, or affected by, the inherent risk factors affects the degree to which such events and conditions are susceptible to misstatement. The inherent risk factors influence the auditor's assessment of the likelihood and magnitude of misstatement for the identified risks of material misstatement at the assertion level. The greater the degree to which a class of transactions, account balance or disclosures is susceptible to material misstatement, the higher the inherent risk assessment is likely to be.

A222. The relative degrees of the likelihood and magnitude of a possible misstatement determine where on the spectrum of inherent risk the risk of misstatement is assessed. The higher the combination of likelihood and magnitude, the higher the inherent risk; the lower the combination of likelihood and magnitude, the lower the inherent risk. When considering the potential magnitude of the misstatement, the quantitative and qualitative aspects of the potential misstatement may be relevant. A higher inherent risk assessment may also arise from different combinations of likelihood and magnitude, for example a higher risk assessment could result from a lower likelihood but a very high magnitude. Determining the combination of the likelihood and potential magnitude of a possible misstatement is a matter of the auditor's professional judgment. Significant risks, which are identified in accordance with paragraph 49, are those close to the upper end of the spectrum of inherent risk.

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<sup>125</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

- A223. Misstatements in assertions about classes of transactions, account balances or disclosures may be judged to be material due to size, nature or circumstances.
- A224. The assessment of inherent risks for individual risks of material misstatement in relation to audits of smaller and less complex entities may be such that a greater proportion of such risks are assessed close to the lower end of the spectrum of inherent risk.
- A225. In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may designate risks of material misstatement within relative categories along the spectrum of inherent risk, based on their assessment of inherent risk. These relative categories may be described in different ways, for example audit methodologies may use numerical categorizations (e.g., on a scale of one to ten), or the relative placement on the spectrum of inherent risk may be described (e.g., high, medium, low). Regardless of the method of categorization used, the auditor's assessment of inherent risk is appropriate when the design and implementation of further audit procedures to address the identified risks of material misstatement at the assertion level is responsive to the assessment of inherent risk and the reasons for that assessment.
- A226. In assessing the identified risks of material misstatement at the assertion level, the auditor may conclude that some risks of material misstatement relate more pervasively to the financial statements as a whole and potentially affect many assertions, in which case the auditor may update the identification of risks of material misstatement at the financial statement level.
- A227. In circumstances in which risks of material misstatement are identified as financial statement level risks due to their pervasive effect on a number of assertions and that effect is identifiable with specific assertions, the auditor takes into account the evaluation required by paragraph 47(b), including those assertions identified that are affected by those risks when assessing the inherent risk for risks of material misstatement at the assertion level. (Ref: Para. 48(b))

Considerations specific to public sector entities

- A228. In exercising professional judgment as to the assessment of the risk of material misstatement, public sector auditors may consider the complexity of the regulations and directives, and the risks of non-compliance with authorities.

*Significant Risks* (Ref: Para. 49)

- A229. In determining significant risks, the auditor may first identify those assessed inherent risks that have been assessed close to the upper end of the spectrum of inherent risk. The determination of which of the assessed inherent risks are close to the upper end of the spectrum of inherent risk, and are therefore significant risks, is a matter of professional judgment, unless the risk is of a type specified to be treated as a significant risk in accordance with the requirements of another ISA (see paragraph A230). Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because these are likely to give rise to risks of material misstatement at the assertion level that are assessed as close to the lower end on the spectrum of inherent risk. However, risks of material misstatement that may be assessed as having higher inherent risk and may therefore be assessed as significant risks, may arise from matters such as the following:
- Transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved.
  - Accounting estimates that have high estimation uncertainty or complex models.

- Complexity in data collection and processing to support account balances.
- Account balances or quantitative disclosures that involve complex calculations
- Accounting principles that may be subject to differing interpretation.
- Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions.

A230. Significant risks include those risks of material misstatement that are treated as significant in accordance with the requirements of other ISAs. ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.<sup>126</sup>

#### Implications for the audit

A231. ISA 330 describes the consequences for further audit procedures of identifying a risk as significant. When a risk is assessed as a significant risk, the implications for the audit include the design and implementation of an appropriate response to address the assessed risk, which may include for example the use of more experienced engagement team members, including those with specialized skills, to perform audit procedures or audit work may involve the use of experts. In addition, the ISAs set out required responses, including:

- Controls that address significant risks are required to be identified as relevant to the audit in accordance with paragraph 39.
- ISA 330 requires controls that address significant risks to be tested in the current period (when the auditor intends to rely on the operating effectiveness of such controls) and substantive procedures to be planned and performed that are specifically responsive to the identified significant risk.<sup>127</sup>
- ISA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk.<sup>128</sup>
- ISA 260 (Revised) requires communicating with those charged with governance about the significant risks identified by the auditor.<sup>129</sup>
- ISA 701 requires the auditor to take into account significant risks when determining those matters that required significant auditor attention, which are matters that may be key audit matters.<sup>130</sup>
- Review of audit documentation by the engagement partner on or before the date of the auditor's report which allows significant matters, including significant risks, to be resolved on a timely basis to the engagement partner's satisfaction.<sup>131</sup>

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<sup>126</sup> ISA 240, paragraphs 25–27

<sup>127</sup> ISA 330, paragraphs 15 and 21

<sup>128</sup> ISA 330, paragraph 7(b)

<sup>129</sup> ISA 260 (Revised), paragraph 15

<sup>130</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraph 9

<sup>131</sup> ISA 220, paragraphs 17 and A18

- ISA 600 requires more involvement by the group engagement partner if the significant risk relates to a component in a group audit and for the group engagement team to direct the work required at the component by the component auditor.<sup>132</sup>

The nature, timing and extent of the involvement of individuals with specialized skills and knowledge may vary throughout the audit.

*Assessing Control Risk (Ref: Para. 50)*

A232. The auditor's intention to test the operating effectiveness of controls provides the basis for the auditor's assessment of control risk. In assessing control risk, the auditor takes into account the expectation about the operating effectiveness of the controls (based on the auditor's evaluation of the design effectiveness and implementation of the controls set out in paragraph 42).

A233. The auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, minimum) or in terms of the auditor's expectation of how effective the control(s) is in addressing the identified risk. For example, if control risk is assessed as maximum, the auditor contemplates no expectation of the operating effectiveness of controls. If control risk is assessed at less than maximum, the auditor contemplates an expectation of the operating effectiveness of controls.

A234. If a risk of material misstatement is addressed by one or more controls, the auditor takes into account whether one, or a combination of controls, will address the assessment of inherent risk.

A235. The assessment of control risk takes into account the expected results from the auditor's planned tests of the operating effectiveness of controls relevant to the audit, including general IT controls. For controls relevant to the audit as determined in accordance with paragraph 39, and for which the auditor intends to test the operating effectiveness, the auditor may identify related general IT controls as relevant to the audit in accordance with paragraph 41. For example, when the auditor plans to test the operating effectiveness of an automated control, the auditor may also plan to test the operating effectiveness of the relevant general IT controls that support the continued functioning of that application control to address the risks arising from the use of IT, and to provide a basis for the auditor's expectation that the application control operated effectively throughout the period. When the auditor expects general IT controls that have been determined to be relevant to the audit to be ineffective, this determination may affect the auditor's assessment of control risk at the assertion level depending on whether the auditor is able to perform other tests to address those risks arising from the use of IT. Further guidance about the procedures that the auditor may perform in these circumstances is provided in ISA 330.<sup>133</sup>

*Risks for Which Substantive Procedures Alone Cannot Provide Sufficient Appropriate Audit Evidence (Ref: Para. 51)*

A236. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include

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<sup>132</sup> ISA 600, paragraphs 30 and 31

<sup>133</sup> ISA 330, paragraphs A29–A31

risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A237. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an information system that involves a high-degree of integration across its IT applications. In such cases:

- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

A238. ISA 540 (Revised) provides further guidance related to accounting estimates about risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence.<sup>134</sup>

A239. Paragraph 39 requires the identification of controls that address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence to be relevant to the audit because the auditor is required, in accordance with ISA 330,<sup>135</sup> to design and perform tests of such controls.

*Classes of Transactions, Account Balances and Disclosures that are Not Significant, but are Material* (Ref: Para. 52)

A240. As explained in ISA 320,<sup>136</sup> 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.<sup>137</sup> Classes of transactions, account balances or disclosures are quantitatively or qualitatively material if omitting, misstating or obscuring information about them could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole.

A241. There may be classes of transactions, account balances or disclosures that are quantitatively or qualitatively material but have not been determined to be significant classes of transactions, account balances or disclosures (i.e., there are no relevant assertions identified). For example, the entity may have a disclosure about executive compensation for which the auditor has not identified a risk of material misstatement. However, the auditor may determine that this disclosure is material based on the consideration in paragraph A240.

A242. Audit procedures to address classes of transactions, account balances or disclosures that are quantitatively or qualitatively material but are not determined to be significant are addressed in ISA

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<sup>134</sup> ISA 540 (Revised), paragraphs A87–A89

<sup>135</sup> ISA 330, paragraph 8

<sup>136</sup> ISA 320, paragraph A1

<sup>137</sup> ISA 320, paragraph 4

330.<sup>138</sup> When a class of transactions, account balance or disclosure is determined to be significant as required by paragraph 46, the class of transactions, account balance or disclosure, is also treated as a material class of transactions, account balance or disclosure for the purposes of paragraph 18 of ISA 330.

*Revision of Risk Assessment* (Ref: Para. 53)

A243. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. Paragraphs 16 and 17 of ISA 330 provide further guidance about evaluating the operating effectiveness of controls.

**Documentation** (Ref: Para. 54)

A244. The manner in which the requirements of paragraph 54 are documented is for the auditor to determine using professional judgment. For example, in audits of smaller and less complex entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.<sup>139</sup> Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures.<sup>140</sup> The form and extent of the auditor's documentation is influenced by the nature, size and complexity of the entity and its system of internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A245. More detailed documentation may be required where the auditor applies a higher level of professional judgment, for example when exercising professional judgment to support the rationale for difficult judgments made. However, the auditor is not required to document every inherent risk factor that was taken into account in identifying and assessing the risks of material misstatement at the assertion level.

A246. For the audits of smaller and less complex entities, the form and extent of documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor may include those on which the auditor based the assessment of the risks of material misstatement.

A247. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes

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<sup>138</sup> ISA 330, paragraph 18

<sup>139</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9

<sup>140</sup> ISA 330, paragraph 28



## Appendix 1

(Ref: Para. 23(a)(i), A57)

### Considerations for Understanding the Entity and its Business Model

The appendix provides further matters that the auditor may consider in understanding the entity and its business model.

#### Activities of the Entity

1. Examples of matters that the auditor may consider when obtaining an understanding of the activities of the entity (included in the entity's business model) include:
  - (a) Business operations such as:
    - 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.
  - (b) Investments and investment activities such as:
    - Planned or recently executed acquisitions or divestitures.
    - Investments and dispositions of securities and loans.
    - Capital investment activities.
    - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
  - (c) Financing and financing activities such as:
    - 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 (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.

#### Nature of Special-Purpose Entities

2. A special-purpose entity (sometimes referred to as a special-purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitization of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As ISA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.<sup>141</sup>
3. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special-purpose entity.

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<sup>141</sup> ISA 550, paragraph A7

## Appendix 2

(Ref: Para. A60, A83, A209)

### Events and Conditions That May Indicate Susceptibility to Risks of Material Misstatement

In obtaining the understanding of the entity and its environment and the applicable financial reporting framework in accordance with paragraph 23, the auditor considers whether and, if so, how events and conditions are subject to by, or affected by, the inherent risk factors.

The following are examples of events and conditions that may indicate the existence of risks of material misstatement in the financial statements, either at the financial statement level or the assertion level. The examples provided by inherent risk factor cover a broad range of events and conditions; however, not all events and conditions are relevant to every audit engagement and the list of examples is not necessarily complete. The events and conditions have been categorized by the inherent risk factor that may have the greatest effect in the circumstances. Importantly, due to the interrelationships among the inherent risk factors, the example events and conditions also are likely to be subject to, or affected by, other inherent risk factors to varying degrees.

#### Inherent Risk Factors at the Assertion Level

##### **Complexity:**

Regulatory:

- Operations that are subject to a high degree of complex regulation.

Business model:

- The existence of complex alliances and joint ventures.

Applicable financial reporting framework:

- Accounting measurements that involve complex processes.

Transactions:

- Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.

##### **Subjectivity:**

Applicable financial reporting framework:

- A wide range of possible measurement criteria of an accounting estimate. For example, management's recognition of depreciation or construction income and expenses.
- Management's selection of a valuation technique or model for a non-current asset, such as investment properties.

##### **Change:**

Economic conditions:

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.

Markets:

- Operations exposed to volatile markets, for example, futures trading.

Customer loss:

- Going concern and liquidity issues including loss of significant customers.

Industry model:

- Changes in the industry in which the entity operates.

Business model:

- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.

Geography:

- Expanding into new locations.

Entity structure:

- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.

Human resources competence:

- Changes in key personnel including departure of key executives.

IT:

- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.

Applicable financial reporting framework:

- Application of new accounting pronouncements.

***Uncertainty:***

Reporting:

- 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.

***Susceptibility to misstatement due to management bias or fraud:***

Reporting:

- Opportunities for management and employees to engage in fraudulent financial reporting, including omission, or obscuring, of significant information in disclosures.

Transactions:

- Significant transactions with related parties.
- 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.

**Other Inherent Risk Factors**

- Constraints on the availability of capital and credit.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Investigations into the entity's operations or financial results by regulatory or government bodies.

***Other events or conditions that may indicate risks of material misstatement at the financial statement level:***

- Lack of personnel with appropriate accounting and financial reporting skills.
- Control deficiencies, especially those not addressed by management.
- Past misstatements, history of errors or a significant amount of adjustments at period end.

## Appendix 3

(Ref: Para. 16(f), 27–38, A51, A92, A105–A165)

### Understanding the Entity's System of Internal Control

1. This appendix further explains the components of, as well as the limitations of, the entity's system of internal control as set out in paragraphs 16(f), 27–38, A51, A92 and A105–A165, as they relate to a financial statement audit.

### Components of the System of Internal Control

#### Control Environment

2. The control environment encompasses the following elements:
  - (a) *How the entity demonstrates a commitment to integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards or codes of conduct, how they are communicated (e.g., through policy statements), and how they are reinforced in practice (e.g., through management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts). The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
  - (b) *How those charged with governance demonstrate independence from management and exercise oversight of the entity's system of internal control.* An entity's control consciousness is influenced significantly by those charged with governance. Considerations include whether there are sufficient individuals who are independent from management and objective in their evaluations and decision-making; how those charged with governance identify and accept oversight responsibilities and whether those charged with governance retain oversight responsibility for management's design, implementation and conduct of the entity's system of internal control. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures.
  - (c) *How the entity has established, with oversight from those charged with governance, structures, reporting lines, and appropriate authorities and responsibilities in pursuit of its objectives.* This includes considerations about:
    - Key areas of authority and responsibility and appropriate lines of reporting;
    - Policies relating to appropriate business practices, knowledge and experience of key personnel, and resource provided for carrying out duties; and
    - Policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

The appropriateness of an entity's organizational and governance structure depends, in part, on its size and the nature of its activities.

- (d) *How the entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with its objectives.* This includes how the entity ensures the individuals have the knowledge and skills necessary to accomplish the tasks that define the individual's job, such as:
- Standards for recruiting the most qualified individuals – with an emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior.
  - Training policies that communicate prospective roles and responsibilities, including practices such as training schools and seminars that illustrate expected levels of performance and behavior; and
  - Periodic performance appraisals driving promotions that demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.
- (e) *How the entity holds individuals accountable for their internal control responsibilities in pursuit of its objectives.* This may be accomplished through, for example:
- Mechanisms to communicate and hold individuals accountable for performance of internal control responsibilities and implement corrective actions as necessary;
  - Establishing performance measures, incentives and rewards for those responsible for internal control, including how the measures are evaluated and maintain their relevance;
  - How pressures associated with the achievement of internal control objectives impact the individual's responsibilities and performance measures; and
  - How the individuals are disciplined as necessary.

The appropriateness of the above matters will be different for every entity depending on its size, the complexity of its structure and the nature of its activities.

### **Entity's Risk Assessment Process**

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.
4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial information consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment.* Changes in the regulatory, economic or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel.* New personnel may have a different focus on or understanding of the system of internal control.
- *New or revamped information system.* Significant and rapid changes in the information system can change the risk relating to the entity's system of internal control.
- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology.* Incorporating new technologies into production processes or the information system may change the risk associated with the entity's system of internal control.
- *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with the entity's system of internal control.
- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with the entity's system internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.
- *Use of IT.* Risks relating to:
  - Maintaining the integrity of data and information processing (including cyber security risks);
  - Risks to the entity business strategy that arise if the entity's IT strategy does not effectively supporting the entity's business strategy; or
  - Changes or interruptions in the entity's IT environment or turnover of IT personnel or when the entity does not make necessary updates to the IT environment or such updates are not timely.

### **The Entity's Process to Monitor the System of Internal Control**

5. An important management responsibility is to establish and maintain the entity's system of internal control on an ongoing basis. Management's process to monitor the system of internal control includes considering whether controls are operating as intended and that they are modified as appropriate for changes in conditions. The entity's process to monitor the system of internal control may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.



6. When distinguishing between a monitoring activity and a control in the control activities component, the underlying details of the activity are considered, especially where the activity involves some level of supervisory review. As also explained in the application material, supervisory reviews are not automatically classified as monitoring activities and it may be a matter of judgment whether a review is classified as a control in the control activities component or a monitoring activity. For example, the intent of a monthly completeness control in the control activities component would be to detect and correct errors, where a monitoring activity would ask why errors are occurring and assign management the responsibility of fixing the process to prevent future errors. In simple terms, a control in the control activities component responds to a specific risk, whereas a monitoring activity assesses whether controls within each of the five components of the system of internal control are operating as intended.
7. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of the system of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider in performing monitoring activities any communications relating to the system of internal control from external auditors.

#### Use of internal audit

8. The objectives and scope of an internal audit function, the nature of its responsibilities and its status within the organization, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. These matters may be set out in an internal audit charter or terms of reference.
9. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, the system of internal control and governance processes. If so, the internal audit function may play an important role in the entity's process to monitor the system of internal control. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting.

#### The Information System and Communication

10. The information system relevant to financial reporting encompasses policies, procedures and records that:
  - Identify and record all valid transactions.
  - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
  - Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
  - Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.

- Present properly the transactions and related disclosures in the financial statements.
  - Capture, process and disclose information about events and conditions other than transactions.
11. The quality of the information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
12. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to the entity's system of internal control may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

### Control Activities

13. Controls in the control activities component consist of application controls and general IT controls, both of which may be manual or automated in nature, and may pertain to the following:
- *Authorization and approvals.* An authorization affirms that a transaction is valid (i.e. it represents an actual economic event or is within an entity's policy). An authorization typically takes the form of an approval by a higher level of management or of verification and a determination if the transaction is valid. For example, a supervisor approves an expense report after reviewing whether the expenses seem reasonable and within policy. An example of an automated approval is where an invoice unit cost is automatically compared with the related purchase order unit cost within a pre-established tolerance level. Invoices within the tolerance level are automatically approved for payment. Those invoices outside the tolerance level are flagged for additional investigation.
  - *Reconciliations* – Reconciliations compare two or more data elements and, if differences are identified, action is taken to bring the data into agreement. Reconciliations generally address the completeness or accuracy of processing transactions.
  - *Verifications* – Verifications compare two or more items with each other or compare an item with a policy, and perform a follow-up action when the two items do not match or the item is not consistent with policy. Verifications generally address the completeness, accuracy, of validity of processing transactions.
  - *Physical or logical controls, including those that address security of assets against unauthorized access, acquisition, use or disposal.* Controls that encompass:
    - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
    - The authorization for access to computer programs and data files (i.e., logical access).
    - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation depends on circumstances such as when assets are highly susceptible to misappropriation.

- *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

For example, a manager authorizing credit sales is not responsible for maintaining accounts receivable records or handling cash receipts. If one person is able to perform all these activities he or she could, for example, create a fictitious sale that could go undetected. Similarly, salespersons should not have the ability to modify product price files or commission rates.

Sometimes segregation is not practical, cost effective, or feasible. For example, smaller and less complex entities may lack sufficient resources to achieve ideal segregation, and the cost of hiring additional staff may be prohibitive. In these situations, management institutes alternative controls. In the example above, if the salesperson can modify product price files, a detective control activity can be put in place to have personnel unrelated to the sales function periodically review whether and under what circumstances the salesperson changed prices.

14. Certain controls in the control activities component may depend on the existence of appropriate supervisory controls established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, non-routine transactions such as major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

#### **Benefits of IT**

15. Generally, IT benefits an entity's system of internal control by enabling an entity to:
  - Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
  - Enhance the timeliness, availability, and accuracy of information;
  - Facilitate the additional analysis of information;
  - Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
  - Reduce the risk that controls will be circumvented; and
  - Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

#### **Limitations of internal control**

16. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of the system of internal control (for example, an exception report) is not effectively used because the

individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

17. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in an IT application that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
18. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

## Appendix 4

(Ref: Para. A193)

### Considerations for Understanding General IT Controls

The appendix provides further matters that the auditor may consider in understanding general IT controls.

1. The nature of the general IT controls (GITCs) typically implemented for each of the aspects of the IT environment

- (a) Applications

General IT controls at the IT application layer will correlate to the nature and extent of application functionality and the access paths allowed in the technology. For example, more controls will be relevant for highly-integrated IT applications with complex security options than a legacy IT application supporting a small number of account balances with access methods only through transactions.

- (b) Database

General IT controls at the database layer typically address risks arising from the use of IT related to unauthorized updates to financial reporting information in the database through direct database access or execution of a script or program.

- (c) Operating system

General IT controls at the operating system layer typically address risks arising from the use of IT related to administrative access, which can facilitate the override of other controls. This includes actions such as compromising other user's credentials, adding new, unauthorized users, loading malware or executing scripts or other unauthorized programs.

- (d) Network

General IT controls at the network layer typically address risks arising from the use of IT related to network segmentation, remote access, and authentication. Network controls may be relevant when an entity has web-facing applications used in financial reporting. Network controls are also may be relevant when the entity has significant business partner relationships or third party outsourcing, which may increase data transmissions and the need for remote access.

2. Examples of general IT controls that may be exist by IT process include:

- (a) Process to manage access:

- *Authentication*

Controls that ensure a user accessing the IT application or other aspect of the IT environment is using their own log-in credentials (i.e., the user is not using another user's credentials).

- *Authorization*

Controls that allow users to access the information necessary for their job responsibilities and nothing further, which facilitates appropriate segregation of duties.

- *Provisioning*  
Controls to authorize new users and modifications to existing users' access privileges.
  - *Deprovisioning*  
Controls to remove user access upon termination or transfer.
  - *Privileged access*  
Controls over administrative or powerful users' access.
  - *User access reviews*  
Controls to recertify or evaluate user access for ongoing authorization over time.
  - *Security configuration controls*  
Each technology generally has key configuration settings that help restrict access to the environment.
  - *Physical access*  
Controls over physical access to the data center and hardware, as such access may be used to override other controls.
- (b) Process to manage program or other changes to the IT environment
- *Change management process*  
Controls over the process to design, program, test and migrate changes to a production (i.e., end user) environment.
  - *Segregation of duties over change migration*  
Controls that segregate access to make and migrate changes to a production environment.
  - *Systems development or acquisition or implementation*  
Controls over initial IT application development or implementation (or in relation to other aspects of the IT environment).
  - *Data conversion*  
Controls over the conversion of data during development, implementation or upgrades to the IT environment.
- (c) Process to manage IT Operations
- *Job scheduling*  
Controls over access to schedule and initiate jobs or programs that may affect financial reporting.
  - *Job monitoring*  
Controls to monitor financial reporting jobs or programs for successful execution.

- *Backup and recovery*

Controls to ensure backups of financial reporting data occur as planned and that such data is available and able to be accessed for timely recovery in the event of an outage or attack.

- *Intrusion detection*

Controls to monitor for vulnerabilities and or intrusions in the IT environment.

## CONFORMING AND CONSEQUENTIAL AMENDMENTS ARISING FROM DRAFT PROPOSED ISA 315 (REVISED)

*Note:*

*This section presents the conforming amendments, arising from ISA 315 (Revised) Exposure Draft, in respect of:*

- *ISA 200 – Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*
- *ISA 240 – The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*
- *ISA 330 – The Auditor’s Responses to Assessed Risks*

*With reference to ISA 200 and ISA 240, only those paragraphs that have been affected by conforming amendments are presented. For example, a paragraph in the requirements section of these standards is presented if:*

- *There was a conforming amendment in the paragraph itself, or*
- *A footnote, included in the paragraph, has changed due to conforming amendments, or*
- *Application material, related to the paragraph, has changed due to conforming amendments.*

*With reference to ISA 330, the full standard has been presented for context, also recognizing that many ISA 330 paragraphs are referred to in ED-315 and the supporting flowcharts.*

*In all instances, paragraphs that may not be directly relevant to a proposed conforming change have been greyed.*

*Other conforming amendments to the ISAs have been described in the Explanatory Memorandum.*



## INTERNATIONAL STANDARD ON AUDITING 200

### OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH INTERNATIONAL STANDARDS ON AUDITING

#### Scope of this ISA

...

#### An Audit of Financial Statements

...

7. The ISAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The ISAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:
- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control.
  - Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
  - Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

...

#### Effective Date

...

#### Overall Objectives of the Auditor

...

#### Definitions

13. For purposes of the ISAs, the following terms have the meanings attributed below:

...

- (n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:
- (i) Inherent risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - (ii) Control risk – The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's ~~internal~~ internal controls.

...

## **Requirements**

### **Ethical Requirements Relating to an Audit of Financial Statements**

...

## **Professional Skepticism**

...

## **Professional Judgment**

...

### **Sufficient Appropriate Audit Evidence and Audit Risk**

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A30–A54)

### **Conduct of an Audit in Accordance with ISAs**

#### ***Complying with ISAs Relevant to the Audit***

...

19. The auditor shall have an understanding of the entire text of an ISA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A60–A68)

...

#### ***Objectives Stated in Individual ISAs***

...

#### ***Complying with Relevant Requirements***

...

#### ***Failure to Achieve an Objective***

...

### **Application and Other Explanatory Material**

#### **An Audit of Financial Statements**

##### ***Scope of the Audit*** (Ref: Para. 3)

...

##### ***Preparation of the Financial Statements*** (Ref: Para. 4)

...

## Considerations Specific to Audits in the Public Sector

...

## *Form of the Auditor's Opinion* (Ref: Para. 8)

...

## Definitions

## *Financial Statements* (Ref: Para. 13(f))

...

## **Ethical Requirements Relating to an Audit of Financial Statements** (Ref: Para. 14)

...

## **Professional Skepticism** (Ref: Para. 15)

...

## **Professional Judgment** (Ref: Para. 16)

...

## **Sufficient Appropriate Audit Evidence and Audit Risk** (Ref: Para. 5 and 17)

### *Sufficiency and Appropriateness of Audit Evidence*

A30. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit<sup>142</sup>) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

...

## *Audit Risk*

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## Risks of Material Misstatement

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<sup>142</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 219

- A40. Inherent risk is influenced by the characteristics of events or conditions that affect the susceptibility to misstatement of an ~~higher for some~~ assertions about a ~~and related~~ classes of transactions, account balances, ~~or and~~ disclosures than for others, before consideration of controls (i.e. inherent risk factors). Depending on the extent to which the assertion is subject to, or affected by, such inherent risk factors, the level of inherent risk varies along the spectrum of inherent risk. The auditor determines significant classes of transactions, account balances and disclosures, and their relevant assertions, as part of the process of identifying and assessing the risks of material misstatement. For example, ~~it may be higher for complex calculations or for accounts~~ balances consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty may be identified as significant account balances, and the auditor's assessment of inherent risk for the related risks at the assertion level may be higher because of the high estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.
- A41. Control risk is a function of the effectiveness of the design, implementation and maintenance of ~~internal controls~~ by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of ~~internal controls~~. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The ISAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.<sup>143</sup>

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<sup>143</sup> ISA 330, *The Auditor's Responses to Assessed Risks*, paragraphs 7–17

**Note:**

*Initial conforming amendments were proposed to paragraph A42 of ISA 200 as part of the IAASB approval of ISA 540 (Revised) in June 2018. With the approval of the ISA 315 (Revised) Exposure Draft, further conforming amendments will be required. Accordingly, the conforming amendments to this paragraph will only be presented in the ISA 540 (Revised) Conforming Amendments supplement to the ISA 315 (Revised) Exposure Draft.*

A42 The ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement.” However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

A43a. Risks of material misstatement are assessed at the assertion level in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence.<sup>144</sup>

#### Detection Risk

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#### Inherent Limitations of an Audit

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#### The Nature of Financial Reporting

...

#### The Nature of Audit Procedures

...

#### Timeliness of Financial Reporting and the Balance between Benefit and Cost

...

A52. In light of the approaches described in paragraph A51, the ISAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities;<sup>145</sup> and
- Use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population.<sup>146</sup>

<sup>144</sup> ISA 330, paragraph 6

<sup>145</sup> ISA 315 (Revised), paragraphs 175–2210

<sup>146</sup> ISA 330; ISA 500; ISA 520, *Analytical Procedures*; ISA 530, *Audit Sampling*

Other Matters that Affect the Inherent Limitations of an Audit

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**Conduct of an Audit in Accordance with ISAs**

*Nature of the ISAs* (Ref: Para. 18)

...

Considerations Specific to Audits in the Public Sector

...

*Contents of the ISAs* (Ref: Para. 19)

...

Considerations Specific to Smaller Entities

A66. For purposes of specifying additional considerations to audits of smaller entities, a “smaller entity” refers to an entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
  - (i) Straightforward or uncomplicated transactions;
  - (ii) Simple record-keeping;
  - (iii) Few lines of business and few products within business lines;
  - (iv) Simpler systems of Few internal controls;
  - (v) Few levels of management with responsibility for a broad range of controls; or
  - (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

A67. The considerations specific to smaller entities included in the ISAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.

A67a ISA 315 (Revised) incorporates considerations specific to audits of smaller entities when such entities are also less complex (i.e. smaller entities for which the majority of the characteristics in paragraph A66(b) apply). Accordingly, in this context, ISA 315 (Revised) refers to ‘smaller and less complex entities’.

*Objectives Stated in Individual ISAs* (Ref: Para. 21)

...

Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 21(a))

...

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: Para. 21(b))

...

*Complying with Relevant Requirements*

Relevant Requirements (Ref: Para. 22)

...

Departure from a Requirement (Ref: Para. 23)

...

*Failure to Achieve an Objective* (Ref: Para. 24)

...

# **INTERNATIONAL STANDARD ON AUDITING 240**

## **THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS**

### **Introduction**

#### **Scope of this ISA**

...

#### **Characteristics of Fraud**

...

#### **Responsibility for the Prevention and Detection of Fraud**

...

### ***Responsibilities of the Auditor***

...

7. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override controls ~~procedures~~ designed to prevent similar frauds by other employees.

...

#### **Effective Date**

...

#### **Objectives**

...

#### **Definitions**

...

### **Requirements**

#### **Professional Skepticism**

12. In accordance with ISA 200<sup>147</sup>, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7–A8)
13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may

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<sup>147</sup> ISA 200, paragraph 15



not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)

14. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

#### Discussion among the Engagement Team

15. ISA 315 (Revised) requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion.<sup>148</sup> This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10–A11)

#### Risk Assessment Procedures and Related Activities

16. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control, required by ISA 315 (Revised),<sup>149</sup> the auditor shall perform the procedures in paragraphs 2317–4424 to obtain information for use in identifying the risks of material misstatement due to fraud.

#### ***Management and Others within the Entity***

...

#### ***Those Charged with Governance***

20. Unless all of those charged with governance are involved in managing the entity,<sup>150</sup> the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal controls that management has established to mitigate these risks. (Ref: Para. A19–A21)

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#### ***Unusual or Unexpected Relationships Identified***

...

#### ***Other Information***

23. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

#### ***Evaluation of Fraud Risk Factors***

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present.

<sup>148</sup> ISA 315 (Revised), paragraph 2210

<sup>149</sup> ~~ISA 315 (Revised), paragraphs 5–24~~

<sup>150</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23–A27)

## Identification and Assessment of the Risks of Material Misstatement Due to Fraud

25. In accordance with ISA 315 (Revised), the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.<sup>151</sup>
26. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28–A30)
27. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall ~~obtain an understanding of the entity's related identify the entity's controls, including control activities, relevant to that address such risks as controls relevant to the audit, and evaluate their design and determine whether they have been implemented~~.<sup>152</sup> (Ref: Para. A31–A32)

## Responses to the Assessed Risks of Material Misstatement Due to Fraud

### Overall Responses

...

### Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

...

### Audit Procedures Responsive to Risks Related to Management Override of Controls

...

32. Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:
  - (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:
    - (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
    - (ii) Select journal entries and other adjustments made at the end of a reporting period; and

<sup>151</sup> ISA 315 (Revised), paragraphs 245, 47(a) and 48

<sup>152</sup> ISA 315 (Revised), paragraph 39(b) and 42

- (iii) Consider the need to test journal entries and other adjustments throughout the period.  
(Ref: Para. A41–A44)

...

#### **Evaluation of Audit Evidence (Ref: Para. A49)**

...

#### **Auditor Unable to Continue the Engagement**

...

#### **Written Representations**

...

#### **Communications to Management and with Those Charged with Governance**

...

#### **Communications to Regulatory and Enforcement Authorities**

...

#### **Documentation**

44. The auditor shall include the following in the audit documentation<sup>153</sup> ~~of the auditor's understanding of the entity and its environment and of the identification and~~ the assessment of the risks of material misstatement required by ISA 315 (Revised):<sup>154</sup>
- (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; ~~and~~
  - (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level; ~~and~~
  - (c) Controls identified to be relevant to the audit because they address assessed risks of material misstatement due to fraud.

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#### **Application and Other Explanatory Material**

##### **Characteristics of Fraud (Ref: Para. 3)**

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<sup>153</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and paragraph A6

<sup>154</sup> ISA 315 (Revised), paragraph ~~54~~32

***Professional Skepticism*** (Ref: Para. 12–14)

- A7. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance ~~where~~ when such controls are identified to be controls relevant to the audit. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

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***Discussion Among the Engagement Team*** (Ref: Para. 15)

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**Risk Assessment Procedures and Related Activities**

*Inquiries of Management*

Management's Assessment of the Risk of Material Misstatement Due to Fraud (Ref: Para. 17(a))

...

*Inquiry of Internal Audit* (Ref: Para. 19)

- A18. ISA 315 (Revised) and ISA 610 (Revised 2013) establish requirements and provide guidance relevant to audits of those entities that have an internal audit function.<sup>155</sup> In carrying out the requirements of those ISAs in the context of fraud, the auditor may inquire about specific activities of the function including, for example:

- The procedures performed, if any, by the internal auditor function during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

*Obtaining an Understanding of Oversight Exercised by Those Charged with Governance* (Ref: Para. 20)

- A19. Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and ~~of the relevant internal control~~ the controls that address such risks. Since the responsibilities of those charged with governance and management may vary by entity and by country, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.<sup>156</sup>
- A20. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of ~~internal controls~~ that address ~~over~~ risks of fraud, and the competency and integrity of management. The auditor may obtain

<sup>155</sup> ISA 315 (Revised), paragraphs ~~186~~(a) and ~~342~~3, and ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

<sup>156</sup> ISA 260 (Revised), paragraphs A1–A8, discuss with whom the auditor communicates when the entity's governance structure is not well defined.

this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

### Considerations Specific to Smaller Entities

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#### *Consideration of Other Information* (Ref: Para. 23)

A22. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment, the applicable financial reporting framework and the entity's system of internal control may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

#### *Evaluation of Fraud Risk Factors* (Ref: Para. 24)

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A25. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

Fraud risk factors related to incentives, pressures or opportunities may arise from conditions that create susceptibility to misstatements due to management bias or fraud (which is an inherent risk factor).<sup>157</sup> Alternatively, fraud risk factors may relate to conditions within the entity's system of internal control that provide opportunity to commit fraud or that may affect management's attitude or ability to rationalize fraudulent actions. Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information through, for example, the required understanding of the entity's control environment.<sup>158</sup> Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

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### **Identification and Assessment of the Risks of Material Misstatement Due to Fraud**

#### *Risks of Fraud in Revenue Recognition* (Ref: Para. 26)

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<sup>157</sup> ISA 315 (Revised), paragraph 16(f)

<sup>158</sup> ISA 315 (Revised), paragraphs 27–28

*Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls* (Ref: Para. 27)

- A31. Management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.
- A32. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. ~~In doing so, In identifying the controls relevant to the audit that address the risks of material misstatement due to fraud, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding identifying these controls, and evaluating their design and determining whether they have been implemented,~~ may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

**Responses to the Assessed Risks of Material Misstatement Due to Fraud**

*Overall Responses* (Ref: Para. 28)

...

*Assignment and Supervision of Personnel* (Ref: Para. 29(a))

...

*Unpredictability in the Selection of Audit Procedures* (Ref: Para. 29(c))

...

*Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level* (Ref: Para. 30)

...

**Audit Procedures Responsive to Risks Related to Management Override of Controls**

**Journal Entries and Other Adjustments** (Ref: Para. 32(a))

...

- A42. Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries<sup>159</sup> is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, where IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

<sup>159</sup> ISA 315 (Revised), paragraph 39(c)

A43. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- *The identification and assessment of the risks of material misstatement due to fraud – the presence of fraud risk factors and other information obtained during the auditor's identification and assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.*
- *Controls that have been implemented over journal entries and other adjustments – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.*
- *The entity's financial reporting process and the nature of evidence that can be obtained – for many entities routine processing of transactions involves a combination of manual and automated ~~steps and procedures~~ controls. Similarly, the processing of journal entries and other adjustments may involve both manual and automated ~~procedures~~ and controls. Where information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.*
- *The characteristics of fraudulent journal entries or other adjustments – inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.*
- *The nature and complexity of the accounts – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.*
- *Journal entries or other adjustments processed outside the normal course of business – non standard journal entries may not be subject to the same ~~level of internal~~ nature and extent of controls as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.*

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Accounting Estimates (Ref: Para. 32(b))

...

Business Rationale for Significant Transactions (Ref: Para. 32(c))

...

**Evaluation of Audit Evidence** (Ref: Para. 34–37)

...

*Analytical Procedures Performed Near the End of the Audit in Forming an Overall Conclusion* (Ref: Para. 34)

...

*Consideration of Identified Misstatements* (Ref: Para. 35–37)

...

**Auditor Unable to Continue the Engagement** (Ref: Para. 38)

...

**Written Representations** (Ref: Para. 39)

...

**Communications to Management and with Those Charged with Governance**

*Communication to Management* (Ref: Para. 40)

...

*Communication with Those Charged with Governance* (Ref: Para. 41)

...

*Other Matters Related to Fraud* (Ref: Para. 42)

...

**Communications to Regulatory and Enforcement Authorities** (Ref: Para. 43)

...



**Appendix 1**

(Ref: Para. A25)

**Examples of Fraud Risk Factors**

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration – that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Fraud risk factors related to incentives or pressures typically arise from conditions that create susceptibility to misstatement due to management bias or fraud (which is an inherent risk factor). Fraud risk factors related to opportunities may also arise from other identified inherent risk factors (e.g., complexity or uncertainty may create opportunities that result in susceptibility to misstatement due to fraud). Fraud risk factors related to opportunities may also relate to conditions within the entity's system of internal control, such as limitations or deficiencies in the entity's internal control that create such opportunities. Fraud risk factors related to attitudes or rationalizations may arise, in particular, from limitations or deficiencies in the entity's control environment.

**Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting**

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

***Incentives/Pressures***

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

...

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

...

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

...

***Opportunities***

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

...

The monitoring of management is not effective as a result of the following:

...

There is a complex or unstable organizational structure, as evidenced by the following:

...

~~Internal control components are deficient~~ Deficiencies in internal control as a result of the following:

- ~~Inadequate monitoring of controls~~ process to monitor the entity's system of internal control, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of staff in accounting, information technology, or the internal audit function that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

*Attitudes/Rationalizations*

...

### **Risk Factors Arising from Misstatements Arising from Misappropriation of Assets**

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

*Incentives/Pressures*

...

*Opportunities*

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

...

Inadequate ~~internal controls~~ over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other re-imbursements.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.

- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

*Attitudes/Rationalizations*

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for ~~internal controls~~ over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

**Appendix 2**

(Ref: Para. A40)

**Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud**

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

**Consideration at the Assertion Level**

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures and assertions they may affect.

The following are specific examples of responses:

...

- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of material misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.

...

**Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting**

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

...

## **Appendix 3**

(Ref: Para. A49)

### **Examples of Circumstances that Indicate the Possibility of Fraud**

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

...

## INTERNATIONAL STANDARD ON AUDITING 330

### THE AUDITOR'S RESPONSES TO ASSESSED RISKS

#### Introduction

##### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with ISA 315 (Revised)<sup>160</sup> in an audit of financial statements.

##### Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

##### Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

##### Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Substantive procedure – An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:
    - (i) Tests of details (of classes of transactions, account balances, and disclosures); and
    - (ii) Substantive analytical procedures.
  - (b) Test of controls – An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

#### Requirements

##### Overall Responses

5. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1–A3)

##### Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

6. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4–A8; A42–A52)

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<sup>160</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

7. In designing the further audit procedures to be performed, the auditor shall:
  - (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each significant class of transactions, account balance, and disclosure, including:
    - (i) The likelihood and magnitude of material misstatement due to the particular characteristics of the ~~relevant~~-significant class of transactions, account balance, or disclosure (that is, the inherent risk); and
    - (ii) Whether the risk assessment takes account of ~~relevant~~-controls that address the risk of material misstatement (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9–A18)
  - (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

#### *Tests of Controls*

8. The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of ~~relevant~~ controls if:
  - (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
  - (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20–A24)
9. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25)

#### *Nature and Extent of Tests of Controls*

10. In designing and performing tests of controls, the auditor shall:
  - (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
    - (i) How the controls were applied at relevant times during the period under audit;
    - (ii) The consistency with which they were applied; and
    - (iii) By whom or by what means they were applied. (Ref: Para. A26–A29a)
  - (b) To the extent not already addressed, dDetermine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30–A31)

## Timing of Tests of Controls

11. The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs 12 and 15 below, in order to provide an appropriate basis for the auditor's intended reliance. (Ref: Para. A32)

### Using audit evidence obtained during an interim period

12. If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:
  - (a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and
  - (b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33–A34)

### Using audit evidence obtained in previous audits

13. In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:
  - (a) The effectiveness of other ~~elements~~ components of the entity's system of internal control, including the control environment, the entity's process to monitoring of the system of internal controls, and the entity's risk assessment process;
  - (b) The risks arising from the characteristics of the control, including whether it is manual or automated;
  - (c) The effectiveness of general IT controls;
  - (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
  - (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
  - (f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)
14. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance and reliability of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:
  - (a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36)
  - (b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37–A39)



### Controls over significant risks

15. If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

### Evaluating the Operating Effectiveness of Controls

16. When evaluating the operating effectiveness of ~~relevant~~ controls upon which the auditor intends to rely, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A40)
17. If deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether: (Ref: Para. A41)
  - (a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
  - (b) Additional tests of controls are necessary; or
  - (c) The ~~potential~~ risks of material misstatement need to be addressed using substantive procedures.

### Substantive Procedures

18. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each ~~material~~ class of transactions, account balance, and disclosure that is quantitatively or qualitatively material. (Ref: Para. A42–A47)
19. The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48–A51)

### Substantive Procedures Related to the Financial Statement Closing Process

20. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:
  - (a) Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers; and
  - (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)

### Substantive Procedures Responsive to Significant Risks

21. If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)

### Timing of Substantive Procedures

22. If substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:

- (a) substantive procedures, combined with tests of controls for the intervening period; or
  - (b) if the auditor determines that it is sufficient, further substantive procedures only,
- that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A54–A57)

23. If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified. (Ref: Para. A58)

### **Adequacy of Presentation of the Financial Statements**

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework. In making this evaluation, the auditor shall consider whether the financial statements are presented in a manner that reflects the appropriate:
- Classification and description of financial information and the underlying transactions, events and conditions; and
  - Presentation, structure and content of the financial statements. (Ref: Para. A59)

### **Evaluating the Sufficiency and Appropriateness of Audit Evidence**

25. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A60–A61)
26. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)
27. If the auditor has not obtained sufficient appropriate audit evidence as to the risk of material misstatement related to an ~~material financial statement~~ relevant assertion about a class of transactions, account balance or disclosure, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

### **Documentation**

28. The auditor shall include in the audit documentation:<sup>161</sup>
- (a) The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed;
  - (b) The linkage of those procedures with the assessed risks at the assertion level; and
  - (c) The results of the audit procedures, including the conclusions where these are not otherwise clear. (Ref: Para. A63)

<sup>161</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

29. If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit.
30. The auditor's documentation shall demonstrate that information in the financial statements agrees or reconciles with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers.

## Application and Other Explanatory Material

### Overall Responses (Ref: Para. 5)

- A1. Overall responses to address the assessed risks of material misstatement at the financial statement level may include:
  - Emphasizing to the engagement team the need to maintain professional skepticism.
  - Assigning more experienced staff or those with special skills or using experts.
  - ~~Providing more supervision~~ Changes to the nature, timing and extent of direction and supervision of members of the engagement team and the review of the work performed.
  - Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
  - Changes to the overall audit strategy as required by ISA 300, or planned audit procedures, and may include changes to:
    - The auditor's determination of performance materiality in accordance with ISA 320.
    - The auditor's plans to tests the operating effectiveness of controls, and the persuasiveness of audit evidence needed to support the planned reliance on the operating effectiveness of the controls, particularly when deficiencies in the control environment or the entity's monitoring activities are identified.
    - The nature, timing and extent of substantive procedures. For example, it may be appropriate to perform substantive procedures at or near the date of the financial statements when the risk of material misstatement is assessed as higher.
  - ~~Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.~~
- A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:
  - Conducting more audit procedures as of the period end rather than at an interim date.
  - Obtaining more extensive audit evidence from substantive procedures.

- Increasing the number of locations to be included in the audit scope.

A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

### **Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level**

#### *The Nature, Timing and Extent of Further Audit Procedures (Ref: Para. 6)*

A4. The auditor's assessment of the identified risks of material misstatement at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that:

- Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;
- Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or
- A combined approach using both tests of controls and substantive procedures is an effective approach.

However, as required by paragraph 18, irrespective of the approach selected, the auditor designs and performs substantive procedures for each ~~material~~-class of transactions, account balance, and disclosure that is quantitatively or qualitatively material.

A5. The nature of an audit procedure refers to its purpose (that is, test of controls or substantive procedure) and its type (that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks.

A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.

A7. Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.

A8. Designing and performing further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage between the auditor's further audit procedures and the risk assessment.

#### **Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))**

##### **Nature**

A9. ISA 315 (Revised) requires that the auditor's assessment of the risks of material misstatement at the assertion level is performed by assessing inherent risk and control risk. The auditor assesses inherent risk by assessing the likelihood and magnitude of a material misstatement taking into account how,

and the degree to which, identified events or conditions relating to significant classes of transactions, account balances or disclosures are subject to, or affected by, the inherent risk factors.<sup>162</sup> The auditor's assessed risks, including the reasons for those assessed risks, may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of material misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of material misstatement of the occurrence assertion.

- A10. The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of ~~internal~~ the operating effectiveness of controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

#### Timing

- A11. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from interim date to the period end would not be effective.
- A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.
- A13. In addition, certain audit procedures can be performed only at or after the period end, for example:
- Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers;
  - Examining adjustments made during the course of preparing the financial statements; and
  - Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized.
- A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

<sup>162</sup> ISA 315 paragraph 48

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.
- The timing of the preparation of the financial statements, particularly for those disclosures that provide further explanation about amounts recorded in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.

#### Extent

- A15. The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.
- A16. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

#### Considerations specific to public sector entities

- A17. For the audits of public sector entities, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.

#### Considerations specific to smaller entities

- A18. In the case of very small entities, there may not be many controls ~~activities~~ that could be identified by the auditor, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of controls ~~activities~~ or of ~~other~~ components of the system of internal control may make it impossible to obtain sufficient appropriate audit evidence.

#### Higher Assessments of Risk (Ref: Para 7(b))

- A19. When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for

example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.

### *Tests of Controls*

#### Designing and Performing Tests of Controls (Ref: Para. 8)

A20. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an relevant assertion, and the auditor intends to rely upon those controls. If substantially different controls were used at different times during the period under audit, each is considered separately.

A21. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

A22. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:

- Inquiring about management's use of budgets.
- Observing management's comparison of monthly budgeted and actual expenses.
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts.

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

A23. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

A24. In some cases, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level.<sup>163</sup> This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls that address the risk for which substantive procedures alone cannot provide sufficient appropriate audit evidence.

<sup>163</sup> ISA 315 (Revised), paragraph 5130

## Audit Evidence and Intended Reliance (Ref: Para. 9)

A25. A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

## Nature and Extent of Tests of Controls

### Other audit procedures in combination with inquiry (Ref: Para. 10(a))

A26. Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

A27. The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of controls ~~activities~~, such as automated controls ~~activities performed by a computer~~. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

### Extent of tests of controls

A28. When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control. As well as the degree of reliance on controls, matters the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

ISA 530<sup>164</sup> contains further guidance on the extent of testing.

A29. Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated controls can be expected to function consistently unless the ~~program~~ IT application (including the tables, files, or other permanent data used by the ~~program~~ IT application) is changed. Once the auditor determines that an automated control is

<sup>164</sup> ISA 530, *Audit Sampling*



functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests ~~might~~ may include testing the general IT controls related to the IT application, determining that:

- ~~• Changes to the program are not made without being subject to the appropriate program change controls;~~
- ~~• The authorized version of the program is used for processing transactions; and~~
- ~~• Other relevant general controls are effective.~~

~~Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.~~

A29a. Similarly, the auditor may perform tests of controls that address risks of material misstatement related to the integrity of the entity's data, or the completeness and accuracy of the entity's system-generated reports, or to address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence. These tests of controls may include tests of general IT controls that address the matters in paragraph 10(a). When this is the case, the auditor may not need to perform any further testing to obtain audit evidence about the matters in paragraph 10(a).

A29b. When the auditor determines that a general IT control is deficient, the auditor may consider the nature of the related risk(s) arising from the use of IT that were identified in accordance with ISA 315 (Revised)<sup>165</sup> to provide the basis for the design of the auditor's additional procedures to determine whether the underlying controls affected by the deficient general IT control functioned throughout the period. Such procedures may address determining whether:

- The related risk(s) arising from IT has occurred. For example, if users have unauthorized access to an IT application (but cannot access or modify the system logs that track access), the auditor may inspect the system logs to obtain audit evidence that those users did not access the IT application during the period.
- There are any alternate or redundant general IT controls, or any other controls, that address the related risk(s) arising from the use of IT. If so, the auditor may determine such controls to be relevant to the audit (if not already relevant to the audit) and therefore evaluate their design, determine that they have been implemented and perform tests of their operating effectiveness. For example, if a general IT control related to user access is deficient, the entity may have an alternate control whereby IT management reviews end user access reports on a timely basis. Circumstances when an application control may address a risk arising from the use of IT may include when the information that may be affected by the general IT control deficiency can be reconciled to external sources (e.g., a bank statement) or internal sources not affected by the general IT control deficiency (e.g., a separate IT application or data source).

Testing of indirect controls (Ref: Para. 10(b))

A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls (e.g., general IT controls). As explained in paragraphs A29 to A29b, general IT controls may have been determined to be relevant to the audit in accordance with ISA 315

<sup>165</sup> ISA 315 (Revised), paragraph 41

(Revised) because of their support of the operating effectiveness of automated controls or due to their support in maintaining the integrity of information used in the entity's financial reporting, including system-generated reports. The requirement in paragraph 10(b) acknowledges that the auditor may have already tested certain indirect controls to address the matters in paragraph 10(a). For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, general IT controls) are described as "indirect" controls.

~~A31. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.~~

#### Timing of Tests of Controls

Intended period of reliance (Ref: Para. 11)

A32. Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of controls in the entity's process to monitoring of the system of internal controls.

Using audit evidence obtained during an interim period (Ref: Para. 12(b))

A33. Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel.
- The degree to which audit evidence about the operating effectiveness of those controls was obtained.
- The length of the remaining period.
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.
- The control environment.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the entity's monitoring of controls.

Using audit evidence obtained in previous audits (Ref: Para. 13)

A35. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance and reliability. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for

example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

Controls that have changed from previous audits (Ref: Para. 14(a))

A36. Changes may affect the relevance and reliability of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A37. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

- (a) have not changed since they were last tested; and
- (b) are not controls that mitigate a significant risk,

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year.

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A deficient control environment.
- A deficiency in the entity's process to monitoring of the system of internal controls.
- A significant manual element to ~~the relevant~~ controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT controls.

A39. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

Evaluating the Operating Effectiveness of Controls (Ref: Para.16–17)

A40. A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

A41. The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions

and human error. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor.

*Substantive Procedures (Ref: Para. 6, 18)*

A42. Paragraph 18 requires the auditor to design and perform substantive procedures for each ~~material~~ class of transactions, account balance, and disclosure, ~~irrespective of the assessed risks of material misstatement.~~ that is quantitatively or qualitatively material. For significant classes of transactions, account balances and disclosures, substantive procedures may have already been performed because paragraph 6 requires the auditor to design and perform further audit procedures that are responsive to the assessed risks of material misstatement at the assertion level. Accordingly, substantive procedures are required to be designed and performed in accordance with paragraph 18:

- When the further audit procedures designed and performed in accordance with paragraph 6 for significant classes of transactions, account balances or disclosures did not include substantive procedures; or
- For each class of transactions, account balance or disclosure that is not a significant class of transactions, account balance or disclosure, but that has been identified as quantitatively or qualitatively material in accordance with ISA 315 (Revised).<sup>166</sup>

This requirement reflects the facts that: (a) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and (b) there are inherent limitations to ~~internal~~ controls, including management override.

A42a. In designing the substantive procedures to be performed, the auditor's consideration of the assertion(s) in which a possible misstatement could occur, and if it were to occur, the effect of that misstatement would be most material, may assist in identifying the appropriate nature, timing and extent of the procedures to be performed.

*Nature and Extent of Substantive Procedures*

A43. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

A44. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. ISA 520<sup>167</sup> establishes requirements and provides guidance on the application of analytical procedures during an audit.

A45. The nature assessment of the risk and or the nature of the assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve

<sup>166</sup> ISA 315 (Revised), paragraph 52

<sup>167</sup> ISA 520, *Analytical Procedures*

selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

- A46. Because the assessment of the risk of material misstatement takes account of internal controls upon which the auditor intends to rely, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.
- A47. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. See ISA 500.<sup>168</sup>

#### Considering Whether External Confirmation Procedures Are to Be Performed (Ref: Para. 19)

- A48. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cutoff assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:
- Bank balances and other information relevant to banking relationships.
  - Accounts receivable balances and terms.
  - Inventories held by third parties at bonded warehouses for processing or on consignment.
  - Property title deeds held by lawyers or financiers for safe custody or as security.
  - Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
  - Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
  - Accounts payable balances and terms.
- A49. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.
- A50. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor’s decision about whether to perform external confirmation procedures.

<sup>168</sup> ISA 500, *Audit Evidence*, paragraph 10

A51. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

- The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- The ability or willingness of the intended confirming party to respond – for example, the confirming party:
  - May not accept responsibility for responding to a confirmation request;
  - May consider responding too costly or time consuming;
  - May have concerns about the potential legal liability resulting from responding;
  - May account for transactions in different currencies; or
  - May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

- The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

Substantive Procedures Related to the Financial Statement Closing Process (Ref: Para. 20)

A52. The nature, and also the extent, of the auditor's substantive procedures related to the financial statement closing process depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

*Substantive Procedures Responsive to Significant Risks (Ref: Para. 21)*

A53. Paragraph 21 of this ISA requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

Timing of Substantive Procedures (Ref: Para. 22–23)

A54. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. There are, however, exceptions, for example, a legal opinion obtained in

a previous audit related to the structure of a securitization to which no changes have occurred, may be relevant in the current period. In such cases, it may be appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed, and audit procedures have been performed during the current period to establish its continuing relevance.

Using audit evidence obtained during an interim period (Ref: Para. 22)

A55. In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to:

- (a) Identify amounts that appear unusual;
- (b) Investigate any such amounts; and
- (c) Perform substantive analytical procedures or tests of details to test the intervening period.

A56. Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The control environment and other ~~relevant~~ controls.
- The availability at a later date of information necessary for the auditor's procedures.
- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

A57. Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period end:

- Whether the period-end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.
- Whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.
- Whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:
  - (a) Significant unusual transactions or entries (including those at or near the period end);
  - (b) Other causes of significant fluctuations, or expected fluctuations that did not occur; and
  - (c) Changes in the composition of the classes of transactions or account balances.

#### Misstatements detected at an interim date (Ref: Para. 23)

A58. When the auditor concludes that the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating the procedures performed at the interim date at the period end.

#### Adequacy of Presentation of the Financial Statements (Ref: Para. 24)

A59. Evaluating the appropriate presentation, arrangement and content of the financial statements includes, for example, consideration of the terminology used as required by the applicable financial reporting framework, the level of detail provided, the aggregation and disaggregation of amounts and the bases of amounts set forth.

#### Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 25–27)

A60. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example:

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a significant deficiency in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement.

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks of material misstatement for all or some of and the effect on the significant classes of transactions, account balances, or disclosures and related their relevant assertions. ISA 315 (Revised) contains further guidance on revising the auditor's risk assessment.<sup>169</sup>

A61. The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

A62. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements.

<sup>169</sup> ISA 315 (Revised), paragraph 53~~34~~



- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.
- Understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control.

**Documentation** (Ref: Para. 28)

A63. The form and extent of audit documentation is a matter of professional judgment, and is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the audit.

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