Application and Other Explanatory Material (Working Draft)

Note:

This Application and Other Explanatory is a Working Draft. This initial revision is intended to focus on the more significant proposed changes to the requirements, and the Task Force will continue to make revisions to this material as the project progresses to exposure. In particular, the Task Force will focus on the scalability of the matters herein. Within this document there are paragraphs that have been highlighted as follows:

- Greyed paragraphs not for discussion as they are still for Task Force consideration as appropriate.
- Pale blue paragraphs highlight matters to possibly be relocated to an Appendix (for Board Consideration).
- Placeholders have been presented in areas where the Task Force has not yet developed the application material but intends to do so.

Definitions

Assertions (Ref: Para. 4(a))

A0a. Representations by management with respect to the recognition, measurement, presentation and disclosure 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,[1] to confirm certain matters or support other audit evidence. Assertions that may be used by the auditor are further described in paragraph A142. (Ref: Para. 4(a))

Controls (Ref: Para. 4(ca))

A0b. Policies are implemented through the actions of personnel within the entity, or through their restraint from taking actions that would conflict with such policies.

A0c. Procedures may be mandated, through formal documentation or other communication by those charged with governance or management, or may result from behaviors that are not mandated but are conditioned by the entity's culture.

Qualitative Inherent Risk Factors (Ref: Para. 4(cb))

A0d. Characteristics the auditor may consider when obtaining an understanding of the entity and its environment and applicable financial reporting framework that may impact the susceptibility of an assertion in a class of transaction, account balance or disclosure to a misstatement include:

- *Complexity*—arises when there are many items or relationships among such items that require integration in applying depiction methods to determine information required by the financial reporting framework. For example, complexity may necessitate the use of a complex model to determine a fair value, or may result from complex patterns of trading in financial instruments or complex supplier relationships for a retailer. Complexity may also relate to data, including when data relevant to financial reporting is inherently difficult to identify capture, access or understand. Complexity may result in the use of an expert or require specialized skills.
- *Subjectivity*—results from a lack of specificity in what is required by the applicable financial reporting framework, such that multiple approaches may be appropriate, which is resolved by management making an election or judgment about the appropriate approach for reporting information in the financial statements. When the matter is more subjective, the judgment may be more susceptible to management bias, whether unintentional or intentional. For example, subjectivity may result in significant management judgment in accounting estimates that have been identified as having high estimation uncertainty.
- *Change*—arising from significant economic, accounting, regulatory, industry or other developments from one point in time to another during or between financial reporting periods. This includes changes in the applicable financial reporting framework, or in the entity and its business model in the context of the environment in which the entity operates, that may affect management's assumptions and judgments, including as it relates to management's selection of accounting policies.
- *Uncertainty*—the susceptibility of a class of transaction, account balance or disclosure to an inherent lack of precision in its measurement or occurrence, and which arises from circumstances not within the control of the preparer of the financial information. 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 fraud*—arises from the degree of opportunity in the entity or its environment to commit it, in addition to the incentive or pressure to do so and some rationalization of the act. Fraudulent financial reporting may occur when subjectivity or uncertainty present the opportunity for intentional management bias. Further characteristics relevant to the susceptibility of classes of transactions, account balances and disclosures to fraud are described in paragraphs A1 to A5 of ISA 240.

Relevant Assertions (Ref: Para. 4(cc))

A0e. There is a reasonable possibility that a material misstatement related to a class of transactions, account balance or disclosure may occur, individually or in combination with other misstatements, when the likelihood of a material misstatement is more than remote.

Significant Risk (Ref: Para. 4(e))

A0f. 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 it 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 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 the susceptibility to misstatement is subject to, or affected by the qualitative inherent risk factors, taking into account the likelihood that a misstatement will occur, as well as the potential magnitude of misstatement should that misstatement occur.

System of Internal Control (Ref: Para. 4(f))

A0g. 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 and can be applied, based on the decisions of management 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. 5)

A1. Obtaining an understanding of the entity and its environment, the applicable financial reporting framework and ~~including~~ the entity's system of internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic and iterative process of gathering, updating and analyzing information, and continues

[1] ISA 580, *Written Representations*

throughout the audit. The understanding of the entity establishes ~~a frame of reference~~ the basis from which the auditor identifies and assesses the risks of material misstatement of the financial statements.

A1a. (Previously A4) The risks to be assessed include both those due to error and those due to fraud, 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.[2] 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 in regard to accounting estimates;
- ISA 550 in regard to related party relationships and transactions;
- ISA 570 in regard to going concern; and
- ISA 600 in regard to group financial statements.

A1b. (Existing from paragraph A1) The understanding of the entity also establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements, for example relating to risks of fraud in accordance with ISA 240 or when assessing risks related to accounting estimates in accordance with ISA 540;
- Determining materiality in accordance with ISA 320;[3]
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- ~~Identifying areas relating to amounts or disclosures in the financial statements where special audit consideration may be necessary, for example: related party transactions or management's assessment of the entity's ability to continue as a going concern; or when considering the business purpose of transactions;~~
- Developing expectations for use when performing analytical procedures in accordance with ISA 520;[4]
- 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;[5] and
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

A2. 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. However, risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion. ~~I~~information obtained by performing risk assessment procedures and related activities in accordance with paragraphs 5 to 10 of this ISA may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about significant classes of transactions, account balances, or disclosures, and related assertions, and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

A2a. [*Placeholder for paragraph explaining in what circumstances performing risk assessment procedures may be used as audit evidence*]

A2b. [*Placeholder for explanatory material about how data analytics tools and techniques can assist the risk assessment process – relate to obtaining audit evidence in previous paragraph*].

A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient and appropriate to meet the objective stated in this ISA, which is to identify and assess the risks of material misstatement. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

A4. [Moved up]

A5. [NOT CONSIDERED BY TF] Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11–21A), 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 include:

- Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.
- Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.

[NOT CONSIDERED BY TF] *Inquiries of Management, the Internal Audit Function and Others within the Entity* (Ref: Para. 6(a))

A6. 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 with the internal audit function, if the entity has such a function, and others within the entity.

A7. 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)[6] 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 toward 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 contract terms.

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[2] ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 12–24

[3] ISA 320, *Materiality in Planning and Performing an Audit*

[4] ISA 520, *Analytical Procedures*, paragraph 5

[5] ISA 330, *The Auditor's Responses to Assessed Risks*

[6] ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 4(b)

- 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 to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.

A8. 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.

[NOT CONSIDERED BY TF] Inquiries of the Internal Audit Function

A9. 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, and in identifying and assessing risks of material misstatement at the financial statement and 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, 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.[7] 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.

A10. 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.

A11. In addition, in accordance with ISA 240,[8] 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.

A12. 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.

[NOT CONSIDERED BY TF] Considerations specific to public sector entities (Ref: Para 6(a))

A13. 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 deficiencies in internal control over financial reporting.

Analytical Procedures (Ref: Para. 6(b))

<u>A13a This International Standard on Auditing (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 subject to the requirements of ISA 520.</u>

A14. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. 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.

A15. 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.

A16. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

<u>A16a. [*Placeholder for paragraph on using data analytics tools and techniques to perform analytical procedures*]</u>

[NOT CONSIDERED BY TF] Considerations Specific to Smaller Entities

A17. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

[NOT CONSIDERED BY TF] *Observation and Inspection* (Ref: Para. 6(c))

A18 Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- The entity's operations.
- 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.

[NOT CONSIDERED BY TF] *Information Obtained in Prior Periods* (Ref: Para. 9)

A19. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.

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[7] The relevant requirements are contained in ISA 610 (Revised 2013).

[8] ISA 240, paragraph 19

- The nature of the entity and its environment, and the entity's system of internal control (including deficiencies in internal control).
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.
- Those particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example, due to their complexity.

A20. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, 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. 10)

A21. 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.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject 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.
- 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 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.[9]

A21a. In addition to the intended benefits of the engagement team discussion included in paragraph A21, the engagement team also have an opportunity to exercise professional skepticism effectively while performing risk assessment procedures, through identifying and discussing inconsistent or contradictory information obtained in performing those procedures, as well as through remaining appropriately alert for indicators of possible management bias (both intentional and unintentional). Further, the ability of the engagement team to effectively exercise professional skepticism throughout the audit is enhanced through obtaining an appropriately thorough understanding of the entity that provides a sufficient and appropriate basis for the auditor to identify and assess the risks of material misstatement in the financial statements. Accordingly, 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 the appropriate engagement team members to be involved in the performance of audit procedures related to those areas.

A22. As part of the discussion among the engagement team required by paragraph 10, consideration of the disclosure requirements of the applicable financial reporting framework assists in identifying early in the audit where there may be risks of material misstatement in relation to disclosures. Examples of matters the engagement team may discuss include:

- Changes in financial reporting requirements that may result in significant new or revised disclosures;
- Changes in the entity's environment, financial condition or activities that may result in significant new or revised disclosures, for example, a significant business combination in the period under audit;
- Disclosures for which obtaining sufficient appropriate audit evidence may have been difficult in the past; and
- Disclosures about complex matters, including those involving significant management judgment as to what information to disclose.

A23. 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, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

[NOT CONSIDERED BY TF] Considerations Specific to Smaller Entities

A24. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

The Required Understanding of the Entity and Its Environment and the Applicable Financial Reporting Framework~~, Including the Entity's Internal Control~~ (Ref: Para. 11)

~~The Entity and Its Environment~~

A24a. When obtaining an understanding of the entity to assist in the identification of a possible misstatement, the auditor may identify events or conditions that indicate the existence of risks of material misstatement. This ISA requires the auditor to consider whether, and if so, the extent to which such events or conditions are affected by, or subject to, the qualitative inherent risk factors. When events or conditions are identified that are subject to, or affected by one or more of the qualitative inherent risk factors, the relative degree of complexity, subjectivity, ambiguity, change, uncertainty or susceptibility to fraud may assist the auditor in understanding how those characteristics of the events or conditions may affect the susceptibility to misstatement of classes of transactions, account balances or disclosures at the assertion level. The higher the degree to which events or conditions are subject to, or affected by the qualitative inherent risk factors, the more likely it is that a class of transactions, account balance or disclosure that is affected by the events or conditions may contain a possible misstatement. This understanding therefore contributes to the auditor's identification of significant classes of transactions, account balances and disclosures and the identification and assessment of inherent risk at the assertion level in accordance with paragraph 26.

A24b. Sources of information available to the auditor include information obtained through interactions with management and those charged with governance, as well as from other key entity personnel, such as internal auditors, and directly or indirectly from certain external parties such a regulators. Information is also obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits (updated as appropriate). Information provided from sources

[9] ISA 240, paragraph 15

other than management may provide different (potentially contradictory) information from that provided by management, which may assist the auditor in exercising effective professional skepticism in identifying and assessing the risks of material misstatement.

A24c.[*Placeholder for paragraph to explain that sufficiency of the auditor's understanding of the entity and its environment will assist the auditor in understanding how the applicable financial reporting framework has been applied (i.e., for the auditor to have sufficient understanding about what could be expected in the financial statements), which will assist the auditor in identifying were possible risks of misstatement may be*.]

The Entity and Its Environment

~~*Nature of the Entity*~~ The Entity's Organizational Structure, Ownership and Governance, and Business Model (Ref: Para. 11(a)(i))

Organizational structure and ownership

A25. (Previously A31)~~An u~~Understanding ~~of~~ the entity's organizational structure and ownership ~~nature of an entity~~ enables the auditor to understand such matters as:

- Whether the entity has a complex structure, for example, with subsidiaries, key divisions or other components in multiple locations. Further, the legal structure may also be different from the operating structure. Complex structures are conditions that often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately and whether adequate disclosure of such issues in the financial statements has been made.
- The extent of complexity in the entity's IT infrastructure, for example the entity may have a complex IT infrastructure because the entity is a large group that has grown through extensive merger and acquisition activity and has multiple legacy IT systems in diverse businesses that are not (yet) well integrated
- The ownership, and relationships between owners and other people or entities. This understanding assists in determining whether related party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial statements. ISA 550[10] establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

A25a. [*Placeholder for possible guidance about how data analytics tools and techniques can be used to identify aspects such as related parties and other qualitative analyses of the environment and entity*].

Governance *(Ref: Para. 11(a)(i))*

A26. Responsibilities of management and those charged with governance are broader than responsibilities for the oversight of the system of internal control (governance in relation to the control environment is further discussed in paragraph X), but are generally prerequisites for an effective system of internal control. Matters the auditor that may be relevant for the auditor to consider in obtaining an understanding of the entity and its environment include:

- The existence (and separation) of a non-executive Board 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.
- Whether those charged with governance are involved in managing the entity.
- Whether those charged with governance are responsible for approving the financial statements.
- The existence of sub-groups of those charged with governance such as an audit committee, and the remit of such a group.
- The responsibilities of those charged with governance for oversight of financial reporting.

Business risks arising from the entity's business model and its strategy and objectives (Ref: Para. 11(a)(i))

A27. The auditor's understanding of the entity's business model, and how that impacts its business strategy and business objectives may assist the auditor in identifying business risks relevant to the audit, which may assist the auditor in identifying possible risks of misstatement, for example, the reasonability of key assumptions and expectations of management and/or those charged with governance.

A27a. The entity's business model, which sets out how the entity creates and delivers value, is broader than financial reporting, and may vary significantly between entities. Some entities may have more than one business model for different parts of the entity (for example different divisions or components), and it is likely that the larger or more complex the entity, the greater the likelihood that there will be different business models the auditor may need to obtain an understanding of in order to obtain an understanding of the entity. Not all aspects of the business model are relevant to the auditor's understanding, but matters that may be relevant to the auditor because they may result in business risks include:

- ~~Objectives and strategies, and related business risks, for example, e~~Environmental risks or the concentration of customers or suppliers.
- The key activities of the entity, including:
  - Business Operations
  - Investments and investment activities
  - Financing and financing activities.
  - The markets the entity operates in and how it engages in those markets.
- How the entity's business model incorporates the use of IT, such as the extent of interaction with customers, suppliers, lenders and other stakeholders through IT interfaces and other technologies, and the extent to which such IT is in-house or outsourced, or involves use of the IT interfaces or other applications of third parties.
- How resources (people and technological) are being maintained and enhanced.

(Previously A33) Significant changes in the business model from prior periods may give rise to, or change, risks of material misstatement.

Business ~~R~~risks

A28. (Previously A37) The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

A29. (Previously A38) Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognize the need for change may also give rise to business risk. Business risk may arise, for example, from:

- The development of new products or services that may fail;

[10] ISA 550, *Related Parties*

- 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 liabilities and reputational risk.

A30. (Previously A41) A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the financial statement level or the assertion level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, including on the entity's ability to continue as a going concern, which the auditor evaluates ~~considers~~ when ~~assessing~~ concluding whether a material uncertainty exists. ~~of the going concern assumption~~ Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. [Placeholder for updating: Examples of conditions and events that may indicate risks of material misstatement are indicated in Appendix 2]

A31. (Previously A39) An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, 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.

A32. (Previously A40) Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives and 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 systems and processes are incompatible).
- 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).

A33. (Previously A42) Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A89–A91.

[NOT CONSIDERED BY TF] Considerations Specific to Public Sector Entities

A34. (Previously A43) For the audits of public sector entities, "management objectives" may be influenced by concerns regarding public accountability and may include objectives ~~which~~ that have their source in law, regulation or other authority.

Activities of the Entity [*Potentially to be moved to a new Appendix*]

A35. (Previously A32) 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:

- 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.
- 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.
- 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.

[NOT CONSIDERED BY TF] Special-Purpose Entities

A36. (Previously A34) 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.[11]

A37. (Previously A35) 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.

Relevant Industry, Regulatory and Other External Factors (Ref: Para. 11(a)(ii))

Industry factors

A38. (Previously A25) 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.

A39. (Previously A26) 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.[12]

Regulatory factors

A40. (Previously A27) 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 relevant to financial reporting. Examples of matters the auditor may consider include:

- ~~Accounting principles and industry specific practices.~~
- 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, including direct supervisory activities.
- Taxation legislation and regulations ~~(corporate and other)~~.
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Data security regulations, for example privacy of customer information regulations.
- Environmental requirements affecting the industry and the entity's business.

A41. (Previously A28) ISA 250 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.[13]

[NOT CONSIDERED BY TF] Considerations specific to public sector entities

A42. (Previously A29) For the audits of public sector entities, law, regulation or other authority may affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

Other external factors

A43. (Previously A30) 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 Financial Reporting Measures ~~*Used Internally and Externally*~~ (Ref: Para. 11(a)(iii))

A44. Management and others will measure and review those things they regard as important. 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 misstate the financial statements. Accordingly, an understanding of the entity's ~~internal and external~~ performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. See ISA 240 for requirements and guidance in relation to the risks of fraud.

A45. The measurement and review of financial performance is not the same as the monitoring of the system of internal controls (discussed as a component of the system of internal control in paragraphs A95–A96), 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).
- Monitoring of the system of internal controls is specifically concerned with ~~the effective operation of internal control~~ monitoring the operating effectiveness of controls including monitoring the effectiveness of management's measurement and review of financial performance.

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

A46. 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.

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11 ISA 550, paragraph A7

12 ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14

13 ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 12

A47. External parties may also measure and review the entity's financial performance, in particular for entities where this information is publicly available. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.

A48. 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 that risks of misstatement of related financial statement information do 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. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

[NOT CONSIDERED BY TF] Considerations Specific to Smaller Entities

A49. Smaller entities often do not have processes to measure and review financial performance. 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 by considering the information that the entity uses to manage its business. However, if such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

The Applicable Financial Reporting Framework (Ref: Para. 11(b))

~~*The Entity's Selection and Application of Accounting Policies (Ref: Para. 11(c))*~~

A50. (Previously pat of A32 and A36) ~~An understanding of the entity's selection and application of accounting policies may encompass such matters as~~ Examples of matters that the auditor may consider when obtaining an understanding of the entity's applicable financial reporting framework, and how it applies to the entity's facts and circumstances, include:

- The entity's ~~F~~financial reporting practices in terms of the applicable financial reporting framework such as:
  - o 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).
  - o Revenue recognition.
  - o Accounting for ~~fair values~~ financial instruments.
  - o Foreign currency assets, liabilities and transactions.
  - o Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, for the recognition of ~~stock-based payments~~ share-based payments).
- An understanding of the entity's selection and application of accounting policies, taking into account any changes thereto as well as the entity's facts and circumstances, may encompass such matters as:
  - o The methods the entity uses to recognize, measure, present and disclose significant and unusual classes of transactions, account balances and disclosures ~~to account for significant and unusual transactions~~.
  - o The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
  - o Reasons for any ~~C~~changes in the entity's accounting policies, including whether the changes are appropriate in light of nature and circumstances of the entity.
  - o Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.

[*Placeholder: further material will be developed to discuss or use examples about how this information helps the auditor to understand the classes of transactions, account balances and disclosures to be expected in the entity's financial statements, with a link to the QIRF's*]

The Required Understanding of the Entity's Internal Control (Ref: Para. 12)

A50a. ISA 200 explains that an audit in accordance with the ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit.[14] This includes responsibility for such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. ISA 200 further explains that 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 control.[15]

A50b. Appendix 1 further describes the nature and inherent limitations of an entity's system of internal control, including [*placeholder for contents of Appendix 1*]. Appendix 1 also provides further explanation of the components of a system of internal control as it relates to a financial statement audit.

A50c. (previously A50) The auditor's ~~An~~ understanding of the entity's system of internal control, through understanding the components of internal control, provides a basis for the identification and assessment of the risks of material misstatement at the financial statement and assertion levels, in response to which the auditor plans and performs ~~assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of~~ further audit procedures in accordance with ISA 330. In particular, obtaining an understanding of the components of internal control:

- Assists the auditor in identifying the risks of material misstatement related to the significant classes of transactions, account balances and disclosures; and
- Provides a basis for the auditor's determination of the extent of intended reliance on controls.

A50d. Paragraphs 14–21A includes the auditor's required understanding of the components of internal control. Due to the nature of the components, 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 risk at the financial statement level, while the auditor's understanding of the information system and communication component, and the control activities component are likely to affect the identification and assessment of risk at the assertion level. The auditor identifies controls relevant to the audit in accordance with paragraphs 20 and 21, which may include controls in the control environment, the risk assessment process and the process to monitor controls components that may assist in addressing 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 21A.

~~A51. The following application on internal control is presented in four sections, as follows:~~

- ~~General Nature and Characteristics of Internal Control.~~

[14] ISA 200, paragraphs 4 and 13 (g)

[15] ISA 200, paragraph A41

- ~~Controls Relevant to the Audit.~~
- ~~Nature and Extent of the Understanding of Relevant Controls.~~
- ~~Components of Internal Control.~~

[A51. now deleted]

General Nature and Characteristics of the System of Internal Control

~~Purpose of Internal Control~~

A52. 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.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

[NOT CONSIDERED BY TF] Considerations specific to smaller entities

A53. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

Limitations of Internal Control

A54. 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 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.

A55. 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 a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

A56. 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.

[NOT CONSIDERED BY TF] Considerations specific to smaller entities

A57. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

A58. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

System of Internal Control Relevant to Financial Reporting

A59. (Previously A68) There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance. However, not all of these objectives and controls are relevant to the auditor's risk assessment. (*from previous paragraph A72*) For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit.

A60. The entity's system internal control relevant to financial reporting will include aspects of the system of internal control that relate to the entity's reporting objectives (in particular, many that relate to its financial reporting objectives), but may also include aspects that relate to its operations objectives, or its compliance objectives when such aspects are relevant to financial reporting. [*PLACEHOLDER For example: controls over compliance with laws and regulations may be relevant to financial reporting when such controls relate to the determination of liabilities in the financial statements*]. In particular, the auditor is required 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 certain financial reporting and compliance objectives.

~~Characteristics of Manual and Automated Elements of Internal Control Relevant to the Auditor's Risk Assessment~~ Understanding the Entity's Use of Information Technology in the System of Internal Control

A61. (Previously A61) An entity's system of internal control contains manual elements and ~~often contains~~ automated elements. (*from previous paragraph A62*) An entity's mix of manual and automated elements in 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 an entirely 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 impacts the manner in which the system of internal control relevant to financial reporting is 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 for each component the entity's use of IT. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A62. (Previously A63) Generally, IT benefits an entity's 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.

A63. (Previously A66) Manual elements in the system of internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

- High volume or 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 ~~activities~~ where the specific ways to perform the control can be adequately designed and automated.

Division of the System of Internal Control into Components ~~of the Entity's System of Internal Control~~

A64. (Previously A59) ~~The division of internal control into the following five components, for purposes of the ISA, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit~~:

~~(a) The control environment;~~

~~(b) The entity's risk assessment process;~~

~~(c) The information system, including the related business processes, relevant to financial reporting, and communication;~~

~~(d) Control activities; and~~

~~(e) Monitoring of controls.~~

The components of internal control for the purpose of this ISA ~~The division~~ does not necessarily reflect how an entity designs, implements and maintains its system of internal control, or how it may classify any particular component. ~~Auditors~~ Entities may use different terminology or frameworks to describe the various aspects of the system of internal control~~, and their effect on the audit than those used in this ISA,~~ For the purpose of an audit, auditors may also use different terminology or frameworks provided all the components described in this ISA are addressed.

A65. 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 internal control, and therefore a foundation for the controls that address risks of misstatements at the assertion level. 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, and therefore these components provide support to and oversight of 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. Such controls are referred to as "indirect controls" for the purposes of this ISA.

A66. 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 are referred to as "direct controls" for the purposes of this ISA.

A67. Notwithstanding the types of controls that are typically within each component, direct or indirect controls may exist in any of the components. In particular, the control activities component includes general IT controls, which are controls that address the continued functioning of automated controls in the entity's system of internal control, and also are typically "indirect controls."

A68. (Previously A60) ~~Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A77–A121 below. Appendix 1 provides further explanation of these components of internal control~~.

~~*Controls Relevant to the Audit*~~

A69. (Previously A69) ~~Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following~~:

- ~~Materiality.~~
- ~~The significance of the related risk.~~
- ~~The size of the entity.~~
- ~~The nature of the entity's business, including its organization and ownership characteristics.~~
- ~~The diversity and complexity of the entity's operations.~~
- ~~Applicable legal and regulatory requirements.~~
- ~~The circumstances and the applicable component of internal control.~~
- ~~The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.~~
- ~~Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.~~

A70. ~~Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.~~

A71. [Moved down]

A72. ~~An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit~~.

[NOT CONSIDERED BY TF] Considerations Specific to Public Sector Entities

A73. Public sector auditors often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice. Public sector auditors can also have responsibilities to report on compliance with law, regulation or other authority. As a result, their review of internal control may be broader and more detailed.

~~*Nature and Extent of the Understanding of Relevant Controls* (Ref: Para. 13)~~

A74~~. 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. 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 effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.~~

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

A75. The auditor is required to perform risk assessment procedures to obtain a sufficient and appropriate understanding of each component of internal control relevant to financial reporting. The nature, timing, and extent of risk assessment procedures that the auditor performs to obtain the understanding is a matter of the auditor's professional judgment as to what will provide a sufficient and appropriate basis for the auditor's identification and assessment of risks of material misstatement, and this will vary from entity to entity depending on matters such as:

- The size and complexity of the entity.
- Previous experience with the entity.
- The nature of each component.
- The nature of the entity's documentation of specific controls.

The entity's use of IT and the nature and extent of changes in systems and operations may also affect how the auditor's understanding is obtained. The auditor may also determine that specialized skills are needed to assist with obtaining the understanding.

A76. When entities have more complex and sophisticated operations and systems, it becomes more likely for the auditor's risk assessment procedures to be more robust in order to obtain the understanding of the components of the system of internal control.

Components of the Entity's System of Internal Control

Control Environment (Ref: Para's. 14–14B)

Understanding the Control Environment (Ref: Para. 14)

A77. 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 and expected conduct of its people.

A78. ~~Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:~~

~~(a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.~~

~~(b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.~~

~~(c) *Participation by those charged with governance* – Attributes of those charged with governance such as:~~

- ~~Their independence from management.~~
- ~~Their experience and stature.~~
- ~~The extent of their involvement and the information they receive, and the scrutiny of activities.~~
- ~~The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.~~

~~(f) *Management's philosophy and operating style* – Characteristics such as management's:~~

- ~~Approach to taking and managing business risks.~~
- ~~Attitudes and actions toward financial reporting.~~
- ~~Attitudes toward information processing and accounting functions and personnel.~~

~~(g) *Organizational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.~~

~~(h) *Assignment of authority and responsibility* – Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.~~

~~(i) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.~~

When obtaining an understanding of the matters set out paragraph 14, the auditor may consider the following, including understanding the pervasiveness of the effect on the entity, or impact on other components of internal control, if aspects related to financial reporting are weak:

(a) *How the entity demonstrates a commitment to integrity and ethical values*— 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 may prompt personnel to engage in dishonest, illegal or unethical acts).

(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.

(c) *How the entity has established, with oversight from those charged with governance, structures, reporting lines, and appropriate authorities and responsibilities in the 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 resources 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.

(d) *How the entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with its objectives*— 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 the 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.

A78a. The auditor's consideration of the entity's use of information technology 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, taking into account the auditor's knowledge about 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 appropriate systems and related maintenance, or whether a sufficient number of appropriately skilled individuals have been employed).
- The extent of change within the IT environment (for example, is the system new or have there been significant changes during the period).

Audit evidence for elements of understanding the control environment

A79. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, in considering the extent to which management demonstrates a commitment to integrity and ethical values, ~~through inquiries of management and employees,~~ the auditor may obtain an understanding, through inquiries of management and employees, of how management communicates to employees its views on business practices and ethical behavior. The auditor may then ~~determine whether relevant controls have been implemented by~~ consider~~ing~~, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

A80. [NOT CONSIDERED BY TF] The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control 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.

Evaluating the Effect of the Control Environment on the Assessment of the Risks of Material Misstatement (Ref: Para. 14A)

A81. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, as described in paragraph A77, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The extent to which the strengths in ~~effectiveness of the design of~~ the control environment collectively provide an appropriate foundation for the other components of internal control 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.

A82. An active and independent board of directors 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.

A83. The existence of ~~a satisfactory~~ an appropriate control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, ~~a satisfactory~~ an appropriate control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in ISA 330, the control environment also influences the nature, timing and extent of the auditor's further procedures.[16]

A84. 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 controls activities component) and thereby, the auditor's assessment of the risks of material misstatement.

[NOT CONSIDERED BY TF] Considerations Specific to Smaller Entities

A85. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small 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. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small entity; it may, however, increase other risks, for example, the risk of override of controls.

[16] ISA 330, paragraphs A2–A3

A86. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might 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.

A87. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

~~Components of Internal Control—~~The Entity's Risk Assessment Process (Ref: Para's. 15–16A)

A88. 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 determines the risks to be managed. ~~If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.~~

Understanding the Entity's Risk Assessment Process (Ref: Para. 15)

A89. In order to understand how management and those charged with governance have considered business risks, particularly those related to financial reporting, and decided about actions to address those risks, matters the auditor may consider include how management or those charged with governance have:

(a) Specified objectives with sufficient clarity to enable the identification and assessment of the risks relating to the objectives;

(b) Identified the risks to achieving the entity's objectives and analyzing the risks as a basis for determining how the risks should be managed;

(c) Considered the potential for fraud when considering the risks to achieving the entity's objectives; and

(d) Identified and assessed changes that could significantly impact the entity's system of internal control.

A90. Some entities, including smaller or less complex entities, may not have established a formal risk assessment process, for example the risk assessment process may not be documented or performed on regular basis. However, in such cases management may still have a basis for determining how business risks are to be managed, such as how changes in the operating environment are dealt with or bringing in new personnel. Irrespective of whether the risk assessment process is formally established or not, inquiry and observation about identified risks and how they are addressed by management is still necessary to obtain an understanding.

A91. Understanding the risks relating to the use of IT identified by the entity, as well as how these risks have been addressed, is an important aspect of the auditor's identification of risks related to IT, and an important input to the auditor's identification and assessment of the risks of material misstatement. 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. Business risks relating to its use of IT, which are relevant to financial reporting objectives, may include:

- Risks relating to maintaining the secrecy, confidentiality and integrity of data and information processing (cyber security risks).
- Risks to the entity's business strategy that arise if the entity's IT strategy does not effectively support that business strategy; or
- Other direct risks to an entity's business operations relating to its use of IT, such as changes or interruptions in the entity's IT infrastructure or turnover of IT personnel.

Evaluating the Appropriateness of the Entity's Risk Assessment Process (Ref: Para. 16A)

A92. 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 entities such as smaller owner-managed entities, risks are not managed through an established risk assessment process but through direct personal involvement in the business, and may therefore be appropriate.

A93. Whether the absence of an appropriate risk assessment process represents a significant deficiency in internal control is a matter of the auditor's professional judgment. Circumstances that may indicate a significant deficiency in internal control exists include matters such as:

- The absence of a risk assessment process within the entity when such a process would ordinarily expected to have been established; or
- Evidence of an ineffective risk assessment process such that 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.

[NOT CONSIDERED BY TF] Considerations Specific to Smaller Entities ~~(Ref: Para. 17)~~

A94. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

~~Components of Internal Control—~~The Entity's Process to Monitor~~ing of~~ the System of Internal Control~~s~~ (Ref: Para. ~~22~~17A–17C)

A95. (Previously A110) The entity's process to Mmonitor~~ing~~ the system of internal control~~s~~ ~~is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through~~ may consist of ongoing activities, separate ~~evaluations~~ activities, or ~~a~~ some combination of the two, by the entity to ascertain whether the five components of internal control, including controls within each component, are designed and operating effectively. The scope and frequency of such activities are determined by management and those charged with governance based on the size and structure of the entity. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities. Separate activities are conducted periodically and will vary in scope and frequency depending on the assessment of the risks by the entity.

A96. (Previously A111) Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Understanding the Entity's Process to Monitor the System of Internal Control (Ref: Para. 17A)

A97. 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 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.

A98. It may be difficult to distinguish between a control and a monitoring activity, for example a supervisory review may not be automatically classified as a monitoring activity by the entity. Typically, a control responds to a specific risk that has been identified whereas a monitoring activity assesses whether a control(s) established within the components of the entity's system of internal control are operating as intended. However, there may be monitoring activities that assist in addressing risks of material misstatement at the assertion level that the auditor determines are controls relevant to the audit in accordance with paragraph 20–21. These may include, for example, periodic reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements, or certain activities performed by internal audit.

A99. 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:

- Particularly in highly complex and automated systems, that:
  - Determine whether underlying controls are operating as intended;
  - 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.
- That monitor the permissions applied in automated application controls that enforce the segregation of duties.
- That monitor how errors or control deficiencies related to the automation of financial reporting are identified and addressed.

A100. Controls within the entity's process to monitor controls, including those that monitor underlying automated controls, may be automated or manual. They also may be 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.

[NOT CONSIDERED BY TF] Considerations Specific to Smaller Entities

A101. (Previously A112) Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

[NOT CONSIDERED BY TF] The Entity's Internal Audit Function (Ref: Para. ~~23~~17B)

A102. (Previously A113) If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control, in particular the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor's inquiries in paragraph 6(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.

A103. (Previously A114) 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.

A104. (Previously A115) 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, internal control and governance processes. If so, the internal audit function may play an important role in the entity's monitoring of internal control over financial reporting. 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.

A105. (Previously A116) The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6(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.

A106. (Previously A117) 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.

A107. (Previously A118) 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.

A108. (Previously A119) 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.

A109. (Previously A120) 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 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.

Sources of Information (Ref: Para. ~~24~~17C)

A110. (Previously A121) Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are 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 associated risks, such as the risks arising from a complex IT system; and
- The basis upon which management considers the information to be sufficiently reliable for the purpose of the monitoring activities,

is required ~~as part of~~ in order to inform the auditor's understanding of the entity's process to monitor the system of internal control.

~~Components of Internal Control—~~The Information System, Including Related Business Processes, Relevant to Financial Reporting, and Communication

The Information System, ~~Including Related Business Processes,~~ Relevant to Financial Reporting (Ref: Para. 18)

A111. (Previously A90) The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

- Initiate, record, process, and report entity transactions (as well as events and conditions) 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;
- Transfer information from transaction processing systems to the general 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 ~~accounts receivables~~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

~~Related business processes (Ref: Para. 18)~~

A112.(Previously A95) Obtaining an understanding of the entity's information system includes ~~A~~an entity's business processes, which are 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 how transactions are originated, assists the auditor obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

A113. The auditor's required understanding of the information system of how the entity has designed or otherwise established the processes and procedures relating to those aspects of the information system in paragraphs 18(a)–(d), and whether such processes and procedures have been placed into operation may be obtained in various ways. The auditor's risk assessment procedures to obtain such understanding may include, for example:

- 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 procedures by entity's personnel.

A114. The auditor's risk assessment procedures to understand the information system may also include performing walk-throughs of the relevant systems in order to confirm that the understanding obtained, for example, through inquires of personnel and inspection of manuals and other systems documentation, reflects how the information system is operating.

A114a. [*Placeholder for data analytics explanation on how techniques may be used for walk-throughs or to obtain the understanding of the info system, including examples such as testing of journal entries and financial statement close process*]

A115. The auditor identifies controls relevant to the audit in accordance with paragraphs 20–21, which may include controls over the information system, For such controls identified, the auditor may evaluate the design of the controls and determine whether they are implemented together with procedures performed to confirm the auditor's understanding of the information system,

Significant Classes of Transactions, Account Balances and Disclosures in Understanding the Information System

A116. (Previously A92) The auditor's understanding of the information system relevant to financial reporting required by paragraph 18 of this ISA (~~including the understanding of relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers) is a matter of the auditor's professional judgment.~~ 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 understands the classes of transactions, account balances and disclosures to be expected in the financial statements as an outcome of the procedures performed in accordance with paragraph 11. The auditor identifies the significant classes of transactions, account balance and disclosures based on the results of the auditor's risk assessment procedures as part of the identification of risks of material misstatement in accordance with paragraph 26. This identification is performed without regard to the entity's controls.

A117.As risk identification and assessment is an iterative process, the auditor may use expectations formed in paragraph 11 about the significant classes of transactions, account balances and disclosures in determining the scope of the auditor's understanding of the information system provided that the auditor completes the understanding, as necessary, based on the identification of the significant classes of transactions, account balances and disclosures in accordance with paragraph 26. For example, the auditor may have an expectation that certain specific significant classes of transactions related to revenue exist, but in obtaining the understanding about those significant classes of transactions, the auditor may identify additional classes of transactions related to revenue that are significant. The auditor's understanding of the information system relevant to financial reporting is not required to include an understanding related to classes of transactions, account balances or disclosures that are not identified as significant.

A117a. [*Placeholder for how data analytics tools and techniques can assist with identifying significant classes of transactions, account balances and disclosures*].

Understanding the Entity's Use of Information Technology in the Information System

A118. In understanding the entity's information system, the auditor is required to understand how information relating to significant classes of transactions, account balances and disclosures flows through the entity's information system, whether manually or using information technology. As part of this understanding, the IT infrastructure relevant to those flows is also identified. The auditor also understands the IT infrastructure relevant to the storage of accounting records and other supporting information and any other aspects that support the entity's financial reporting process. The relevant IT infrastructure may include IT applications, data warehouses or report writers, as well as the related databases, operating systems or networks that support those IT applications, data warehouses, and report writers. This understanding is used in the auditor's determination of the general IT controls relevant to the audit in accordance with paragraph 21of this ISA.

A119. (Previously A62) The use of manual or automated elements in internal control ~~also~~ affects the manner in which transactions are initiated, recorded, processed, and reported:

- ~~Controls~~ Procedures in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
- Controls~~ in IT systems~~ in the information system consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial

data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material ~~accounts~~ balances or may be critical to the effective functioning of manual controls that depend on IT.

A120. (Previously A65) Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- ~~In monitoring the effectiveness of automated controls.~~

A121. Matters that are relevant to the auditor's understanding of the entity's use of IT in the information system include matters, such as:

- The volume and complexity of data being processed by the system.
- The underlying technology platform, including for example:
  - o The type of application, e.g., a purchased application with little or no customization, or a highly customized or highly integrated application.
  - o The complexity of the nature of the applications and the underlying technology.
  - o The complexity of the security of the system, including vulnerability to cyber security risks particularly where there are web-based transactions.
  - o How automated the controls are, including the number of controls as well as the complexity of the controls.
- Whether there is third-party hosting or outsourcing of IT, and what controls are in place to integrate the information, as well as the controls at the third-party over IT.
- The extent of the entity's reliance on system-generated reports in the processing of information.
- The volume and complexity of automated application controls and the extent to which management is relying on those controls, for example, whether there is highly automated, paperless processing.
- If there was major data conversion during the period, or the extent of changes made, and how this was undertaken.
- How data is input and the number of interfaces in the IT system relevant to financial reporting.
- Whether program changes have been made to the manner in which information is processed, and the extent of such changes during the period.
- How IT facilitates communication within and across systems, internally and externally, as appropriate, through system interfaces.

A121a. [*Placeholder for how data analytics tools and techniques can be used to assist in understanding the entity's IT system*].

Information Obtained from Outside of the General and Subsidiary Ledgers

A122. (Previously A91)Financial statements may contain information that is obtained from outside of the general and subsidiary ledgers. Examples of such information may include:

- Information obtained from lease agreements disclosed in the financial statements, such as renewal options or future lease payments.
- Information disclosed in the financial statements that is produced by an entity's risk management system.
- Fair value information produced by management's experts and disclosed in the financial statements.
- Information disclosed in the financial statements that has been obtained from models, or from other calculations used to develop estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
  - o Assumptions developed internally that may affect an asset's useful life; or
  - o 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.[17]

A123. (From previous paragraph A92) For example, Certain amounts or disclosures in the entity's financial statements (such as disclosures about credit risk, liquidity risk, and market risk) may be based on information obtained from the entity's risk management system. However, the auditor is not required to understand all aspects of the risk management system, and uses professional judgment in determining the necessary understanding.

[NOT CONSIDERED BY TF] Considerations specific to smaller entities ~~(Ref: Para. 18)~~

A124. (Previously A96)The information system, and related business processes relevant to financial reporting in small entities, including relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers, is likely to be less sophisticated than in larger entities, but its role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's information system~~s~~ relevant to financial reporting may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

[NOT CONSIDERED BY TF] Communication (Ref: Para. 19)

A125. (Previously A97) 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 internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting 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. Open communication channels help ensure that exceptions are reported and acted on.

[17] See paragraphs 19–20 of ISA 570 (Revised), *Going Concern*.

[NOT CONSIDERED BY TF] Considerations specific to smaller entities

A126. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

~~Components of Internal Control—~~Control Activities ~~Relevant to the Audit~~ (Ref: Para. 19A-20)

A126a. (Previously A99) Controls within the control activities component are the policies and procedures that help ensure that management directives are carried out. These controls include those policies and procedures that are put in place by the entity to effect control over the flows of information relating to significant classes of transactions, account balances and disclosures and the financial reporting process used to prepare the financial statements. For all audits, the auditor is required to understand the entity's approach to controls related to the specific types of controls specified in paragraph 19A. ~~Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:~~

- ~~Authorization.~~
- ~~Performance reviews.~~
- ~~Information processing.~~
- ~~Physical controls.~~
- ~~Segregation of duties.~~

(Previously A104) The auditor's knowledge about the presence or absence of such controls ~~activities~~ is likely to be obtained from the understanding of the other components of internal control, in particular from the auditor's understanding of the information system ~~assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities~~.

A127. An understanding of whether, and if so, the extent to which, controls of these types exist may affect the auditor's identification of risks of material misstatement. For example, if the entity does not have appropriate segregation of duties in the procedures that the entity has implemented to initiate, record, process and correct, as necessary, the information related to transactions, then this may affect the auditor's identification of risks of material misstatement related to the classes of transactions affected. The absence of appropriate controls related to, for example, segregation of duties may also affect the risks of material misstatement at the financial statement level when such absence is pervasive across the entity's information system.

A128.(Previously A71) Physical controls includes those that address security of assets against unauthorized acquisition, use, or disposition and may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is limited to those relevant to the financial reporting objectives.

A129. The auditor may obtain an understanding of the entity's approach to general IT controls primarily through the work performed in identifying and understanding general IT controls in accordance with paragraph 21.

Controls Relevant to the Audit (Ref: Para 20)

A130. (Previously A100) Controls ~~activities~~ that are relevant to the audit ~~are:~~ include those that are required to be treated as such, being controls ~~activities that relate to~~ that are relevant to ~~significant risks and those that relate to~~ risks for which substantive procedures alone do not provide sufficient appropriate audit evidence and significant risks ~~as required by paragraphs 29 and 30, respectively or Those that are considered to be relevant in the judgment of the auditor~~, as well as controls over journal entries.

A131. The auditor determines whether there are any other controls relevant to the audit based on:

- Considering whether the auditor's understanding of the system of internal control obtained through the other requirements in paragraphs 14–19A provides a sufficient and appropriate basis for the auditor's identification and assessment of the risks of material misstatement or whether it is appropriate to understand additional controls in order to provide this basis.
- The auditor's intended reliance on controls in planning and performing further audit procedures in accordance with ISA 330.[18]

A132. Controls relevant to the audit primarily include controls in the control activities component, such as those over the information system, because such controls typically address risks of material misstatement at the assertion level (i.e., direct controls). However, the auditor may determine that there are controls relevant to the audit that exist in the control environment, risk assessment process or the process to monitor the system of internal control components because such controls either address or assist in addressing the identified risks of material misstatement at the assertion level, such as significant risks or risks for which substantive procedures alone are not sufficient appropriate audit evidence. Controls in these components may also address or assist in addressing other risks of material misstatement for which the auditor has judged it appropriate to understand the related controls. For example, controls relevant to the audit may include reviews by management of accounting information that are designed to contribute to how the entity prevents or detects misstatements related to such significant risks and which exist in the process to monitor the system of internal control component.

A133.(Previously A101) ~~The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.~~

A134. (Previously A103) Controls ~~activities~~ relevant to the audit may include controls established by management that address risks of material misstatement related to significant disclosures not being prepared in accordance with the applicable financial reporting framework. ~~in addition to controls that address risks related to account balances and transactions.~~ Such controls ~~activities~~ may relate to information included in the financial statements that is obtained from outside of the general and subsidiary ledgers.

Identifying and Assessing the Risks of Material Misstatement (Ref: Para 25)

A135. Paragraph 25 requires the identification and assessment of the risks of material misstatement at the financial statement level and for significant classes of transactions, account balances and disclosures, at the assertion level, which are the two levels at which risks of material misstatement may exist as explained in ISA 200.[19] ISA 200 also includes a description of the risks of material misstatement, which explains that inherent risk and control risk are the components making up the risks of material misstatement.[20]

A136. The auditor's assessment of the identified risks provides the basis for considering the appropriate nature, timing and extent of further audit procedures to be performed, thereby supporting the auditor's decisions made in regard to the requirements in ISA 330. In particular, paragraph 7 of ISA 330 requires the auditor to consider, in the design of such procedures, the reasons for the assessment given to the risk of material misstatement at the assertion level, which includes the reasons for the assessments of inherent risk and control risk.

[18] ISA 330, *The Auditor's Responses to Assessed Risks*

[19] ISA 200, paragraph A36

[20] ISA 200, paragraphs A39

A137. The assessment of inherent risk also takes into account the qualitative inherent risk factors, the effect of which assists the auditor in understanding the reasons for the assessed inherent risks and may therefore assist the auditor in determining further audit procedures. The auditor's assessment of control risk takes into account relevant controls, thereby requiring that the operating effectiveness of those controls to be tested as required by ISA 330.[21]

A137a. [*Placeholder for using data analytics tools and techniques to assist with the identification of possible misstatements, including from fraud*].

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

A138. (Previously A122) 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 increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A138a. (Previously A123) Risks at the financial statement level may derive in particular from a deficient control environment (although these risks may also relate to other for ~~factors~~ changes, such as declining economic conditions or other events that may affect the entity's ability to continue as a going concern). When the outcome of the required evaluation in paragraph 14A relating to the entity's control environment is such that deficiencies in the control environment have been identified, this may have implications for the auditor's assessment of the risk of material misstatement at the financial statement level. For example, deficiencies ~~such as~~ relating to lack of management competence or lack of oversight over the preparation of the financial statements may have a more pervasive effect on the financial statements and ~~may require an overall response by the auditor~~ therefore may have implications for the audit.

A138b. The implications for the audit arising from the assessment of risks of material misstatement at the financial statement level may include implications related to:

- Managing quality at the engagement level, for example, in relation to the nature, timing and extent of direction and supervision of the members of the engagement team and the review of the work performed, and the need to assign more experienced staff or those with special skills
- The audit overall strategy, such as:
  - 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 weaknesses 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).

A138c. (Previously A124) The auditor's understanding of the control environment or other components of the system of internal control may raise doubts about the auditability of an entity's financial statements. 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.

A138d. (Previously A125) ISA 705 (Revised)[22] 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

Assessment of Risks of Material Misstatement at the Assertion Level (Ref: Para. 25(b))

A139. (Previously A126) ~~Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence.~~ In assessing the risks of material misstatement at the assertion level as required by paragraph 25, the auditor performs separate assessments of inherent risk and control risk in accordance with paragraphs 26 and 29A, respectively.

A139a. (Part of paragraph A126) In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

A140. ISA 200 explains that inherent risk is higher for some assertions and [related] classes of transactions, account balances, and disclosures than for others;[23] this is referred to as the spectrum of inherent risk in this ISA. For example, paragraph A154 explains that significant risks are at the highest end of the spectrum of risk. [*Placeholder – conforming amendments to be considered as necessary*).

A140a. Paragraph 7(b) of ISA 330 requires the auditor obtain more persuasive audit evidence the higher the auditor's assessment of risk, which recognizes that risks may be assessed along a spectrum. When the auditor plans to test the operating effectiveness of controls, the auditor uses the consideration required by paragraph 29A of the extent to which those controls address the related assessment of inherent risk to assess control risk.

A140b. [*Placeholder for example illustrating the interaction of control risk with inherent risks along the spectrum of risk*]

~~A132. (Previously A132) Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing and extent of further audit procedures to be performed. In identifying the risks of material misstatement in the financial statements, the auditor exercises professional skepticism in accordance with ISA 200.~~[24]

The Use of Assertions

~~A141. (Previously A127) In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding recognition, measurement, and presentation of classes of transactions and events, account balances and disclosures.~~

[A141. Now deleted]

A142. (Previously A128) The auditor may use the assertions as described in paragraph A143(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.

[21] ISA 330, paragraph 7(ii)

[22] ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

[23] ISA 200, paragraph A40

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

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

A143. (Previously A129) 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:

– Occurrence—transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.

– 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.

– Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.

– Cutoff—transactions and events have been recorded in the correct accounting period.

– Classification—transactions and events have been recorded in the proper accounts.

– 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.

(j) Assertions about account balances, and related disclosures, at the period end:

– Existence—assets, liabilities, and equity interests exist.

– Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

– 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.

– 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.

– Classification—assets, liabilities and equity interests have been recorded in the proper accounts.

– 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.

Assertions about other disclosures

A144. (Previously A130) The assertions described in paragraph 143(a)–(b) above, adapted as appropriate, may also be used by the auditor in considering the different types of potential misstatements that may occur in disclosures not directly related to recorded classes of transactions, events, or account balances. As an example of such a disclosure, the entity may be required to describe its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks.

Considerations specific to public sector entities

A145. (Previously A131) When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A143(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.

Material Misstatements

A145a. (Previously A139) Potential misstatements in individual statements and disclosures may be judged to be material due to size, nature or circumstances. (Ref: Para. 26(d))

~~*Process of Identifying Risks of Material Misstatement*~~ <u>*Assessing Inherent Risk*</u> (Ref: Para. 26)

<u>Identifying Significant Classes of Transactions, Account Balances, and Disclosures and their Relevant Assertions (paragraph 26(a))</u>

<u>A146. The required understanding in paragraph 11 results in the auditor obtaining an understanding that provides the basis for the auditor's expectations of the classes of transactions, account balances and disclosures in the financial statements. Based on that expectation, and the results of the auditor's risk assessment procedures, as required by paragraph 26(a) the auditor is required to identify the significant classes of transactions, account balances and disclosures, and their relevant assertions, as part of the inherent risk assessment at the assertion level.</u>

<u>A147. The identification the significant classes of transactions, account balances and disclosures, and their relevant assertions may be done in combination (i.e., as one exercise); or in some cases, the auditor may identify, for example, a significant account balance and then determine the relevant assertions, or in other cases, the auditor may identify a relevant assertion and determine the related class of transaction, account balance or disclosure.</u>

<u>A148. When considering the effect of the qualitative inherent risk factors, other quantitative and qualitative risk factors the auditor may also take into account in identifying significant classes of transactions, account balances and disclosures, and their relevant assertions, include:</u>

- <u>The size in relation to performance materiality, and the composition of the class of transactions, account balance or disclosure.</u>
- <u>The volume of activity and homogeneity of the individual transactions processed through the account balance or class of transactions, or reflected in the disclosure, including whether they are subject to differing risks.</u>
- <u>The existence of related party transactions in the class of transaction or account balance, or that are relevant to the disclosure.</u>
- <u>With respect to disclosures, qualitative aspects that may be material to users include:</u> *(the following bullets from A135))*
  - 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.

A149. (Previously A133) Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement, including risks of material misstatement relating to disclosures.

A150. (Previously A134) As explained in ISA 320,[25] 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.[26]

A151. Regardless of the recorded value of a class of transactions, an account balance or (where applicable) a disclosure, the extent to which its susceptibility to misstatement is subject to, or affected by, the qualitative inherent risks factors influences the auditor's identification of its relevant assertions (if any), consideration of whether it is a significant class of transactions, account balance or disclosure, and assessment of the significance of its inherent risk. For example, a liability subject to measurement uncertainty may have a recorded value significantly below performance materiality but still may be subject to a risk of understatement in making an estimate of the liability, which results in the auditor identifying and assessing a risk of material misstatement related to the valuation assertion. [Placeholder: *Conversely, an asset with a recorded value of greater than performance materiality may not be affected significantly by any qualitative inherent risk factors and the auditor may determine that there is not a reasonable possibility of a material misstatement in respect of any of the assertions applicable to that asset and accordingly that none of them is a relevant assertion).*] Accordingly, the asset in the first case would be a significant account balance and the asset in the second case would not.

A152.(*Previously part of paragraph A135; bullets now in A148 above*)) The auditor's ~~consideration~~ identification of significant disclosures ~~in the financial statements~~ when identifying risks includes both quantitative and qualitative disclosures, ~~the misstatement of which could be material~~ for which there is more than a reasonable possibility of material misstatement (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole).

Considerations specific to smaller entities

A153. (Previously A136) Disclosures in the financial statements of smaller entities may be less detailed or less complex (e.g., some financial reporting frameworks allow smaller entities to provide fewer disclosures in the financial statements). However, this does not relieve the auditor of the responsibility to obtain an understanding of the entity and its environment, including internal control, as it relates to disclosures.

Assessing Inherent Risk at the Assertion Level (Ref: Para. 26(d))

A154. Considerations when identifying risks of material misstatement at the assertion level and assessing inherent risk include the likelihood that a misstatement will occur, and if so, the magnitude of a possible misstatement. The degree to which the susceptibility to misstatement is subject to, or affected by, the qualitative inherent risk factors reflects the influence those factors have on the likelihood and magnitude considerations for the identified risks of material misstatement. The relative degrees of the likelihood and magnitude of a possible misstatement and their intersection, determines where, on the spectrum of inherent risk, the risk of material misstatement exists. Determining the likelihood and potential magnitude of a possible misstatement is a matter of the auditor's professional judgment. The higher the likelihood and the greater the magnitude, the higher the inherent risk; the lower the likelihood and the lower the magnitude, the lower the inherent risk. Significant risks, which are identified in accordance with paragraph 27, are those at the highest end of the spectrum of inherent risk. For most audits, risks of material misstatement will exist along the spectrum of inherent risk.

A155.In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may apply the concept of a spectrum of inherent risk by designating risks of material misstatement within relative categories of significance along the spectrum of inherent risk, based on their assessment of inherent risk. For example, an auditor may use categorizations such as low, medium, high and significant. However the auditor does so, application of the spectrum 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 takes into account the auditor's assessment of control risk and the reasons for the auditor's inherent and control risk assessments.

~~*Relating Controls to Assertions* (Ref: Para. 26(c))~~

~~A137. 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 assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.~~

~~A138. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.~~

~~A139. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. 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 completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.~~

Significant Risks (Ref: Para. 27)

A156. As explained in paragraph A156, significant risks are at the highest end of the spectrum of inherent risk. In determining significant risks, the auditor is focused on those inherent risks that have been assessed at the higher end of the spectrum of inherent risk, based on the auditor's assessment of inherent risk. In determining whether an identified risk of material misstatement at the assertion level is a significant risk, the auditor considers the impact of the qualitative inherent risk factors on the assessment of inherent risk. For example, in determining whether an identified risk of misstatement related to the valuation assertion for a complex accounting estimate is a significant risk, the auditor may consider that the assessment of inherent risk is impacted to a considerable extent by one or more of the qualitative inherent risk factors, such as complexity and measurement uncertainty. This may result in the auditor's assessment of inherent risk being at the higher end of the spectrum of inherent risk. The determination of which of the assessed inherent risks is at the highest end of the spectrum of inherent risk, and is therefore a significant risk, 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.

A157. (Previously A140; rest in A159 below) Risks of a type specified to be treated as a s~~S~~ignificant risk~~s~~ in accordance with the requirements of another ISA often relate to judgmental matters such as ~~significant~~ non-routine transactions ~~or judgmental matters~~. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.

A158. (Previously A141) Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- ~~Greater management intervention to speccify the accounting treatment.~~
- Transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved.
- Estimates that have high estimation uncertainty.

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[25] ISA 320, paragraph A1

[26] ISA 320, paragraph 4

- Complexity ~~Greater manual intervention for~~ in data collection and processing to support account balances.
- Complex calculations or accounting principles.
- Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions.
- ~~The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over risks.~~

A159. (From A140 and A142) Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because these are likely to be assessed as lower on the spectrum of inherent risk, and may arise ~~Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising~~ from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

Significant risks relating to the risks of material misstatement due to fraud and related party transactions

A160. (Previously A144) 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.[27]

[*Placeholder for paragraph referring to significant risks in related party transactions (ISA 550 references)*]

Implications for the audit

A161. ~~ISA 330 describes the consequences for further audit procedures of identifying a risk as significant~~[28] 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. In addition, other ISAs [set out] required responses, including:

- Paragraphs 15 and 21 of ISA 330 require controls to be tested in the current period for significant risks and substantive procedures planned and performed that are specifically responsive to the identified significant risk. [29]
- Identifying controls over significant risks as relevant to the audit in accordance with paragraph 20.
- Communication with those charged with governance (paragraph 15 of ISA 260 (Revised)).
- Determining that the matter is a key audit matter if the auditor has determined that the matter requires significant auditor attention (paragraph 9 of ISA 701).
- The need for more persuasive audit evidence (paragraph 7 of ISA 330).
- The use of more experienced team members, including those with specialized skills, to perform audit procedures or audit work may involve the use of experts.
- That the engagement partner and engagement quality control reviewer are required to review the related workpapers.
- More involvement by the group engagement partner if the significant risk relates to a component in a group audit, the group engagement team directs the work required at the component by the component auditor (ISA 600)

Assessing Control Risk (Ref: Para. 29A)

A162 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 assessment of inherent risk. When the auditor intends to test controls, the auditor takes into account the expectation of their operating effectiveness in assessing control risk. In doing so, the auditor is required to consider the extent to which the controls address the related assessment of inherent risk. Often, only multiple controls, will be sufficient to address the assessment of inherent risk.

A163. The auditor's control risk assessment may be expressed using categorizations (e.g., maximum, moderate, minimum) or can be expressed in terms how effective the control(s) is in addressing the risk. However, the method used to indicate the control risk assessment is appropriate when the design and implementation of further audit procedures appropriately take account of the extent to which the auditor intends to test the operating effectiveness of controls in responding to the assessed risks of material misstatement at the assertion level.

A164. (Previously A139) Controls can be ~~either r~~more directly or more indirectly related to ~~an assertion~~ the assessment of inherent risk. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. 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 assessment of inherent risk related to the completeness assertion for sales revenue. Accordingly, it may be less effective in ~~reducing~~ addressing the assessment of inherent risk for that assertion than controls more directly related to ~~that assertion~~ the risk, such as matching shipping documents with billing documents.

A165. When the auditor intends to test the operating effectiveness of automated controls determined to be relevant to the audit, the auditor is likely to test the operating effectiveness of the general IT controls related to the automated controls in order to determine that the automated controls functioned appropriately throughout the financial statement period. If the related general IT controls are not operating effectively, or the auditor does not intend to test them, the auditor may obtain audit evidence to address the risks related to IT by performing other procedures that may involve, for example, reviewing relevant access and program change histories or logs for the financial statement period to determine whether any unauthorized access or unauthorized changes occurred. Provided that the auditor obtains audit evidence that either the general IT controls are operating effectively or that the risks related to IT have not occurred, the auditor may take into account the operating effectiveness of the automated controls in the assessment of control risks.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para. 30)

A166. (Previously A148) 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 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.

A167. (Previously A149) 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 integrated system. 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.

[27] ISA 240, paragraphs 25–27

[28] ~~ISA 330, paragraphs 15 and 21~~

[29] ISA 330, paragraphs 15 and 21

- 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.

A168. (Previously A150) The consequences for further audit procedures of identifying such risks are described in ISA 330.[30]

Revision of Risk Assessment (Ref: Para. 31)

A169. (Previously A151) 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. See ISA 330 for further guidance.

Documentation (Ref: Para. 32)

A170. (Previously A152) The manner in which the requirements of paragraph 32 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.[31] 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.[32] The form and extent of the documentation 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 course of the audit.

A171. (Previously A153) For entities that have uncomplicated businesses and processes relevant to financial reporting, the 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 include those on which the auditor based the assessment of the risks of material misstatement.

A172. (Previously A154) The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of ISA 230 are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

A173. (Previously A155) For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

[30] ISA 330, paragraph 8

[31] ISA 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9

[32] ISA 330, paragraph 28

Appendix 1

(Ref: Para. 4(c), 14–24, A77–A121)

(Note: *No further changes have been made to the Appendices)*

(To note for Appendix 1 – some of the material in this appendix has been elevated to the standard but has not been shown in marked)

Internal Control Components

- This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14–24 and A77–A121, as they relate to a financial statement audit.

Control Environment

The control environment encompasses the following elements:

(a) *Communication and enforcement of 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, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, 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) *Commitment to competence*. Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.

(c) *Participation by those charged with governance*. An entity's control consciousness is influenced significantly by those charged with governance. 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 and the process for reviewing the effectiveness of the entity's internal control.

(d) *Management's philosophy and operating style*. Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.

(e) *Organizational structure*. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.

(f) *Assignment of authority and responsibility*. The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include 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.

(g) *Human resource policies and practices*. Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Entity's Risk Assessment Process

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.

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 data 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 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 internal control.
- *New or revamped information systems*. Significant and rapid changes in information systems can change the risk relating to 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 information systems may change the risk associated with 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 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 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.

Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).

The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods 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.

The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, 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

Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- *Performance reviews*. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
- *Information processing*. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT controls are program change controls, controls that restrict

access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

- *Physical controls*. 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.
  - 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, and therefore the audit, 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.

Certain control activities may depend on the existence of appropriate higher level policies 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.

Monitoring of Controls

An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls 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.

Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.

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 internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Appendix 2

(Ref: Para. A41, A133)

Conditions and Events That May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement in the financial statements. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.

- Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Deficiencies in internal control, especially those not addressed by management.
- Incentives for management and employees to engage in fraudulent financial reporting.

- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.

- Events or transactions that involve significant measurement uncertainty, including accounting estimates, and related disclosures.
- Omission, or obscuring, of significant information in disclosures.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.