ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement

Application and Other Explanatory Material

Definitions

Assertions (Ref: Para. 4(aa))

A0a. Representations by management with respect to the recognition, measurement, presentation and disclosure of information in the financial statements of classes of transactions, account balances and disclosures differ from written representations provided to the auditor by management, as required by ISA 580,[1] to confirm certain matters or support other audit evidence.

A0aa. Assertions that the auditor may use in addressing the requirements of this ISA are further described in paragraph A121c. (Ref: Para. 4(aa))

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 management or those charged with governance, or may result from behaviors that are not mandated but are rather conditioned by the entity's culture. Procedures may be enforced through the actions permitted by the IT applications used by the entity or other aspects of the entity's IT environment.

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

A0d. Inherent risk factors may be qualitative or quantitative. Qualitative inherent risk factors relating to the preparation of information required by the applicable financial reporting framework include:

- *Complexity*—arises when there are many items or relationships among such items that require integration in preparing information required by the financial reporting framework. For example, complexity in determining a fair value may result from the need to use multiple unobservable inputs or may result from complex patterns of trading in financial instruments. Similarly, complexity in calculating supplier rebate provisions may result from complex supplier relationships. Complexity may also relate to data, or the flow of data, including when data relevant to financial reporting is inherently difficult to identify, capture, access or understand, or the manner in which it is processed by the entity's financial reporting systems is complex. Complexity may result in the need to apply specialized skills or knowledge, including the use of a management's expert, in preparing the information.
- *Subjectivity*— results from inherent limitations in the knowledge or data available to prepare information in accordance with the requirements of the applicable financial reporting framework. There may be a lack of specificity in what is required by the applicable financial reporting framework, such that multiple approaches, and outcomes in terms of the information to be included in the financial statements, may be appropriate. Subjectivity gives rise to the need for management to make an election or judgment about the appropriate approach to take and the resulting information to include in the financial statements. When a matter is more subjective, the related judgments may be more susceptible to management bias, whether

[1] ISA 580, *Written Representations*

unintentional or intentional. For example, significant management judgment may be involved in making accounting estimates that have been identified as having high estimation uncertainty, and conclusions regarding methods, models and assumptions may reflect unintentional or intentional management bias.

- *Change*—arising from significant economic, accounting, regulatory, industry or other developments from one point in time to another, and which may occur during or between financial reporting periods. This includes changes in the requirements of the applicable financial reporting framework, or in the entity and its business model in the context of the environment in which the entity operates. Such changes may affect management's assumptions and judgments, including as they relate to management's selection of accounting policies or how accounting estimates are made or related disclosures determined.
- *Uncertainty*—arises when the required information cannot be prepared, based only on sufficiently precise and comprehensive data that is verifiable through direct observation. In these circumstances, an approach may need to be taken that applies the best available knowledge to prepare the information using sufficiently precise and comprehensive observable data, to the extent available, and reasonable assumptions supported by the best available data, when it is not. Constraints on the availability of knowledge or data, which are not within the control of management (subject to cost constraints where applicable) are sources of uncertainty and their effect on the preparation of the required information cannot be eliminated. For example, estimation uncertainty arises when the required monetary amount cannot be determined with precision and the outcome of the estimate is not known before the date the financial statements are finalized.
- *Susceptibility to management bias*— results from conditions that create susceptibility to intentional or unintentional failure by management to maintain neutrality in preparing the information. Management bias is often associated with certain conditions that have the potential to give rise to management not maintaining neutrality in exercising judgment (indicators of potential management bias), which could lead to a material misstatement of the information that would be fraudulent if intentional. Such indicators include inherent incentives or pressures (for example, as a result of motivation to achieve a desired result, such as a desired profit target or capital ratio), and opportunity, not to maintain neutrality. Further factors relevant to the susceptibility of assertions about classes of transactions, account balances and disclosures to fraud are described in paragraphs A1 to A5 of ISA 240.[2] The other inherent risk factors may also create opportunities for management bias.

A0e. The susceptibility to misstatement of an assertion about a significant class of transactions, account balance or disclosure is subject to, or affected by, the combination of the inherent risk factors. For example, the extent to which a financial statement item is subject to or affected by complexity or subjectivity, is often closely related to the extent to which it is subject to change or uncertainty. Further, when a financial statement item is subject to, or affected by, complexity, subjectivity, change or uncertainty, these inherent risk factors may create opportunity for a lack of management bias, thereby increasing the susceptibility to management bias.

A0f. Other inherent risk factors, including quantitative, that affect the susceptibility of an assertion to misstatement include:

- The size of the class of transactions, account balance or disclosure in relation to performance materiality;
- The composition of the class of transactions, account balance or disclosure;

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

- 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; and
- The existence of related party transactions in the class of transaction or account balance, or that are relevant to the disclosure.

A0g. Appendix 2 sets out examples of events and conditions that may indicate the existence of risks of material misstatement in the financial statements in the context of inherent risk factors.

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

A0h. Significance can be described as the relative importance of a matter, taken in context. The significance of a matter is judged by the auditor in the context in which the matter is being considered. The significance of a risk of material misstatement at the assertion level is considered in the context of the implications of the assessment of its inherent risk for the performance of the audit, including the nature, timing and extent of the auditor's further audit procedures and the persuasiveness of the audit evidence that will be required to reduce audit risk to an acceptable level. Significance can be considered in the context of how, and the degree to which, the susceptibility to misstatement is subject to, or affected by the inherent risk factors, 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))

A0i. The entity's system of internal control may be reflected in policy and procedures manuals, systems and forms, and the information embedded therein, and is effected by people. The system of internal control is implemented by management, those charged with governance, and other personnel based on the structure of the entity. The system of internal control can be applied, based on the decisions of management, those charged with governance and other personnel and in the context of legal or regulatory requirements, to the operating model of the entity, the legal entity structure, or a combination of these.

Risk Assessment Procedures and Related Activities (Ref: Para. 5–10)

Risk Assessment Procedures (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 throughout the audit. The auditor's understanding is obtained and updated on an iterative basis. As the auditor performs audit procedures, the audit evidence obtained may cause the auditor to update the understanding on which the risk assessment was based and the nature, timing or extent of other planned audit procedures. For example, information gathered in understanding the entity's system of internal control assists the auditor in assessing control risk at the assertion level, such that control risk may be assessed at less than maximum based on an expectation about the operating effectiveness of the control(s). However, information gathered when testing the control(s) as part of performing further audit procedures may indicate that the control(s) are not effective, and as a result the auditor's original assessment may need to be updated. (*Remaining moved to A1b*)

A1a. (previously A4) The risks of material misstatement to be identified and 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.[3] 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[4] in regard to accounting estimates;
- ISA 550[5] in regard to related party relationships and transactions;
- ISA 570[6] in regard to going concern; and
- ISA 600[7] in regard to group financial statements.

A1b. (previously in A1) The understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control also establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements (e.g., 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;[8]
- 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;[9]
- 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;[10] and
- Evaluating the sufficiency and appropriateness of audit evidence obtained (e.g., relating to ~~such as the appropriateness of~~ assumptions ~~and of~~ or management's oral and written representations).

A2. Information obtained by performing risk assessment procedures and related activities in accordance with paragraphs 5 to 10 of this ISA is ~~may be used by the auditor as~~ audit evidence ~~to~~ that supports the identification and assessment~~s~~ of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures, and related assertions, and about the operating effectiveness of controls, even though such risk assessment procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may also ~~choose to perform~~ design substantive procedures or tests of controls to be performed concurrently with risk assessment procedures because it is

[3] ISA 240, paragraphs 12–24

[4] ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

[5] ISA 550, *Related Parties*

[6] ISA 570, *Going Concern*

[7] ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

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

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

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

efficient to do so, or the nature of the information influences the procedures to be undertaken. For example, through the use of technology to perform procedures on large volumes of data, audit evidence may be obtained that informs the identification and assessment of risks of material misstatement, as well as the conclusions that such risks have been reduced to an acceptably low level.

A3. The auditor uses professional judgment to determine the nature and extent of the understanding required to provide the appropriate basis for identifying and assessing risks of material misstatement. The auditor's primary consideration is whether the understanding that has been obtained ~~is sufficient to~~ meets the objective stated in this ISA. The depth of the overall understanding that is required by the auditor will vary according to the nature and circumstances of the entity, and is less than that possessed by management in managing the entity.

A4. [MOVED to A1a]

Types of Risk Assessment Procedures and Sources of Information (Ref: Para. 6)

A4a. ISA 500[11] explains the types of audit procedures that may be performed in obtaining audit evidence from risk assessment procedures and further audit procedures. The nature and timing of the audit procedures may be affected by the fact that some of the accounting data and other information may only be available in electronic form or only at certain points in time.[12]

A4b. Some of the information used by the auditor when performing risk assessment procedures may be electronic data available from the entity's information system, for example the general ledger, sub-ledgers or other operational data. In performing risk assessment procedures, the auditor may use automated tools and techniques to perform the risk assessment procedures, including for analysis, recalculations, reperformance or reconciliations.

A4c. Other sources of information available to the auditor may 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 obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, updated as appropriate.
- Information from sources other than management.

These sources 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. Regardless of the source of information, the auditor considers the relevance and reliability of the information to be used as audit evidence in accordance with ISA 500.[13]

A5. 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 and its environment, the applicable financial reporting framework, and the entity's system of internal control (see paragraphs 11–21B), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures may include ~~M~~making inquiries of the entity's external legal counsel or external supervisors, or of valuation experts that the entity has used. (*Other previous bullet moved to A18*)

[11] ISA 500, *Audit Evidence,* paragraphs A14–A17 and A21–A25.

[12] ISA 500, paragraph A12

[13] ISA 500, paragraph 7

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)[14] 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.
- 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.

Inquiries of the ~~I~~internal ~~A~~audit ~~F~~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, the applicable financial reporting framework and the entity's system of internal control, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity and its environment, the applicable financial reporting framework and the system of internal control, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.[15] 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.

14 ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 4(b)

15 The relevant requirements are contained in ISA 610 (Revised 2013).

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,[16] 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.

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))

A14. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in <u>identifying and</u> 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 a~~Analytical procedures <u>performed as risk assessment procedures</u> may use data aggregated at a high level ~~(which may be the situation with analytical procedures performed as risk assessment procedures), where~~ <u>and accordingly</u> the results of those analytical procedures <u>may</u> only provide a broad initial indication about whether a material misstatement may exist. <u>For example, the auditor may perform a simple comparison of information, such as the change in account balances from interim or monthly reporting with balances from prior periods, to obtain an indication of those balances where further auditor consideration may be necessary to identify areas of possible misstatement.</u> ~~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>Analytical procedures performed as risk assessment procedures may also be performed using automated tools or techniques, which may result in the auditor being able to perform more granular risk assessment procedures. For example, the auditor may extract data from the entity's information system, and further analyze this data by using visualization techniques to identify more specific areas of possible misstatement.</u>

[16] ISA 240, paragraph 19

A16a. This ISA deals with the auditor's use of analytical procedures as risk assessment procedures. ISA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"). Accordingly, analytical procedures performed as risk assessment procedures are not required to be performed in accordance with the requirements of ISA 520. However, the requirements and application material in ISA 520 may provide useful guidance to the auditor when performing analytical procedures as part of the risk assessment procedures.

~~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.~~

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.
- Internal ~~D~~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.
- (from previous A5) ~~Reviewing~~ ~~i~~Information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications; or other external documents about the entity's financial performance (such as those referred to in paragraph A47).

Information from Client or Engagement Acceptance or Continuance (Ref: Para. 7)

A18a. The engagement partner is required to be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and to determine that conclusions reached in this regard are appropriate.[17] Information considered during such procedures may be relevant to the identification and assessment of the risks of material misstatement. Examples may include:

- Information about the nature of the entity and its business risks.
- Information about the integrity and ethical values of management and those charged with governance, which may be relevant to the auditor's understanding of the control environment.
- The applicable financial reporting framework and information about its application to the nature and circumstances of the entity, such as identified accounting complexities or applicable events and conditions.

Information from Other Engagements Performed for the Entity (Ref: Para. 8)

A18b. The engagement partner may have performed other engagements for the entity, for example agreed-upon procedures engagements (e.g., procedures relating to an entity's debt covenant compliance) or other audit or

[17] ISA 220, *Quality Control for an Audit of Financial Statements,* paragraph 12

assurance engagements (e.g., audits of special purpose financial statements or reviews of interim financial information) through which the engagement partner may have obtained knowledge relevant to the audit, including about the entity and its environment.

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.
- 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 entity's system of internal control, for example, may affect the relevance and reliability of information obtained in the prior year period. In evaluating whether such information remains relevant and reliable for the current period audit, the auditor may consider whether changes have occurred that may affect the relevance or reliability of such information. For example, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion among the Engagement Team (Ref: Para. 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. Sharing information contributes to an enhanced understanding of all engagement team members.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject, how the inherent risk factors may affect the classes of transactions, account balances and disclosures, and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures. In particular, it assists engagement team members in further considering inconsistent information based on each member's own understanding of the nature and circumstances of the entity.

- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

ISA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.[18] The discussion in accordance with paragraph 10 may be held concurrently with the discussion among the engagement team that is required by ISA 240 to discuss the susceptibility of the entity's financial statements to fraud.

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 while performing risk assessment procedures, through identifying and discussing inconsistent or contradictory information obtained in performing those procedures, as well as considering whether there are indicators of possible management bias (both intentional and unintentional). Professional skepticism is necessary for the critical assessment of audit evidence, and a robust and open engagement team discussion, including for recurring audits, may lead to improved identification and assessment of the risks of material misstatement. Another outcome from the discussion may be that the auditor identifies specific areas of the audit for which exercising professional skepticism may be particularly important, which may in turn drive the consideration of 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.

~~Considerations Specific to Smaller Entities~~

A24. ~~Many small audits are carried out entirely by the engagement~~When an engagement is carried out by a single 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. Under these circumstances, where an engagement

[18] ISA 240, paragraph 15

team discussion would not be possible, the consideration of matters referred to in paragraph A22 equally assists the engagement partner in identifying where there may be risks of material misstatement.

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

A24a. The auditor's understanding of the entity and its environment, and the applicable financial reporting framework, establishes a frame of reference within which the auditor plans and performs the audit, and exercises professional judgment throughout the audit. Specifically, the understanding needs to be sufficient to provide an appropriate basis for the auditor to understand the classes of transactions, account balances and disclosures to be expected in the entity's financial statements, which assists in identifying areas in the financial statements where material misstatements are likely to arise. The depth and breadth of understanding required will depend on the size and complexity of the entity.

A24b. In addition, the ability of the engagement team to effectively exercise professional skepticism throughout the audit is enhanced through obtaining a thorough understanding of the entity that provides a basis for the identification and assessment of the risks of material misstatement and that supports the auditor's design and performance of further audit procedures.

The Entity and Its Environment (Ref: Para 11(a))

[A25–A30 MOVED to A43a–A43f]

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

A31. An understanding of the ~~nature of an~~ entity's organizational structure and ownership 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 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 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 establishes requirements and provides guidance on the auditor's considerations relevant to related parties.
- The entity's IT environment, for example the entity may have a complex IT environment because the entity has grown through extensive merger and acquisition activity and has multiple legacy IT systems in diverse businesses that are not well integrated. Alternatively, an entity's IT environment may be relatively simple because the IT system comprises only packaged software with no or limited modifications.

A31a. In obtaining an understanding of the entity and its environment, the auditor may be able to enhance that understanding by using automated tools and techniques. For example, if the IT environment is complex, the auditor's ability to understand flows of transactions and processing through the use of automated tools and techniques may assist in identifying areas of potential misstatement, or the auditor may use automated tools and techniques to assist with the identification of related party transactions.

Governance

A31b. 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 A80a), but are generally prerequisites for an effective system of internal control. Matters that may be relevant for the auditor to consider in obtaining an understanding of the governance of the entity 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

A31c. The auditor's understanding of the entity's business model, and how that affects its business strategy and business objectives may assist the auditor in identifying business risks relevant to the audit. Furthermore, this may assist the auditor in identifying risks of material misstatement, for example, incentives and pressures on management may result in intentional or unintentional management bias, which may affect the reasonability of key assumptions and expectations of management or those charged with governance.

A31d. Different terms may be used to describe an entity's objectives, strategy or business model. For example, in larger more complex entities these may be individually described, with significant detail supporting the description. In smaller, less complex entities, these concepts may be combined with a very simple description setting out how the entity operates.

A31e. An entity's business model describes how an entity considers, for example its organizational structure, operations or scope of activities, business lines (including competitors and customers), processes, growth opportunities, globalization, regulatory requirements and technologies. The auditor's understanding of the business model provides the auditor with an initial understanding about how the entity is structured, the markets in which it operates and how the entity operates within those markets.

A31f. 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, such as those operating in the public sector, may create and deliver value in different ways to those creating wealth for shareholders, but will still have a business model to promote value in the public interest.] 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 that affect the identification and assessment of risks of material misstatement include:

- Environmental risks or the concentration of customers or suppliers.
- The key activities of the entity, including:
    - o Business Operations

- o Investments and investment activities
- o Financing and financing activities.
- o The markets the entity operates in and how it engages in those markets.

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

- 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.

A32. [MOVED to Appendix 1 and A49a]

A33. [MOVED to A31f]

A34-A35 [MOVED to Appendix 1]

A36. [MOVED to A49a]

~~*Objectives and Strategies and Related*~~ Business ~~R~~risks ~~(Ref: Para. 11(d))~~

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.

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;
- 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.

A38a. (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 assertion level or the financial statement 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 ~~considers~~ evaluates when ~~assessing the appropriateness of the going concern assumption~~ concluding whether a material uncertainty exists. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in Appendix 2.

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.

A40. Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- Use of IT (a potential related business risk might be, for example, that ~~systems and processes are incompatible~~ the entity is implementing a new IT system that will affect both operations and financial reporting).
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A41. [MOVED TO A38a]

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 A88a–A89d.

Considerations Specific to Public Sector Entities

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

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

Industry ~~F~~factors

A43a. (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.

A43b. (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.[19]

Regulatory ~~F~~factors

A43c. (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.
- Environmental requirements affecting the industry and the entity's business.

A43d. (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.[20]

Considerations specific to public sector entities

A43e. (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 ~~E~~external ~~F~~factors

A43f. (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.

~~Measurement and Review of the Entity's~~ Relevant Financial ~~Performance~~ Reporting Measures (Ref: Para. 11(~~e~~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 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.

[19] ISA 220, paragraph 14

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

A45. The measurement and review of financial performance is not the same as the monitoring of the system of internal control~~s~~ (discussed as a component of the system of internal control in paragraphs A89e–A89r), 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 control~~s~~ is specifically concerned with ~~the effective operation of internal control~~ monitoring the 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.

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, reports may be issued by:

- ~~external information such as a~~Analysts~~'~~ ~~reports and~~ or credit ~~rating~~ agenc~~y~~ies ~~reports may represent useful information for the auditor~~.
- Revenue authorities.
- Regulators.
- Trade unions.
- Providers of finance.

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.

~~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. 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 Entity's Selection and Application of Accounting Policies~~ The Applicable Financial Reporting Framework (Ref: Para. 11(b~~e~~))

A49a. (previously A32 and A36) Examples of matters that the auditor may consider when obtaining an understanding of the entity's applicable financial reporting framework, and how it applies in the context of the nature and circumstances of the entity and its environment include:

- The entity's ~~F~~financial reporting practices in terms of the applicable financial reporting framework, such as:
  - Accounting principles and industry-specific practices, including for industry-specific significant classes of transactions, account balances and related disclosures in the financial statements (for example, loans and investments for banks, or research and development for pharmaceuticals).
  - Revenue recognition.
  - Accounting for ~~fair values~~ financial instruments, including related credit losses.
  - Foreign currency assets, liabilities and transactions.
  - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for ~~stock-based compensation~~ 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 reasons therefore, may encompass such matters as:
  - The methods the entity uses to recognize, measure, present and disclose significant and unusual classes of transactions, account balances and disclosures ~~account for significant and unusual transactions~~.
  - The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
  - Changes in the environment, such as changes in the applicable financial reporting standards or tax reforms that may necessitate a ~~C~~changes in the entity's accounting policies.
  - Whether the changes are appropriate in the context of the nature and circumstances of the entity and its environment.
  - Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.

A49b. Obtaining an understanding of the entity and its environment assists the auditor in considering where changes in the entity's financial reporting may be expected. For example, if the entity has had a significant business combination during the period, the auditor would likely expect changes in classes of transactions, account balances and disclosures associated with that business combination. Alternatively, if there were no significant changes during the period the auditor's understanding may help confirm that the understanding obtained in the prior period remains applicable.

A49c. (Previously A136) Disclosures in the financial statements of smaller, non-complex 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, the applicable financial reporting framework as it applied to the entity, and its related system of internal control, as it relates to disclosures.

How Events or Conditions are Subject to, or Affected by, the Inherent Risk Factors

A49d. When obtaining an understanding of the entity, the auditor identifies events or conditions that may indicate the existence of risks of material misstatement. Appendix 2 provides examples of such events or conditions. The auditor is required to take into account these events or conditions in understanding how the applicable financial reporting framework applies in the context of the nature and circumstances of the entity, which allows the auditor to consider which classes of transactions, account balances and disclosures may be affected. In addition, the auditor is required to take into account how these events or conditions are affected by, or subject to, the inherent risk factors. The auditor may identify events or conditions that are subject to, or affected by one or more of the inherent risk factors. Understanding whether, and the relative degree to which complexity, subjectivity, change, uncertainty or susceptibility to management bias or other quantitative or qualitative inherent risk factors affect the events and conditions may assist the auditor in identifying and assessing the risks of material misstatement at the assertion level.

A49e. Events or conditions that may be affected by, or subject to, the susceptibility of management bias may be indicative of risks of material misstatement due to fraud. Accordingly, this may be relevant information for use in accordance with paragraph 24 of ISA 240, which requires the auditor to evaluate whether the information obtained from risk assessment procedures indicates one or more fraud risk factors are present.

A49f. (previously A58) In small entities, ~~On the other hand,~~ the owner-manager ~~in a small entity~~ may have ~~be more~~ greater opportunities for intentional management bias ~~able to override controls~~ ~~because the system of internal control is less structured~~. This may result in the auditor identifying an increased susceptibility to management bias at the financial statement level, which is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

The Understanding of the Entity's System of Internal Control (Ref: Para. 12-13)

A50. The auditor's ~~An~~ understanding of the components of the entity's system of internal control assists the auditor in identifying types of potential risks of material misstatements ~~and factors that affect the risks of material misstatement~~, and contributes to 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 ~~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 the system of internal control:

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

A50a. The auditor is required to perform risk assessment procedures to obtain an understanding of each component of internal control relevant to financial reporting. Paragraphs 14–19A include the auditor's required understanding of the components of the system of internal control. 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 sufficient and appropriate audit evidence 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.

A50b. 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 risks of material misstatement at the financial statement level. The auditor's understanding of the information system and communication component, and the control activities component are more likely to affect the identification and assessment of risks of material misstatement at the assertion level.

A50c. Appendix 3 further describes the nature and inherent limitations of an entity's system of internal control respectively. Appendix 3 also provides further explanation of the components of a system of internal control as it relates to a financial statement audit.

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

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

System of Internal Control Relevant to Financial Reporting ~~*General Nature and Characteristics 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.

A52a. (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.

A52b. The entity's system of internal control relevant to financial reporting will include aspects of the system of internal control that relate to the entity's reporting objectives (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. For example, controls over compliance with laws and regulations may be relevant to financial reporting when such controls are relevant to the entity's preparation of contingency disclosures in the financial statements. In particular, the auditor is required 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 both financial reporting and compliance objectives.

~~Considerations specific to smaller entities~~

A53. Smaller or non-complex entities may use less structured means and simpler ~~processes~~ controls (i.e., policies and procedures) to achieve their objectives.

Considerations Specific to Public Sector Entities

A53a. 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.

~~Limitations of Internal Control~~

A54-A56 [MOVED to Appendix 3]

~~Considerations specific to smaller entities~~

A57. [MOVED TO A99i]

A58. [MOVED TO A49f]

A59. [MOVED to A67a]

~~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.~~

~~*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. An entity's system of internal control contains manual elements and ~~often contains~~ automated elements. (from previous 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 affects the manner in which the system of internal control relevant to financial reporting is designed and implemented. Each component of the system of internal control may involve some extent of automation. The auditor's understanding of the system of internal control relevant to financial reporting involves understanding the entity's use of IT for each component. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A62. [MOVED TO A90b and A99c]

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.

A64. [MOVED TO A106a]

~~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~~.

A66. Manual elements in 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.

A67. [MOVED TO A106b]

Division of the System of Internal Control into Components

~~A67a. (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;~~

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

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

~~(c) Control activities; and~~

(d) ~~Monitoring of controls.~~

The ~~division~~ components of the system of internal control for the purpose of this ISA do~~es~~ not necessarily reflect how an entity designs, implements and maintains 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.

A67b. 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. For the purpose of this ISA, such controls are referred to as "indirect controls".

A67c. 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.

A67d. 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 may include "indirect controls", for example, controls that address the continued functioning of automated controls over the processing of transactions, but may also include "direct controls", for example, controls over the integrity of data in the entity's information systems.

~~Controls Relevant to the Audit~~

A68. [MOVED TO A52a]

~~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. [MOVED to A102a]

A71. [MOVED to A99g]

~~A72. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. 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. 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.~~

A73. [MOVED TO A53a]

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

A73a. The auditor identifies controls relevant to the audit in accordance with paragraphs 20 through 21A. Controls relevant to the audit may be mainly controls that address potential risks of misstatement at the assertion level (i.e., controls in the control activities component). However, controls relevant to the audit may also include controls in 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 21B.

A74. [MOVED to A109a]

A75-A76 [MOVED to A109e-A109f]

Components of the Entity's System of Internal Control (Ref: Para. 14-19A)

~~Components of Internal Control—~~Control Environment (Ref: Para. 14-14B)

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 internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A78. [MOVED to Appendix 3]

~~Audit Evidence for Elements of the Control Environment~~

A79. Relevant audit evidence for the auditor's understanding of the control environment 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, the auditor may obtain an understanding through inquiries of management and employees~~, the auditor may obtain an understanding~~ of how management communicates to employees its views on business practices and ethical behavior. The auditor may also ~~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. 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.

A80a. (previously 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.

Consequently, the nature and extent of risk assessment procedures to understand the control environment may be much less than that for a more complex entity. For example, if the role of governance is undertaken directly by the owner-manager, the auditor may determine that independence of those charged with governance is not relevant or applicable. Further, the organizational structure may be appropriately simple and include a small number of employees involved in roles related to financial reporting. ~~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.~~

A80b. (previously 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, smaller entities ~~might~~ may not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.

A80c. (previously 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.

A80d. The auditor's consideration of the entity's use of IT as it relates to the control environment may include such matters as:

- Whether governance over IT is commensurate with the nature and size of the entity and its business operations enabled by IT, 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, or for smaller entities, whether it may not be necessary to have employees with IT skills due to the entity's use of packaged software with no or limited modifications).
- The extent of change within the IT environment (for example, is the system new or have there been significant changes during the period).

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

A80e. (previously 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 identification and assessment of the risks of material misstatement. As further explained in paragraph A123, deficiencies in the control environment may lead to risks of material misstatement at the financial statement level, which may have implications for the audit, including.as explained in ISA 330, an influence on the nature, timing and extent of the auditor's further procedures.[21]

A81. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. ~~For example, a~~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

[21] ISA 330, paragraphs A2–A3

reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

- Their independence from management and their ability to evaluate the actions of management.
- Whether they understand the entity's business transactions.
- The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework, including whether the financial statements include adequate disclosures.

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. Overall, although the control environment that provides an appropriate foundation for the system of internal control may help reduce the risk of fraud, an appropriate control environment is not an absolute deterrent to fraud.(End of sentence moved from A83)

~~A83. The existence of a satisfactory 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 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.~~

A84. [MOVED TO A80e]

~~Considerations Specific to Smaller Entities~~

A85-A87 [MOVED to A80a-A80c]

~~*Components of Internal Control—*~~*The Entity's Risk Assessment Process* (Ref: Para. 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 determine~~s~~ the risks to be managed. (Rest of para moved to A89b.)

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

A88a. 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:

- Specified objectives with sufficient clarity to enable the identification and assessment of the risks relating to the objectives;
- Identified the risks to achieving the entity's objectives and analyzing the risks as a basis for determining how the risks should be managed;
- Considered the potential for fraud when considering the risks to achieving the entity's objectives; and

- Identified and assessed changes that could significantly affect the entity's system of internal control.

~~Considerations Specific to Smaller Entities (Ref: Para. 17)~~

A89. 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. ~~There is unlikely to be an established risk assessment process in a small entity.~~ 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 how management identifies of the need to hire personnel or seek expertise. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of ~~the circumstances, however~~ whether the risk assessment process is formally established or not, inquiry ~~about identified risks~~ and observation about how management identifies risks and how they are addressed ~~and~~ ~~how they are addressed by management~~ is still necessary to obtain an understanding.

A89a. 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 (including cybersecurity 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 environment or turnover of IT personnel.

Evaluating the Appropriateness of the Entity's Risk Assessment Process (Ref: Para. 17)

A89b. (previously part of A88) 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 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.

A89c. In making this evaluation, the auditor considers the appropriateness of the entity's risk assessment process as it relates to identifying and assessing business risks relevant to financial reporting that may give rise to risks of material misstatement in the financial statements. As explained in paragraph A38, not all business risks relevant to financial reporting give rise to risks of material misstatement.

A89d. 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, which may the case when the process has failed to identify a risk of material misstatement when it would be expected the risk assessment process would have identified the risk.

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

A89e. (previously A110) The entity's process to ~~M~~monitor the system of internal controls 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 evaluation activities, or some combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities. Separate activities are conducted periodically and will vary in scope and frequency depending on the assessment of the risks by the entity.

A89f. (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)

A89g. 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.

A89h. 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 in particularly highly complex and automated systems that:
  - o Evaluate the continuing design effectiveness of underlying controls and modify them, as appropriate, for changes in conditions; or
  - o Evaluate the operating effectiveness of underlying controls.
- Controls that monitor the permissions applied in automated application controls that enforce the segregation of duties.
- Controls that monitor how errors or control deficiencies related to the automation of financial reporting are identified and addressed.

A89i. 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.

~~Considerations Specific to Smaller Entities~~

A89j. (previously A112) In smaller entities, ~~M~~management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations and there may not be any other monitoring activities. This may be the case when the owner-manager's involvement ~~often~~ is how ~~will identify~~

significant variances from expectations and inaccuracies in financial data are identified. The owner-manager's actions and follow-up also may be how ~~leading to~~ remedial actions ~~to the control~~ are implemented. In such cases, the auditor's understanding of the process to monitor controls may be accomplished through inquiry of the owner-manager and employees about these activities and may also involve inspection or observation of related communications or other evidence of remedial actions.

A89k. For some larger entities, there may not be a distinct process for monitoring the system of internal control. In such cases, it may be difficult to distinguish between controls in the control activities component and monitoring activities. For example a supervisory review may not be considered a monitoring activity by the entity, but the review may have a role in monitoring the effectiveness of underlying controls. For such entities, understanding the process to monitor controls may include understanding periodic reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

A89l. Regardless of the size of the entity, there may be monitoring activities, such as management or supervisory reviews, 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. Such controls may also include certain activities performed by internal audit.

The Entity's Internal Audit Function (Ref: Para. ~~23~~ 17C)

A89m. (previously A113 and A116)) If the entity has an internal audit function, the auditor's understanding of the entity's process to monitor controls involves 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 internal audit function plays in the ~~entity's monitoring of internal control over financial reporting~~ process, through ~~T~~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. ~~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~~.

A89n. (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.

A89o. (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.

A89p. (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.

A89q. (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~~ 17D)

A89r. (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 IT; 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~~ to inform the auditor's understanding of the entity's process to monitor~~ing~~ ~~activities as a component~~ 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)

A90. The information system relevant to financial reporting ~~objectives, which includes the accounting system,~~ consists of the policies, procedures and records designed and established to:

- Initiate, record, process, and report entity transactions (as well as to capture, process and disclose information about events and conditions other than transactions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- ~~Transfer~~ Reflect information from transaction processing ~~systems~~ ~~to~~ in 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.

A90a. (previously A95) An entity's business processes 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.

A90b. (previously A62) The entity's information system relevant to financial reporting may include the use of manual ~~or~~ and automated elements ~~in internal control~~ that also affect~~s~~ the manner in which transactions are initiated, recorded, processed, and reported~~:~~. In particular, ~~Alternatively, an entity may use automated~~ procedures to initiate, record, process, and report transactions may be enforced through the IT applications used by the entity, and how the entity has configured those applications, in which case records in the form of digital information ~~electronic format~~ may replace or supplement records in the form of paper documents. (Ref: Para. 18(b))

A90c. (previously A96) The information system, and related business processes relevant to financial reporting in smaller 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. Smaller 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 to identify potential risks of material misstatement.

Significant classes of transactions, account balances and disclosures

A90d. (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. As risk identification and assessment is an iterative process, the auditor may use expectations formed in paragraph 11 about the 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 25B. For example, the auditor may have an expectation that certain significant classes of transactions related to revenue exist, but in obtaining the understanding about the information system, the auditor may identify additional classes of transactions related to revenue that may be 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.

Information obtained from outside of the general and subsidiary ledgers

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:
    - Assumptions developed internally that may affect an asset's useful life; or
    - Data such as interest rates that are affected by factors outside the control of the entity.
- Information disclosed in the financial statements about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.
- Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records.
- Information disclosed in the financial statements that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern.[22]

A92. [first sentences MOVED to A90b] ~~For example,~~ C~~c~~ertain amounts or disclosures in the entity's financial statements (such as disclosures about credit risk, liquidity risk, and market risk) may be based on information obtained from the entity's risk management system. However, the auditor is not required to understand all aspects of the risk management system, and uses professional judgment in determining the necessary understanding.

Understanding the entity's use of information technology in the information system (Ref: Para. 18(d))

A92a. The IT environment that supports the entity's information system relevant to financial reporting may include IT applications and databases (including data warehouses or report writers), as well as the related operating systems and network software that support those IT applications and databases. This understanding of the IT environment is used in the auditor's identification of risks arising from IT and determination of the general IT controls relevant to the audit in accordance with paragraphs 21 and 21A of this ISA. 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. In gaining this understanding, the aspects of the IT environment relevant to those flows may be identified concurrently. The auditor's understanding of the IT environment also includes IT-related aspects for the storage of accounting records, other supporting information and any other aspects that support the entity's financial reporting process.

A92b. 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 extent of automated procedures for processing, and the complexity of those procedures, including, whether there is highly automated, paperless processing.
- The extent of the entity's reliance on system-generated reports in the processing of information.
- How data is input (i.e., manual input, customer or vendor input, or file load).

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

- How IT facilitates communication within and across applications, databases or other aspects of the IT environment, internally and externally, as appropriate, through system interfaces.
- The volume and complexity of data in digital form being processed by the system,
- The IT environment, including IT applications and the underlying IT infrastructure, for example:
  - o The type of application (e.g., a packaged application with little or no customization, or a highly-customized or highly-integrated application that may have been purchased and customized, or developed in-house).
  - o The complexity of the nature of the IT applications and the underlying IT infrastructure.
  - o The complexity of the security over the IT environment, including vulnerability of the IT applications, databases, and other aspects of the IT environment to cyber security risks, particularly when there are web-based transactions or transactions initiated through external interfaces.
  - o The extent of change within the IT environment (e.g., new aspects of the IT environment or significant changes in the IT applications or the underlying IT infrastructure)
  - o Whether there is third-party hosting or outsourcing of IT.
- If there was major data conversion during the period, or the extent of changes made, and how this was undertaken.
- Whether program changes have been made to the manner in which information is processed, and the extent of such changes during the period.

A92c. Obtaining an understanding of the entity's IT environment may be simple for a small entity that uses packaged software and does not have access to the source code to make any program changes. In contrast, entities with complex IT environments may require greater effort to understand the extent of IT applications that are relevant to financial reporting, which may include IT applications in operations that may provide information to, or be integrated with, the financial reporting applications. The complexity of the underlying IT infrastructure, including the network and operating systems, and how access has been configured through the network to the IT applications may also contribute to risks arising from IT. [*This paragraph subject to further Task Force consideration and enhancements prior to June 2018*]

A93-A94. [MOVED to A100f and A100g]

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

A95. [MOVED to A90a]

~~Considerations specific to smaller entities (Ref: Para. 18)~~

A96. [MOVED to A90c]

Evaluating the Design of the Information System and Whether It Has Been Placed into Operation (Ref: Para 18A)

A96a. The auditor's understanding of the design of the information system required by paragraphs 18(a)–(d) 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.

A96b. These risk assessment procedures may also be used by the auditor to evaluate the design of the information system and determine whether it has been placed into operation. In addition, the auditor may select transactions and perform walk-throughs of the relevant processes or procedures. The auditor may also use automated techniques by obtaining direct access to, or an digital download from, the databases in the entity's information system that store the accounting records of transactions. Using this information, the auditor may confirm the understanding obtained about how transactions flow through the information system by tracing journal entries or other digital records related to a particular transaction, or an entire population of transactions, from initiation in the accounting records through to recording in the general ledger. Analysis of complete or large sets of transactions may also result in the identification of variations from the normal, or expected, processing procedures for these transactions, which may result in the identification of additional potential risks of material misstatement related to non-standard procedures.

A96c. Regardless of the techniques used to evaluate the design of the information system and determine whether it has been implemented, the auditor's analysis as part of these procedures of the sources of data, and the IT applications involved in processing that data, can also assist in identifying the IT applications and other matters relevant to IT set out in paragraph A92b.

A96d. When the auditor has identified controls over the information system as relevant to the audit in accordance with paragraph 20, the auditor may evaluate the design of those controls and determine whether they are implemented, as required by paragraph 21B, together with the procedures performed to evaluate the design of the information system and whether it has been placed into operation. For example, the auditor may perform a walk-through of a transaction to confirm the flow of transactions relevant to the transaction and at the same time, evaluate the design and implementation of controls relevant to the audit that relate to that class of transactions, such as those related to approvals or reconciliations.

Communication (Ref: Para. 19)

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 the system of internal control ~~over~~ relevant to 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, particularly in larger entities. (previously A98) Communication may be less structured (e.g., formal manuals may not be necessary) and easier to achieve in a smaller entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability. Regardless of the size of the entity, ~~O~~open communication channels help ensure that exceptions are reported and acted on.

~~Considerations specific to smaller entities~~

A98. [MOVED to A97]

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

A99. Controls in 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. Such c~~C~~ontrols ~~activities~~, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of ~~specific~~ types of controls in the control activities component include those relating to the following:

- Application controls and general IT controls.
- Authorization and approvals.
- ~~Performance reviews.~~
- ~~Information processing.~~
- Physical controls, including those addressing security of assets; and physical counts or reconciliations of assets with accounting records.
- Segregation of duties.

A99a. (previously A105) ~~The concepts underlying~~ C~~c~~ontrols ~~activities~~ in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of controls ~~activities~~ ~~are not relevant~~ do not exist because of controls directly applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed application controls ~~activities~~.

A99b. The extent to which the auditor obtains an understanding of the controls in the control activities component varies based on the extent to which such controls are determined to be relevant to the audit. The auditor addresses the requirements in paragraphs 20 through 21A to determine the controls that are relevant to audit, which may include a combination of the types of controls above.

A99c. (previously A109 and A62). Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These application controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry. These controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.

A99d. Some individual controls may consist of both automated and manual aspects, such as controls that ~~Further, manual controls may be independent of IT,~~ may use information produced by IT (e.g., an exception report) that is subject to manual procedures (e.g., review and follow-up)~~. or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions.~~ Such controls may be referred to as IT-dependent manual controls. ~~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 or may be critical to the effective functioning of manual controls that depend on IT.~~ For many entities, most controls may be either automated controls or IT-dependent manual controls because of the extent of use of IT applications for financial reporting purposes. In some cases, authorizations, approvals and the preparation of reconciliations may involve the use of technology-enabled workflow or use of supporting records in digital form.

A99e. (previously A103) Controls in the control ~~activities~~ component ~~relevant to the audit~~ may include controls established by management that address risks of material misstatement related to disclosures not being prepared in accordance with the applicable financial reporting framework, Such controls ~~activities~~ may relate to information included in the financial statements that is obtained from outside of the general and subsidiary ledgers.

A99f. The greater the extent of automated controls or IT-dependent manual controls that management uses and relies on in relation to its financial reporting, the more important it may become for the entity to implement general IT controls that address the continued functioning of the automated aspects of application controls.

A99g. (previously A71) ~~Internal control over safeguarding~~ Physical controls include those that address security of assets against unauthorized acquisition, use, or disposal and may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is ~~generally~~ limited to those relevant to ~~the reliability of~~ financial reporting.

A99h. When the entity does not have appropriate segregation of duties in the procedures implemented by the entity to initiate, record, process and correct, as necessary, the information related to transactions, this may affect the auditor's identification of risks of material misstatement at the assertion level in relation 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.

A99i. (previously A57) Smaller entities ~~often~~ that have fewer employees ~~which~~ may be limited in 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, although it may introduce risks of material misstatement related to the opportunity for management override of controls.

Controls Relevant to the Audit (Ref: Para 20-21B)

Determining Controls Relevant to the Audit (Ref: Para 20)

A100. ~~Control activities that are relevant to the audit are:~~

- ~~Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30, respectively; or~~
- ~~Those that are considered to be relevant in the judgment of the auditor.~~

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 (i.e., indirect controls) 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. (from previous A102) However, w~~W~~hen multiple controls ~~activities~~ each achieve the same objective, it is unnecessary to ~~obtain an understanding of~~ identify each of the controls ~~activities~~ related to such objective.

Controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (Ref: Para.20(a))

A100a. The auditor determines whether there are any risks of material misstatement at the assertion level for which it is not possible or practicable to obtain sufficient appropriate audit evidence in accordance with paragraph 30. The auditor is required, in accordance with ISA 330,[23] to design and perform tests of relevant controls when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. As a result, controls that address these risks are required to be relevant to the audit.

~~Understanding~~ Controls ~~Related to~~ that address ~~S~~significant ~~R~~risks (Ref: Para. 2~~9~~0(b))

A100b. The auditor determines whether any assessed inherent risks at the assertion level are significant risks in accordance with paragraph 27. Significant risks are those that exist at the highest end of the spectrum of inherent risk and therefore are those assessed inherent risks that require the most persuasive audit evidence in accordance with ISA 330.[24] Paragraph 20 requires that the auditor identify controls over significant risks as relevant to the audit. The risk assessment procedures performed to understand these controls in accordance with paragraph 21B contribute to the audit evidence related to the significant risk. Regardless of whether the auditor intends to test the operating effectiveness of controls over significant risks, the understanding obtained about management's approach to addressing those risks may inform the design and performance of substantive procedures responsive to significant risks as required by ISA 330.[25]

A100c. (previously A145) Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

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

[*Paragraph to be subject to further enhancements with coordination with ISA 540 TF*]

A100d. (previously A146) For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A100e. (previously A147) In some cases, management may not have appropriately responded to significant risks ~~of material misstatement~~ by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant deficiency in internal control.[26]

Controls over ~~J~~journal entries (Ref: Para. ~~18(f)~~ 20(c))

A100f. (previously A93) An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases,

[23] ISA 330, paragraph 8

[24] ISA 330, paragraph 7(b)

[25] ISA 330, paragraph 21

[26] ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph A7

and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A100g. (previously A94) An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of ~~computer-assisted audit~~ automated techniques. For example, applying automated techniques to analyze a full set of journal entries within a general ledger may assist in understanding the nature and extent of journal entries made, which account balances are subject to standard or non-standard journal entries and which entity personnel made or authorized the journal entries. These techniques can be accompanied by inquiries of management or inspection of supporting documentation for journal entries to identify the controls the entity has implemented over journal entries.

Other controls relevant to the audit (Ref: Para. 20(d-e))

A100h. (previously A104). It is a matter of the auditor's judgment the extent to which other controls are identified as relevant to the audit. The auditor's knowledge about the presence or absence of controls ~~activities~~ obtained from the understanding of the other components of internal control assists the auditor in determining whether it is ~~necessary~~ appropriate to devote additional attention to ~~obtaining an~~ understanding ~~of~~ controls ~~activities~~ to provide a basis for the design and performance of further audit procedures.

A101. The auditor's judgment about whether a control ~~activity~~ is relevant to the audit is influenced by:

- The identification of risks of material misstatement and the related assessments of inherent risk at the assertion level ~~the risk that the auditor has identified that may give rise to a material misstatement~~; and
- W~~w~~hether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

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

A101a. When the auditor intends to take into account the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures, such controls are required to be identified as relevant to the audit because ISA 330[27] requires the auditor to design and perform tests of those controls. For many audits, the auditor may plan to test controls over routine classes of transactions because such testing may be more effective or efficient for large volumes of homogenous transactions.

A102. The auditor's emphasis may be on identifying ~~and obtaining an understanding of~~ controls ~~activities~~ that address the ~~areas~~ assertions for which ~~where~~ ~~the auditor considers that~~ the assessed inherent risks of material misstatement are, or are likely to be, higher because ISA 330 requires more persuasive audit evidence the higher the auditor's assessment of risk. Regardless of whether the audit plans to test the operating effectiveness of controls, the auditor may identify certain controls relevant to the audit related to higher risks because the auditor may determine that the auditor does not have enough audit evidence from the other risk assessment procedures performed to be able to identify and assess the risks of material misstatement in relation to certain assertions or to design further audit procedures responsive to the assessed risks.

[27] ISA 330, paragraph 8(a)

A102a. (previously 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 and the auditor intends to test controls over such data in determining its reliability for use as audit evidence.

A103. [MOVED to A99e]

A104. [MOVED to A100h]

~~Considerations Specific to Smaller Entities~~

A105. [MOVED to A99a]

~~A106. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.~~

Risks Arising from IT (Ref: Para. 21)

A106a (previously A64) IT ~~also~~ poses specific risks to an entity's system of internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

Specific IT risks related to the above may result when the entity outsources uses third-party hosting for aspects of its IT environment. IT risks may also increase with the volume or complexity of automated application controls and based on the extent to which management is relying on those controls for effective processing of transactions.

A106b. (previously A67) The extent and nature of the risks arising from IT ~~to internal control~~ vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT~~,~~ or from use of manual elements~~,~~ in its system of internal control by establishing effective controls in light of the characteristics of the entity's information system.

A106c. The auditor's required understanding for the entity's use of IT in the system of internal control, including the about the matters in A92b related to the information system, may assist in the identification of the nature and extent of risks arising from the entity's use of IT.

[*Further enhancements to this application material to be considered by the Task Force for June 2018 subject to Board views on related requirement*.]

General IT Controls Relevant to the Audit (Ref: Para. 21A)

~~A107. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT controls and application controls.~~

~~A108. General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:~~

- ~~Data center and network operations.~~
- ~~System software acquisition, change and maintenance.~~
- ~~Program change.~~
- ~~Access security.~~
- ~~Application system acquisition, development, and maintenance.~~

~~They are~~ General IT controls are generally implemented to deal with the risks referred to in paragraph A106a-b above. Accordingly, the auditor uses the understanding obtained about the risks arising from IT in determining the general IT controls relevant to the audit.

[PLACEHOLDER for specific guidance here on GITC identification including how GITCs may exist at various levels (application, network, operating system, etc.). This will explain how IT risks drive the determination of which aspects of IT environment GITCs may be relevant – taking into account the factors in 21A(a-d). And then for those aspects determined to be "in-scope" for GITCs, how the auditor determines the nature and extent of GITCs relevant to the audit (program change, access, etc.. This guidance will be developed by the Task Force for June 2018 with the assistance of an IT audit specialist]

A109. [MOVED to A99c]

Evaluating the Design, and Determining Implementation of, Controls Relevant to the Audit (Ref: Para 21B)

A109a. (previously 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 designed effectively, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.

A109b. (previously 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. The auditor is required to relate controls relevant to the audit to their potential respective risks of material misstatement at the assertion level so that the auditor may evaluate whether, and the extent to which, a control is appropriately designed to address the related potential risk(s) of material misstatement. 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. In many cases, an individual control may not in itself address a potential risk of material misstatement. Often, only multiple controls activities, together with other components of internal control, will be sufficient to address a potential risk of material misstatement.

A109c. (previously A138) Conversely, some controls ~~activities~~ may have a specific effect on an individual assertion embodied in a particular significant class of transactions or account balance. For example, the controls ~~activities~~ that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the potential risks of material misstatement relevant to the existence and completeness assertions for the inventory account balance.

A109d. (previously A139) Controls can be either directly or indirectly related to a~~n~~ potential risks of material misstatement at the assertion level. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements ~~in~~ related to 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 potential risks of material misstatement relevant to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing those risks ~~for that assertion~~ than controls more directly related to ~~that assertion~~those risks, such as matching shipping documents with billing documents.

A109e. (previously A75). Risk assessment procedures to obtain audit evidence about the design and implementation of ~~relevant~~ controls relevant to the audit may include:

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- ~~Tracing transactions through the information system relevant to financial reporting.~~

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

A109f. (previously A76). ~~Obtaining an understanding of an entity's controls~~ Evaluating the design and determining the implementation of controls relevant to the audit is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A63), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of the general IT controls ~~such as those~~ over program changes to the relevant IT application or other aspect of the entity's IT environment in which the automated control resides. Tests of the operating effectiveness of controls are further described in ISA 330.[28]

A109g. Notwithstanding that the risk assessment procedures to obtain audit evidence about the design and implementation of controls relevant to the audit are ordinarily not sufficient to test the operating effectiveness of controls and thus assess control risk below the maximum, these procedures provide information important to the auditor's identification and assessment of the risks of material misstatement, and to the design of further audit procedures. In addition to contributing toward the auditor's understanding of the components of the entity's system of internal control, the results of these procedures may:

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

[28] ISA 330, *Paragraphs 8–11*

For example, the results of these procedures may inform the auditor's consideration of possible deviations in a population when designing audit samples.

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

A110-A111 [MOVED to A89e and A89f]

A112 [MOVED to A89j]

A113 and A116 [MOVED to A89m]

A114 and A115 [MOVED to Appendix 3]

A117 through A121 [MOVED to A89n-A89r]

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

A121a. (previously A132) Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls relevant to the audit and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing and extent of further audit procedures to be performed. In identifying and assessing the risks of material misstatement in the financial statements, the auditor exercises professional skepticism in accordance with ISA 200.[29]

The Use of Assertions

~~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.~~

A121b.(previously A128) In identifying and assessing the risks of material misstatement, ~~T~~the auditor may use the assertions as described in paragraph A121c(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.

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

A121c. (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:

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

(ii) Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

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

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

(iv) Cutoff—transactions and events have been recorded in the correct accounting period.

(v) Classification—transactions and events have been recorded in the proper accounts.

(vi) Presentation—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

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

(i) Existence—assets, liabilities, and equity interests exist.

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

(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

(iv) Accuracy, valuation and allocation—assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

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

(vi) Presentation—assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

~~Assertions about other disclosures~~

A121d. (previously A130) The assertions described in paragraph A121c (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

A121e. (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.

<u>*Identifying Potential Risks of Material Misstatement* (Ref: Para. 25A)</u>

<u>A121f. Potential risks of material misstatement are identified by the auditor throughout the auditor's risk assessment procedures to obtain an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control.</u>

<u>A121g. While gaining the understanding of the entity and its environment and how the applicable financial reporting framework applies in the context of the nature and circumstances of the entity in accordance with paragraph 11, the auditor considers the characteristics of events and conditions (i.e., the inherent risk factors) that give rise to, or</u>

affect the classes of transactions, account balances and disclosures to be expected in the financial statements. Understanding how the inherent risk factors affect the classes of transactions, account balances and disclosures enables the auditor to consider which assertions about which classes of transactions, account balances or disclosures may be subject to potential risks of material misstatement (refer to A24a).

A121h. (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~~ sets out examples, in the context of the inherent risk factors, of events and conditions that that may indicate risks of material misstatement.

A121i. The auditor's understanding of the system of internal control assists in confirming the auditor's initial identification of potential risks of material misstatement and may result in the identification of additional potential risks of material misstatement. In particular, the auditor's understanding of the information system involves using the auditor's expectations about the classes of transactions, account balances and disclosures that may be significant to understand the underlying related flows of information that result in the reporting of transactions and information about events or conditions in the financial statements. In obtaining this understanding, the auditor may identify additional potential risks of material misstatement related to the expected significant classes of transactions, account balances or disclosures, or the auditor's procedures may reveal new potential risks of material misstatement that update the auditor's initial identification of classes of transactions, account balances and disclosures that may be significant (see paragraph A90d).

Identifying Risks of Material Misstatement and Significant Classes of Transactions, Account Balances and Disclosures, and their Relevant Assertions (Ref: Para. 25B)

A121j The auditor considers the likelihood that a misstatement(s) will occur, and if so, the magnitude of a possible misstatement(s) in relation to the potential risks of material misstatement in order to identify the risks of material misstatement. The degree to which the susceptibility to misstatement is subject to, or affected by, the inherent risk factors reflects the influence those factors have on the likelihood and magnitude considerations for the potential risks of material misstatement.

A121k. (Previously A139) Misstatements in individual statements and disclosures may be judged to be material due to size, nature or circumstances.

A121l. For an identified risk of material misstatement, the auditor considers the extent of assertions that it may affect to enable the determination of the risks of material misstatement at the financial statement level. Identified risks of material misstatements that do not relate more pervasively to the financial statements and affect many assertions are risks of material misstatement at the assertion level.

A121m. The auditor identifies the significant classes of transactions, account balances and disclosures by determining which of their related assertions have a reasonable possibility of being subject to a misstatement that is material, individually or in combination with other misstatements (i.e., a significant class of transactions, account balance or disclosure is one for which there is at least one relevant assertion). When there is a remote possibility of a material misstatement with respect to an assertion, the assertion is not relevant. In determining the relevant assertions, the auditor considers the information gathered from the auditor's risk assessment procedures about the identified risks of material misstatement and the assertions that they may affect.

~~Assessment~~ Identification of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 25B(b)(i))

A122. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole, and may ~~and~~ potentially affect many or all assertions. Risks of this nature ~~are not necessarily risks~~ may not be identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level. Risks of material misstatement due to fraud may be especially relevant to the auditor's consideration of the risks of material misstatement at the financial statement level. For example, the risk of management override of internal control may pervasively affect the risk of material misstatement at the assertion level, although the auditor may consider particular assertions to have a greater potential for misstatement based on greater susceptibility to management bias. ~~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.~~

A122a. Circumstances in which risks of material misstatement may be identified at the financial statement level due to their effect on a number of assertions (but not necessarily all assertions) may include, for example:

- A lack of management competence in preparing complex accounting estimates that affect assertions related to several significant accounting estimates.
- Changes in IT applications that affect processing of routine transactions, which in turn affects assertions related to many classes of transactions.

A123. Risks at the financial statement level may derive in particular from a deficient control environment (although these risks may also relate to other ~~factors~~ circumstances, 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 ~~For example, deficiencies (~~such as a 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~~ have been identified, this may have implications for the auditor's identification of the risks of material misstatement at the financial statement level.

A124. The auditor's understanding of the control environment and other components of the system of internal control may raise doubts about the auditability of an entity's financial statements, such that it may affect the auditor's opinion or be cause for withdrawal from the engagement. For example:

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

A125. ISA 705 (Revised)[30] 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.

Identifying Significant Disclosures (paragraph 25B(c))

A125a. (previously A135) The auditor's ~~consideration~~ identification of significant disclosures ~~in the financial statements~~ includes both quantitative and qualitative disclosures, ~~the misstatement of which could be material~~ for which there is more than one relevant assertion ~~(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).~~ Depending on the circumstances of the entity and the engagement, examples of

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

disclosures that will have qualitative aspects and that may be significant ~~relevant when assessing the risks of material misstatement~~ include disclosures about:

- Liquidity and debt covenants of an entity in financial distress.
- Events or circumstances that have led to the recognition of an impairment loss.
- Key sources of estimation uncertainty, including assumptions about the future.
- The nature of a change in accounting policy, and other relevant disclosures required by the applicable financial reporting framework, where, for example, new financial reporting requirements are expected to have a significant impact on the financial position and financial performance of the entity.
- Share-based payment arrangements, including information about how any amounts recognized were determined, and other relevant disclosures.
- Related parties, and related party transactions.
- Sensitivity analysis, including the effects of changes in assumptions used in the entity's valuation techniques intended to enable users to understand the underlying measurement uncertainty of a recorded or disclosed amount.

Assessing~~ment~~ ~~of~~ Inherent Risk~~s of Material Misstatement~~ at the Assertion Level (Ref: Para. 26~~5(b)~~)

Assessing the Likelihood and Magnitude of Material Misstatement (Ref: Para: 26(a))

A125b. The degree to which events or conditions relating to significant classes of transactions, account balances and disclosures are subject to, or affected by, the inherent risk factors affects the degree to which such events and conditions are susceptible to misstatement. The effect of the inherent risk factors therefore has an influence on the auditor's assessment of the likelihood and magnitude of material misstatement for the identified risks of material misstatement at the assertion level. It is likely that the higher the extent of the effect of the inherent risk factors, the higher the inherent risk.

A125c. The relative degrees of the likelihood and magnitude of a possible misstatement, determine where on the spectrum of inherent risk the risk of material misstatement exists. 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. However, determining how the likelihood and potential magnitude of a possible misstatement affects the auditor's assessment of inherent risk is a matter of the auditor's professional judgment, for example where there is a low likelihood but higher magnitude of misstatement. Significant risks, which are identified in accordance with paragraph 27, are those at the highest end of the spectrum of inherent risk relative to other risks of material misstatement in a particular audit.

A125d. For many audits, the assessment of the individual risks of material misstatement may result in the determination that the risks exist at various points along the spectrum of inherent risk (i.e., dispersed throughout the spectrum from the low end to the highest end). The assessment of individual risks in relation to audits of smaller, non-complex entities may be such that a greater proportion of risks are assessed at the lower end of the spectrum of inherent risk.

A125e. In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may designate risks of material misstatement within relative categories along the spectrum of inherent risk, based on their assessment of inherent risk. These relative categories may be described in different ways, for example numerical categorizations may be used (e.g., on a scale of one to ten), or the relative placement on the spectrum of risk may be described (e.g., high, medium, low). However the auditor does so, the auditor's 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 the reasons for the auditor's inherent risk assessments.

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 ~~identifying and~~ assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks of material misstatement at the assertion level relate more pervasively to the financial statements as a whole and potentially affect many assertions, in which case the auditor may update the identification of risks of material misstatement at the financial statement level.

Evaluating the Effect of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 26(b))

A126a. Paragraph 25B(b)(i) requires the auditor to identify risks of material misstatement at the financial statement level by determining the extent to which the identified risks of material misstatement relate more pervasively to the financial statements as a whole and affect many assertions. This determination assists the auditor in considering the effect of the identified risks of material misstatement at the financial statement level on the risks of material misstatement at the assertion level. In circumstances in which risks of material misstatement may be identified at the financial statement level due to their effect on a number of assertions (but not necessarily all assertions), the auditor evaluates that effect on the relevant assertions in assessing the risks of material misstatement at the assertion level.

A126b. Risks of material misstatement that are not identifiable with specific assertions at the class of transactions, account balance, or disclosure level may pervasively increase the risks of material misstatement at the assertion level. For these risks, it may not be possible to determine specific assertions that may be more susceptible to the risk (e.g., risk of management override of controls).

A126c. ISA 330[31] requires the auditor to design and implement overall responses to address risks of material misstatement at the financial statement level. [*Guidance developed by ISA 315 TF to be further considered in context of ISA 330 A1-A3 guidance.*] Examples of such overall responses may include:

- Changes 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.
- Changes to the audit overall strategy as required by ISA 300 or planned audit procedures in accordance with ISA 330, 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.
    - Changes to 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.]

31 ISA 330, paragraph 5

A127-A131 [MOVED to A121b-A121e]

~~*Process of Identifying Risks of Material Misstatement*~~

A132. [MOVED to A121a]

A133. [MOVED to A121h]

A134. [MOVED to paragraph A150e]

A135 [MOVED to A125a]

A136. [MOVED TO A49c]

A137-A139 [MOVED TO A109b-A109d]

~~*Material Misstatements*~~

A139. [Moved to A121k]

~~*Significant Risks*~~

~~Identifying~~ *Significant Risks* (Ref: Para. 27~~28~~)

A140. ~~Significant risks often relate to 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. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.~~ ~~.~~ In determining significant risks, the auditor may first identify those assessed inherent risks that have been assessed at the higher end of the spectrum of inherent risk. The determination of which of the assessed inherent risks are at the highest end of the spectrum of inherent risk, and are therefore significant risks, is a matter of professional judgment, unless the risk is of a type specified to be treated as a significant risk in accordance with the requirements of another ISA (see paragraph A144). Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because these are likely to give rise to risks of material misstatement at the assertion level that are assessed as lower on the spectrum of inherent risk. However, (Previously A141) ~~R~~risks of material misstatement that may be assessed as having higher inherent risk ~~greater for significant non-routine transactions,~~ and may therefore be assessed as significant risks, may aris~~e~~ing from matters such as the following:

- ~~Greater management intervention to specify the accounting treatment.~~
- Transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved.
- Estimates that have high estimation uncertainty or complex models.
- Complexity ~~Greater manual intervention for~~ in data collection and processing to support account balances.
- Account balances or quantitative disclosures that involve complex calculations ~~and~~
- (from A142) Accounting principles that may be subject to differing interpretation.
- Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions.
- ~~The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over risks.~~

A141. [Moved to A140]

~~A142. 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.~~

A143. [Moved to paragraph 144a]

~~Significant risks relating to the risks of material misstatement due to fraud~~

A144. <u>Significant risks include those risks of material misstatement that are treated as significant in accordance with the requirements of other ISAs.</u> ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.[32]

<u>Implications for the audit</u>

A144a. (Previously paragraph A143) ISA 330 describes the consequences for further audit procedures of identifying a risk as significant.<u> When a risk is assessed as a significant risk, the implications for the audit include the design and implementation of an appropriate response to address the assessed risk, which may include for example the use of more experienced team members, including those with specialized skills, to perform audit procedures or audit work may involve the use of experts. In addition, the ISAs set out required responses, including:</u>

- <u>Controls that address significant risks are required to be identified relevant to the audit in accordance with paragraph 20.</u>
- <u>Paragraphs 15 and 21 of ISA 330 respectively require controls that address significant risks to be tested in the current period (when the auditor intends to rely on the operating effectiveness of such controls) and substantive procedures to be planned and performed that are specifically responsive to the identified significant risk.[33]</u>
- <u>Paragraph 7 of ISA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk.</u>
- <u>Paragraph 15 of ISA 260 (Revised) requires communicating with those charged with governance about the significant risks identified by the auditor.</u>
- <u>Paragraph 9 of ISA 701 requires the auditor to take into account significant risks when determining those matters that required significant auditor attention, which are matters that may be key audit matters.</u>
- <u>The engagement partner review of audit documentation allows significant matters, including significant risks, to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report.[34]</u>
- <u>When an engagement quality control review is performed, the reviewer is required to perform an objective evaluation of significant judgments made by the engagement team, which includes significant judgments</u>

[32] ISA 240, paragraphs 25–27

[33] ISA 330, paragraphs 15 and 21

[34] ISA 220, paragraph 17 and A18

in relation to significant risks.[35] That the engagement partner is required to review, in particular on judgments in relation to significant risks.

- Paragraphs 30 and 31 of ISA 600 require more involvement by the group engagement partner if the significant risk relates to a component in a group audit and for the group engagement team to direct the work required at the component by the component auditor.

A145-A147 [MOVED to A100c-A100e]

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

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.

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.
- 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.

A149a. [*PLACEHOLDER for example of an estimate that would give rise to a risk for which substantive procedures alone do not provide sufficient appropriate audit evidence – to be coordinated with ISA 540 Task Force]*

A150. Paragraph 20 requires the identification of controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence to be relevant to the audit because the auditor is required, in accordance with ISA 330[36], to design and perform tests of relevant controls when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. ~~The consequences for further audit procedures of identifying such risks are described in ISA 330.~~

Assessing Control Risk (Ref: Para. 30A)

A150a. The control risk assessment remains at the maximum level when the auditor does not intend to test the operating effectiveness of controls that address the assessed inherent risks. The required understanding of the entity's system of internal control and identification of controls relevant to the audit as required by paragraphs 11 to 21B, informs the auditor's intentions as to whether to perform tests of the operating effectiveness of controls.

A150b. When the auditor intends to test the operating effectiveness of controls (based on the auditor's evaluation of the design effectiveness and implementation of the controls set out in paragraph 21B), the auditor takes into account the expectation of the operating effectiveness of the controls when assessing control risk. In doing so, the auditor

[35] ISA 220, paragraph 20

[36] ISA 330, paragraph 8

is required to consider the extent to which the controls address the related assessed inherent risks. In many cases, only multiple controls will be sufficient to address assessed inherent risks.

A150c. The auditor's control risk assessment may be expressed using categorizations (for example, maximum, moderate, minimum) or can be expressed in terms how effective the control(s) is in addressing the identified risk.

A150d. The assessment of control risk takes into account the auditor's planned tests of the operating effectiveness of controls relevant to the audit, including general IT controls. For application controls for which the auditor plans to test their operating effectiveness as determined in accordance with paragraph 20, the auditor may identify related general IT controls as relevant to the audit in accordance with paragraph 21A. When the auditor plans to test the operating effectiveness of an automated application control, for example, the auditor may also test the relevant general IT controls that support the continued functioning of that application control to provide a basis for the auditor's expectation that the application control operated effectively throughout the period. When the auditor does not plan to test the operating effectiveness of the general IT controls related to the application control or expects such general IT controls to be ineffective, this may affect the auditor's assessment of control risk at the assertion level. This may be the case when the auditor determines a general IT control to be ineffective and this affects the extent of the operating effectiveness of the application control (i.e., the application control may address the related assessed inherent risks to a lesser extent than originally expected). Further, the auditor may need to design and perform substantive procedures to address the extent of risk resulting from the ineffective application or general IT controls.

Classes of Transactions, Account Balances and Disclosures that are Not Significant, but are Material (Ref: Para. 30B)

A150e. *(Previously A134)* As explained in ISA 320,[37] 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.[38] Classes of transactions, account balances or disclosures are quantitatively or qualitatively material if omitting, misstating or obscuring it could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

A150f. When a class of transactions, account balance or disclosure is determined to be significant as required by paragraph 25B(c), the class of transactions, account balance or disclosure is deemed to be material because there is a risk of material misstatement therein.[39] There may also be classes of transactions, account balances or disclosures that are quantitatively or qualitatively material but have not been determined to be significant (i.e., there are no relevant assertions identified). For example, an asset with a recorded value of greater than performance materiality may not be affected significantly by any 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. Accordingly, none of the assertions would deemed to be a relevant assertion and the asset would not be identified as a significant account balance.

A150g. The auditor may also use automated techniques to confirm whether all significant classes of transactions and account balances have been identified by, for example, analyzing types of transactions and their volume. By applying automated techniques, the auditor may, for example identify that an account with a zero balance at period end actually was comprised of numerous offsetting transactions and journal entries occurring during the

[37] ISA 320, paragraph A1

[38] ISA 320, paragraph 4

[39] Paragraph 4(cc)

period thus indicating that the account balance or class of transactions may be significant (e.g., a "loan processing suspense" account in a financial institution entity).

A150h. Before planning further audit procedures to address the assessed risks of material misstatement in accordance with ISA 330, the auditor is required to reconsider whether material classes of transactions, account balances or disclosures are significant. Audit procedures to address classes of transactions, account balances or disclosures that are quantitatively or qualitatively material but are not determined to be significant are addressed in ISA 330.[40]

Revision of Risk Assessment (Ref: Para. 31)

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~~ Paragraphs 16 and 17 of ISA 330 ~~for~~ provide further guidance about evaluating the operating effectiveness of controls.

Documentation (Ref: Para. 32)

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.[41] 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.[42] The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its system of internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A153. For entities that have ~~uncomplicated~~ non-complex 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.

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.

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

[40] ISA 330, paragraph 18

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

[42] ISA 330, paragraph 28

Appendix 1

(Ref: Para. 11(a)(i), A31c)

Considerations for Understanding the Entity and its Business Model

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

Activities of the Entity

1. (previously A32) Examples of matters that the auditor may consider when obtaining an understanding of the ~~nature~~ activities of the entity (included in the entity's business model) include:

   (a) Business operations such as:

   - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
   - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
   - Alliances, joint ventures, and outsourcing activities.
   - Geographic dispersion and industry segmentation.
   - Location of production facilities, warehouses, and offices, and location and quantities of inventories.
   - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post-employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
   - Research and development activities and expenditures.
   - Transactions with related parties.

   (b) Investments and investment activities such as:

   - Planned or recently executed acquisitions or divestitures.
   - Investments and dispositions of securities and loans.
   - Capital investment activities.
   - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.

   (c) Financing and financing activities such as:

   - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.

- ○ Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
- ○ Beneficial owners (local, foreign, business reputation and experience) and related parties.
- ○ Use of derivative financial instruments.

Nature of Special-Purpose Entities

2. (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.[43]

3. (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.

[43] ISA 550, paragraph A7

Appendix 2

(Ref: Para. A38a, A49d, ~~A41, A133~~)

~~Conditions and~~ Events and Conditions That May Indicate Risks of Material Misstatement

In obtaining the understanding of the entity and its environment and the applicable financial reporting framework in accordance with paragraph 11, the auditor considers whether and, if so, how events and conditions are affected by, or subject to, the inherent risk factors.

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

Complexity:

Regulatory:

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

Business model:

- The existence of complex alliances and joint ventures.

Applicable financial reporting framework:

- Accounting measurements that involve complex processes.

Transactions:

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

Subjectivity:

Applicable financial reporting framework:

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

Change:

Economic conditions:

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

Markets:

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

Customer loss:

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

Industry model:

- Changes in the industry in which the entity operates.

Business model:

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

Geography:

- Expanding into new locations.

Entity structure:

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

Human resources competence:

- Changes in key personnel including departure of key executives.

IT:

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

Applicable financial reporting framework:

- Application of new accounting pronouncements.

Uncertainty:

Reporting:

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

Susceptibility to management bias:

Reporting:

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

Transactions:

- Significant transactions with related parties.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.

- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.

<u>Other inherent risk factors:</u>

<u>Stress:</u>

<u>IT:</u>

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

<u>Other events or conditions that may indicate risks of material misstatement at the financial statement level:</u>

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

Appendix ~~1~~3

(Ref: Para. 4(c), 14–24, A77–A121)

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

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

Components of Internal Control

Control Environment

2. The control environment encompasses the following elements:

    (a) *How the entity demonstrates a commitment to ~~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 or codes of conduct, how they are communicated (e.g., through policy statements), and how they are reinforced in practice (e.g., through~~. 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.~~

    (b) *How ~~Participation by~~ those charged with governance demonstrate independence from management and exercise oversight of the entity's system of internal control*. An entity's control consciousness is influenced significantly by those charged with governance. Considerations include whether there are sufficient individuals who are independent from management and objective in their evaluations and decision-making; how those charged with governance identify and accept oversight responsibilities and whether those charged with governance retain oversight responsibility for management's design, implementation and conduct of the entity's system of internal control. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures ~~and the process for reviewing the effectiveness of the entity's internal control~~.

    (c) *How the entity has established, with oversight from those charged with governance, structures, reporting lines, and appropriate authorities and responsibilities in pursuit of its objectives.* This includes considerations about:

        - Key areas of authority and responsibility and appropriate lines of reporting;

- Policies relating to appropriate business practices, knowledge and experience of key personnel, and resource provided for carrying out duties; and
- Policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

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

(d) *How the entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with its objectives.* This includes how the entity ensures the individuals have the knowledge and skills necessary to accomplish the tasks that define the individual's job, such as

- Standards for recruiting the most qualified individuals – with an emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior.
- Training policies that communicate prospective roles and responsibilities, including practices such as training schools and seminars that illustrate expected levels of performance and behavior; and
- Periodic performance appraisals driving promotions that demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

~~(c) *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) *How the entity holds individuals accountable for their internal control responsibilities in pursuit of its objectives.* This may be accomplished through, for example:

- Mechanisms to communicate and hold individuals accountable for performance of internal control responsibilities and implement corrective actions as necessary;
- Establishing performance measures, incentives and rewards for those responsible for internal control, including how the measures are evaluated and maintain their relevance;
- How pressures associated with the achievement of internal control objectives impact the individual's responsibilities and performance measures; and
- How the individuals are disciplined as necessary.

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

~~(d) *Organizational structure*. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting.[last sentence moved up]~~

~~(e) *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.~~

~~(f) *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

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.

4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial 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.

The Entity's Process to Monitori~~ng~~ the System of Internal Control~~s~~

5. (previously 11) An important management responsibility is to establish and maintain the entity's system of internal control on an ongoing basis. Management's process to monitori~~ng~~ ~~of~~ the system of internal control~~s~~ includes considering whether ~~they~~ controls 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.

6. When distinguishing between a monitoring activity and a control in the control activities component, the underlying details of the activity are considered, especially where the activity involves some level of supervisory review. As also explained in the application material, supervisory reviews are not automatically classified as monitoring activities and it may be a matter of judgment whether a review is classified as a control in the control activities component or a monitoring activity. For example, the intent of a monthly completeness control in the control activities component would be to detect and correct errors, where a monitoring activity would ask why there were errors in the first place and assign management the responsibility of fixing the process to prevent future errors. In simple terms, a control in the control activities component responds to a specific risk, whereas a monitoring activity assesses whether controls within each of the five components of internal control are operating as intended.

7. (previously 13) 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

Use of internal audit

8. (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.

9. (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.

   (previously 12) ~~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.~~

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

(previously 5) ~~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).~~

10. (previously 6) The information system relevant to financial reporting ~~objectives, which includes the financial reporting system,~~ encompasses ~~methods~~ <u>procedures</u> 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.

11. (previously 7) 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.

12. (previously 8) Communication, which involves providing an understanding of individual roles and responsibilities pertaining to <u>the entity's system of</u> 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

13. Generally, <u>controls in the</u> control activities <u>component</u> ~~that may be relevant to an audit~~ may be categorized as policies and procedures that pertain to the following:

- ~~*Information processing*~~*Application controls and general IT controls*. ~~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.

- *Authorization and approvals*. An authorization affirms that a transaction is valid (i.e. it represents an actual economic event or is within an entity's policy). An authorization typically takes the form of an approval by a higher level of management or of verification and a determination if the transaction is valid. For example, a supervisor approves an expense report after reviewing whether the expenses seem reasonable and within policy. An example of an automated approval is where an invoice unit cost is automatically compared with the related purchase order unit cost within a pre-established tolerance level. Invoices within the tolerance level are automatically approved for payment. Those invoices outside the tolerance level are flagged for additional investigation.

- ~~*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.~~

- *Physical controls, including those addressing security of assets; and physical counts or reconciliations of assets with accounting records.* 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.

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

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

14. (previously 10) Certain controls in the control activities component 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.

Limitations of internal control

15. (previously 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.

16. (previously 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.

17. (previously 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.