

### ISA 315 (Revised),<sup>1</sup> Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

#### Application and Other Explanatory Material – Proposed changes

##### 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,<sup>2</sup> 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.

##### 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 and affect the susceptibility to misstatement of financial statement items. Qualitative inherent risk factors relating to the preparation of information required by the applicable financial reporting framework (referred to in this paragraph as "required information") include:

- Complexity—arises either from the nature of the information or in the way that the required information is prepared, including when such preparation processes are more inherently difficult to apply. For example, complexity may arise:
  - In calculating supplier rebate provisions because it may be necessary to take into account different commercial terms with many different suppliers, or many interrelated commercial terms that are all relevant in calculating the rebates due; or
  - When there are many potential data sources, with different characteristics used in making an accounting estimate, the processing of that data involves many inter-related steps, and the data is therefore inherently more difficult to identify, capture, access, understand or process

<sup>1</sup> International Standard on Auditing (ISA) 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Risks of Material Misstatement through Understanding the Entity and its Environment*.

<sup>2</sup> ISA 580, *Written Representations*

- Subjectivity—arises from inherent limitations in the ability to prepare required information in an objective manner, due to limitations in the availability of knowledge or information, such that management may need to make an election or subjective judgment about the appropriate approach to take and about the resulting information to include in the financial statements. Because of different approaches to preparing the required information, different outcomes could result from appropriately applying the requirements of the applicable financial reporting framework. As limitations in knowledge or data increase, the subjectivity in the judgments that could be made by reasonably knowledgeable and independent individuals, and the diversity in possible outcomes of those judgments will also increase.
- Change—results from events or conditions that, over time, affect the entity’s business or the economic, accounting, regulatory, industry or other aspects of the environment in which it operates, when the effects of those events or conditions are reflected in the required information. Such events or conditions may occur during, or between, financial reporting periods. For example, change may result from developments in the requirements of the applicable financial reporting framework, or in the entity and its business model, or in the environment in which the entity operates. Such change may affect management’s assumptions and judgments, including as they relate to management’s selection of accounting policies or how accounting estimates are made or related disclosures are determined.
- Uncertainty—arises when the required information cannot be prepared based only on sufficiently precise and comprehensive data that is verifiable through direct observation. In these circumstances, an approach may need to be taken that applies the best available knowledge to prepare the information using sufficiently precise and comprehensive observable data, to the extent available, and reasonable assumptions supported by the best available data, when it is not. Constraints on the availability of knowledge or data, which are not within the control of management (subject to cost constraints where applicable) are sources of uncertainty and their effect on the preparation of the required information cannot be eliminated. For example, estimation uncertainty arises when the required monetary amount cannot be determined with precision and the outcome of the estimate is not known before the date the financial statements are finalized.
- Susceptibility to misstatement due to management bias or fraud— results from conditions that create susceptibility to intentional or unintentional failure by management to maintain neutrality in preparing the information. Management bias is often associated with certain conditions that have the potential to give rise to management not maintaining neutrality in exercising judgment (indicators of potential management bias), which could lead to a material misstatement of the information that would be fraudulent if intentional. Such indicators include inherent incentives or pressures (for example, as a result of motivation to achieve a desired result, such as a desired profit target or capital ratio), and opportunity, not to maintain neutrality. Factors relevant to the susceptibility to fraud of assertions about classes of transactions, account balances and disclosures are described in paragraphs A1 to A5 of ISA 240.<sup>3</sup>

A0e. Other inherent risk factors, that affect susceptibility to misstatement of an assertion about a class of transactions, account balance or disclosure include:

- The quantitative or qualitative significance of the class of transactions, account balance or disclosure, and of the items in relation to performance materiality;
- The composition of the class of transactions, account balance or disclosure, including whether the items they are composed of or are subject to differing risks;

<sup>3</sup> 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 class of transactions or account balance or class of transactions, or reflected in the disclosure; or
- The existence of related party transactions in the class of transaction or account balance, or that are relevant to the disclosure.

*IT Environment (Ref: Para 4(cbb))*

- A0f. A report-writer is an IT application that is used to extract data from one or more sources (such as a data warehouse, a database or an IT application) and present the data in a specified format. A data warehouse is a central repository of integrated data from one or more disparate sources (such as multiple databases) from which reports may be generated or that may be used by the entity for other data analysis activities.
- A0g. A network is used in the IT infrastructure to transmit data and to share information, resources and services through a common communications link. The network also typically establishes a layer of logical security (enabled through the operating system) for access to the underlying resources. The operating system is responsible for managing communications between hardware, IT applications, and other software used in the network. Databases store the data used by IT applications and may consist of many interrelated data tables. Data in databases may also be accessed directly through database management systems by IT or other personnel with database administration privileges.

*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, which affect the likelihood that a misstatement will occur, as well as the potential magnitude of misstatement were that misstatement to 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. As the auditor performs audit procedures, the audit evidence obtained may cause the auditor to update the understanding on which the risk assessment was based and the nature, timing or extent of other planned audit procedures in accordance with ISA 330. For example, information gathered in understanding the

entity's system of internal control assists the auditor in assessing control risk at the assertion level, such that control risk may be assessed at less than maximum based on an expectation about the operating effectiveness of the control(s) and the planned testing of such control(s). Information gathered when testing the operation of the control(s) as part of performing further audit procedures may indicate that the control(s) are not effective, and as a result the auditor's original assessment is updated in accordance with paragraph 31. (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.<sup>4</sup> In addition, the following ISAs provide further requirements and guidance on identifying and assessing risks of material misstatement in regard to specific matters or circumstances:

- ISA 540<sup>5</sup> in regard to accounting estimates;
- ISA 550<sup>6</sup> in regard to related party relationships and transactions;
- ISA 570<sup>7</sup> in regard to going concern; and
- ISA 600<sup>8</sup> 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:

- Identifying and assessing risks of material misstatement of the financial statements (e.g., relating to risks of fraud in accordance with ISA 240 or when identifying or assessing risks related to accounting estimates in accordance with ISA 540);
- Determining materiality or performance materiality in accordance with ISA 320;<sup>9</sup>
- 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;<sup>10</sup>
- Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence in accordance with ISA 330;<sup>11</sup> and

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<sup>4</sup> ISA 240, paragraphs 12–24

<sup>5</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

<sup>6</sup> ISA 550, *Related Parties*

<sup>7</sup> ISA 570, *Going Concern*

<sup>8</sup> ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

<sup>9</sup> ISA 320, *Materiality in Planning and Performing an Audit*, paragraphs 10–11

<sup>10</sup> ISA 520, *Analytical Procedures*, paragraph 5

<sup>11</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

- 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 assessments of the risks of material misstatement. In addition, the auditor may obtain some audit evidence about classes of transactions, account balances, or disclosures, and related assertions, and about the operating effectiveness of controls, even though such risk assessment procedures were not specifically planned as substantive procedures or as tests of controls. The auditor ~~also~~ may also choose to perform designed substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so. For example, through the use of technology the auditor may perform procedures on large volumes of data, and audit evidence may be obtained that provides information that is useful for the identification and assessment of risks of material misstatement, as well as providing sufficient appropriate audit evidence to support the conclusion that such risks have been reduced to an acceptably low level.
- A3. The auditor uses professional judgment to determine the nature and extent of the required understanding ~~required~~. The auditor’s primary consideration is whether the understanding that has been obtained is sufficient to meets the objective stated in this ISA. The auditor’s risk assessment procedures to obtain the overall understanding may be less extensive in audits of smaller and less complex entities. The depth of the overall understanding that is required by the auditor 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<sup>12</sup> explains the types of audit procedures that may be performed in obtaining audit evidence from risk assessment procedures and further audit procedures. The nature and timing of the audit procedures may be affected by the fact that some of the accounting data and other information may only be available in electronic form or only at certain points in time.<sup>13</sup>
- 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. 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.
  - Publicly available information about the entity, for example entity-issued press releases, and materials for analysts or investor group meetings, analysts reports or information about trading activity.

<sup>12</sup> ISA 500, *Audit Evidence*, paragraphs A14–A17 and A21–A25.

<sup>13</sup> ISA 500, paragraph A12

These sources may provide potentially contradictory information to that provided by management, which may assist the auditor in exercising professional skepticism in identifying and assessing the risks of material misstatement. Regardless of the source of information, the auditor considers the relevance and reliability of the information to be used as audit evidence in accordance with ISA 500.<sup>14</sup>

- 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 11–2421D), 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 Mmaking 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*)

*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~~ of 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)<sup>15</sup> identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
  - Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
  - Inquiries directed towards s in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contractual terms.
  - Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
  - Inquiries directed towards s the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
  - Inquiries directed towards s 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.

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<sup>14</sup> ISA 500, paragraph 7

<sup>15</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 4(b)

### Considerations Specific to Public Sector Entities

A8a. When making inquiries of those who may have information that is likely to assist in identifying risks of material misstatement, auditors of public sector entities may obtain information from additional sources such as from the auditors that are involved in performance or other audits related to the entity.

#### Inquiries of the Internal Audit Function

- 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.<sup>16</sup> Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.
- 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,<sup>17</sup> if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.
- 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

- 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 control deficiencies in internal control over related to 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 identifying and assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed

<sup>16</sup> The relevant requirements are contained in ISA 610 (Revised 2013).

<sup>17</sup> ISA 240, paragraph 19

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 performed as risk assessment procedures may use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), and accordingly the results of those analytical procedures may only provide a broad initial indication about whether a the likelihood of a material misstatement may exist. For example, in the audit of many entities, including those with less complex business models and processes, and a less complex information system, the auditor may perform a simple comparison of information, such as the change in account balances from interim or monthly reporting with balances from prior periods, to obtain an indication of potentially higher risk areas. 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.

A16a. Analytical procedures can be performed using a number of tools or techniques, which may be automated. Applying automated analytical procedures to the data may be referred to as data analytics. For example, the auditor may use a spreadsheet to perform a comparison of actual recorded amounts to budgeted amounts, or may perform a more advanced procedure by extracting data from the entity's information system, and further analyzing this data using visualization techniques to identify more specific areas of possible misstatement.

A16b. 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-risk assessment procedures include observation or inspection of the following:

- The entity's operations.
- Internal Documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).



- The entity's premises and plant facilities.
- (from previous A5) Reviewing 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).
- The behaviors and actions of management or those charged with governance (such as the observation of an audit committee meeting).

Considerations specific to public sector entities

A18a. Risk assessment procedures performed by auditors of public sector entities may also include observation and inspection of documents prepared by management for the legislature, for example as documents related to mandatory performance reporting.

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

A18b. In accordance with ISA 220, the engagement partner is required to be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and to determine that conclusions reached in this regard are appropriate.<sup>18</sup> Information obtained in the client and engagement acceptance or continuance process may be relevant to the identification and assessment of the risks of material misstatement. Examples may include:

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

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

A18c. The engagement partner may have performed other engagements for the entity and may thereby have obtained knowledge relevant to the audit, including about the entity and its environment. Such engagements may include agreed-upon procedures engagements (e.g., agreed-upon procedures relating to an entity's debt covenant compliance) or other audit or assurance engagements (e.g., audits of special purpose financial statements or reviews of interim financial information).

Information Obtained in Prior Periods (Ref: Para. 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 control deficiencies in internal control).

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<sup>18</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 12

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

*Discussion Among the Engagement Team* (Ref: Para. 10)

#### ~~Considerations Specific to Smaller Entities~~

A20a. ~~(previously paragraph A24) Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering~~ Paragraph 10 requires the engagement partner and other key engagement team members to discuss the application of the applicable financial reporting framework in the context of the nature and circumstances of the entity and its environment, and the susceptibility of the entity's financial statements to material misstatement due to fraud or error. When the engagement is carried out by a single individual (such as a sole practitioner) i.e., where an engagement team discussion would not be possible, consideration of the matters referred to in paragraphs A21 and A22 nonetheless may assist the auditor in identifying where there may be risks of material misstatement.

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

ISA 240 requires the engagement team discussion to place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud may occur provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.<sup>19</sup>

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, even in circumstances where the applicable financial reporting framework only requires simplified 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.

A22a. In addition to the intended benefits of the engagement team discussion included in paragraph A21, the engagement team may also have an opportunity to exercise professional skepticism while performing risk assessment procedures, such as through identifying and discussing contradictory information obtained in performing those procedures, as well as in considering whether there are indicators of possible management bias (both intentional and unintentional). Professional skepticism is necessary for the critical assessment of audit evidence, and a robust and open engagement team discussion, including for recurring audits, may lead to improved identification and assessment of the risks of material misstatement. Another outcome from the discussion may be that the auditor identifies specific areas of the audit for which exercising professional skepticism may be particularly important, which may in turn drive the consideration of those engagement team members who are appropriately skilled to be involved in the performance of audit procedures related to those areas.

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

#### Considerations Specific to Public Sector Entities

A23a. As part of the discussion among the engagement team, as required by paragraph 10, by auditors of public sector entities, consideration may also be given to any additional broader objectives, and related risks, arising from the audit mandate or obligations for public sector entities.

A24. [MOVED TO A20a]

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<sup>19</sup> ISA 240, paragraph 15

**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 identifies and assesses risks of material misstatement, and plans and performs audit procedures. Specifically, the auditor applies professional judgment in determining whether the understanding required by paragraph 11 is sufficient to provide an appropriate basis for the auditor to understand the classes of transactions, account balances and disclosures to be expected in the entity's financial statements. This understanding assists the auditor in identifying areas in the financial statements where material misstatements may be more likely to arise and assists the auditor in exercising professional skepticism throughout the audit. The nature and extent of the understanding required will likely depend on the nature, size and complexity of the entity.

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

A24b. In obtaining an understanding of the entity and its environment, the auditor may be able to enhance the understanding by using automated tools and techniques. For example, the auditor may use automated techniques to understand flows of transaction and processing as part of the auditor's procedures to understand the information system. An outcome of these procedures may be that the auditor obtains information about the entity's organizational structure or with whom the entity conducts business (e.g., vendors, customers, related parties).

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

[A25–A30 MOVED to A43a–A43f]

The entity's organizational structure and ownership

A31. An understanding of the ~~nature of an entity's~~ organizational structure and ownership may enables the auditor to understand such matters as:

- ~~Whether the entity has a complex structure,~~ The complexity of the entity's structure. For example, the entity may be a single entity or the entity's structure may include with subsidiaries, divisions or other components in multiple locations. Further, the legal structure may be different from the operating structure. Complex structures often introduce issues—factors that may give rise to increased susceptibility to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately and whether adequate disclosure of such issues in the financial statements has been made.
- The ownership, and relationships between owners and other people or entities, including related parties. This understanding may assists in determining whether related party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial statements.<sup>20</sup>
- The distinction between the owners, those charged with governance and management. In some entities, particularly smaller and less complex entities, owners of the entity may be involved in managing the entity, or those charged with governance may be involved in managing the entity.<sup>21</sup>

<sup>20</sup> ISA 550 establishes requirements and provide guidance on the auditor's considerations relevant to related parties.

<sup>21</sup> ISA 260, paragraphs A1 and A2, provides guidance on the identification of those charged with governance and explains that in some cases, some or all of those charged with governance are involved in managing the entity.

- The entity's IT environment. For example, an entity's IT environment may be relatively simple because it consists only of commercial software for which the entity does not have access to the underlying source code to which no changes have been made. Alternatively, an entity may have grown through extensive merger and acquisition activity and have multiple legacy IT systems in diverse businesses that are not well integrated resulting in a complex IT environment.

#### Considerations specific to public sector entities

A31a. In obtaining an understanding of the entity's organizational structure and ownership, auditors of public sector entities may consider the relevance of ownership of a public sector entity (i.e., ownership of a public sector entity may not have the same relevance as in the private sector because decisions related to the entity may be initiated outside of the entity as a result of political processes and therefore management may not have control over decisions that are made), Matters related to understanding the legal structure of the entity may include applicable laws and regulations, and the classification of the entity (i.e. whether the entity is a ministry, department, agency or other type of entity).

#### Governance

A31b. Responsibilities of management and those charged with governance are broader than responsibilities for the oversight of the system of internal control, but are generally prerequisites for an effective system of internal control. The responsibilities of those charged with governance in relation to the control environment are further discussed in Appendix 3. Deficient governance processes may limit an entity's ability to provide appropriate oversight of its system of internal control, which may increase the entity's susceptibility to risks of material misstatement. Matters that may be relevant for the auditor to consider in obtaining an understanding of the governance of the entity include:

- Whether any or all of those charged with governance are involved in managing the entity.
- The existence (and separation) of a non-executive Board, if any, from executive management.
- Whether those charged with governance hold positions that are an integral part of the entity's legal structure, for example as directors.
- The existence of sub-groups of those charged with governance such as an audit committee, and the responsibilities of such a group.
- The responsibilities of those charged with governance for oversight of financial reporting, including approval of the financial statements.

#### The Entity's Business Model

A31c. The auditor's understanding of the entity's business model, and how it is affected by its business strategy and business objectives, may assist the auditor in identifying business risks that are relevant 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 reasonableness of key assumptions and expectations of management or those charged with governance thereby increasing the susceptibility to risks of material misstatement.

A31d. An entity's business model describes how an entity considers, for example its organizational structure, operations or scope of activities, business lines (including competitors and customers thereof), processes, growth opportunities, globalization, regulatory requirements and technologies. The entity's business model describes

how the entity creates, preserves and captures financial or broader value, such as public benefits, for its stakeholders.

A31e. Strategies are the approaches by which management plans to achieve the entity's objectives, including how the entity plans to address the risks and opportunities that it faces. An entity's strategies are changed over time by management, to respond to changes in its objectives and in the internal and external circumstances in which it operates.

A31f. A description of a business model typically includes:

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

A31g. Understanding the entity's objectives, strategy and business model helps the auditor to understand the entity at a strategic level and to understand the business risks the entity takes and faces. Not all aspects of the business model are relevant for the auditor's understanding, but those aspects that give rise to business risks, which are relevant to the identification and assessment of risks of material misstatement, are likely to be more relevant for the auditor's understanding.

A31h. Appendix 1 provides examples of matters that may be considered when obtaining an understanding of the activities of the entity, as well as other matters that may be considered when auditing financial statements of special purpose entities.

A32. [MOVED to Appendix 1 and A49b]

A33. ~~Significant changes in the entity from the prior periods may give rise to, or change, risks of material misstatement.~~

A34-A35 [MOVED to Appendix 1]

A36. [MOVED to A49b]

#### Considerations specific to public sector entities

A36a. Entities operating in the public sector may create and deliver value in different ways to those creating wealth for owners, but will still have a 'business model' to promote value in the public interest. Matters public sector auditors may obtain an understanding of that are relevant to the business model of the entity, include:

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

Objectives and Strategies and Related Business Risks in the context of the entity's business model (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. In obtaining an understanding of the business model, it is likely that the auditor also obtains an understanding of the business risks. (Part from Para. A39) An understanding of the business risks that have an effect on the financial statements assists the auditor in identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. Business risks are is broader than the risks of material misstatement of the financial statements, although it business risks includes the latter. The auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement. Business risk may arise from, among other matters, inappropriate objectives or strategies, ineffective execution of strategies, or change or complexity. A failure to recognize the need for change may also give rise to business risk. 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 legal liability 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 significant fall in real estate market values may increase the risk of material misstatement associated with the valuation of receivables assertion for a lender of medium-term real estate backed loans. However, the same risk, particularly in combination with a contracting economy, severe economic downturn that concurrently increases the underlying risk of lifetime credit losses on its loans, may also have a longer-term consequence which the auditor considers when assessing the appropriateness of the going concern assumption. The resulting net exposure to credit losses may cast significant doubt on the entity's ability to continue as a going concern. If so, this could have implications for management's and the auditor's conclusion as to the appropriateness of the entity's use of the going concern basis of accounting and determination as to whether a material uncertainty exists. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of events and conditions 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 business model, objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:~~

- ~~• Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).~~
- ~~• New products and services (a potential related business risk might be, for example, that there is increased product liability).~~

- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- Use of IT (a potential related business risk might be, for example, that ~~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~~Ordinarily, 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 15–17 and paragraphs A88–A89d.

#### Considerations Specific to Public Sector Entities

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

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

##### Industry ~~F~~actors

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.<sup>22</sup>

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<sup>22</sup> ISA 220, paragraph 14



## Regulatory 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 and any changes thereto. 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 restriction 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.<sup>23</sup>

## Considerations specific to public sector entities

A43e. (previously A29) For the audits of public sector entities, there may be particular laws or, regulations or other authority that may affect the entity's operations. Such elements ~~are~~ may be an essential to consideration when obtaining an understanding of the entity and its environment.

## Other External 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 Measures Used to Assess the Entity's Financial Performance (Ref: Para. 11(ea)(iii))

A44. Management and others ordinarily measure and review those ~~things-matters~~ they regard as important. The procedures undertaken to measure the relevant performance of the entity may vary depending on the size or complexity of the entity, as well as the involvement of owners or those charged with governance in the management of the entity.

A44a. (previously in A44) Performance measures, whether used externally or internally, may create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to intentionally misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the susceptibility to misstatement due to management bias or risks of material misstatement, including those due to fraud. For example, the auditor may identify incentives or pressures that may increase the risk of management override of controls. See ISA 240 for requirements and guidance in relation to the risks of fraud.

<sup>23</sup> 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 controls (discussed as a component of the system of internal control in paragraphs A41089e–A42489r), though their purposes may overlap:

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

In some cases, however, performance indicators also provide information that enables management to identify control deficiencies 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~~ and analyze the entity's financial performance, in particular for entities where financial information is publicly available. For example, publicly available financial information may be issued by:

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

Such ~~reports~~ financial information 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~~ the likelihood with which 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.

A48a. ~~Such information~~ Performance measures and targets, whether imposed internally or externally, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential an increased risk of susceptibility due to management bias or fraud 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, whether internal or external, by considering the information that the entity uses to manage its business. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.~~

### Considerations specific to public sector entities

A49a. In addition to considering relevant measures used by a public sector entity to assess the entity's financial performance, auditors of public sector entities may also consider non-financial information such as achievement of public benefit outcomes (for example, the number of people assisted by a specific program).

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

A49b. ~~(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:

- (previously paragraph A32) The entity's financial reporting practices in terms of the applicable financial reporting framework, such as:
  - Accounting principles and industry-specific practices, including for industry-specific significant classes of transactions, account balances and related disclosures in the financial statements (for example, loans and investments for banks, or research and development for pharmaceuticals).
  - Revenue recognition.
  - Accounting for ~~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).
- (previously paragraph A36) An understanding of the entity's selection and application of accounting policies, including any changes thereto as well as the reasons therefore, may encompass such matters as:
  - The methods the entity uses to recognize, measure, present and disclose ~~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 framework or tax reforms that may necessitate a ~~C~~changes in the entity's accounting policies.
  - Whether the changes in the selection and application of accounting policies 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, or comply with, such requirements.

A49c. Obtaining an understanding of the entity and its environment assists the auditor in considering where changes in the entity's financial reporting (e.g., from prior periods) may be expected. For example, if the entity has had a significant business combination during the period, the auditor would likely expect changes in classes of transactions, account balances and disclosures associated with that business combination. Alternatively, if there were no significant changes in the financial reporting framework during the period the auditor's understanding may help confirm that the understanding obtained in the prior period remains applicable.

A49d. *(previously A136)* Disclosures in the financial statements of smaller and less complex entities may be simpler and less detailed or less complex (e.g., some financial reporting frameworks allow smaller entities to provide fewer simpler and less detailed disclosures in the financial statements). However, this does not relieve the auditor of the responsibility to obtain an understanding of the entity and its environment, the applicable financial reporting framework as it applies to the entity, including and its related system of internal control, as it relates to disclosures.

#### Considerations specific to public sector entities

A49e. The applicable financial reporting framework in a public sector entity is determined by the legislative and regulatory frameworks relevant to each jurisdiction or within each geographical area. Matters that may be considered in the entity's application of the applicable financial reporting requirements, and how it applies in the context of the nature and circumstances of the entity and its environment, include whether the entity applies a full accrual-basis of accounting (such as the International Public Sector Accounting Standards), a cash-basis of accounting, or a hybrid. The financial reporting applied by a public sector further impacts the ability to assess the accountability for all assets and liabilities of the entity, as well as the entity's system of internal control.

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

A49f. When obtaining an understanding of the entity, in accordance with paragraph 11(b)(i), the auditor identifies how events or conditions are affected by, or subject to, the inherent risk factors. Appendix 2 provides examples of such events or conditions. The auditor is required to consider 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. The auditor may identify events or conditions that are or 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 misstatement due to management bias or fraud, 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.

A49g. The extent to which a class of transactions, account balance or disclosure is subject to, or affected by, complexity or subjectivity, is often closely related to the extent to which it is subject to change or uncertainty. Further, when a class of transactions, account balance or disclosure is subject to, or affected by, complexity, subjectivity, change or uncertainty, these inherent risk factors may create opportunity for management bias, whether unintentional or intentional, and affect susceptibility to misstatement due to management bias or fraud. Accordingly, the auditor's identification of risks of material misstatement, and assessment of inherent risk at the assertion level, are also affected by the interrelationships among the inherent risk factors.

A49h. Events or conditions that may be affected by, or subject to, the susceptibility of misstatement due to management bias or fraud may be indicative of increased risks of material misstatement due to fraud. Accordingly, this may be relevant information for use in accordance with paragraph 24 of ISA 240, which requires the auditor to evaluate whether the information obtained from the other risk assessment procedures and related activities indicates that one or more fraud risk factors are present.

- A49i. When complexity is an inherent risk factor, there may be an inherent need for more complex processes in preparing the information, and such processes may be inherently more difficult to apply. As a result, applying them may require specialized skills or knowledge, and may require the use of a management's expert. For example, when there are many potential data sources, with different characteristics, and the processing of that data involves many inter-related steps, the data may be inherently more difficult to identify, capture, access, understand or process.
- A49j. When the judgment is more subjective, the susceptibility to misstatement due to management bias, whether unintentional or intentional, may also increase. For example, significant management judgment may be involved in making accounting estimates that have been identified as having high estimation uncertainty, and conclusions regarding methods, models and assumptions may reflect unintentional or intentional management bias.
- A49k. ~~(previously A58) On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud. Where there are increased opportunities for intentional management bias or fraud (e.g., owner-managed entities where there is an increased opportunity for management override of controls), the auditor may identify an increased susceptibility to misstatement due to management bias or fraud.~~

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

A50. ~~An understanding 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 in designing the nature, timing and extent of further audit procedures. Obtaining an understanding of the components of the entity's system of internal control:~~

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

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

- The size and complexity of the entity, including its IT environment.
- Previous experience with the entity.
- The nature of each component<sup>24</sup> of the entity's system of internal control.
- The nature and form of the entity's documentation, including as it relates to specific controls.

A50b. The entity's use of IT and the nature and extent of changes in the IT environment may also affect the specialized skills that are needed to assist with obtaining the required understanding.

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<sup>24</sup> See paragraph A67d

A50c. Appendix 3 further describes the nature of the entity's system of internal control and inherent limitations of internal control, respectively. Appendix 3 also provides further explanation of the components of a system of internal control for the purposes of the ISAs.

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.

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

~~Purpose of Internal Control~~

A52. The entity's system of internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

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

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

A52a. The entity's system of internal control relevant to financial reporting will include aspects of the system of internal control that relate to the entity's reporting objectives, including its financial reporting objectives, but may also include aspects that relate to its operations or compliance objectives, when such aspects are relevant to financial reporting. For example, controls over compliance with laws and regulations may be relevant to financial reporting when such controls are relevant to the entity's preparation of contingency disclosures in the financial statements. In particular, the auditor is required by paragraph 18 to understand how the entity initiates transactions and captures information relevant to financial reporting as part of the auditor's understanding of the information system. Such information may include information from the entity's systems and controls designed to address compliance and operations objectives. Further, some entities may have information systems that are highly integrated such that controls may be designed in a manner to simultaneously achieve financial reporting, compliance and operational objectives, and combinations thereof.

~~Considerations specific to smaller entities~~

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

Considerations Specific to Public Sector Entities

A53a. (previously A73) Auditors of public sector entities often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice or reporting on spending against budget. Auditors of public sector entities can may also have responsibilities to report on compliance with law, regulation or other authority. As a result, their review considerations about the system 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 A99d]~~

~~A58. [MOVED TO A49k]~~

~~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 Components of the System of Internal Control*~~

~~A61. An entity's system of internal control contains manual elements and ~~often contains~~ automated elements. An entity's mix of manual and automated elements in the entity's system of internal control varies with the nature and complexity of the entity's use of IT. (last sentence of A61 MOVED to A66) The overall objective and scope of an audit does not differ whether an entity operates in a mainly manual environment, a completely automated environment, or an environment involving some combination of manual and automated elements. An entity's use of IT affects the manner in which the information relevant to financial reporting is processed, stored and communicated, and therefore affects the manner in which the system of internal control relevant to financial reporting is designed and implemented. Each component of the system of internal control may involve some extent of automation. The auditor's understanding of the system of internal control relevant to financial reporting involves understanding the entity's use of IT for each component.~~

~~A62. [MOVED elements of A62 to A90b and A99d] The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:~~

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

~~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.~~

~~A63. [MOVED to Appendix 3] 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 A92b]

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. ~~(from previous A61) The characteristics of manual or automated elements are relevant to the auditor's risk identification and assessment of the risks of material misstatement, and further audit procedures based thereon. Manual elements in internal control Automated controls may be less more reliable than automated elements manual controls because they cannot be more as easily bypassed, ignored, or overridden, and they are also more less prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements Automated controls may be less suitable more effective than manual controls in for the following circumstances:~~

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

A67. [MOVED to A106]

~~Components Division of the Entity's 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;~~
- ~~(b) The entity's risk assessment process;~~
- ~~(c) The information system, including the related business processes, relevant to financial reporting, and communication;~~
- ~~(d) Control activities; and~~
- ~~(e) Monitoring of controls.~~



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

~~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 the system of internal control. Similarly, the entity's risk assessment process and its process for monitoring the system of internal control are designed to operate in a manner that also supports the entire system of internal control. Therefore these components support the controls within the other components of the entity's system of internal control. Due to the manner in which the controls within these components are designed to operate, they are typically not precise enough to prevent, or detect and correct, misstatements at the assertion level and instead may have an indirect effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls may be referred to as "indirect controls."~~

~~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 may be referred to as "direct controls."~~

~~A67d. The nature of each of the components of the entity's system of internal control may also affect the auditor's identification and assessment of the risks of material misstatement as follows:~~

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

~~A67e. Notwithstanding the types of controls that are typically within each component of the entity's system of internal control, direct or indirect controls may exist in any of the components. In particular, the control activities component includes general IT controls, which may include 'indirect controls.' For example, controls that address the continued functioning of automated controls over the processing of transactions, such as controls over the integrity of information in the entity's information system, may also include 'direct controls.'~~

#### ~~*Controls Relevant to the Audit*~~

~~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.~~

~~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 A100I]

~~A71. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition disposal 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.~~

~~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 are likely to include mainly controls that address potential risks of misstatement at the assertion level (i.e., controls in the control activities component). However, controls relevant to the audit may also include controls in other components of internal control, i.e., the control environment, the risk assessment process and the process to monitor controls components that address the risks of material misstatement at the assertion level. The auditor evaluates the design of each control relevant to the audit and determines whether it has been implemented in accordance with paragraph 21B.~~

A74. [MOVED to A109a]

A75-A76 [MOVED to A109e-A109f]

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

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

A77. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's system of internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A77a. (previously A85) The control environment within relating to smaller and less complex entities is likely to differ vary from larger or more complex entities. For example, the organizational structure may be simpler and include a small number of employees involved in roles related to financial reporting. Further, those charged with

governance in smaller and less complex entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. Accordingly, some considerations about the entity's control environment may be inapplicable or less relevant. For example, if the role of governance is undertaken directly by the owner-manager, the auditor may determine that the independence of those charged with governance is not relevant. 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.

A77b. (previously A86) In addition, audit evidence for elements of the control environment in smaller and less complex entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, ~~yet~~ but is still effective. For example, ~~small~~ such 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. (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 and less complex entity's control environment.

A78. [MOVED to Appendix 3]

#### Audit Evidence for Elements of the Control Environment Understanding 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 considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the that code.

A80. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified control 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. The auditor's consideration of the entity's use of IT as it relates to the control environment may include such matters as:

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

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

A80b. (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 A126d–A126e, control deficiencies in the control environment may lead to risks of material misstatement at the financial statement level, which may have implications for the audit, including, as explained in ISA 330, an influence on the nature, timing and extent of the auditor's further procedures.<sup>25</sup>

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 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.

A81a. Some entities are dominated by a single individual who exercises a great deal of discretion. The actions and attitudes of that individual may have a pervasive effect on the culture of the entity, which in turn may have a pervasive effect on the control environment. Such an effect may be positive or negative. For example, direct involvement by this single individual may be key to enabling the entity to meet its growth and other objectives, and can also contribute significantly to an effective system of internal control. On the other hand, such concentration of knowledge and authority can also lead to an increased susceptibility to misstatement through management override of controls.

A82. ~~An a~~Active and independent board of directors involvement by those charged with governance, who are also independent, may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings. Overall, although a control environment that provides an appropriate foundation for the system of internal control may help reduce the risk of fraud, an ~~satisfactory~~ appropriate control environment is not an ~~absolute~~ necessarily an effective 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.~~<sup>26</sup>

A84. [MOVED TO A80b]

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<sup>25</sup> ISA 330, paragraphs A2–A3

<sup>26</sup> ISA 330, paragraphs A2–A3

~~Considerations Specific to Smaller Entities~~

A85. [MOVED to A77a]

A86. [MOVED to A77b]

A87 [MOVED to A77b]

~~Components of Internal Control—The Entity's Risk Assessment Process (Ref: Para. 15-17)~~

A88. The entity's risk assessment process is an iterative process for identifying and analyzing risks to achieving the entity's objectives, and forms the basis for how management or those charged with governance determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement (*Rest of paragraph moved to A89c*).

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

A89. Some entities, including smaller and less complex entities, and particularly owner-managed entities, may not have established a formal risk assessment process, or the risk assessment process may not be documented or performed on regular basis. Irrespective whether the risk assessment process is formally established or not, the auditor may still obtain the understanding required by paragraph 15 about how the entity identifies risks relevant to financial reporting and how these risks are addressed through observation and inquiry. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however inquiry about identified risks and how they are addressed by management is still necessary.

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

A89a. In order to understand how management and those charged with governance have identified business risks relevant to financial reporting objectives, and have decided about actions to address those risks, matters the auditor may consider include how management or, as appropriate, those charged with governance have:

- Specified objectives with sufficient clarity to enable the identification and assessment of the risks relating to the objectives;
- Identified the risks to achieving the entity's objectives and analyzed the risks as a basis for determining how the risks should be managed;
- Considered the potential for fraud when considering the risks to achieving the entity's objectives; and
- Identified and evaluated changes that could significantly affect the entity's system of internal control. (Ref: Para. A15(a)(i))

As explained in paragraph A38, not all business risks give rise to risks of material misstatement.

A89b. Understanding the risks arising from the entity's use of IT identified by the entity, as well as how these risks have been addressed, is an important input to the auditor's identification of risks arising from the use of IT in accordance with paragraph 21A. It may also help the auditor understand the nature and extent of automated processes, and the data, used in controls that may be relevant to the audit.

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

A89c. (*previously part of A88*) Whether the entity's risk assessment process is appropriate to the circumstances of the entity, including its nature, size, and complexity, is a matter of the auditor's professional judgment. For example, in some smaller and less complex entities, and particularly owner-managed entities, an appropriate risk

assessment may be performed through the direct involvement of management or the owner-manager (e.g., the manager or owner-manager may routinely devote time to monitoring the activities of competitors and other developments in the market place to identify emerging risks that may affect how the entity applies the requirements of the applicable financial reporting framework related to the entity's ability to continue as a going concern).

A89d. When the auditor determines, in accordance with paragraph 17(b), that a control deficiency exists related to the entity's risk assessment process, the auditor is required to determine, in accordance with paragraph 21C, whether any such deficiency constitutes a significant control deficiency. Whether the absence of an appropriate risk assessment process represents a significant control deficiency is a matter of the auditor's professional judgment. Circumstances that may indicate a significant control deficiency exists include matters such as:

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

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

A89e. ~~(previously A110) The entity's process to Mmonitoring the system of internal controls is a continuous process to assess evaluate the effectiveness of the system of internal control over time. It involves assessing the effectiveness of controls on a timely basis and to taking necessary remedial actions on a timely basis. Management accomplishes monitoring of controls through~~ The entity's process to monitor the system of internal controls may consist of ongoing activities, separate evaluations (conducted periodically), or a some combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities. The entity's process will likely vary in scope and frequency depending on the assessment of the risks by the entity.

#### ~~Considerations Specific to Smaller Entities~~

A89f. ~~(previously A112) In smaller and less complex entities, and in particular owner-manager entities, the entity's process to monitor the system of internal control~~ Management's monitoring of control is often accomplished by management's or the owner-manager's close-direct involvement in operations, and there may not be any other monitoring activities. For example, Tthis is the case when involvement often will identify significant variances from expectations and inaccuracies in financial data are identified through the owner-manager's direct involvement. The owner-manager's actions and follow-up may also be how leading to remedial actions to the control. are implemented. In such cases, the auditor's understanding of the process to monitor the system of internal control may be accomplished through inquiry of the owner-manager and employees about these activities, and may also involve inspection or observation of related communications or other evidence of remedial actions.

A89g. For entities where there is no distinct process for monitoring the system of internal control, it may be difficult to distinguish between controls in the control activities component and activities related to monitoring. For example, a supervisory review may not be considered a monitoring activity by the entity, but the review may have a role in monitoring the effectiveness of underlying controls. For such entities, understanding the process to monitor the system of internal control may include understanding periodic reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

A89h. Controls in the entity's process to monitor the system of internal control are likely to consist of primarily indirect controls. However, monitoring activities, such as management or supervisory reviews, may be precise enough to address risks of material misstatement at the assertion level (i.e., direct controls). Such controls may also include certain activities performed by the internal audit function. The auditor may determine certain direct controls to be controls relevant to the audit in accordance with paragraph 20–21A.

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

A89i. In order to understand how the entity monitors its system of internal control, matters that may be relevant for the auditor to consider include:

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

A89j. The entity's process to monitor the system of internal control includes monitoring underlying controls that involve the use of IT, and may include, for example:

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

A89k. Controls within the entity's process to monitor the system of internal control, including those that monitor underlying automated controls, may be automated or manual, or a combination of both. For example, an entity may use automated monitoring controls over access to certain technology with automated reports of unusual activity to management, who manually investigate identified anomalies.

Sources of Information (Ref: Para. 24 17B)

A89l. *(previously A121)* Much of the information used in monitoring may be produced by the entity's information system. If management assumes that ~~data~~ information used for monitoring ~~are~~ is accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

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

is required ~~as part of~~ to provide a basis for the auditor's understanding of the entity's process to monitoring activities as a component ~~the system of~~ internal control.

A89m. (*previously A111*) Management's monitoring activities may ~~include using~~ use information ~~from in~~ communications from external parties such as customer complaints or regulator comments that may indicate problems or highlight areas in need of improvement.

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

A89n. (*previously A113 and A116*) If the entity has an internal audit function, the auditor's understanding of the entity's process to monitor the system of internal control involves obtaining an understanding of 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 that the entity's monitoring of internal control over financial reporting process. 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.

A89o. (*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.

A89p. (*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.

A89q. (*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.

A89r. (*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.



~~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 or procedures, and records, designed and established to:

- Initiate, record, process, and report entity transactions (as well as to capture, process and disclose information about events and conditions other than transactions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- ~~Transfer~~ Incorporate information from transaction processing systems ~~to~~ in the general ledger (e.g., transferring of accumulated transactions from a subsidiary ledger);
- Capture and process information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of ~~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~~ include the activities designed to:

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

Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor in obtaining an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

A90b. The entity's information system relevant to financial reporting may include the use of manual and automated elements, which also affect the manner in which transactions are initiated, recorded, processed, and reported. In particular, procedures to initiate, record, process, and report transactions may be enforced through the IT applications used by the entity, and how the entity has configured those applications. In addition, records in the form of digital information may replace or supplement records in the form of paper documents.

A90c. ~~(previously A96)~~ The information system, and related business processes relevant to financial reporting in smaller and less complex 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 and involve a less complex IT environment, but ~~is~~ the role of the information system is just as significant important. Regardless of the size or nature of the entity, the information system includes relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers. Smaller and less complex entities with ~~active~~ direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's information system relevant to

financial reporting may therefore ~~be easier~~ require less effort in an audit of smaller and less complex entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important to identify risks of material misstatement.

A90d. *(previously first sentence of A92)* The auditor's understanding of the information system relevant to financial reporting required by paragraph 18 of this ISA (including the understanding of relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers) is a matter of the auditor's professional judgment includes understanding the flows of information relating to the entity's significant classes of transactions, account balances, and disclosures in the financial statements. The auditor's understanding of the information system relevant to financial reporting is not required to include an understanding of the flows of information related to classes of transactions, account balances or disclosures that are not significant classes of transactions, account balances or disclosures.

A90e. Risk identification and assessment is an iterative process. The auditor's expectations formed in paragraph 11 about the classes of transactions, account balances and disclosures may assist the auditor in determining the significant classes of transactions, account balances and disclosures in accordance with paragraph 25B, which are those that need to be understood when obtaining an understanding of the information system in accordance with paragraph 18. For example, the auditor may have an expectation that certain significant classes of transactions related to revenue exist, but in obtaining the understanding about the flows of information in the information system, the auditor may identify additional classes of transactions related to revenue that may be significant.

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

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.<sup>27</sup>

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<sup>27</sup> See paragraphs 19–20 of ISA 570 (Revised), *Going Concern*

A92. [first sentence MOVED to A90d] ~~For example, 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 auditor is required to understand the IT environment relevant to the entity's information system because the entity's use of IT applications or other aspects in the IT environment may give rise to risks arising from the use of IT. The nature and significance of these risks vary based on whether, and the extent to which, the entity's relies on IT, including automated controls, to support the processes in its information system and to maintain the completeness and accuracy of the underlying data and information. The entity may implement general IT controls in response to these risks. General IT controls may be relevant to the audit and may need to be taken into account in the auditor's assessment of control risk at the assertion level.

A92b. ~~(previously A64) IT also poses specific risks to an entity's internal control, including, for example:~~ Examples of risks arising from the use of IT include:

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

A92c. The auditor may take an approach to obtaining the understanding the IT environment that involves identifying the IT applications and supporting IT infrastructure concurrently with the auditor's understanding of how information relating to significant classes of transactions, account balances and disclosures flows through the entity's information system.

A92d. In obtaining the understanding of the IT environment, the auditor may also obtain a high-level understanding of the IT processes and the personnel involved in maintaining the IT environment (e.g., the number and skill level of the IT support resources that manage security and changes to the environment), which assists the auditor in understanding the complexity of the IT environment. This understanding may include identifying significant changes in the IT environment, which may be revealed through significant changes in the flows of transactions or information through the entity's information system.

A92e. Obtaining the auditor's understanding of the IT environment in accordance with paragraph 18(d), and the auditor's identification of IT applications and other aspects of the IT environment relevant to the audit in accordance with paragraph 21, may involve an iterative process or may be performed concurrently. Matters that may be relevant

to the auditor's understanding of the IT environment, or the determination of the aspects that are relevant to the audit, include matters such as:

- The extent of automated procedures for processing, and the complexity of those procedures, including, whether there is highly automated, paperless processing.
- The extent of the entity's reliance on system-generated reports in the processing of information.
- How data is input (i.e., manual input, customer or vendor input, or file load).
- How IT facilitates communication between applications, databases or other aspects of the IT environment, internally and externally, as appropriate, through system interfaces.
- The volume and complexity of data in digital form being processed by the system, including whether accounting records or other information are stored in digital form.
- Matters related to the individual aspects of the IT environment, for example:
  - The type of application (e.g., a commercial application with little or no customization, or a highly-customized or highly-integrated application that may have been purchased and customized, or developed in-house).
  - The complexity of the nature of the IT applications and the underlying IT infrastructure.
  - The complexity of the security over the IT environment, including vulnerability of the IT applications, databases, and other aspects of the IT environment to cyber security risks, particularly when there are web-based transactions or transactions involving external interfaces.
  - The extent of change within the IT environment (e.g., new aspects of the IT environment or significant changes in the IT applications or the underlying IT infrastructure)
  - Whether there is third-party hosting or outsourcing of IT.
  - Whether the entity is using emerging technologies that affect its financial reporting.
- Whether there was a major data conversion during the period and, if so, the nature and significance of the changes made, and how the conversion was undertaken.
- Whether program changes have been made to the manner in which information is processed, and the extent of such changes during the period

A92f. Obtaining an understanding of the entity's IT environment may be more easily accomplished for a smaller and less complex entity that uses commercial software and when the entity does not have access to the source code to make any program changes. Such entities may not have dedicated IT resources but may have a person assigned in an administrator role for the purpose of granting employee access or installing vendor-provided updates to the IT applications. Specific matters that the auditor may consider in understanding the nature of a commercial accounting software package, which may be the single IT application used by a smaller and less complex entity in its information system, may include:

- The extent to which the software is well established and has a reputation for reliability;
- The extent to which it is possible for the entity to modify the source code of the software; and
- The nature and extent of modifications that have in fact been made to the software. Many software packages allow for configuration (e.g., setting or amending reporting parameters). These do not usually involve modifications to source code; however, the auditor may consider the extent to which the entity is

able to configure the software when considering the completeness and accuracy of information produced by the software that is used as audit evidence.

A92g. Complex IT environments may include highly-customized or highly-integrated IT applications and may therefore require more effort to understand. Financial reporting processes or IT applications may be integrated with other IT applications. Such integration may involve IT applications that are used in the entity's business operations and that provide information to the financial reporting IT applications. In such circumstances, certain IT applications used in the entity's business operations may be relevant to financial reporting. Complex IT environments also may require dedicated IT departments that have structured IT processes supported by personnel that have software development and IT environment maintenance skills. In other cases, an entity may use third-party service providers to manage certain aspects of, or IT processes within, its IT environment.A93-A94. [MOVED to A100h and A100i]

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 Implemented (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, a combination of:

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

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

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

A96c. Regardless of the techniques used to evaluate the design of the information system and determine whether it has been implemented, the auditor's understanding of the sources of data, and the IT applications involved in processing that data, may also assist the auditor in understanding the IT environment.

A96d. When the auditor has identified controls over the information system as relevant to the audit in accordance with paragraph 20, the auditor is required to evaluate the design of those controls and determine whether they have been implemented, in accordance with paragraph 21B. These procedures may be performed together with the procedures performed to evaluate the design of the information system and whether it has been implemented. 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 may include 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.

A97a. *(previously part of paragraph A97 and A98)* Communication may be less structured (e.g., formal manuals may not be used) and easier to achieve in a smaller and less complex entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability. Regardless of the size of the entity, Open communication channels help ensure that exceptions are reported and acted on.

~~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 ~~C~~control activities component are the policies and procedures that help ensure that management directives are carried out. include those controls 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~~controls activities consist of application controls and general IT controls, both of which may be manual or automated in nature. Regardless of whether controls are within the IT environment or manual systems, controls may have various objectives and ~~are~~ may be applied at various organizational and functional levels. Examples of ~~specific~~ controls in the control activities component include those relating to the following: authorizations and approvals, reconciliations, verifications (such as edit and validation checks or automated calculations), segregation of duties, and physical or logical controls, including those addressing safeguarding of assets.

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

A99a. *(previously A105)* ~~The concepts underlying ~~C~~control activities~~ in smaller and less complex entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, in smaller and less complex entities, may find that certain types of more controls activities are not relevant because of controls may be directly applied by management. For example, management's sole authority for granting credit to

customers and approving significant purchases can provide strong control over important account balances and transactions, ~~lessening or removing the need for more detailed control activities.~~

A99b. Some individual controls may consist of both automated and manual aspects, such as controls that may use information produced by IT (e.g., an exception report) that is subject to manual procedures (e.g., review and follow-up). For many entities, most controls may be automated controls or involve a combination of automated and manual aspects because of the extent of use of IT applications for financial reporting purposes. In some cases, authorizations, approvals and the preparation of reconciliations may involve the use of technology enabled workflow or use of supporting records in digital form.

A99c. The greater the extent of automated controls, or controls involving automated aspects, that management uses and relies on in relation to its financial reporting, the more important it may become for the entity to implement general IT controls that address the continued functioning of the automated aspects of application controls.

A99d (previously A57) It may be less practicable to establish segregation of duties in smaller and less complex entities ~~often that have fewer employees which may be limited in the extent to which segregation of duties is practicable.~~ However, in an small owner-managed entity, the owner-manager may be able to exercise more effective oversight through direct involvement than in a larger entity, which. This oversight may compensate for the generally more limited opportunities for segregation of duties. Although, as also explained in ISA 240, domination of management by a single individual can be a potential control deficiency since there is an opportunity for management override of controls.<sup>28</sup>

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, ~~in addition to controls that address risks related to account balances and transactions.~~ Such controls activities may relate to information included in the financial statements that is obtained from outside of the general and subsidiary ledgers.

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

##### 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 are primarily direct controls and are primarily controls in the control activities component because such controls typically are controls over the entity's information system and address risks of material misstatement at the assertion level. However, there may be direct controls that exist in the control environment, the entity's risk assessment process or the entity's process to monitor the system of internal control components. Controls are required to be relevant to the audit when such controls meet one or more of the criteria included in paragraph 20. (from previous A102) However, ~~when 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.

A100a. Controls relevant to the audit are ordinarily expected to include at least controls over journal entries because the manner in which an entity incorporates information from transaction processing into the general ledger

<sup>28</sup> ISA 240, paragraph A27

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

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

A100b. The auditor determines whether there are any risks of material misstatement at the assertion level for which it is not possible or practicable to obtain sufficient appropriate audit evidence through substantive procedures alone as described in paragraph 30. The auditor is required, in accordance with ISA 330,<sup>29</sup> to design and perform tests of relevant controls that address such risks of material misstatement when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. As a result, when such controls exist that address these risks, they are relevant to the audit.

Understanding Controls Related to that address Significant Risks (Ref: Para. 290(b))

A100c. The auditor determines whether any assessed risks of material misstatement at the assertion level are significant risks in accordance with paragraph 27. Significant risks are those that exist close to the upper end of the spectrum of inherent risk and therefore are those risks of material misstatement that require the most persuasive audit evidence in accordance with ISA 330.<sup>30</sup> Paragraph 20 requires that the auditor identify controls that address significant risks to be controls relevant to the audit. The risk assessment procedures performed to understand these controls in accordance with paragraph 21B contribute to the audit evidence related to the significant risk.

A100d. Regardless of whether the auditor intends to test the operating effectiveness of controls that address significant risks, the understanding obtained about management's approach to addressing those risks may inform the design and performance of substantive procedures responsive to significant risks as required by ISA 330.<sup>31</sup> (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:

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

A100e. (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.

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<sup>29</sup> ISA 330, paragraph 8

<sup>30</sup> ISA 330, paragraph 7(b)

<sup>31</sup> ISA 330, paragraph 21



A100f ISA 240<sup>32</sup> requires the auditor to identify the controls that address risks of material misstatement due to fraud as controls relevant to the audit and explains that it is important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In identifying the controls relevant to the audit that address the risks of material misstatement due to fraud, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties.

A100g. (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 control deficiency in internal control.<sup>33</sup>

Controls over Journal entries (Ref: Para. 48(f) 20(c))

A100h. (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, and cash disbursements in the general or a subsidiary ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A100i. (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 consolidation 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.

Testing of operating effectiveness of controls (Ref: Para. 20(d))

A100j. When the auditor determines that a risk(s) for which substantive procedures alone do not provide sufficient appropriate audit evidence exists, the auditor is required to the auditor is required, in accordance with ISA 330,<sup>34</sup> to design and perform tests of relevant controls. Further, when the auditor voluntarily intends to take into account the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures, such controls are required to be identified as relevant to the audit because ISA 330<sup>35</sup> requires the auditor to design and perform tests of those controls. For example, the auditor may plan to test controls over routine classes of transactions because such testing may be more effective or efficient for large volumes of homogenous transactions.

A100k. The auditor's intentions to test the operating effectiveness of controls may also be influenced by the identified risks of material misstatement at the financial statement level. For example, if deficiencies are identified related

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<sup>32</sup> ISA 240, paragraphs 27 and A32.

<sup>33</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph A7

<sup>34</sup> ISA 330, paragraph 8

<sup>35</sup> ISA 330, paragraph 8(a)

to the control environment, this may affect the auditor's overall expectations about the operating effectiveness of direct controls.

A100l. ~~(previously A70) The auditor may plan to test the operating effectiveness of cControls over the completeness and accuracy of information produced by the entity may be relevant to the audit if when the auditor intends to take into account the operating effectiveness of those controls make use of the information in designing and performing further audit procedures- to determine the reliability of that information for its use as audit evidence. The auditor may also plan to test the operating effectiveness of cControls relating to operations and compliance objectives may also be relevant to an audit if when they relate to data the auditor evaluates or uses in applying audit procedures.~~

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

A100m. The extent to which other controls are identified as relevant to the audit is a matter of the auditor's professional judgment. The auditor's judgment about whether it is appropriate to devote additional attention to evaluating the design of controls and determining whether they have been implemented in order to provide a basis for the design and performance of further audit procedures is influenced by:

- ~~(previously A104)The auditor's knowledge about the presence or absence of controls activities obtained from the understanding of the components of the other components of system of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. For example, when an engagement is new or the entity has made significant changes to its information system, the auditor may determine that more information about the entity's controls is needed to provide a basis for the design of the auditor's further audit procedures, including to assist the auditor in deciding whether to test the operating effectiveness of such controls; and~~
- The identification of risks of material misstatement and the related assessments of inherent risk at the assertion level because ISA 330 requires more persuasive audit evidence the higher the auditor's assessment of risk.<sup>36</sup> For risks that are assessed as higher, but are not significant risks, the auditor may identify controls over those risks to be relevant to the audit. Similar to controls over significant risks, the auditor's evaluation of the design of these controls and determination of whether they have been implemented contributes to the audit evidence related to the higher risk. This understanding of controls may also assist the auditor in designing further audit procedures responsive to the risk.

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

~~A102. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.~~

A103. [MOVED to A99e]

A104. [MOVED to A100l]

~~Considerations Specific to Smaller Entities~~

A105. [MOVED to A99a]

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<sup>36</sup> ISA 330, paragraph 7(b)

~~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.~~

IT Applications and Other Aspects of the IT Environment Relevant to the Audit (Ref: Para 21)

A106a. An entity may be using and relying upon IT to accurately process and maintain the integrity of information in the entity's information system relevant to financial reporting. In obtaining the understanding of the IT environment in accordance with paragraph 18(d), the auditor may have obtained information about the nature and number of the IT applications and the complexity of the IT processes in the entity's IT environment. Obtaining a high-level understanding of the extent to which the entity's IT processes include the implementation of general IT controls may assist the auditor in identifying whether there are IT applications on which management is relying for the purposes of financial reporting and that therefore may be IT applications relevant to the audit. In addition, the auditor is required to take into account the matters included in paragraph 21 because these matters may further assist the auditor in identifying those IT applications for which the entity's general IT controls may be relevant to the audit.

A106b. In smaller and less complex entities that use commercial software and that do not have access to the source code to make any program changes, the entity may not have any IT processes other than, for example, to process updates to the software received from the vendor. Also, in smaller and less complex entities, management may not be relying on the IT applications, and the controls within them, to maintain the integrity of information. For example, management may instead be relying on reconciliations of information about transactions processed by the IT application to hard copy records or external documents (e.g., reconciliation of cash sales to deposits reported on a bank statement). When an entity uses an IT application that is reputable, widely-used and considered reliable, the entity is unable to change its programming, and the entity maintains hard-copy accounting records, the auditor may determine that there are no IT applications relevant to the audit. In such a case, the auditor is also likely to be able to obtain audit evidence about the completeness and accuracy of the information produced by the entity used as audit evidence through substantive testing without the need to test controls over its production.

A106c. In larger entities, the entity may be relying on IT to a greater extent and the IT environment may involve multiple IT applications and the IT processes to manage the IT environment may be complex. When an entity has greater complexity in its IT environment, determining the IT applications and other aspects of the IT environment that are relevant to the audit is likely to require the involvement of team members with specialized skills in IT.

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

A106d. Automated controls that may be determined to be relevant to the audit in accordance with paragraph 21 may include, for example, automated calculations or input, processing and output controls, such as a three-way match of a purchase order, shipping document, and vendor invoice. System-generated reports that the auditor may intend to use as audit evidence may include, for example, a trade receivable aging report or an inventory valuation report.

A106e. In considering whether the IT applications in which automated controls exist and reports are generated are relevant to the audit, the auditor is likely to consider whether, and the extent to which, the entity may have access to source code that enables management to make program changes to such controls or the IT applications. For system-generated reports to be used as audit evidence, the auditor may obtain audit evidence about the completeness and accuracy of the reports by substantively testing the inputs and outputs of the report. In other cases, the auditor may plan to test the operating effectiveness of the controls over the preparation and maintenance of the report, in which case the IT application from which it is produced is likely to be relevant to the audit.

A106f. Some IT applications may include report-writing functionality within them while some entities may also utilize separate report-writing applications (i.e., report-writers). In such cases, the auditor may need to determine the sources of system-generated reports (i.e., the application that prepares the report and the data sources used by the report) to determine the IT applications relevant to the audit. The data sources used by IT applications may be databases that, for example, can only be accessed through the IT application or by IT personnel with database administration privileges. In other cases, the data source may be a data warehouse that may itself be considered to be an IT application relevant to the audit.

A106g. The entity's ability to maintain the integrity of information stored and processed in the information system may vary based on the complexity and volume of the related transactions and other information. The greater the complexity and volume of data that supports a significant class of transaction, account balance or disclosure, the less likely it may become for the entity to maintain integrity of that information through application controls alone (e.g., input and output controls or review controls). It also becomes less likely that the auditor will be able to obtain audit evidence about the completeness and accuracy of such information through substantive testing alone when such information is used as audit evidence. In some circumstances, when volume and complexity of transactions are lower, management may have an application control that is sufficient to verify the accuracy and completeness of the data (e.g., individual sales orders processed and billed may be reconciled to the hard copy originally entered into the IT application). When the entity relies on general IT controls to maintain the integrity of certain information used by IT applications, the auditor may determine that the IT applications that maintain that information are relevant to the audit.

A106h. The auditor may have identified a risk for which substantive procedures alone are not sufficient because of the entity's use of highly-automated and paperless processing of transactions, which may involve multiple integrated IT applications. In such circumstances, the controls relevant to the audit are likely to include automated controls. Further, the entity may be relying on general IT controls to maintain the integrity of the transactions processed and other information used in processing. In such cases, the IT applications involved in the processing and the storage of the information are likely relevant to the audit.

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

A106i. The other aspects of the IT environment that may be relevant to the audit include the network, operating system and databases, and in certain circumstances interfaces between IT applications. When there are no IT applications relevant to the audit, other aspects of the IT environment are also not relevant. When there are IT applications relevant to the audit, the other aspects of the IT environment that are relevant to the audit varies based on the extent to which such aspects support and interact with the IT applications determined to be relevant to the audit. The database(s) that stores the data processed by an IT application relevant to the audit is also relevant to the audit. Similarly, because an IT application's ability to operate is often dependent on the operating system, the operating system is typically relevant to the audit. The network may be relevant to the audit, for example, when an IT application interacts with vendors or external parties through the internet.

Risks Arising from the Use of IT and General IT Controls Relevant to the Audit (Ref: Para. 21A)

A106j. (previously A67) The extent and nature of the risks arising from the use of IT to internal control vary depending on the nature and characteristics of the entity's information system. IT applications and other aspects of the IT environment relevant to the audit. Specific IT risks may result when the entity uses third-party hosting for relevant aspects of its IT environment. It is more likely that there will be more IT risks arising from the use of IT when the volume or complexity of automated application controls is higher and management is placing greater reliance on those controls for effective processing of transactions or the effective maintenance of the integrity of underlying information. Examples of risks arising from the use of IT are included in paragraph A92b. The entity responds to

~~the risks arising from the use of IT<sub>1</sub> or from use of manual elements<sub>1</sub> in internal control by establishing effective controls in light of the characteristics of the entity's information system.~~

~~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 implemented to address risks referred to in paragraph A64 above arising from the use of IT. Accordingly, the auditor uses the understanding obtained about the IT applications and other aspects of the IT environment that are relevant to the audit and the related risks arising from the use of IT in determining the general IT controls relevant to the audit. In doing so, the auditor may take an approach of understanding the general IT controls that the entity has established over its IT processes for management of access, program change and IT operations for each IT application or other aspect of the IT environment that is relevant to the audit. In some cases, an entity may use common IT processes across its IT environment or across certain IT applications, in which case common risks arising from the use of IT and common general IT controls may be identified.~~

~~A108a. In identifying the risks arising from the use of IT, the auditor may also consider the nature of the IT application or other aspect of the IT environment and the reasons for it being determined to be relevant to the audit. For some IT applications or other aspects of the IT environment, the risks identified may relate primarily to unauthorized access or unauthorized program changes. In the case of databases or data warehouses, the auditor may be focused on the risk of inappropriate changes to the data through direct database access and the ability to directly manipulate information.~~

~~A108b. In general, a greater number of general IT controls related to IT applications and databases are likely to be relevant to the audit than for other aspects of the IT environment. This is because these aspects are the most closely concerned with the processing and storage of information and most subject to automated controls used in the entity's information system. In identifying general IT controls, the auditor may consider controls over actions of both end users and of the entity's IT personnel or IT service providers.~~

~~A108c. Identifying the risks arising from the use of IT and the general IT controls relevant to the audit is likely to require the involvement of team members with specialized skills in IT, other than for the simplest of IT environments. Such involvement is likely to be essential, and may need to be extensive, for complex IT environments. Appendix 4 provides further explanation of the nature of the general IT controls typically implemented for different aspects of the IT environment. In addition, examples of general IT controls for different IT processes are provided.~~

~~A109. 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 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.~~

#### 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 control 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 that address risks of material misstatement at the assertion level to their respective risks of material misstatement so that the auditor may evaluate whether, and the extent to which, a control is appropriately designed to address the related risk(s) of material misstatement. Generally, it is useful to obtain an understanding of controls and relate them to ~~assertions~~ risks of material misstatement in the context of processes and systems and, when applicable, IT applications in which they exist ~~because individual control activities often do not in themselves address a risk.~~ The relationship to IT applications assists with relating the general IT controls relevant to the audit to the controls that they support. In many cases, an individual control may not in itself adequately address a risk of material misstatement. Often, only multiple controls ~~activities~~, together with other components of the system of internal control, will be sufficient to address a risk of material misstatement.

A109c. (*previously A138*) Conversely, some controls ~~activities~~ may have a specific effect on an individual ~~assertion~~ risk of material misstatement at the assertion level 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 risks of material misstatement relevant to the existence and completeness assertions for the inventory account balance.

A109d. (*previously A139*) Controls that support other controls are indirect controls. ~~Controls can be either directly or indirectly related to an assertion.~~ The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements ~~in related to the at assertion~~ risk of material misstatement. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the risks of material misstatement relevant to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing those risks ~~for that assertion~~ than controls more directly related ~~thereto that assertion~~, such as matching shipping documents with billing documents. Similarly, a general IT control alone is typically not sufficient to address a risk of material misstatement at the assertion level.

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, the auditor may evaluate the design and determine whether the control has been implemented concurrently with the testing of its operating effectiveness, when, for example, there is some automation that provides for consistent operation of the control and the relevant risks arising from the use of IT have been addressed (e.g., when general IT controls are operating effectively). ~~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 controls such as those over program changes.~~ Tests of the operating effectiveness of controls, including tests of indirect controls, are further described in ISA 330.<sup>37</sup>

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

- Influence the auditor's plans to test the operating effectiveness of the controls. When a control is not designed or implemented effectively, there is no benefit in testing it. Conversely, the auditor may conclude that a control, which is effectively designed and implemented, may be appropriate to test in order to take its operating effectiveness into account in designing substantive procedures. When the auditor plans to test a control, the information obtained about the extent to which the control addresses the risk(s) of material misstatement is an input to the auditor's control risk assessment at the assertion level.
- Provide the auditor with a greater understanding of the risks of material misstatement, including the identification of additional risks of material misstatement. This understanding is used in designing the nature, timing and extent of substantive audit procedures that are responsive to the risks of material misstatement, including when the auditor does not plan to test the operating effectiveness of the controls. For example, the results of these procedures may inform the auditor's consideration of possible deviations in a population when designing audit samples.
- Result in the identification of risks of material misstatement at the financial statement level when the results of the auditor's procedures are inconsistent with expectations about the entity's system of internal control that may have been set based on information obtained during the engagement acceptance or continuance process.

A110-A111 [MOVED to A89e and A89m]

A112 [MOVED to A89f]

A113 and A116 [MOVED to A89n]

A114 and A115 [MOVED to Appendix 3]

A117 through A120 [MOVED to A89o-A89r]

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<sup>37</sup> ISA 330, Paragraphs 8–11

## Identifying and Assessing the Risks of Material Misstatement (Ref: Para 25-30B26(b))

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 accordance with ISA 330. In identifying and assessing the risks of material misstatement in the financial statements, the auditor exercises professional skepticism in accordance with ISA 200.<sup>38</sup>

### *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, ~~The~~ auditor may use the assertions as described in paragraph A1219c(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.
  - (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.

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<sup>38</sup> ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 15



- (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 A1219c(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 A129121(a)–(b), management may often assert that transactions and events have been carried out in accordance with law, regulation or other authority. Such assertions may fall within the scope of the financial statement audit.

#### Identifying Risks of Material Misstatement (Ref: Para. 25)

A121f. *(previously paragraph A122)* Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level. ~~for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud~~

A121g. Risks of material misstatements that do not relate pervasively to the financial statements are risks of material misstatement at the assertion level.

A121h. While obtaining the understanding as required by paragraph 11, the auditor takes into account the inherent risk factors. (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 may indicate susceptibility to misstatement that may be material.

A121i. The auditor's understanding required by paragraphs 11 to 13, and the identification and assessment of the risks of material misstatement, is an iterative process. For example, the auditor may form initial expectations about the

significant classes of transactions, account balances and disclosures based on the understanding of the entity and its environment and the applicable financial reporting framework obtained in accordance with paragraph 11. These expectations may be confirmed or updated as the auditor performs further risk assessment procedures to address the requirements in paragraphs 12 and 13, in particular relating to the auditor's understanding of the entity's information system. Specifically, the auditor may identify additional risks of material misstatement related to the classes of transactions, account balances or disclosures that were expected to be significant, thus confirming their significance. The auditor may also identify risks of material misstatement that are related to classes of transactions, account balances or disclosures not previously considered significant and which may therefore give rise to the identification of additional significant classes of transactions, account balances, or disclosures. (Ref: Para. 25(b) and 25B)

A121j. (Previously A139) ~~Potential Misstatements~~ in individual classes of transactions, account balances or disclosures may be judged to be material due to size, nature or circumstances. ~~(Ref: Para. 26(d))~~

#### Considerations Specific to Public Sector Entities

A121k. For public sector entities, the identification of risks at the financial statement level may include consideration of matters related to the political climate, public interest and program sensitivity.

A122. [MOVED to A121f]

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, such as declining economic conditions). 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.~~

A124. [MOVED to A126e]

A125. [MOVED to A126f]

A126. [MOVED to A127h]

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

A126a. Because risks of financial statement level have a pervasive effect on the financial statements, it may not be possible to identify the specific assertions that are more susceptible to the risk (e.g., risk of management override of controls). In other cases, a number of assertions may be identified as susceptible to the risk, and which may therefore affect the auditor's risk identification and assessment of risks of material misstatement at the assertion level.

A126b. The evaluation of whether risks identified relate pervasively to the financial statements as required by paragraph 25(a) supports the auditor's ability to perform the assessment of the risks of material misstatement at the financial statement level as required by paragraph 25A. The determination of the effect of the risks of material misstatement at the financial statement level on the risks of material misstatement at the assertion level as required by paragraph 25A(a) is taken into account in the auditor's assessment of inherent risk at the assertion level in accordance with paragraph 26(b). (Ref: Para. 25A(b))

A126c. Risks of material misstatement due to fraud may be particularly relevant to the auditor's consideration of the risks of material misstatement at the financial statement level. For example, the risk of management override of controls may pervasively affect the risks of material misstatement at the assertion level, although the auditor may consider particular assertions to have a greater potential for misstatement based on greater susceptibility to management bias or fraud

A126d. The auditor's identification and assessment of risks of material misstatement at the financial statement level is influenced by the auditor's understanding of the entity's system of internal control, including the outcome of the evaluations required by paragraphs 14A and 17(b) and any control deficiencies identified in accordance with paragraph 21C. In particular, risks at the financial statement level may arise from deficiencies in the control environment or from external events or conditions, such as declining economic conditions. When the outcome of the required evaluation in paragraph 14A relating to the entity's control environment is such that deficiencies in the control environment have been identified, this in particular may have implications for the auditor's identification and assessment of the risks of material misstatement at the financial statement level.

A126e. *(previously paragraph 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.

A126f. *(previously paragraph A125)* ISA 705 (Revised)<sup>39</sup> establishes requirements and provides guidance in determining whether there is a need for the auditor to express a qualified opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement where withdrawal is possible under applicable law or regulation.

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

A127. The auditor identifies the significant classes of transactions, account balances and disclosures by determining whether there are one or more risks of material misstatement related to the assertions for classes of transactions, account balances and disclosures expected in the financial statements (i.e., whether there is a reasonable possibility of being subject to a misstatement that is material, individually or in combination with other misstatements). When there is a remote possibility of a material misstatement with respect to an assertion, there are no identified risks of material misstatement and the assertion is not relevant. In determining the relevant assertions, the auditor considers the information gathered from the auditor's risk assessment procedures about the identified risks of material misstatement and the assertions that they may affect.

A127a. In determining significant classes of transactions, account balances and disclosures from the identified risks of material misstatement, understanding how the inherent risk factors affect the classes of transactions, account balances and disclosures enables the auditor to consider which related assertions may be subject to risks of material misstatement (see paragraph A49f).

A127b. 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 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).

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<sup>39</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

Identifying Significant Disclosures (Ref; Para. 25B)

~~A127c. (previously A135) The auditor's consideration of disclosures in the financial statements when identifying risks include quantitative and qualitative disclosures, the misstatement of which could be material (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, Significant disclosures include both quantitative and qualitative disclosures for which there is one or more relevant assertions. e~~Examples of significant disclosures that have qualitative aspects and that may be 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.

~~Assessment of Inherent Risks of Material Misstatement at the Assertion Level (Ref: Para. 265(b))~~

Assessing the Likelihood and Magnitude of the Risks of Material Misstatement at the Assertion Level (Ref: Para: 26(a))

A127d. The degree to which events or conditions relating to significant classes of transactions, account balances and disclosures are subject to, or affected by, the inherent risk factors affects the degree to which such events and conditions are susceptible to misstatement. The inherent risk factors influence the auditor's assessment of the likelihood and magnitude of misstatement for the identified risks of material misstatement at the assertion level. The greater the degree to which a class of transactions, account balance or disclosures is susceptible to material misstatement, the higher the inherent risk assessment is likely to be.

A127e. The relative degrees of the likelihood and magnitude of a possible misstatement determine where on the spectrum of inherent risk the risk of misstatement exists. The higher the combination of likelihood and magnitude, the higher the inherent risk; the lower the combination of likelihood and magnitude, the lower the inherent risk. A higher inherent risk assessment may also arise from different combinations of likelihood and magnitude, for example a higher risk assessment could result from a lower likelihood but a very high magnitude. Determining the combination of the likelihood and potential magnitude of a possible misstatement is a matter of the auditor's professional judgment. Significant risks, which are identified in accordance with paragraph 27, are those close to the upper end of the spectrum of inherent risk.

A127f. The assessment of inherent risks for individual risks of material misstatement in relation to audits of smaller and less complex entities may be such that a greater proportion of such risks are assessed close to the lower end of the spectrum of inherent risk.

A127g. In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may designate risks of material misstatement within relative categories along the spectrum of inherent risk, based on their assessment of inherent risk. These relative categories may be described in different ways, for example audit methodologies may use numerical categorizations (e.g., on a scale of one to ten), or the relative placement on the spectrum of risk may be described (e.g., high, medium, low). Regardless of the method of categorization used, the auditor's assessment of inherent risk is appropriate when the design and implementation of further audit procedures to address the identified risks of material misstatement at the assertion level is responsive to the assessment of inherent risk and the reasons for that assessment.

A127h. ~~(previously paragraph 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 the identified risks of material misstatement at the assertion level, the auditor may conclude that some risks of material misstatement relate more pervasively to the financial statements as a whole and potentially affect many assertions, in which case the auditor may update the identification of risks of material misstatement at the financial statement level.

A127i. In circumstances in which risks of material misstatement are identified as financial statement level risks due to their pervasive effect on a number of assertions and that effect is identifiable with specific assertions, the auditor takes into account the evaluation required by paragraph 25A(b), including those assertions identified that are affected by those risks when assessing the inherent risk for risks of material misstatement at the assertion level. (Ref: Para. 26(b))

#### Considerations specific to public sector entities

A127j. In exercising judgment as to the assessment of the risk of material misstatement, public sector auditors may consider the complexity of the regulations and directives, and the risks of non-compliance with authorities.

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. 2728)

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 close to the upper end of the spectrum of inherent risk. The determination of which of the assessed inherent risks are close to the upper end of the spectrum of inherent risk, and are therefore significant risks, is a matter of professional judgment, unless the risk is of a type specified to be treated as a significant risk in accordance with the requirements of another ISA (see paragraph 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 close to the lower end on the spectrum of inherent risk. However, (previously A141) 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 ariseing 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.
- ~~Complex calculations or accounting principles~~ Account balances or quantitative disclosures that involve complex calculations
- (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.~~[Moved to A141]
- ~~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. Significant risks include those risks of material misstatement that are treated as significant in accordance with the requirements of other ISAs. ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.<sup>40</sup>

#### Implications for the audit

A144a. (previously paragraph A143) ISA 330 describes the consequences for further audit procedures of identifying a risk as significant. When a risk is assessed as a significant risk, the implications for the audit include the design and implementation of an appropriate response to address the assessed risk, which may include for example the

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<sup>40</sup> ISA 240, paragraphs 25–27

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:

- Controls that address significant risks are required to be identified as relevant to the audit in accordance with paragraph 20.
- ISA 330 requires controls that address significant risks to be tested in the current period (when the auditor intends to rely on the operating effectiveness of such controls) and substantive procedures to be planned and performed that are specifically responsive to the identified significant risk.<sup>41</sup>
- ISA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor’s assessment of risk.<sup>42</sup>
- ISA 260 (Revised) requires communicating with those charged with governance about the significant risks identified by the auditor.<sup>43</sup>
- ISA 701 requires the auditor to take into account significant risks when determining those matters that required significant auditor attention, which are matters that may be key audit matters.<sup>44</sup>
- Review of audit documentation by the engagement partner on or before the date of the auditor’s report which allows significant matters, including significant risks, to be resolved on a timely basis to the engagement partner’s satisfaction.<sup>45</sup>
- ISA 600 requires more involvement by the group engagement partner if the significant risk relates to a component in a group audit and for the group engagement team to direct the work required at the component by the component auditor.<sup>46</sup>

A145 [MOVED to A100d]

A14 6 [MOVED to A100e]

A147 [MOVED to A100g]

*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 information system that involves a high-degree of integration integrated across its IT system applications. In such cases:

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<sup>41</sup> ISA 330, paragraphs 15 and 21

<sup>42</sup> ISA 330, paragraph 7(b)

<sup>43</sup> ISA 260, paragraph 15

<sup>44</sup> ISA 701, paragraph 9

<sup>45</sup> ISA 220, paragraphs 17 and A18

<sup>46</sup> ISA 600, paragraphs 30 and 31

- 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. ISA 540 (Revised) provides further guidance related to accounting estimates about risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.<sup>47</sup>

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,<sup>48</sup> to design and perform tests of such controls. The consequences for further audit procedures of identifying such risks are described in ISA 330.

Assessing Control Risk (Ref: Para. 30A)

A150a. The auditor's intention to test the operating effectiveness of controls provides the basis for the auditor's assessment of control risk. In assessing control risk, the auditor takes into account the expectation about the operating effectiveness of the controls (based on the auditor's evaluation of the design effectiveness and implementation of the controls set out in paragraph 21B). The auditor's assessment of control risk remains at the maximum level when the auditor is not required to or does not intend to test the operating effectiveness of controls that address the risks of material misstatement at the assertion level and the auditor's assessment of inherent risk.

A150b. If a risk of material misstatement is addressed by one or more controls, the auditor takes into account whether one, or a combination of controls, will address the assessment of inherent risk.

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 expected results from the auditor's planned tests of the operating effectiveness of controls relevant to the audit, including general IT controls. For controls relevant to the audit as determined in accordance with paragraph 20, and for which the auditor intends to test the operating effectiveness, the auditor may identify related general IT controls as relevant to the audit in accordance with paragraph 21A. For example, when the auditor plans to test the operating effectiveness of an automated control, the auditor may also plan to test the operating effectiveness of the relevant general IT controls that support the continued functioning of that application control to address the risks arising from the use of IT and to provide a basis for the auditor's expectation that the application control operated effectively throughout the period. When the auditor expects general IT controls that have been determined to be relevant to the audit to be ineffective, this determination may affect the auditor's assessment of control risk at the assertion level depending on whether the auditor is able to perform other tests to address those risks arising from the use of IT. Further guidance about the procedures that the auditor may perform in these circumstances is provided in ISA 330.<sup>49</sup>

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<sup>47</sup> ISA 540 (Revised), paragraphs A87– A89

<sup>48</sup> ISA 330, paragraph 8

<sup>49</sup> ISA 330, paragraphs A29-A31



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,<sup>50</sup> materiality and audit risk are considered when identifying and assessing the risks of material misstatement in classes of transactions, account balances and disclosures. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial reporting needs of users of the financial statements.<sup>51</sup> Classes of transactions, account balances or disclosures are quantitatively or qualitatively material if omitting, misstating or obscuring information about them could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole.

A150f. There may be classes of transactions, account balances or disclosures that are quantitatively or qualitatively material but have not been determined to be significant classes of transactions, account balances or disclosures (i.e., there are no relevant assertions identified). For example, the entity may have a disclosure about executive compensation for which the auditor has not identified a risk of material misstatement. However, the auditor may determine that this disclosure is material based on the consideration in paragraph A150e.

A150g. 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.<sup>52</sup> When a class of transactions, account balance or disclosure is determined to be significant as required by paragraph 25B, the class of transactions, account balance or disclosure, is also treated as a material class of transactions, account balance or disclosure for the purposes of paragraph 18 of ISA 330.

*Revision of Risk Assessment (Ref: Para. 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 smaller and less complex entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.<sup>53</sup> Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures.<sup>54</sup> The form and extent of the auditor's documentation is influenced by the nature, size and complexity of the entity and its system of internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

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<sup>50</sup> ISA 320, paragraph A1

<sup>51</sup> ISA 320, paragraph 4

<sup>52</sup> ISA 330, paragraph 18

<sup>53</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9

<sup>54</sup> ISA 330, paragraph 28

A153. For the audits of smaller and less complex entities ~~that have uncomplicated businesses and processes relevant to financial reporting~~, the form and extent of documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor may include those on which the auditor based the assessment of the risks of material misstatement.

~~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.

**Appendix 1**

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

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

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

Activities of the Entity

1. (*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.<sup>55</sup>
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.

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<sup>55</sup> ISA 550, paragraph A7

## Appendix 2

(Ref: Para. A38a, A49f, A41, A133)

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

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

The following are examples of ~~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 ~~conditions 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 misstatement due to management bias or fraud:**

Reporting:

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

Transactions:

- Significant transactions with related parties.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.

**Other inherent risk factors:**

**Stress:**

IT:

- 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.

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

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

### **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.

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

(e) 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.

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

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

~~and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.~~

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

### Entity's Risk Assessment Process

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~~ information consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:
  - *Changes in operating environment.* Changes in the regulatory, economic or operating environment can result in changes in competitive pressures and significantly different risks.
  - *New personnel.* New personnel may have a different focus on or understanding of the system of internal control.
  - *New or revamped information systems.* Significant and rapid changes in the information systems can change the risk relating to the entity's system of internal control.
  - *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
  - *New technology.* Incorporating new technologies into production processes or the information systems may change the risk associated with the entity's system of internal control.
  - *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with the entity's system of internal control.

- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with the entity's system internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.
- Use of IT. Risks relating to
  - Maintaining the integrity of data and information processing (including cyber security risks)
  - Risks to the entity business strategy that arise if the entity's IT strategy does not effectively supporting the entity's business strategy; or
  - Changes or interruptions in the entity's IT environment or turnover of IT personnel or when the entity does not make necessary updates to the IT environment or such updates are not timely.

#### **The Entity's Process to Monitoring the System of Internal Controls**

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 monitoring of the system of internal controls includes considering whether they controls are operating as intended and that they are modified as appropriate for changes in conditions. ~~Monitoring of controls.~~ The entity's process to monitor the system of internal control may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.
6. When distinguishing between a monitoring activity and a control in the control activities component, the underlying details of the activity are considered, especially where the activity involves some level of supervisory review. As also explained in the application material, supervisory reviews are not automatically classified as monitoring activities and it may be a matter of judgment whether a review is classified as a control in the control activities component or a monitoring activity. For example, the intent of a monthly completeness control in the control activities component would be to detect and correct errors, where a monitoring activity would ask why errors are occurring and assign management the responsibility of fixing the process to prevent future errors. In simple terms, a control in the control activities component responds to a specific risk, whereas a monitoring activity assesses whether controls within each of the five components of 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 the system of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider in performing monitoring activities any communications relating to the system of internal control from external auditors, 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, the system of internal control and governance processes. If so, the internal audit function may play an important role in the entity's process to monitoring the system of internal control 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.~~

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

- Capture, process and disclose information about events and conditions other than transactions.
11. (previously 7) The quality of ~~system-generated~~ the information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
12. (previously 8) Communication, which involves providing an understanding of individual roles and responsibilities pertaining to the entity's system of 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, Controls in the control activities component that may be relevant to an audit consist of application controls and general IT controls, both of which may be manual or automated in nature, and may be categorized as policies and procedures that pertain to the following:
- ~~Information processing.~~ The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
  - Authorization and approvals. An authorization affirms that a transaction is valid (i.e. it represents an actual economic event or is within an entity's policy). An authorization typically takes the form of an approval by a higher level of management or of verification and a determination if the transaction is valid. For example, a supervisor approves an expense report after reviewing whether the expenses seem reasonable and within policy. An example of an automated approval is where an invoice unit cost is automatically compared with the related purchase order unit cost within a pre-established tolerance level. Invoices within the tolerance level are automatically approved for payment. Those invoices outside the tolerance level are flagged for additional investigation.
  - Reconciliations – Reconciliations compare two or more data elements and, if differences are identified, action is taken to bring the data into agreement. Reconciliations generally address the completeness or accuracy of processing transactions.
  - Verifications – Verifications compare two or more items with each other or compare an item with a policy, and perform a follow-up action when the two items do not match or the item is not consistent with policy. Verifications generally address the completeness, accuracy, of validity of processing transactions.

- ~~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 or logical controls, including those that address security of assets against unauthorized access, acquisition, use or disposal. Controls that encompass:
  - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
  - The authorization for access to computer programs and data files (i.e., logical access).
  - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, ~~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, smaller entities may lack sufficient resources to achieve ideal segregation, and the cost of hiring additional staff may be prohibitive. In these situations, management institutes alternative controls. In the example above, if the salesperson can modify product price files, a detective control activity can be put in place to have personnel unrelated to the sales function periodically review whether and under what circumstances the salesperson changed prices.

14. (previously 10) Certain controls in the control activities component may depend on the existence of appropriate higher level policies – supervisory controls established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, non-routine transactions such as major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

## Benefits of IT

15. [MOVED from A63] Generally, IT benefits an entity's system of internal control by enabling an entity to:

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

### Limitations of internal control

16. *(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 the system of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
17. *(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 an IT application software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
18. *(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.

**Appendix 4**

(Ref: Para. A108c)

**Considerations for Understanding General IT Controls**

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

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

(a) Applications

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

(b) Database

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

(c) Operating system

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

(d) Network

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

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

(a) Process to manage access:

o Authentication

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



- Authorization  
Controls that allow users to access the information necessary for their job responsibilities and nothing further, which facilitates appropriate segregation of duties.
  - Provisioning  
Controls to authorize new users and modifications to existing users' access privileges
  - Deprovisioning  
Controls to remove user access upon termination or transfer.
  - Privileged access  
Controls over administrative or powerful users' access.
  - User access reviews  
Controls to recertify or evaluate user access for ongoing authorization over time.
  - Security configuration controls  
Each technology generally has key configuration settings that help restrict access to the environment.
  - Physical access  
Controls over physical access to the data center and hardware, as such access may be used to override other controls.
- (b) Process to manage program or other changes to the IT environment
- Change management process  
Controls over the process to design, program, test and migrate changes to a production (i.e., end user) environment.
  - Segregation of duties over change migration  
Controls that segregate access to make and migrate changes to a production environment.
  - Systems development or acquisition or implementation  
Controls over initial IT application development or implementation (or in relation to other aspects of the IT environment).
  - Data conversion  
Controls over the conversion of data during development, implementation or upgrades to the IT environment.
- (c) Process to manage IT Operations
- Job scheduling  
Controls over access to schedule and initiate jobs or programs that may affect financial reporting.

- Job monitoring  
Controls to monitor financial reporting jobs or programs for successful execution.
- Backup and recovery  
Controls to ensure backups of financial reporting data occur as planned and that such data is available and able to be accessed for timely recovery in the event of an outage or attack.
- Intrusion detection  
Controls to monitor for vulnerabilities and or intrusions in the IT environment.