

Draft of Proposed ISA 315 (Revised) (Requirements) — **Marked from Agenda Item 3-A**

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

**[Version, June 22, 2018]**

### Scope of this ISA

This International Standard on Auditing (ISA) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements ~~through understanding the entity and its environment, including the entity's internal control.~~

### Key Concepts in this ISA

- 1A. ISA 200 deals with the overall objectives of the auditor, including to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is a function of the risks of material misstatement and detection risk. ISA 200 explains that the risks of material misstatement may exist at two levels: the overall financial statement level; and the assertion level for classes of transactions, account balances and disclosures.
- 1B. Risks at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level consist of two components, inherent and control risk:
- Inherent risk is defined as the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - Control risk is defined as the risk that a misstatement that could occur in an assertion about a class of transactions, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's system of internal control.
- 1C. A separate assessment of inherent risk and control risk for risks of material misstatement at the assertion level is required by this ISA. Inherent risk is influenced by factors that, alone or in combination with others, increase, to varying degrees, the susceptibility of an assertion ~~about a class of transactions, account balance or disclosure~~ to a misstatement that could be material, before taking account of controls. For purposes of the ISAs, these factors are referred to as 'inherent risk factors.' As explained in ISA 200, inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale that is referred to in this ISA as the 'spectrum of inherent risk.' ~~Depending on the extent to which the assertion is subject to, or affected by, such factors, the inherent risk varies for different risks of material misstatement at the assertion level, on a continuous scale. For example, ISA 200 explains that inherent risk is higher for some assertions about particular classes of transactions, account balances and disclosures than for others.~~

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

- 1D. ~~In assessing control risk, the auditor takes into account whether the auditor's further audit procedures contemplate planned reliance on the operating effectiveness of controls (that is, control risk is assessed as less than maximum). If the auditor does not perform tests of controls, the auditor's assessment of the risk of material misstatement at the assertion level cannot be reduced for the effective operation of controls with respect to the particular assertion (that is, control risk is assessed as maximum).<sup>2</sup> The auditor's assessment of control risk takes into account the auditor's expectations about the operating effectiveness of controls in designing further audit procedures. If the auditor does not plan to test the operating effectiveness of controls, the auditor assesses control risk at the maximum. When the auditor is required, or intends, to test operating effectiveness as part of the auditor's further audit procedures, the auditor assesses control risk at less than the maximum.~~
- 1E. The auditor identifies and assesses the risks of material misstatement at the financial statement level and the assertion level in accordance with this ISA, in order to design and implement overall responses to address the ~~assessed~~ risks of material misstatement at the financial statement level, and determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence regarding the risks of material misstatement at the assertion level.
- 1F. Risks of material misstatement identified and assessed by the auditor include both those due to error and those due to fraud. Although both are addressed by this ISA, the significance of fraud is such that further requirements and guidance are included in ISA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify, ~~and assess and respond to~~ the risks of material misstatement due to fraud.
- 1G. ~~'Considerations specific to audits of smaller entities' are incorporated in t~~The application material of this ISA incorporates ~~and other explanatory material of this ISA. This ISA further acknowledges that these~~ considerations specific to audits of smaller entities when such entities are ~~may also extend to~~ less complex entities. Accordingly, in this context, this ISA refers to ~~the term~~ 'smaller and less complex entities.'

#### Effective Date

2. This ISA is effective for audits of financial statements for periods ~~ending~~ beginning on or after December 15, ~~2013~~2020.

#### Objective

3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, ~~through understanding the entity and its environment, including the entity's internal control,~~ thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

#### Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Application controls – ~~Manual or automated c~~Controls of a preventative or detective nature that support the initiation, recording, processing and reporting of transactions or other information in the entity's information system, the objectives of which are to maintain the completeness

<sup>2</sup> ISA 530, *Audit Sampling*, Appendix 3

and accuracy of such transactions and other information. ~~Manual or automated application~~Such controls may rely on information, or other controls that maintain the integrity of information, or may rely on the operation of other controls. [NEW definition for ISA 315 – Elevated and updated from GLOSSARY]

- (aa) Assertions – Representations ~~by management~~, explicit or otherwise, ~~that are embodied with respect to the recognition, measurement, presentation and disclosure of information in the financial statements.~~Such representations, which are inherent in management representing that the financial statements are in accordance with the applicable financial reporting framework. Assertions are as used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and in responding to the risks of material misstatement. (Ref. Para: A0a–A0aa).
- (b) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity’s ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
- (c) Internal control: See 4(f) below – now “System of Internal Control”
- (ca) Controls – Policies or procedures that are embedded within the components of the system of internal control to achieve the control objectives of management or those charged with governance. In this context:
- Policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.
  - Procedures are actions to implement policies. (Ref: Para. A0b–A0c)
- (caa) General information technology (IT) controls – Controls ~~related to~~ the IT environment that support the effective functioning of application controls or the integrity of information by helping to maintain the continued operation, as designed, of the entity’s information system. General IT controls include controls over the entity’s IT processes. Also see the definition of IT environment [NEW definition for ISA 315 – Elevated and updated from GLOSSARY]
- (cb) Inherent Risk Factors – Characteristics of events or conditions that affect susceptibility to misstatement of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be qualitative or quantitative, and include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to management bias or fraud. (Ref: Para A0d–A0e)
- (cbb) IT environment – The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that ~~is~~ an entity uses to support business operations and achieve business strategies. For the purposes of this ISA:
- An IT application is a ~~program or a~~ set of programs that is used in the initiation, processing, recording and reporting of transactions or information. IT applications may include data warehouses and report-writers.
  - The IT infrastructure is comprised of the network, operating systems, and databases and their related hardware and software.

- The IT processes are the entity’s processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations, which includes monitoring the IT environment. (Ref: Para: A0f-A0g) [NEW definition for ISA 315 – Elevated and updated from GLOSSARY]
- (cc) Relevant assertions – An assertion is relevant to a class of transactions, account balance or disclosure when the nature or circumstances of that item are such that there is a reasonable possibility of occurrence of a misstatement with respect to that assertion that is material, individually or in combination with other misstatements. There is such possibility when the likelihood of a material misstatement is more than remote. The determination of whether an assertion is a relevant assertion is made before consideration of controls. (Ref: Para. A0ga)
- (d) Risk assessment procedures – The audit procedures ~~designed and performed to obtain an understanding of the entity and its environment, including the entity’s internal control,~~ to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
- (da) Significant class of transactions, account balance or disclosure – A class of transactions, account balance or disclosure for which there is one or more relevant assertions.
- (e) Significant risk – ~~An identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration.~~ An identified risk of material misstatement:
- For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which one or a combination of the inherent risk factors affect the likelihood of a misstatement occurring or the magnitude of potential misstatement should that misstatement occur; or
  - That is to be treated as a significant risk in accordance with the requirements of other ISAs.<sup>3</sup> (Ref: Para. A0h)
- (f) System of Internal Control (Previously (c) Internal Control) – The ~~process~~ system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. ~~The term “controls” refers to any aspects of one or more of the components of internal control.~~ For the purposes of the ISAs, the system of internal control consists of five inter-related components: (Ref: Para. A0i)
- Control environment.
  - The entity’s risk assessment process.
  - The entity’s process to monitor the system of internal control.
  - The information system and communication.
  - Control activities.

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<sup>3</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 27 and ISA 550, *Related Parties*, paragraph 18

## Requirements

### Risk Assessment Procedures and Related Activities

5. The auditor shall design and perform risk assessment procedures to obtain an understanding of:
  - The entity and its environment in accordance with paragraph 11(a);
  - The applicable financial reporting framework in accordance with paragraph 11(b); and
  - The entity's system of internal control in accordance with paragraphs 12–21D

to ~~provide~~ obtain a sufficient appropriate audit evidence as the basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1–A35)
6. The risk assessment procedures shall include the following: (Ref: Para A4a–A5)
  - (a) Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6–A13)
  - (b) Analytical procedures. (Ref: Para. A14–A1716b)
  - (c) Observation and inspection. (Ref: Para A18–A18a)
7. The auditor, in identifying and assessing the risks of material misstatement, shall take into account ~~consider whether~~ information obtained from the auditor's ~~client acceptance or continuance process of the client relationship or the audit engagement~~ is relevant to identifying risks of material misstatement.(Ref: Para. A18b)
8. If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying and assessing risks of material misstatement. (Ref: Para. A18c)
9. Where the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall evaluate whether such information remains relevant and reliable as audit evidence ~~determine whether changes have occurred since the previous audit that may affect its relevance to~~ for the current audit. (Ref: Para. A19–A20)
10. The engagement partner and other key engagement team members shall discuss the application of the applicable financial reporting framework in the context of the nature and circumstances of the entity and its environment, and the susceptibility of the entity's financial statements to material misstatement, ~~and the application of the applicable financial reporting framework to the entity's facts and circumstances.~~ The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A20a–A23a)

**Obtaining anThe Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control and the Applicable Financial Reporting Framework** (Ref: Para. A24a–A24b)

~~The Entity and Its Environment~~

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

~~(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A25–A30). The entity and its environment, including:~~

~~(i) The entity's organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT; (Ref: Para A31–A43)~~

~~(ii) Relevant industry, regulatory and other external factors; and (Ref: Para. A43a–A43f)~~

~~(iii) The relevant measures used, internally and externally, to assess the entity's financial performance. (Ref: Para. A44–A49a)~~

~~(b) The nature of the entity, including:~~

~~(i) its operations;~~

~~(ii) its ownership and governance structures;~~

~~(iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and~~

~~(iv) the way that the entity is structured and how it is financed,~~

~~to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements (Ref: Para. A31–A35).~~

~~(b) The applicable financial reporting framework, including: (Ref: Para.A49b–A49e)~~

~~(i) How it applies in the context of the nature and circumstances of the entity and its environment, including how events or conditions are subject to, or affected by, the inherent risk factors; and (Ref: Para.A49f–A49k)~~

~~(ii) The entity's accounting policies and any changes thereto, including the reasons for any such changes to the entity's accounting policies.~~

~~(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. (moved to paragraph 11(b)(ii) above)) The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry (Ref: Para.A36). (moved to paragraph 11A below)~~

~~(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement (Ref: Para A37–A43).~~

~~(e) The measurement and review of the entity's financial performance (Ref: Para. A44–A49).~~

- 11A. *(Previously part of 11(c))* The auditor shall evaluate whether the entity's accounting policies, and any changes thereto, are appropriate for its business in the context of the nature and circumstances of the entity and its environment, and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

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

12. The auditor shall perform risk assessment procedures to obtain an understanding of the entity's system of internal control relevant to financial reporting, including the entity's use of IT, by understanding each of the components of internal control relevant to the audit. For this purpose, the auditor shall address the requirements set out in paragraphs 14 to 19A of this ISA. (Ref: Para. A50–A67e)

*[Rest of paragraph 12 moved to paragraph 20]* Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref Para. A50–A73)

### **Nature and Extent of the Understanding of Relevant Controls**

13. The auditor shall identify controls relevant to the audit, and shall evaluate the design of ~~the such~~ controls and determine whether the controls have been implemented in accordance with the requirements set out in paragraphs 20 to 21B. *(moved to paragraph 21B)* ~~When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel.~~ (Ref. Para. A74–A7673a)

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

#### **Control Environment**

14. The auditor shall obtain an understanding of the control environment relevant to financial reporting, including understanding how the entity: ~~As part of obtaining this understanding, the auditor shall evaluate whether:~~ (Ref: Para. A77–A80a)

- (a) Demonstrates a commitment to integrity and ethical values;
- (b) When those charged with governance are separate from management, demonstrates that those charged with governance are independent of management and exercise oversight of the entity's system of internal control;
- (c) Establishes, with the oversight of those charged with governance, structures, reporting lines, and appropriate authorities and responsibilities, in pursuit of its objectives;
- (d) Demonstrates a commitment to attract, develop, and retain competent individuals in alignment with its objectives; and
- (e) Holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control.

- 14A. *[Previously paragraphs 14(a)-(b)]* Based on the auditor's understanding of the control environment in accordance with paragraph 14, the auditor shall evaluate whether: (Ref: Para. A80b–A82)

- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
- (b) The strengths in those areas of the entity's control environment elements addressed in paragraphs 14(a) to (e) collectively provide an appropriate foundation for the other components of the system of internal control, or whether those other components are undermined by control deficiencies in the control environment component.

#### The Entity's Risk Assessment Process

- 15. ~~The auditor shall obtain an understanding of whether the entity has a process for:~~ The auditor shall obtain an understanding of the ~~make inquiries about the nature of the~~ entity's risk assessment process, including its formality, ~~The auditor shall obtain an by understanding of:~~ (Ref: Para. A88–A94-89b)
  - (a) Whether, and if so, how, the entity's process:
    - (i) ~~(a)Identifying~~ Identifies business risks relevant to financial reporting objectives;
    - (ii) ~~(b)Estimating–Assesses~~ the significance of those risks, including ~~(c)assessing~~ the likelihood of their occurrence; and
    - (iii) ~~Deciding about actions to a~~ Addresses those risks.
  - (b) The results of the entity's process.
- 16. ~~If the entity has established such a process (referred to hereafter as the "entity's risk assessment process"), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying any such risks are of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk so, the auditor shall obtain an understanding of why the entity's risk assessment process failed to identify it such risks of material misstatement, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process consider the implications for the auditor's evaluation required by paragraph 17.~~
- 17. ~~If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. A89) Based on the auditor's understanding of the entity's risk assessment process in accordance with paragraph 15, and if applicable, paragraph 16, the auditor shall: (Ref: Para. A89c–A89d)~~
  - (a) Evaluate whether the nature of the entity's risk assessment process, including its formality, is appropriate to the entity's circumstances considering the nature and size of the entity; and
  - (b) If not, determine whether the lack of an appropriate risk assessment process represents one or more control deficiencies.

~~(Section moved up) Monitoring of The entity's process to monitor the system of internal controls (Ref: Para. A89e–A89h)~~

17A. ~~(Previously paragraph 22) The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control relevant to financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A110–A112) The auditor shall obtain an understanding of make inquiries about the nature of the entity's process to monitor the system of internal control, including its formality. The auditor shall obtain an by understanding of how the entity's process: (Ref: Para. A89i–A89k)~~

~~(a) Monitors the effectiveness of controls; and~~

~~(b) Addresses the identification and remediation of control deficiencies, including those related to the entity's risk assessment process.~~

17B. ~~(Previously paragraph 24) The auditor shall obtain an understanding of the sources of the information used in the entity's process to monitor the system of internal control monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A110–A112)~~

17C. ~~(Previously paragraph 23) If the entity has an internal audit function,<sup>4</sup> the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed, or to be performed. (Ref: Para. A110–A112)~~

~~The Information System, including the related business processes, relevant to financial reporting, and Communication~~

18. ~~The auditor shall obtain an understanding of the information system relevant to financial reporting, including the related business processes, relevant to financial reporting, including the following areas (Ref: Para. A90–A92 and A95–A96) through understanding: (Ref: Para. A90–A90c)~~

~~(a) The classes of transactions in the entity's operations that are significant to the financial statements; How information relating to significant classes of transactions, account balances and disclosures flows through the entity's information system, whether manually or using IT, and whether obtained from within or outside of the general ledger and subsidiary ledgers. This understanding shall include how: (Ref: Para. A90d–A92)~~

~~(i) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements; Transactions are initiated, and how information about them is recorded, processed, corrected as necessary, and incorporated in the general ledger and reported in the financial statements; and~~

~~(ii) Information about events and conditions, other than transactions, is captured, processed and disclosed in the financial statements.~~

<sup>4</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 14(a), defines the term "internal audit function" for purposes of the ISA.

- (b) ~~(e) The related accounting records, supporting information and specific accounts in the financial statements and other supporting records relating to the flows of information in paragraph 18(a); that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be either manual or electronic form;~~
- ~~(d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements.~~
- (c) ~~(e) The financial reporting process used to prepare the entity's financial statements from the records described in paragraph 18(b), including as it relates to significant accounting estimates and disclosures and to accounting estimates relating to significant classes of transactions, account balances and disclosures; and~~
- ~~(d) The entity's IT environment relevant to (a) through (c) above. (Ref: Para. A92(a)–A92(g) and Para. A106a–A106c)~~
- ~~(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A93–A94) [MOVED TO Paragraph 20]~~

~~This understanding of the information system relevant to financial reporting shall include 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.~~

- 18A. ~~In obtaining the understanding required by paragraph 18, the auditor shall evaluate the design of the information system relevant to financial reporting, including those aspects in paragraph 18(a)–(d), and determine whether it has been implemented (i.e., placed into operation) by the entity. (Ref: Para. A96a–A96d)~~
19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters ~~relating~~ relevant to financial reporting, including: (Ref: Para. A97–A97a98)
- (a) Communications between management and those charged with governance; and
- (b) External communications, such as those with regulatory authorities.

#### ~~Control Activities relevant to the audit~~

- 19A. ~~The auditor's shall obtain an understanding of the control activities component is obtained by identifying the controls relevant to the audit in the ~~eat~~ control activities component in accordance with the requirements of paragraphs 20 through 21A, and by evaluating their design and determining whether they have been implemented in accordance with paragraph 21B. (Ref: Para. A99–A99(e))~~

#### Controls relevant to the audit

20. The auditor shall ~~obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all control activities related to each significant class of transactions,~~

~~account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A99–A106) identify controls relevant to the audit, being those: (Ref: Para. A100)~~

- (a) That address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; (Ref: Para. A100b)
- (b) That address risks that are identified as a significant risk; (Ref: Para. A100c–A100g)
- (c) Over journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments; (Ref: Para. A100h–A100i)
- (d) Controls for which the auditor plans to test the operating effectiveness in determining the nature, timing and extent of substantive testing; or (Ref: Para. A100j–A100l)
- (e) That, in the auditor's professional judgment, are appropriate to evaluate their design and determine whether they have been implemented to enable the auditor to: (Ref: Para. A100m)
  - (i) Identify and assess the risks of material misstatement at the assertion level; or
  - (ii) Design further audit procedures responsive to assessed risks.

~~(Previously in paragraph 12) Although most controls relevant to the audit are likely to relate to financial reporting, n~~Not all controls that relate are relevant to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment as to whether a control, individually or in combination with others controls, is identified as being relevant to the audit.

21. ~~In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A107–A109).~~Based on the understanding obtained in accordance with paragraph 18(d), and the identification of the controls relevant to the audit in accordance with paragraph 20, the auditor shall identify the IT applications and the other aspects of the entity's IT environment that are relevant to the audit. In doing so, the auditor shall take into account whether the IT applications include or address: (Ref: Para. A106a–A106i)

- (a) Automated controls that management is relying on and that the auditor has determined to be relevant to the audit;
- (b) Maintenance of the integrity of information stored and processed in the information system that relates to significant classes of transactions, account balances or disclosures;
- (c) System-generated reports on which the auditor intends to rely on without directly testing the inputs and outputs of such reports; or
- (d) Risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.

21A. For the IT applications and other aspects of the IT environment that are relevant to the audit, the auditor shall identify: (Ref: Para. A106j–A108c).

- (a) The risks arising from the use of IT; and
- (b) The general IT controls relevant to the audit.

21B. ~~(previously paragraph 13) When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. For each~~

control identified as relevant to the audit in accordance with paragraphs 20 and 21A, the auditor shall:  
(Ref: Para. A109a–A109g)

- (a) Evaluate the design of the control, which shall include:
- (i) For controls that address **identified** risks of material misstatement at the assertion level, relating the control ~~directly~~ to risk(s) of material misstatement at the assertion level that the control addresses; and
  - (ii) For controls that support the operation of other controls, relating the control ~~directly~~ to the control(s) it supports.
- (b) Determine whether the control has been implemented by performing procedures in addition to inquiry of the entity's personnel.

[Previous paragraphs 22, 23 and 24 are MOVED TO paragraphs 17A, 17B and 17C]

#### Control Deficiencies Within the System of Internal Control

21C. The auditor shall, in accordance with ISA 265,<sup>5</sup> determine on the basis of the work performed in accordance with this ISA:

- (a) Whether one or more control deficiencies within the system of internal control have been identified; and
- (b) If so, whether the control deficiencies, individually or in combination, constitute significant control deficiencies.

21D. The auditor shall consider the implications for the audit of one or more control deficiencies in the system of internal control, including for:

- The assessment of control risk for risks of material misstatement at the assertion level in accordance with paragraph 30A; and
- Designing and implementing overall responses to address the assessed risks of material misstatement as required by ISA 330.<sup>6</sup>

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

25. The auditor shall identify ~~and assess~~ the risks of material misstatement and, in doing so, shall determine the significant classes of transactions, account balances and disclosures, and their relevant assertions. The auditor shall determine whether the identified risks of material misstatement determine whether they exist at: (Ref: Para. A121a–A121k)

- (a) The financial statement level, by evaluating whether the identified risks relate more pervasively to the financial statements as a whole, including ~~and~~ potentially affecting many assertions; and or (Ref: Para. A121f)
- (b) The assertion level for classes of transactions, account balances, and disclosures, taking into account the inherent risk factors. (Ref. Para A121g)

<sup>5</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraphs 7–8

<sup>6</sup> ISA 330, paragraph 5

~~to provide a basis for designing and performing further audit procedures.~~

25A. The auditor shall assess the identified risks of material misstatement at the financial statement level by: (Ref: Para. A126a–A126f)

- (a) Determining how, and the degree to which, such risks affect the assessment of risks of material misstatement at the assertion level (Ref: Para. A127i), and
- (b) Evaluating the nature and extent of their pervasive effect on the financial statements to provide the basis for designing and implementing overall responses to the identified risk of material misstatement at the financial statement level in accordance with ISA 330.<sup>7</sup> (Ref: Para A126b)

~~26. For this purpose the auditor shall:~~

- (a) ~~Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures (including the quantitative or qualitative aspects of such disclosures) in the financial statements; (Ref: Para. A132 – A136)~~
- ~~(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;~~
- ~~(c) Relate the identified risks to what could go wrong at the assertion level, taking account of relevant controls that the auditor intends to test, and (Ref: Para. A137–A139)~~
- ~~(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement could result in a material misstatement. (Ref: Para. A140)~~

#### *Inherent Risk*

~~25B. The auditor shall determine significant classes of transactions, account balances and disclosures, and their relevant assertions, based on the identified risks of material misstatement. (Ref. Para's. A127-A127e)~~

26. For each identified risks of material misstatement at the assertion level, the auditor shall assess inherent risk by assessing the likelihood and magnitude of material misstatement. In doing so, the auditor shall take into account how, and the degree to which: (Ref. Para.'s: A127d-A127j)

- (a) Identified events and conditions relating to significant classes of transactions, account balances and disclosures are subject to, or affected by, the inherent risk factors. (Ref: Para. A127d–A127h)
- (b) The risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level. (Ref. Para. A126b and A127i)

#### *Risks that Require Special Audit Consideration*

27. ~~As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk. The auditor shall determine,~~

<sup>7</sup> ISA 330, paragraph 5

based on the auditor's assessment of inherent risk, whether any of the assessed risks of material misstatement are significant risks. (Ref: Para. A140–A144a)

28. ~~In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:~~
- ~~(a) Whether the risk is a risk of fraud;~~
  - ~~(b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;~~
  - ~~(c) The complexity of transactions;~~
  - ~~(d) Whether the risk involves significant transactions with related parties;~~
  - ~~(e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and~~
  - ~~(f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A141–A145)~~
29. ~~[MOVED to paragraph 20 and 21B] If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding identify the entity's controls, including control activities, relevant to that risk, evaluate the design of those controls and determine that they have been implemented.~~

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

30. The auditor shall determine, for any of the risks of material misstatement at the assertion level, whether substantive procedures alone do not provide, whether in respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures alone. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. ~~[MOVED to paragraph 20 and 21B] In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A149148–A151150)~~

*Control Risk*

- 30A. For each identified risks of material misstatement at the assertion level, the auditor shall assess control risk as follows: (Ref: Para. A150a–A150d)
- ~~(a) When the auditor does not plan to test the operating effectiveness of controls in designing further audit procedures to be performed to respond to a risk of material misstatement at the assertion level, the auditor shall assess control risk at the maximum.~~
  - (a) (b) When the auditor plans to test the operating effectiveness of controls in designing further audit procedures to be performed to respond to a risk of material misstatement at the assertion level, the auditor shall assess control risk at less than maximum. In doing so, the auditor shall take into account whether the design, implementation and expected operating effectiveness of such controls support the auditor's intended reliance thereon.

- (b) ~~(a)~~ When the auditor does not plan to test the operating effectiveness of controls in designing further audit procedures to be performed to respond to a risk of material misstatement at the assertion level, the auditor shall assess control risk at the maximum.

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

30B. The auditor shall: (Ref: Para. A150e–A150g)

- (a) Identify the classes of transactions, account balances and disclosures that are quantitatively or qualitatively material, and that have not been identified as significant classes of transactions, account balances or disclosures in accordance with paragraph 25B; and
- (b) Evaluate whether the auditor’s conclusion that there are no relevant assertions (~~i.e., that is, no~~ related risks of material misstatement) for these classes of transactions, account balances and disclosures remains appropriate.

*Revision of Risk Assessment*

31. The auditor’s assessments of the risks of material misstatement at the financial statement level and assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the identification and assessments of the risks of material misstatement, the auditor shall revise the assessment and modify the planned overall responses or further planned audit procedures accordingly. (Ref: Para. A452151)

**Documentation**

32 The auditor shall include in the audit documentation:<sup>8</sup> (Ref: Para. A152–A155)

- (a) The discussion among the engagement team, where required ~~by~~ in accordance with paragraph 10, and the significant decisions reached;
- (b) ~~Key elements~~ aspects of the auditor’s understanding obtained regarding ~~each of the aspects~~ of the entity and its environment specified in paragraph 11 and of each of the components of the system of internal control specified in paragraphs ~~14–2414, 15, 17A through 19A~~; the sources of information from which the auditor’s understanding was obtained; and the risk assessment procedures performed;
- (c) The controls identified to be relevant to the audit in accordance with the requirements in paragraphs 20 and 21A.
- (d) ~~(e)~~ The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25– through 30A, and the rationale for the more difficult including the related significant judgments made in identifying and assessing the risks of material misstatement; and (Ref: Para A152a)

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

- ~~(d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27–30 24A–24B. (Ref: Para. A170–A173).~~