

ISA 315 (Revised)¹ – Revised Application Material

This Agenda Item sets out the revised application material marked-up to the application material as presented at the June 2019 Board meeting.

Application and Other Explanatory Material

Definitions (Ref: Para. 16)

Assertions (Ref: Para. 16(b))

- A1. Representations by management with respect to the recognition, measurement, presentation and disclosure of information in the financial statements ~~effor~~ classes of transactions, account balances and disclosures, which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework, differ from written representations provided to the auditor by management, as required by ISA 580,² to confirm certain matters or support other audit evidence.
- A2. Assertions that the auditor may use in addressing the requirements of this ISA are further described in paragraph A204.

~~Control Activities (Ref: Para. 16(ca))~~

- ~~A2a. [Part moved to paragraph A4a]. Indirect controls are controls that are not sufficiently precise to prevent, detect or correct misstatements at the assertion level but which may have an indirect effect on the likelihood that a misstatement will be detected or prevented on a timely basis.~~

Controls (Ref: Para. 16(d))

A2a. Controls are embedded within the components of the entity's system of internal control.

- A3. Policies are implemented through the actions of personnel within the entity, or through their restraint from taking actions that would conflict with such policies.
- A4. Procedures may be mandated, through formal documentation or other communication by management or those charged with governance, or may result from behaviors that are not mandated but are rather conditioned by the entity's culture. Procedures may be enforced through the actions permitted by the IT applications used by the entity or other aspects of the entity's IT environment.
- A4a. ~~Controls activities~~ may be direct or indirect controls. Direct controls are controls that are precise enough to address risks of material misstatement at the assertion level. Indirect controls are controls that support direct controls.

Information Processing Controls (Ref: Para. 16(ea))

- A4b. Risks to the integrity of information arise from susceptibility to ineffective implementation of the entity's information policies, which are policies that define the information flows, records and reporting processes in the entity's information system. Information processing controls are procedures that

¹ Proposed ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement* (ED-315)

² ISA 580, *Written Representations*

support effective implementation of the entity's information policies. Information processing controls may be automated (i.e., embedded in IT applications) or manual (e.g., input or output controls) and may rely on other controls, including other information processing controls or general IT controls.

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

Appendix 2 sets out further considerations relating to understanding the inherent risk factors.

A5. Inherent risk factors may be qualitative or quantitative and affect the susceptibility to misstatement of ~~financial statement items, assertions.~~ Qualitative inherent risk factors relating to the preparation of information required by the applicable financial reporting framework include:

- Complexity;
- Subjectivity;
- Change;
- Uncertainty; and
- Susceptibility to misstatement due to management bias or ~~misappropriation of assets~~ other fraud risk factors insofar as they affect inherent risk.

A6. Other inherent risk factors, that affect susceptibility to misstatement of an assertion about a class of transactions, account balance or disclosure may include:

- The quantitative or qualitative significance of the class of transactions, account balance or disclosure, and of the items in relation to performance materiality; or
- The volume or a lack of uniformity in the composition of the items to be processed through the class of transactions or account balance, or to be reflected in the disclosure.
- ~~• The composition of the class of transactions, account balance or disclosure, including whether the items are subject to differing risks;~~
- ~~• The volume of activity and homogeneity of the individual transactions processed through the class of transactions or account balance or class of transactions, or reflected in the disclosure; or~~
- ~~• The existence of related party transactions in the class of transaction or account balance, or that are relevant to the disclosure.~~

A7. [Moved]

A8. [Moved]

Relevant Aspects of the Information System and Communication (Ref: Para. 16(g))

A8a. ~~[Previously part of para. A139] Regardless of the size or nature of the entity, the information system includes relevant aspects of that system relates to information disclosed in the financial statements~~

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

A9. A risk of material misstatement may relate to more than one assertion, in which case all the assertions to which such a risk relates ~~would be~~ are relevant assertions.

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

A10. Significance can be described as the relative importance of a matter, ~~taken in context. The significance of a matter and~~ 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~~ In the context of inherent risk, significance may be 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 how and the degree to which the inherent risk factors affect the combination of the likelihood of a misstatement occurring 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 magnitude of the potential misstatement is subject to, or affected by, the inherent risk factors, which affect the likelihood that a should that misstatement will occur., as well as the potential magnitude of the misstatement were that misstatement to occur.~~

A11. *[Moved]*

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

Why Risk Assessment Procedures and Related Activities are Performed (Ref: Para. 17)

A11a. ~~Information obtained by performing risk assessment procedures and related activities in accordance with paragraphs 17 to 22 of this ISA provides audit evidence that supports:~~

- ~~The identification and assessment of the risks of material misstatement; and~~
- ~~The design of further audit procedures in accordance with ISA 330.~~

A11b. ~~The auditor may obtain audit evidence about classes of transactions, account balances and disclosures, and related assertions, and about the operating effectiveness of controls, even though risk assessment procedures were not specifically planned as substantive procedures or as tests of controls.~~

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

A12. *[Moved and partly deleted]*

A13. The risks of material misstatement to be identified and assessed include both those due to fraud and those due to error, and both are covered by this ISA. However, the significance of fraud is such that further requirements and guidance are included in ISA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify and assess the risks of material misstatement due to fraud.³ In addition, the following ISAs provide further requirements and guidance on identifying and assessing risks of material misstatement regarding specific matters or circumstances:

- ISA 540 (Revised)⁴ in regard to accounting estimates;
- ISA 550⁵ in regard to related party relationships and transactions;

³ ISA 240, paragraphs 12–2425

⁴ ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

⁵ ISA 550, *Related Parties*

- ISA 570 (Revised)⁶ in regard to going concern; and
- ISA 600⁷ in regard to group financial statements.

A14. [Moved]

A15. [Moved]

A15a. Professional skepticism is necessary for the critical assessment of audit evidence gathered when performing risk assessment procedures, and assists the auditor in remaining alert for possible indications of management bias. Professional skepticism is an attitude ~~which~~that is applied by the auditor when making professional judgments that then provides the basis for the auditor's actions. The auditor applies their professional judgment in determining when they have audit evidence that provides an appropriate basis for risk assessment, and ~~is also applied~~ in designing the auditor's responses to assessed risks of material misstatement.

~~A15b. Obtaining audit evidence from risk assessment procedures in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence.~~

A15c. The application of professional ~~skeptism~~skepticism by the auditor may include:

- Questioning contradictory information and the reliability of documents;
- Considering responses to inquiries and other information obtained from management and those charged with governance;
- Being alert to conditions that may indicate possible misstatement due to error or fraud; and
- Considering whether audit evidence obtained supports the auditor's identification and assessment of the risks of material misstatement in light of the entity's nature and circumstances.

~~Why Obtaining Information from Varying Sources in an Unbiased Manner is Important to Risk Assessment Procedures (Ref: Para. 17)~~

~~A15d. [Previously paragraph 16c] Obtaining information from varying sources in an unbiased manner may provide potentially contradictory information, which may assist the auditor in exercising professional skepticism in identifying and assessing the risks of material misstatement.~~

Sources of Information (Ref: Para. 17)

A15e Obtaining audit evidence from risk assessment procedures in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence. [Previously paragraph 16d] Sources of information for risk assessment procedures may include:

- ~~Information obtained through interactions~~Interactions with management, those charged with governance, and other key entity personnel, such as internal auditors.

⁶ ISA 570 (Revised), *Going Concern*

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

- ~~Information obtained directly or indirectly from certain~~Certain external parties such as regulators, ~~whether obtained directly or indirectly.~~
- ~~Other relevant sources of audit evidence, including the~~The auditor's acceptance and continuance procedures and other engagements performed by the engagement partner for the entity.
- ~~Information obtained from the~~The auditor's previous experience with the entity and from audit procedures performed in previous audits, updated as appropriate.
- Publicly available information about the entity, for example entity-issued press releases, and materials for analysts or investor group meetings, analysts' reports or information about trading activity.

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 500.⁸

Scalability (Ref: Para. 17)

A16. The nature and extent of risk assessment procedures will vary based on the nature (e.g., size and complexity) and circumstances of the entity (e.g., the formality of the entity's policies and procedures, and processes and systems). ~~necessary to provide an appropriate basis for the risk identification and assessment and the design of further audit procedures will vary based on the nature (e.g., size and complexity) and circumstances of the entity (e.g., the formality of the entity's policies and procedures, and processes and systems).~~ The auditor uses professional judgment to determine the nature and extent of the risk assessment procedures to be performed. ~~The auditor's primary consideration is whether the understanding that has been obtained meets to meet~~ the objective stated in this ISA.

A16a. Although the extent to which an entity's policies and procedures, and processes and systems are formalized may vary, the auditor is still required to obtain an the understanding of that aspect in accordance with paragraphs 23, 28, 30, 31A, 36 and 39.

Examples:

Some entities, including less complex entities, and particularly owner-managed entities, may not have established structured processes and systems, such as a risk assessment process or a process to monitor the system of internal control, or may have established such processes or systems with limited documentation or irregularity a lack of consistency in how they process is are undertaken, such as the entity's risk assessment process or the entity's process to monitor the system of internal control. When such systems and processes lack formality, the auditor may still be able to perform risk assessment procedures through observation and inquiry.

Other entities, typically larger more complex entities, are expected to have more formalized and documented policies and procedures. Accordingly, t~~The~~ auditor may use such documentation in performing risk assessment procedures.

A16b. The nature and extent of risk assessment procedures to be performed the first time an engagement is undertaken may differ to be more extensive than procedures for a recurring engagement. In

⁸ ISA 500, *Audit Evidence*, paragraph 7

subsequent periods for which the auditor already has a base knowledge and may therefore focus on changes that have occurred during since the preceding period.

~~Sources of Information (Ref: Para. 17) [Moved above]~~

Types of Risk Assessment Procedures (Ref: Para. 18)

A17. ISA 500⁹ explains the types of audit procedures that may be performed in obtaining audit evidence from risk assessment procedures and further audit procedures. The nature, timing and extent of the audit procedures may be affected by the fact that some of the accounting data and other ~~information~~ evidence may only be available in electronic form or only at certain points in time.¹⁰ ~~[Previously paragraph A20a] The auditor may perform substantive procedures or tests of controls, in accordance with ISA 330, concurrently with risk assessment procedures, when it is efficient to do so. [New] Some of the audit evidence obtained in doing so, which supports the identification and assessment of risks of material misstatement, may also support the detection of misstatements at the assertion level or the evaluation of the operating effectiveness of controls.~~

A18. Although the auditor is required to perform all the risk assessment procedures described in paragraph 18 in the course of obtaining the required understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control (see paragraphs ~~27–43~~ 23–39), the auditor is not required to perform all of them for each ~~aspect of that understanding requirement~~. Other procedures may be performed ~~where~~ when the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures may include making inquiries of the entity's external legal counsel or external supervisors, or of valuation experts that the entity has used.

A19. [Moved]

A20. [Moved]

Automated Tools and Techniques (Ref: Para. 18)

~~A20a. Through the use of technology~~ Using automated tools and techniques, the auditor may perform risk assessment procedures on large volumes of data (from the general ledger, sub-ledgers or other operational data) including for analysis, recalculations, reperformance or reconciliations. ~~Audit evidence obtained that supports the identification and assessment of risks of material misstatement, may also provide some audit evidence to support further audit procedures in accordance with ISA 330.~~

A20b. [Moved to paragraph A17]

Inquiries of Management and Others within the Entity (Ref: Para. 18(a))

Why Inquiries are Made of Management and Others Within the Entity

A21. Much of the information obtained by the auditor to support an appropriate basis for the identification and assessment of risks, and the design of further audit procedures, ~~is~~ may be obtained through inquiries of management and those responsible for financial reporting. ~~Information may also be obtained by the auditor through inquiries of other appropriate individuals within the entity.~~

⁹ ISA 500, *Audit Evidence*, paragraphs A14–A17 and A21–A25.

¹⁰ ISA 500, paragraph A12

A22. ~~The~~ Inquiries of management and those responsible for financial reporting and of other appropriate individuals within the entity and other employees with different levels of authority may offer the auditor ~~may also obtain information, or a different~~ varying perspectives ~~when~~ for identifying and assessing risks of material misstatement through inquiries of others within the entity and other employees with different levels of authority.

Examples:

- Inquiries directed towards those charged with governance may help the auditor understand the extent of oversight over the preparation of the financial statements by management. ISA 260 (Revised)¹¹ 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 responsible for initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed towards in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contractual terms.
- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- Inquiries directed ~~about~~ towards the risk management function (or inquiries of those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed towards IT personnel may provide information about system changes, system or control failures, or other IT-related risks.

A23. [Deleted]

Considerations Specific to Public Sector Entities

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

¹¹ ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 4(b)

Inquiries of the Internal Audit Function (Ref: Para 18(a))

Appendix 4 sets out considerations for understanding an entity's internal audit function.

Why Inquiries are Made of the Internal Audit Function (if ~~any~~ the function exists)

A25. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may assist the auditor in understanding the entity and its environment, and the entity's system of internal control, in the identification and assessment of risks.

A26. [Moved]

A27. [Moved]

A28. [Moved]

Considerations ~~s~~Specific to Ppublic Ssector Eentities

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

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

Why Analytical Procedures are Performed as a Risk Assessment Procedure

A30. [Previously paragraph A31] Analytical procedures ~~may also~~ help identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that ~~might~~ indicate matters that may 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.

A31. [Previsouly paragraph A30] Analytical procedures performed as risk assessment procedures may therefore assist in identifying and assessing the risks of material misstatement by identifying aspects of the entity of which the auditor was unaware and may assist in identifying and assessing the risks of material misstatement by or identifying characteristics of events or conditions relevant to the auditor's consideration of the inherent risk factors, such as change.

Types of Analytical Procedures

A32. Analytical procedures performed as risk assessment procedures may:

- Include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold (non-financial).
- Use data aggregated at a high level. Accordingly, the results of those analytical procedures may provide a broad initial indication about the likelihood of a material misstatement.

Example:

In the audit of many entities, including those with less complex business models and processes, and a less complex information ~~systems~~ system, the auditor may perform a simple comparison of information, such as the change in interim or monthly account balances from balances in prior periods, to obtain an indication of potentially higher risk areas.

A33. [Moved]

A34. This ISA deals with the auditor's use of analytical procedures as risk assessment procedures. ISA 520¹² deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures") and the auditor's responsibility to perform analytical procedures near the end of the audit. 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~~ process.

Automated Tools and Techniques

A34a. 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.

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~~ classes of transactions, account balances or disclosures for which further specific risk assessment procedures may be warranted.

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

Why Observation and Inspection are Performed as Risk Assessment Procedures

A35. ~~Observation~~ Because inquiry alone is not enough,¹³ observation and inspection may support or corroborate inquiries of management and others, and may also provide information about the entity and its environment.

Scalability

A35a. Where policies or procedures are not documented, or the entity has less formalized controls, the auditor may still be able to obtain some audit evidence to support the identification and assessment of the risks of material misstatement through observation or inspection of the performance of the control.

¹² ISA 520, *Analytical Procedures*

¹³ ISA 500, *paragraph A2*

Examples:

- The auditor may obtain an understanding of controls over an inventory count, even if they have not been documented by the entity, through direct observation.
- The auditor may be able to observe segregation of duties.
- The auditor may be able to observe passwords being entered.

Observation and Inspection as Risk Assessment Procedures

A35b. Risk assessment procedures may include observation or inspection of the following:

- The entity's operations.
- Internal documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- The entity's premises and plant facilities.
- Information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications; or other external documents about the entity's financial performance (such as those referred to in paragraph A74).
- The behaviors and actions of management or those charged with governance (such as the observation of an audit committee meeting).

Automated Tools or Techniques

A35c. Automated tools or techniques may also be used to observe or inspect, in particular assets, for example through the use of remote observation tools (e.g., a drone).

Considerations Specific to Public Sector Entities

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

Information from Other Relevant Sources of Audit Evidence (Ref: Para. 19)Why the Auditor Considers Information from Other Relevant Sources of Audit Evidence

A37. Information obtained from other ~~relevant sources of audit evidence~~ may be relevant to the identification and assessment of the risks of material misstatement by providing information and insights about:

- The nature of the entity and its business risks, and what may have changed from previous periods.
- The integrity and ethical values of management and those charged with governance, which may also be relevant to the auditor's understanding of the control environment.

- The applicable financial reporting framework and its application to the nature and

~~Information from Other Relevant Sources of Audit Evidence~~

A38. ~~Other relevant sources of audit evidence~~information come frominclude:

- The auditor's acceptance or continuance of the client relationship or the audit engagement, in accordance with ISA 220, including from procedures regarding the acceptance and continuance of client relationships and audit engagements, and the conclusions reached.¹⁴
- Other engagements performed for the entity by the engagement partner. Such engagements may include agreed-upon procedures engagements or other audit or assurance engagements, including engagements to address incremental reporting requirements in the jurisdiction.

Information from the Auditor's Previous Experience with the Entity and Previous Audits (Ref: Para. 21)

Why Information from Previous Audits is Important to the Current Audit

A39. The auditor's previous experience with the entity, and from audit procedures performed in previous audits, may provide the auditor with information that is relevant to the auditor's determination of the nature and extent of risk assessment procedures, and the identification and assessment of risks of material misstatement.

Nature of the Information from Previous Audits

A39a. [~~Previously part of paragraph A39~~] Such information from previous audits that may be important to the current audit information may include:

- Past misstatements and whether they were corrected on a timely basis.
- The nature of the entity and its environment, and the entity's system of internal control (including control deficiencies).
- Significant changes that the entity or its operations may have undergone since the prior financial period.
- 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.

~~Evaluating Information from Prior Periods~~

A40. ~~In evaluating whether~~If the nature or circumstances of the entity may have changed, or new information may have been obtained in, the information from prior periods ~~remains~~may no longer be relevant and/or reliable for the current audit, the auditor may consider whether changes have occurred that may affect the relevance or reliability of such information.

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

Example:

~~To determine whether information from prior periods remains relevant, the auditor may make inquiries and perform other appropriate risk assessment procedures, such as walk-throughs~~
The auditor may make inquiries and perform other appropriate risk assessment procedures, such as a walkthrough of relevant systems, to determine whether the information from the prior period remains relevant.

Engagement Team Discussion (Ref: Para. 22–22A)

Why the Engagement Team is Required to Discuss the Application of the Applicable Financial Reporting Framework and the Susceptibility of the Entity's Financial Statements to Material Misstatement

A40a. The discussion among the engagement team about the application of the applicable financial reporting framework and 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 susceptibility to misstatement of 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.¹⁵

~~A40b. 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~~

¹⁵ ISA 240, paragraph 45~~16~~

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, and may lead to the involvement of more experienced members of the engagement team who are appropriately skilled to be involved in the performance of audit procedures related to those areas.

Scalability

A41. 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 A40a and A43 nonetheless may assist the auditor in identifying where there may be risks of material misstatement.

A41a. When an engagement is carried out by a large engagement team, such as for an audit of group financial statements, 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 the members of the engagement team to be informed of all 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.

A42. [Moved]

Matters To Be Discussed

Discussion of Disclosures in the Applicable Financial Reporting Framework

A43. As part of the discussion among the engagement team, 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. 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.

A44. [Moved]

A45. [Moved]

Considerations Specific to Public Sector Entities

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

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework and the Entity's System of Internal Control (Ref: Para. 23–43)

Appendices 1 through 6 set out further considerations relating to obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control.

Obtaining the Required Understanding (Ref: Para. 23–43)

A46a [*Previously paragraph A47f*] Obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control is a dynamic and iterative process of gathering, updating and analyzing information and continues throughout the audit. Therefore, the auditor's expectations may change as new information is obtained.

Why an Understanding of ~~Relevant Aspects~~ of the Entity and Its Environment and the Applicable Financial Reporting Framework, ~~and the Components of the Entity's System of Internal Control~~ is Required (Ref: Para. 23–24)

A47. The auditor's understanding of the entity and its environment, and the applicable financial reporting framework, assists the auditor in understanding the events and conditions that are relevant to the entity, and in identifying ~~relevant~~ inherent risk factors. Such information establishes a frame of reference within which the auditor identifies and assesses risks of material misstatement. This frame of reference also assists the auditor in planning the audit and exercising professional judgment and professional skepticism throughout the audit, for example, when:

- Identifying and assessing risks of material misstatement of the financial statements in accordance with ISA 315 (Revised) or other relevant standards (e.g., relating to risks of fraud in accordance with ISA 240 or when identifying or assessing risks related to accounting estimates in accordance with ISA 540 (Revised));
- Determining materiality or performance materiality in accordance with ISA 320;¹⁶ or
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures.

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.~~

¹⁶ ISA 320, *Materiality in Planning and Performing an Audit*, paragraphs 10–11

A47a. The auditor's understanding of the entity and its environment, and the applicable financial reporting framework, ~~may also inform~~informs how the auditor plans and performs further audit procedures, for example, when:

- Developing expectations for use when performing analytical procedures in accordance with ISA 520;¹⁷
- Designing and performing further audit procedures to obtain sufficient appropriate audit evidence in accordance with ISA 330;¹⁸ and
- Evaluating the sufficiency and appropriateness of audit evidence obtained (e.g., relating to assumptions or management's oral and written representations).

A47b. The auditor's understanding of the entity and its environment and the applicable financial reporting framework ~~may also inform the auditor's understanding of the entity's system of internal control, including the information system. This understanding assists~~assisting the auditor in developing initial expectations about the classes of transactions, account balances and disclosures. ~~The auditor's initial expectations formed about the classes of transactions, account balances and disclosures that may assist the auditor in determining the~~be significant classes of transactions, account balances and disclosures ~~when obtaining an~~-, which form the basis for the scope of the auditor's understanding of the entity's information system.

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.~~

Scalability (Ref: Para. 23–24)

A47c. The nature and extent of the understanding needed is a matter of the auditor's professional judgment and ~~will vary~~varies from entity to entity based on the nature and circumstances of the entity, including:

- The size and complexity of the entity, including its IT environment;
- The auditor's previous experience with the entity;
- The nature of the entity's systems and processes, including whether they are formalized or not; and
- The nature and form of the entity's documentation.

A47d. [Moved to paragraph A47eb]

A47e. ~~Accordingly, the~~ The auditor's risk assessment procedures to obtain the overall understanding may be less extensive in audits of less complex entities and more extensive for entities that are more

¹⁷ ISA 520, *Analytical Procedures*, paragraph 5

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

complex. The depth of the overall understanding that is required by the auditor is expected to be less than that possessed by management in managing the entity.

A47ea. [~~Previously paragraph A78a~~] Some financial reporting frameworks allow smaller entities to provide simpler and less detailed disclosures in the financial statements. However, this does not relieve the auditor of the responsibility to obtain an understanding of the entity and its environment, the applicable financial reporting and the framework as it applies to the entity.

A47eb. [~~Previously paragraph A47d~~] 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.

Obtaining the Required Understanding

A47f. [~~Moved to paragraph A46a~~]

A47g. ~~The auditor applies professional judgment in determining whether the understanding required by paragraph 23 is sufficient to provide an appropriate basis to achieve the objectives in paragraph 17(a) and (b).~~

A47h. ~~The auditor is only required to obtain an understanding of the relevant aspects of the entity and its environment, the applicable financial reporting framework, and the components of the entity's system of internal control as set out in the relevant definitions for the purpose of paragraphs 17(i) and (b) (i.e., meeting the objectives of this standard.)~~

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

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

~~How Events or Conditions are Subject To, or Affected By, the Inherent Risk Factors [Moved section to A88a-A88d to follow revised requirement]~~

~~Appendix 2 provides examples of events and conditions that may indicate susceptibility to risks of material misstatement, categorized by inherent risk factor.~~

~~Why the auditor considers the inherent risk factors when understanding the entity and its environment~~

A48a. ~~When understanding the entity and its environment, the auditor considers how events or conditions related to the entity and its environment are subject to, or affected by, the inherent risk factors. These inherent risk factors help with the auditor's understanding of where risks of material misstatement may arise when the entity has applied the applicable financial reporting framework to these events or conditions by highlighting which classes of transactions, account balances and disclosures may be affected and therefore which may be significant classes of transactions, account balances and disclosures. Understanding whether, and the relative degree to which, the inherent risk factors affect the events and conditions may also assist the auditor in identifying and assessing the risks of material misstatement at the assertion level.~~

~~The Effect of the Inherent Risk Factors on a Class of Transactions, Account Balance or Disclosure~~

~~A48b. 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.~~

Example:

~~If the entity has an accounting estimate based on assumptions that are sensitive to changes, the greater the risk that there may be a material misstatement.~~

~~A48c. The greater the extent to which a class of transactions, account balance or disclosure is subject to, or affected by, complexity or subjectivity, the greater the need for the auditor to apply professional skepticism. 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 misappropriation of assets. 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.~~

~~A48d. Events or conditions that may be affected by, or subject to, the susceptibility of misstatement due to management bias or misappropriation of assets 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.~~

~~Obtaining an Understanding of Relevant Aspects of the Entity and Its Environment~~

~~A48e. The relevant aspects of the entity and its environment are defined in paragraph 16(gc).~~

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

~~The entity's organizational structure and ownership (Ref: Para. 23(a)(i))~~

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

- ~~• The complexity of the entity's structure.~~

Example:

~~The entity may be a single entity or the entity's structure may include subsidiaries, divisions or other components in multiple locations. Further, the legal structure may be different from the operating structure. Complex structures often introduce factors that may give rise to increased susceptibility to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately and whether adequate disclosure of such issues in the financial statements have~~s~~ been made.~~

- The ownership, and relationships between owners and other people or entities, including related parties. This understanding may assist in determining whether related party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial statements.¹⁹
- The distinction between the owners, those charged with governance and management.

Example:

In less complex entities, owners of the entity may be involved in managing the entity, therefore there is little or no distinction. In contrast, such as in some listed entities, there may be a clear distinction between management, the owners of the entity, and those charged with governance.²⁰

- The entity's IT environment.

ExampleExamples:

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~~ can be made.

Alternatively, an entity may ~~have~~:

- Have multiple legacy IT systems in diverse businesses that are not well integrated resulting in a complex IT environment. ~~The entity may be~~
- Be using external or internal service providers for aspects of its IT environment (e.g., outsourcing the hosting of its IT environment to a third party or using a shared service center for central management of IT processes in a group).

Automated ~~T~~tools and ~~T~~techniques

A49a. ~~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~~ The auditor may use automated tools and techniques to understand flows of transactions and processing as part of the auditor's procedures to understand the information system. An outcome of these procedures may be that the auditor obtains information about the entity's organizational structure or those with whom the entity conducts business (e.g., vendors, customers, related parties).

Considerations specific to public sector entities

A50. 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. Therefore, management may not have control over decisions that are made. Matters that may be

¹⁹ ISA 550 establishes requirements and provide guidance on the auditor's considerations relevant to related parties.

²⁰ ISA 260 (Revised), paragraphs A1 and A2, provides guidance on the identification of those charged with governance and explains that in some cases, some or all of those charged with governance may be involved in managing the entity.

relevant include understanding the ability of the entity to make unilateral decisions, and the ability of other public sector entities to control or influence the entity's mandate and strategic direction.

Example:

A public sector entity may be subject to laws or other directives from authorities that require it to obtain approval from parties external to the entity of its strategy and objectives prior to implementing them. Therefore, 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 (Ref: Para. 23(a)(i))

Why the auditor obtains an understanding of governance

A51. Understanding the entity's governance ~~assists~~ may assist the auditor with understanding ~~of~~ the entity's ability to provide appropriate oversight of its system of internal control. However, this understanding may also provide evidence of deficiencies, which may indicate an increase in the susceptibility of the entity's financial statements to risks of material misstatement.

Understanding the ~~E~~ntity's ~~G~~overnance

A51a. 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 (Ref: Para. 23(a)(i))

Appendix 1 sets out additional considerations for obtaining an understanding of the entity and its business model, as well as additional considerations for auditing special purpose entities.

Why the auditor obtains an understanding of the entity's business model and its related risks

A52. 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. 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.

Examples:

An entity's business model may rely on the use of IT in different ways:

- The entity sells ~~widgets~~shoes from a physical store, and uses an advanced stock and point of sale system to record the selling of ~~widgets~~shoes; or
- The entity sells ~~widgets~~shoes online so that all sales transactions are processed in an IT environment, including initiation of the transactions through a website.

For both of these entities the business risks arising from a significantly different business model would be substantially different, notwithstanding both entities sell ~~widgets~~shoes.

A53 – A55: [*Moved to **Appendix 1***]

~~Relevant Aspects of the Business Model Required to be Understood~~Understanding the Entity's business model

~~**Appendix 1** explains the objectives and scope of the entity's business model and provides examples of matters that the auditor may be consider in understanding the activities of the entity that may be included in the business model. In addition, the appendix explains other matters that may be considered when auditing financial statements of special purpose entities.~~

~~**Appendix 2** provides explanations about the inherent risk factors as well as providing examples of events and conditions that may indicate risks of material misstatement. The events and conditions have been categorized by the inherent risk factor that may have the greatest effect in the circumstances.~~

A56. [*Moved*]

A57. [*Moved*]

A58. [*Moved*]

A59. Not all aspects of the business model are relevant ~~aspects~~ for the auditor's understanding. Business risks are broader than the risks of material misstatement of the financial statements, although business risks include 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.

A59a. Business risks increasing the susceptibility to risks of material misstatement may arise from:

- Inappropriate objectives or strategies, ineffective execution of strategies, or change or complexity.
- A failure to recognize the need for change may also give rise to business risk, for example, from:
 - The development of new products or services that may fail;
 - A market which, even if successfully developed, is inadequate to support a product or service; or
 - Flaws in a product or service that may result in legal liability and reputational risk.

- Incentives and pressures on management, which may result in intentional or unintentional management bias, and therefore affect the reasonableness of significant assumptions and the expectations of management or those charged with governance.

A60. [Moved]

A61. Examples of matters that the auditor may consider when obtaining an understanding of the entity's business model, objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include possible risks arising from:

- Industry developments, such as the lack of personnel or expertise to deal with the changes in the industry;
- New products and services that may lead to increased product liability;
- Expansion of the entity's business, and demand has not been accurately estimated;
- New accounting requirements where there has been incomplete or improper implementation;
- Regulatory requirements resulting in increased legal exposure;
- Current and prospective financing requirements, such as loss of financing due to the entity's inability to meet requirements;
- Use of IT, such as the implementation of a new IT system that will affect both operations and financial reporting; or
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements.

A62. Ordinarily, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of the entity's system of internal control and is discussed in paragraph ~~29–3130~~, and paragraphs ~~A445117–A1204~~.

Considerations specific to public sector entities

A62a 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 with a specific objective~~. 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.

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

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

Industry factors (Ref: Para. 23(a)(ii))

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

- The market and competition, including demand, capacity, and price competition.
- Cyclical or seasonal activity.
- Product technology relating to the entity's products.
- Energy supply and cost.

A65. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation.

Example:

In the construction industry, 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.²¹

Regulatory Factors (Ref: Para. 23(a)(ii))

A66. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment and any changes thereto. Matters the auditor may consider include:

- Regulatory framework for a regulated industry, for example, prudential requirements, including related disclosures.
- Legislation and regulation that significantly affect the entity's operations, for example, labor laws and regulations.
- Taxation legislation and regulations.
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restriction policies.
- Environmental requirements affecting the industry and the entity's business.

A67. ISA 250 (Revised) includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.²²

Considerations specific to public sector entities

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

Other External Factors (Ref: Para. 23(a)(ii))

A69. 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.

²¹ ISA 220, paragraph 14

²² ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 13

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

A70. [Moved]

Why the auditor understands ~~relevant~~ measures used by management

A70a. An understanding of the entity's ~~relevant~~ measures assists the auditor in considering whether such measures, whether used externally or internally, create pressures on the entity to achieve performance targets. These pressures may motivate management to take actions that increase the susceptibility to misstatement due to management bias or ~~misappropriation of assets~~ fraud (e.g., to improve the business performance or to intentionally misstate the financial statements) (see ISA 240 for requirements and guidance in relation to the risks of fraud).

A70b ~~Relevant measures~~ Measures may also indicate to the auditor the likelihood with which risks of misstatement of related financial statement information exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry.

Measures used by management

A70c. Management and others ordinarily measure and review those matters they regard as important. Inquiries of management may reveal that it relies on certain key indicators, whether publicly available or not, for evaluating financial performance and taking 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.

A70d. Key indicators used for evaluating financial performance may 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.

A71. [Moved]

A72. [Moved]

A73. [Moved]

Scalability

A73a. The procedures undertaken to understand the entity's ~~relevant performance~~ measures 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.

Examples:

- For some less complex entities, the terms of the entity's bank borrowings (i.e., bank covenants) may be linked to specific performance measures related to the entity's performance or financial position (e.g., a maximum working capital amount). The auditor's understanding of the ~~relevant~~ performance measures used by the bank may help identify areas where there is increased susceptibility to the risk of material misstatement.
- For some entities whose nature and circumstances are more complex, such as those operating in the insurance or banking industries, performance or financial position may be measured against regulatory requirements (e.g., regulatory ratio requirements, such as capital adequacy and liquidity ratios performance hurdles). The auditor's understanding of these performance measures may help identify areas where there is increased susceptibility to the risk of material misstatement.

Other ~~auditor~~ considerations

A74. External parties may also review and analyze the entity's financial performance, in particular for entities where financial information is publicly available. The auditor may also consider publicly available information to help the auditor further understand the business or identify contradictory information such as information from:

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

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

A75. [Moved]

A76. [Deleted]

A77. [Moved]

A77a. The measurement and review of financial performance is not the same as the monitoring of the system of internal control (discussed as a component of the system of internal control in paragraphs ~~A122A123~~–A135c), though their purposes may overlap:

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

In some cases, however, performance indicators also provide information that enables management to identify control deficiencies. ~~Considerations specific to public sector entities~~

Considerations specific to public sector entities

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

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

Scalability

A78a. [Moved to paragraph A47ea]

~~Other auditor considerations~~ Understanding the Applicable Financial Reporting Framework

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

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

- A80. Obtaining an understanding of the entity and its environment ~~assists~~may assist the auditor in considering where changes in the entity's financial reporting (e.g., from prior periods) ~~may~~should be expected.

Example:

If the entity has had a significant business combination during the period, the auditor would likely expect changes in classes of transactions, account balances and disclosures associated with that business combination. Alternatively, if there were no significant changes in the financial reporting framework during the period the auditor's understanding may help confirm that the understanding obtained in the prior period remains applicable.

- A81. [Moved]

Considerations ~~S~~specific to Public ~~S~~ector Entities

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

- A83. [Moved]

- A84. [Moved]

- A85. [Moved]

- A86. [Moved]

- A87. [Moved]

- A88. [Deleted]

How the Inherent Risk Factors Affect Susceptibility to Misstatement of Assertions (Ref: Para. 23(c))

[Moved section from A48a-A48d]

Appendix 2 provides examples of events and conditions that may indicate susceptibility to risks of material misstatement, categorized by inherent risk factor.

Why the auditor considers the inherent risk factors when understanding the entity and its environment and the applicable financial reporting framework

~~A88a.A48a~~ When understanding Understanding the entity and its environment, and the applicable financial reporting framework, assists the auditor ~~considers how in identifying events or and conditions related,~~ the characteristics of which may affect the susceptibility of assertions to the entity and its environment ~~misstatement.~~ These characteristics are ~~subject to, or affected by, the~~ inherent risk factors. ~~These~~ Accordingly, understanding the inherent risk factors ~~help~~ (i.e., that affect the susceptibility of assertions to misstatement, and how they do so) assists the auditor in identifying and assessing the risk of material misstatement at the assertion level, and in performing further audit

~~procedures in accordance with the auditor's understanding of where risks of material misstatement may arise when the entity has applied the applicable financial reporting framework to these events or conditions by highlighting which classes of transactions, account balances and disclosures may be affected and therefore which may be significant classes of transactions, account balances and disclosures. Understanding whether, and the relative degree to which, the ISA 330. The inherent risk factors affect the events and conditions may also assist the auditor in identifying and assessing the risk likelihood and magnitude of material a possible misstatement at the assertion level. when assessing inherent risk.~~

The ~~E~~ffect of the ~~I~~nherent ~~R~~isk ~~F~~actors on a ~~C~~lass of ~~T~~ransactions, ~~A~~ccount ~~B~~alance or ~~D~~isclosure

~~A88b. A48b.~~ The extent to which ~~of~~ susceptibility to misstatement of a class of transactions, account balance or disclosure ~~is subject to, or affected by,~~ arising from complexity or subjectivity, is often closely related to the extent to which it is subject to change or uncertainty.

Example:

If the entity has an accounting ~~estimate~~ estimated based on assumptions that are ~~sensitive~~ subject to changes, ~~significant inherent uncertainty,~~ the greater measurement of the risk that there may accounting estimate is likely to be a material misstatement affected by both subjectivity and uncertainty.

~~A88c. A48c.~~ The greater the extent to which a class of transactions, account balance or disclosure is ~~subject~~ susceptible to, or affected by, ~~misstatement because of~~ complexity or subjectivity, the greater the need for the auditor to apply professional skepticism. Further, when a class of transactions, account balance or disclosure is ~~subject to, or affected by,~~ susceptible to misstatement because of 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 misappropriation of assets.~~ 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.

~~A88d. A48d.~~ Events or conditions that may ~~be affected by, or subject to,~~ the ~~effect~~ susceptibility of misstatement due to management bias ~~or misappropriation of assets~~ may ~~be indicative of increased risks of material~~ also affect susceptibility to misstatement due to other fraud risk factors. 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.

Obtaining an Understanding of the Entity's System of Internal Control (Ref: Para. 28–43)

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.

~~A89. [Deleted]~~

A89. The auditor's understanding of the entity's system of internal control is obtained through risk assessment procedures performed to understand and evaluate each of the components of the system of internal control as set out in paragraphs 28 to 39 of this ISA.

A89a. [~~Previously paragraph A99~~] The components of the entity's system of internal control for the purpose of this ISA may not necessarily reflect how an entity designs, implements and maintains its system of internal control, or how it may classify any particular component. Entities may use different terminology or frameworks to describe the various aspects of the system of internal control. For the purpose of an audit, auditors may also use different terminology or frameworks provided all the components described in this ISA are addressed.

A90. [~~Moved~~]

A91. [~~Moved~~]

A92. [~~Moved~~]

Relevant Aspects of the Entity's System of Internal Control

Relevant Aspects of the Entity's System of Internal Control Required to be Understood

A93. [~~Deleted~~]

A93a. ~~For the purposes of this ISA, understanding the relevant aspects of the entity's system of internal control comprises:~~

- ~~(a) Obtaining an understanding of the relevant aspects of each of the components of the entity's system of internal control, as defined, that are relevant to the preparation of the financial statements in accordance with the requirements of the applicable financial reporting framework; and~~
- ~~(b) Evaluating those aspects, for which the understanding has been obtained, for each of the components of the entity's system of internal control as required by paragraphs 28–36 and paragraph 42~~

A94. [~~Moved to paragraph A136a~~]

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. [~~Repeated later~~]~~

A94a. [~~Moved to Appendix 3~~] ~~Understanding how the entity initiates transactions and captures information relevant to financial reporting as part of the auditor's understanding of the information system may include information from the entity's systems and controls designed to address compliance and operations objectives. [~~Rest moved to paragraph A136a~~]~~

A95. ~~For the purposes of this ISA, the system of internal control relevant to financial reporting means the system of internal control relevant to the preparation of the financial statements in accordance with the requirements of the applicable financial reporting framework.~~

Scalability

A95a. The way in which the entity's 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 or~~ simpler controls (i.e., policies and procedures) to achieve their objectives.

Considerations Specific to Public Sector Entities

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

Information Technology in the Components of the Entity's System of Internal Control

Appendix 5 provides further guidance on understanding the entity's use of IT in the components of the system of internal control.

A97. 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 (i.e., manual and automated controls and other resources used in the entity's system of internal control).

A98. [Moved]

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

A99. [Moved to paragraph A89a]

A100. [Moved]

A101. [Moved]

A102. ~~The nature~~ auditor's understanding 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 in different ways:

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

A103. [Deleted]

A104. [Deleted]

Understanding the Components of the Entity's System of Internal Control (Ref: Para. 27–39)

Control Environment, The Entity's Risk Assessment Process and the Entity's Process to Monitor the System of Internal Control (Ref: Para. 28–33) **1A**

A104a. The controls in the control environment, the entity's risk assessment process and the entity's process to monitor the system of internal control are primarily indirect controls [*Previously paragraph A104d*] (i.e., controls that are not sufficiently precise to prevent, detect or correct misstatements at the assertion level but which support other controls and may therefore have an indirect effect on the likelihood that a misstatement will be detected or prevented on a timely basis). However, some controls within these components may also be direct controls.

Why the Auditor is Required to ~~Evaluate~~ Understand the ~~Relevant Aspects~~ of the Control Environment, The Entity's Risk Assessment Process and the Entity's Process to Monitor the System of Internal Control

~~A104a~~ **A104b.** The control environment provides ~~the an~~ overall foundation for the operation of the other components of the system of internal control. The control environment does not directly prevent, or detect and correct, misstatements. It may, however, influence the effectiveness of controls in 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.

~~A104b~~ **A104c.** Because these components are foundational to the entity's system of internal control, any ~~weaknesses~~ deficiencies in their operation could have pervasive effects to the preparation of the financial statements. Therefore, the auditor's understanding ~~and evaluations~~ of these components affect the auditor's identification and assessment of risks of material misstatement at the financial statement level, and may also affect the identification and assessment of risks of material misstatement at the assertion level. Identified risks of material misstatement at the financial statement level ~~affects~~ affect the auditor's design of overall responses, ~~which 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.²³

~~A104c~~ **A104d.** The auditor's ~~intention~~ intention to test the operating effectiveness of controls may also be influenced by the identified risks of material misstatement at the financial statement level because they may influence the auditor's expectations about the operating effectiveness of controls.

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.~~

A104d. [Moved to paragraph A104a]

²³ ISA 330, paragraphs A2A1–A3

Example:

~~Some 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). [Moved to A4a]~~

~~Monitoring controls may also include certain activities performed by the internal audit function, some of which may be direct controls.~~

Obtaining an Understanding of the Control Environment (Ref: Para. 28)

A105. [*Moved*]

~~A105a. The relevant aspects of the control environment are defined in paragraph 16(gb).~~

Scalability

A106. ~~The nature of the control environment relating to in a less complex entities is likely to vary be different from the control environment in a larger or more complex entities.~~

~~A106a. These~~ For example, those charged with governance in 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~~ or may not be applicable.

A107. In addition, audit evidence ~~for about~~ elements of the control environment in less complex entities may not be available in documentary form, in particular where communication between management and other personnel ~~may be~~ informal, but ~~is the evidence may still be~~ appropriately relevant and reliable in the circumstances ~~effective~~.

Examples:

- The organizational structure in a less complex entity will likely be simpler and may include a small number of employees involved in roles related to financial reporting.
- 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.
- Less complex entities may not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a less complex entity's control environment.

Understanding the Relevant Aspects of the Control Environment ~~control environment~~ (Ref: Para. 23 ~~(e28(a))~~)

A108. Audit evidence for the auditor's understanding of the control environment may be obtained through a combination of inquiries and other risk assessment procedures (i.e., corroborating inquiries through observation or inspection of documents).

A108a. In considering the extent to which management demonstrates a commitment to integrity and ethical values, the auditor may obtain an understanding through inquiries of management and employees about:

- How management communicates to employees its views on business practices and ethical behavior; and
- Inspecting management's written code of conduct and observing whether management acts in a manner that supports that code.

Scalability

~~A108b. The risk assessment procedures performed to obtain the understanding of the control environment and therefore vary to the extent necessary, to provide an appropriate basis for the required evaluation in paragraph 30.~~

A109. *[Moved]*

A110. *[Moved]*

~~Evaluating the Relevant Aspects of the Control Environment (Ref: Para. 28)(b))~~

~~A110a. The auditor's evaluation of the relevant aspects of the entity's control environment is undertaken using the information from based on the understanding of the entity's control environment obtained in accordance with paragraph 28(a).~~

~~Why the Auditor Evaluates the Relevant Aspects of the Control Environment~~

~~A111. [Moved]~~

~~A112. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement.~~

Scalability

A113. Some entities may be dominated by a single individual who may exercise a great deal of discretion. The actions and attitudes of that individual may have a pervasive effect on the culture of the entity, which in turn may have a pervasive effect on the control environment. Such an effect may be positive or negative.

Example:

Direct involvement by a single individual may be key to enabling the entity to meet its growth and other objectives, and can also contribute significantly to an effective system of internal control. On the other hand, such concentration of knowledge and authority can also lead to an increased susceptibility to misstatement through management override of controls.

~~A114. In considering the involvement of those charged with governance, who are also independent, the auditor considers~~The auditor may consider how the different elements of the control environment may be influenced by the philosophy and operating style of senior management. ~~However, other elements may be more limited in their effect~~ taking into account the involvement of independent members of those charged with governance.

A114a.~~[Moved from example below]~~ Although the control environment may provide an appropriate foundation for the system of internal control and may help reduce the risk of fraud, an appropriate control environment is not necessarily an effective deterrent to fraud.

Example:

Human resource policies and procedures directed toward hiring competent financial, accounting, and IT personnel may ~~reduce~~ mitigate the risk of errors in processing and recording financial information. However, such policies and procedures may not mitigate ~~a strong bias by top management to override controls (e.g. overstate earnings).~~ ~~[Moved to paragraph A114a]~~ Overall, ~~although a control environment that provides an appropriate foundation for the system of internal control may help reduce the risk of fraud, an appropriate control environment is not necessarily an effective deterrent to fraud.~~ the override of controls by senior management (e.g., to overstate earnings).

~~A114a~~A114b. The auditor's evaluation of the control environment as it relates to the entity's use of IT 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)).

~~The~~Obtaining an Understanding of the Entity's Risk Assessment Process (Ref: Para. 30–31)

A115. ~~[Moved]~~ .

A116. ~~[Deleted]~~

~~Understanding the Relevant Aspects of the Entity's Risk Assessment Process~~ (Ref: Para. 30)(a)

~~A117.~~The relevant aspects of the entity's risk assessment process are defined ~~[Previously hanging paragraph in A117a]~~ As explained in paragraph 46~~(e.g. A59, not all business risks give rise~~ ~~[previously paragraph A117a]~~ In order to understand risks of material misstatement. In understanding how management and those charged with governance have identified business risks relevant to the preparation of the financial reporting objectives~~statements,~~ 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 precision and 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; and

- Considered the potential for fraud when considering the risks to achieving the entity's objectives;²⁴ and

~~A117a. [Previously last bullet in paragraph A117a] Identified and evaluated changes that could significantly affect the auditor may consider the implications of such business risks for the preparation of the entity's financial statements and other aspects of its system of internal control.~~

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

A118. [Deleted]

A119. [Deleted]

~~Evaluating Whether the Relevant Aspects of the Entity's Risk Assessment Process are Appropriate whether the entity's risk assessment process is appropriate (Ref: Para. 30)(b))~~

~~A119a. The auditor's evaluation of the appropriateness of the relevant aspects of the entity's risk assessment process is undertaken using the information from the understanding of the entity's risk assessment process obtained based on the understanding obtained in accordance with paragraph 30(a).~~

Scalability

A120. Whether the ~~relevant aspects of~~ entity's risk assessment process is appropriate to the entity's circumstances considering the nature and size of the entity, ~~including its nature, size, and complexity,~~ is a matter of the auditor's professional judgment.

Example:

In some 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 business risks). The evidence of this risk assessment occurring in these types of entities is often not formally documented, but it may be evident from the discussions the auditor has with management that management are in fact performing risk assessment procedures.

A121. [Moved]

~~The~~Obtaining an Understanding of the Entity's Process to Monitor the Entity's System of Internal Control (Ref: Para. ~~30~~31A)

A122. [Moved]

Scalability

A123. In less complex entities, and in particular owner-manager entities, the auditor's understanding of the entity's process to monitor the system of internal control is often focused on how management or the

²⁴ See paragraph 187(a) of ISA 240

owner-manager's is directly involved in operations, as there may not be any other monitoring activities.

Example:

Management may receive complaints from customers about inaccuracies in their monthly statement that alerts the owner-manager to issues with the timing of when customer payments are being recognized in the accounting records.

~~Distinguishing Monitoring Activities~~

A124. [~~Previously paragraph A128a~~] For entities where there is no ~~distinct formal~~ process for monitoring the system of internal control, ~~it may be difficult to distinguish between control activities related to the information system and activities related to monitoring.~~ For such entities, understanding the process to monitor the system of internal control may include understanding periodic reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

A125. [~~Moved~~]

~~Understanding the Relevant Aspects of the Entity's Process to Monitor the System of Internal Control (Ref: Para. 31A(a))~~

A126. [~~deleted~~] ~~The relevant aspects of the entity's process to monitor the system of control are defined in paragraph 16(gd).~~

A126a. Matters that may be relevant for the auditor to consider when understanding how the entity monitors its system of internal control include:

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

A127. The auditor may also consider how the entity's process to monitor the system of internal control addresses monitoring information processing controls that involve the use of IT. This may include, for example:

- Controls to monitor complex IT environments that:
 - Evaluate the continuing design effectiveness of information processing controls and modify them, as appropriate, for changes in conditions; or
 - Evaluate the operating effectiveness of information processing controls.
- Controls that monitor the permissions applied in automated information processing controls that enforce the segregation of duties.

- Controls that monitor how errors or control deficiencies related to the automation of financial reporting are identified and addressed.

A128. [Moved]

A128a [Moved to paragraph A124] Sources of Information Understanding the entity's internal audit function (Ref: Para. 33) 31A(a)(ii))

Appendix 4 sets out further considerations relating to the entity's internal audit function.

A129. [~~Moved to paragraph A135a] is appropriate. If management assumes that information used for monitoring is accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities.~~

A130. [Move to paragraph A135b]

The Entity's Internal Audit Function

Appendix 4 sets out further matters for consideration relating to the entity's internal audit function.

Why the Auditor is Required to Obtain an Understanding of the Role of Internal Audit in the Entity's Process to Monitor the System of Internal Control

A131. The auditor's inquiries of appropriate individuals within the internal audit function 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, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.

A132. [Moved]

A133. [Moved]

A134. [Moved]

A135. [Moved]

Other Sources of Information Used in the Entity's Process to Monitor the System of Internal Control

Evaluating Whether Understanding the Relevant Aspects of the Entity's Process to Monitor the System of Internal Control are Appropriate (Ref: Para.30) information (Ref: Para. 31A(b))

Why the auditor is required to understand the sources of information used for the entity's monitoring of the system of internal control

A135a. [Previously paragraph A129] The auditor's understanding of the sources of information used by the entity in monitoring the entity's system of internal control, including whether the information used is relevant and reliable, assists the auditor in evaluating whether the entity's process to monitor the entity's system of internal control is appropriate. If management assumes that information used for

monitoring is ~~accurate-relevant and reliable~~ without having a basis for that assumption, errors that may exist in the information could potentially lead management to draw incorrect conclusions from its monitoring activities. ~~The auditor's evaluation of the relevant aspects of the entity's process to monitor the system of internal control is undertaken using the information from the understanding of the entity's process to monitor the system of internal control obtained.~~

Other ~~S~~ources of ~~I~~nformation ~~U~~sed in the ~~E~~ntity's ~~P~~rocess to ~~M~~onitor the ~~S~~ystem of ~~I~~nternal ~~C~~ontrol

A135b. ~~[Previously paragraph A130]~~ Management's monitoring activities may use information in communications from external parties such as customer complaints or regulator comments that may indicate problems or highlight areas in need of improvement.

Evaluating ~~W~~hether the ~~R~~elevant ~~A~~spects of the ~~E~~ntity's ~~P~~rocess to ~~M~~onitor the ~~S~~ystem of ~~I~~nternal ~~C~~ontrol ~~are~~ is ~~A~~ppropriate (Ref: Para. ~~30~~ 31A(c))

A135c. ~~[Previously paragraph A135a]~~ The auditor's evaluation of the ~~relevant aspects~~ appropriateness of the entity's process to monitor the system of internal control is undertaken using the information from based on the auditor's understanding of the entity's process to monitor the system of internal control obtained in paragraphs 31A(a)–(b).

The Information System and Communication, and Control Activities (Ref: Para. 36–39)

Why the Auditor is Required to ~~Evaluate the Relevant Aspects of~~ Understand the Information System and Communication and Controls in the Control Activities Component ~~(Ref: Para. 36)~~

A135d. ~~[Previously paragraph A135b]~~ The auditor ~~understands and evaluates the relevant aspects of~~ the entity's information system and communication because understanding the entity's policies that define the flows of transactions and other aspects of the entity's information processing activities relevant to the preparation of the financial statements, and evaluating whether the component appropriately supports the preparation of the entity's financial statements support the auditor's identification and assessment of risks of material misstatement at the assertion level. This understanding and evaluation may also 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.

A135e. ~~[Previously paragraph A135c]~~ ~~The control activities component includes controls related to all the components of the entity's system of internal controls and includes both direct and indirect controls. The auditor's identification and evaluation of~~ The auditor is required to identify specific controls in the control activities component is focused on information processing controls, which are control activities related to the entity's information system. However, there may be control activities that are 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 that may be identified. The auditor also identifies and evaluates general IT controls for IT applications and other aspects of the IT environment that the auditor has determined to be subject to risks arising from the use of IT because general IT controls support the continued effective functioning of information processing controls.

A135f. ~~[Previously paragraph A135d] The auditor is not required to identify and evaluate all information processing controls related to the flows of transactions and information processing activities for the significant classes of transactions, account balances and disclosures.~~

A135g. ~~[Moved to A160d]~~

A135h. The auditor is required to identify specific controls in the control activities component and evaluate the design and determine whether the controls have been implemented, as it assists the auditor's understanding about management's approach to addressing certain risks (in particular those that are higher on the spectrum of inherent risk) and therefore informs the design and performance of substantive procedures responsive to these risks as required by ISA 330. Even when the auditor does not plan to test the operating effectiveness of identified controls, the auditor's understanding may still affect the design of the nature, timing and extent of substantive audit procedures that are responsive to the related risks of material misstatement.

Example:

The results of these risk assessment procedures may inform the auditor's consideration of possible deviations in a population when designing audit samples.

A135i. ~~[Previously paragraph A175c] The higher on the spectrum of inherent risk a risk is assessed on the spectrum of inherent risk, the more persuasive the audit evidence needs to be. As explained in ISA 330,²⁵ obtaining more persuasive evidence may involve obtaining evidence that is more relevant or reliable. The auditor's understanding of controls contributes to the audit evidence obtained for these risks and this understanding may further assist the auditor in designing further audit procedures to obtain more relevant and reliable audit evidence.~~

The Iterative Nature of the Auditor's Understanding and Evaluation of the Information System and Communication, and Control Activities

A135j. The auditor's identification and assessment of risks of material misstatement at the assertion level is influenced by both the auditor's understanding of the entity's policies for its information processing activities in the information system and communication, and the auditor's identification and evaluation of related controls in the control activities component.

A135k. As explained in paragraph A47b, the auditor's understanding of the entity and its environment and the applicable financial framework may assist the auditor in developing initial expectations about the classes of transactions, account balances and disclosures that may be significant classes of transactions, account balances and disclosures. The auditor's understanding of the relevant aspects of the information system includes understanding the policies that define flows of information relating to the entity's significant classes of transactions, account balances, and disclosures, and other related aspects of the entity's information processing activities. The auditor's understanding of the information system may be based on those classes of transactions, account balances and disclosures that the auditor expects to be significant classes of transactions, account balances and disclosures. The information obtained while gaining the understanding and performing the evaluation of the information system assists the auditor in determining which classes of transactions, account balances and disclosures are susceptible to material misstatement therefore

²⁵ ISA 330, paragraph A19

~~are.~~ This information, and the information obtained from the auditor's evaluation of the information system assists the auditor's expectations about the significant classes of transactions, account balances and disclosures.

A135l. The auditor's identification and evaluation of controls in the control activities component may first focus on controls over journal entries and controls ~~on which~~that the auditor plans to ~~rely~~ test in designing the nature, timing and extent of substantive procedures because such controls are identified ~~independently~~independently of the auditor's risk assessments. ~~Based on the procedures performed to assess inherent risk for risks of material misstatement [Moved to paragraph A135]~~ The auditor may also controls in the control activities component that are required to be identify concurrently with the auditor's understanding of how information relating to significant classes of transactions, account balances and disclosures flows into, through, and out of the entity's information system.

A135m. The auditor's assessment of inherent risk may also for risks of material misstatement drive the identification of controls in the control activities component. The auditor's identification and evaluation of controls relating to significant risks, and those risks that the auditor considered to have a reasonable possibility of being significant risks but determined not to be significant risks, may ordinarily only be identifiable when the auditor has assessed inherent risk [Moved form paragraph A135h] at the assertion level in accordance with paragraphs 48 through 50, the auditor may subsequently identify and evaluate Furthermore, controls ~~over significant risks, controls that address~~addressing risks for which the auditor has determined that substantive procedures alone do not provide sufficient appropriate audit evidence, ~~and controls that address over risks that have been assessed as higher on the spectrum of inherent risk (in accordance with paragraph 50) may also only be identifiable once the auditor's inherent risk assessments have been undertaken.~~

~~The~~Obtaining an Understanding of the Information System and Communication (Ref: Para. 36)

Appendix 3, Paragraphs 14–18, sets out further ~~matters for consideration~~considerations relating to the information system and communication.

Scalability

A135n. The information system, and related business processes, in less complex entities are likely to be less sophisticated than in larger entities, and to involve a less complex IT environment, but the role of the information system is just as important. Less complex entities with direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the relevant aspects of the entity's information system may therefore require less effort in an audit of a less complex entity, and may ~~be more dependent on~~ involve a greater amount of inquiry than on review~~observation or inspection~~ of documentation. The need to obtain an understanding, however, remains important to identifying risks of material misstatement.

Relevant Aspects of the Information System and Communication

Obtaining an understanding of the information system (Ref: Para. 36(a))

A136. *[Moved]*

A136a. ~~The relevant aspects of the information system and communication component are defined in paragraph 16(gf). [Previously paragraph A94]~~ Included within the entity's system of internal control are aspects 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. Understanding how the entity initiates transactions and captures information as part of the auditor's understanding of the information system may include information about the entity's systems (its policies) designed to address compliance and operations objectives because such information is relevant to the preparation of the financial statements. [From paragraph A94a] 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.

A136b. Understanding the entity's information system also includes an understanding of resources to be used in such activities. Information about the human resources involved that may be relevant to understanding risks to the integrity of the information system include:

- The competence of the individuals undertaking the work;
- Whether there are adequate resources; and
- Is there appropriate segregation of duties.

A137. [Moved]

A137a. Matters the auditor may consider when understanding the ~~controls~~ policies that define the flows of information relating to the entity's significant classes of transactions, account balances, and disclosures in the information system and communication component include the nature of:

- (a) The data or information relating to transactions, other events and conditions to be processed;
- (b) The information processing to maintain the integrity of that data or information; and
- (c) The information processes, personnel and other resources used in the information processing process.

A137b. 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 in a manner that is appropriate to the entity's circumstances.

A138. [Moved]

A139. [Moved]

A140. [Moved]

A141. [Moved]

A141a. ~~The objective of information processing is to capture, store and process data from internal and external sources, and to produce the entity's accounting records and the information that the entity needs to include in its financial statements. The objective of those processes is also to comply with the requirements and principles in the applicable financial reporting framework, and in other applicable laws or regulations.~~

A141b. [Deleted]

A141c. The auditor's understanding of the ~~relevant aspects of the~~ information system may be obtained in various ways and may include:

- ~~• 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~~
- Inspection of policy or process manuals or other documentation of the entity's information system;
- Observation of the performance of the policies or procedures by entity's personnel; or
- Selecting transactions and tracing them through the applicable process in the information system. (i.e., performing a walk-through).

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

A141d. *[Deleted]*

Automated ~~T~~tools and ~~T~~techniques

A141e. The auditor may also use automated techniques to obtain direct access to, or a digital download from, the databases in the entity's information system that store accounting records of transactions. By applying automated tools or techniques to 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 risks of material misstatement.

Information ~~O~~obtained from ~~O~~outside of the ~~G~~general and ~~S~~subsidiary ~~L~~ledgers

A142. Financial statements may contain information that is obtained from outside of the general and subsidiary ledgers. Examples of such information that the auditor may consider include:

- Information obtained from lease agreements relevant to disclosures in the financial statements.
- Information disclosed in the financial statements that is produced by an entity's risk management system.
- Fair value information produced by management's experts and disclosed in the financial statements.
- Information disclosed in the financial statements that has been obtained from models, or from other calculations used to develop accounting estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
 - Assumptions developed internally that may affect an asset's useful life; or
 - Data such as interest rates that are affected by factors outside the control of the entity.

- Information disclosed in the financial statements about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.
- Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records.
- Information disclosed in the financial statements that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern.²⁶

A143. Certain amounts or disclosures in the entity's financial statements (such as disclosures about credit risk, liquidity risk, and market risk) may be based on information obtained from the entity's risk management system. However, the auditor is not required to understand all aspects of the risk management system, and uses professional judgment in determining the necessary understanding.

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

Why Does the Auditor Understand the IT Environment Relevant to the Information System

A144. The auditor's understanding of the information system includes the IT environment relevant to the flows of transactions and processing of information in 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.

A144a. The understanding of the entity's business model and how it integrates the use of IT may also provide useful context to the nature and extent of IT expected in the information system.

Understanding the entity's use of IT

A144b. The auditor's understanding of the IT environment may focus on identifying, and understanding the nature and number of, the specific IT applications and other aspects of the IT environment, that are relevant to the flows of transactions and processing of information in the information system. Changes in the flow of transactions, or information within the information system may result from program changes to IT applications, or direct changes to data in databases involved in processing, or storing those transactions or information.

A145. [Moved]

A146. The auditor may identify 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 into, through and out the entity's information system.

A147. [Moved]

A148. [Deleted and moved]

A149. [Moved]

A150. [Moved]

A151. [Moved]

²⁶ See paragraphs 19–20 of ISA 570 (Revised), *Going Concern*

A152. [Moved]

A153. [Moved]

A154. [Moved]

A155. [Moved]

A155a. [Moved to Paragraph A159a]

A156. [Deleted]

A157. [Deleted]

A158. [Moved]

Obtaining an Understanding of the Entity's Communication (Ref: Para. 36(b))

Scalability

A158a. In larger, more complex entities, information the auditor may consider when understanding the entity's communication may come from policy manuals and financial reporting manuals.

A159. In less complex entities, communication may be less structured (e.g., formal manuals may not be used) due to fewer levels of responsibility and management's greater visibility and availability. Regardless of the size of the entity, open communication channels facilitate the reporting of exceptions and acting on them.

Evaluating Whether the Relevant Aspects of the Information System Support the Preparation of the Entity's Financial Statements (Ref: Para. 36(c))

A159a. [Previously paragraph A155a] The auditor's evaluation of whether the ~~relevant aspects of the~~ entity's information system and communication appropriately supports the preparation of the financial statements is undertaken based on the understanding obtained in paragraphs 36(a)–(b).

Control Activities (Ref: Para. 39)

Controls in the Control Activities Component (Ref: Para. 39)

A160. The control activities component includes controls that are designed to ensure the proper application of policies (which are also controls) in all the other components of the entity's system of internal control, and includes both direct and indirect controls.

Example: [Moved from example after paragraph A170]

The controls that an entity has 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.

A160a. The auditor's identification and evaluation of controls in the control activities component is focused on information processing controls, which are controls related to the entity's information system. However, the auditor is not required to identify and evaluate all information processing controls related to the entity's policies that define the flows of transactions and other aspects of the entity's

information processing activities for the significant classes of transactions, account balances and disclosures.

A160b. There may also 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, which may be identified in accordance with paragraph 39. [Previously paragraph A197] However, the more indirect the relationship between controls that support other controls and the control that is being considered, the less effective that control may be in preventing, or detecting and correcting related, misstatements.

Example:

[Moved from example paragraph A197] 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 addressing those risks than controls more directly related thereto, such as matching shipping documents with billing documents.

A160c. Paragraph 39 also requires the auditor to identify and evaluate general IT controls for IT applications and other aspects of the IT environment that the auditor has determined to be subject to risks arising from the use of IT, because general IT controls support the continued effective functioning of information processing controls. [Previously paragraph A160c] Similarly, a general IT control alone is typically not sufficient to address a risk of material misstatement at the assertion level.

A160d. [Previously A135e] ~~The controls that the auditor is required to identify and evaluate the design and determine the implementation of, in accordance with paragraph 39 and evaluate the design and determine the implementation of in accordance with paragraph 42 are those:~~

- On which the auditor plans to test the operating effectiveness of in determining the nature, timing and extent of substantive procedures because the evaluation of such controls provides the basis for the auditor's design of test of control procedures in accordance with ISA 330. Such controls include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.
- That address risks of material misstatement at the assertion level that have been assessed as higher on the spectrum of inherent risk because ISA 330 requires more persuasive audit evidence the higher the auditor's assessment of risk²⁷. Such controls include controls that address significant risks, controls that address risks that could be but are not significant risks, and controls over journal entries. The auditor's identification and evaluation of such controls may provide the auditor with a greater understanding of the risks of material misstatement, including the identification of additional risks of material misstatement. This understanding also provides the basis for the auditor's design of the nature, timing and extent of substantive audit procedures that are responsive to the related assessed risks of material misstatement.

A160e. Controls in the control activities component are required to be identified when such controls meet one or more of the criteria included in paragraph 39(a). [Previously paragraph A166] However, when multiple controls each achieve the same objective, it is unnecessary to identify each of the controls related to such objective.

²⁷ ISA 330, paragraph 7(b)

Types of Controls in the Control Activities Component (Ref: Para. 39)

A160f. [*Previously paragraph A161b*] Examples of controls in the control activities component include authorizations and approvals, reconciliations, verifications (such as edit and validation checks or automated calculations), segregation of duties, and physical or logical controls, including those addressing safeguarding of assets.

A160g. [*Previously paragraph A165*] Controls in the control activities component may also include controls established by management that address risks of material misstatement related to disclosures not being prepared in accordance with the applicable financial reporting framework. Such controls may relate to information included in the financial statements that is obtained from outside of the general and subsidiary ledgers.

A160h. [*Previously paragraph A161b*] Regardless of whether controls are within the IT environment or manual systems, controls may have various objectives and may be applied at various organizational and functional levels.

Scalability

A161. Controls in the control activities component for less complex entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, in less complex entities, more controls may be directly applied by management.

Example

Management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions.

A161a. It may be less practicable to establish segregation of duties in ~~smaller and~~ less complex entities that have fewer employees. However, in an owner-managed entity, the owner-manager may be able to exercise more effective oversight through direct involvement than in a larger entity, which may compensate for the generally more limited opportunities for segregation of duties. Although, as also explained in ISA 240, domination of management by a single individual can be a potential control deficiency since there is an opportunity for management override of controls.²⁸

Types of Controls in Control Activities

A161b. [*Moved to A160f and A160h*]

A162. [*Moved*]

A163. [*Moved*]

A164. [*Moved*]

A165. [*Moved to paragraph A160g*]

A166. [*Part deleted and part moved to paragraph A160e*]

A167. [*Moved to paragraph A160e with example*]

A168. [*Moved*]

²⁸ ISA 240, paragraph A28

Controls that Address Risks of Material Misstatement at the Assertion Level (Ref: Para. 39(a))Controls that address risks that are determined to be a significant risk (Ref: Para. 39(a)(i))

A169. [Moved]

A170. Regardless of whether the auditor plans 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 330.²⁹ 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 may include whether and how management responds to the risks. Such responses may include:

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

Example:

Where there are one-off events such as the receipt of a 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.

A171. [Moved]

A172. ISA 240³⁰ requires the auditor to understand controls related to assessed risks of material misstatement due to fraud (which are treated as significant risks), and further explains that it is important for the auditor to obtain an understanding of these controls that management has designed, implemented and maintained to prevent and detect fraud. ~~In identifying these controls, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties.~~

A173. [Moved]

Controls that address risks that could be but are not determined to be significant risks (Ref: Para. 39(a)(ii))

A173a. Where the assessments of the risks of material misstatement at the assertion level fall on the spectrum of inherent risk, as well as the determination of significant risks, is a matter of the auditor's professional judgment. Whether the auditor identifies controls that address assessed risks for which the effect of the inherent risk factors indicates that there is a reasonable possibility that the assessed

²⁹ ISA 330, paragraph 21

³⁰ ISA 240, paragraphs 28 and A33

risks could be a significant risk but have not been determined to be a significant risk is also a matter of professional judgment.

A173b. The guidance in paragraph A173a also applies to controls that address risks that could but but are not determined to be significant risks.

Controls over journal entries (Ref: Para. 39(a)(iii))

A174. *[Deleted]*

A175. *[Deleted and moved (part)]*

A175. *[Previously paragraph A167 with example]* Controls that address risks of material misstatement at the assertion level that are expected to be relevant identified for all audits are controls over journal entries, because the manner in which an entity incorporates information from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or non-standard, or automated or manual. The extent to which other controls are relevant identified may vary based on the nature of the entity and the auditor's planned approach to further audit procedures.

Example:

In an audit of a less complex entity, the entity's information system may not be complex and the auditor may not plan to rely on the operating effectiveness of 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 identified controls other than the entity's controls over journal entries.

Automated tools and techniques

A175a. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of automated techniques.

Example:

In the audit of a less complex entity, the auditor may be able to extract a total listing of all journal entries into a simple spreadsheet. It may then be possible for the auditor to sort the journals by applying a variety of filters such as dollar amount, name of the journal preparer or reviewer, entries that gross up the balance sheet and income statement only, or to view the listing by the date the journal entry was posted to the general ledger, to assist the auditor in designing their response to the risks identified relating to journal entries.

~~Controls that are Necessary for the Auditor to Identify Due to Assessments of Related Risks of Material Misstatement (Ref: Para. 39(e))~~

~~A175b. The extent to which other controls that are necessary to be identified to achieve the objectives in paragraph 17(a) and (b) because of where the assessments of the related risks of material misstatement at the assertion level fall on the spectrum of inherent risk is a matter of the auditor's~~

~~professional judgment. The auditor's judgment about whether it is appropriate to identify such controls in order to provide a basis for the design and performance of further audit procedures is influenced by where on the spectrum of inherent risk the assessed risk falls, in particular for those risks of material misstatement that are closer to the upper end of the spectrum of inherent risk but have not been identified as significant risks.~~

A175c. *[Moved to paragraph A135]*

~~Testing of Controls for which the auditor plans to test the operating effectiveness of controls~~ (Ref: Para. 39(da)(iv))

A175d. 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. The auditor is required, in accordance with ISA 330,³¹ to design and perform tests of ~~relevant~~ controls that address such risks of material misstatement when substantive procedures alone ~~cannot do not~~ provide sufficient appropriate audit evidence at the assertion level. As a result, when such controls exist that address these risks, they are required to be identified and evaluated.

A176. In other cases, w~~When the auditor voluntarily intends~~plans to take into account the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures in accordance with ISA 330, such controls are also required to be identified because ISA 330³² requires the auditor to design and perform tests of those controls.

Examples:

The auditor may plan to test the operating effectiveness of controls:

- ~~Over~~ routine classes of transactions because such testing may be more effective or efficient for large volumes of homogenous transactions.
- *[Previously paragraph A178]* Over the completeness and accuracy of information produced by the entity (e.g., controls over the preparation of system-generated reports), to determine the reliability of that information, when the auditor intends to take into account the operating effectiveness of those controls in designing and performing further audit procedures.
- *[Previously paragraph A178]* Relating to operations and compliance objectives when they relate to data the auditor evaluates or uses in applying audit procedures.

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

A178. *[Moved into example above]* ~~...when the auditor intends to take into account the operating effectiveness of those controls in designing and performing further audit procedures to determine the reliability of that information for its use as audit evidence.~~ *[Moved into example above]*

³¹ ISA 330, paragraph 8(b)

³² ISA 330, paragraph 8(a)

A179. [Moved]

Identifying IT Applications and Other Aspects of the IT Environment , Risks Arising from the Entity's Use of IT and General IT Controls (Ref: Para ~~40~~. 39(b)–(c))

Appendix 5 includes example characteristics of IT applications and other aspects of the IT environment, and guidance related to those characteristics, that may be relevant in identifying IT applications and other aspects of the IT environment subject to risks arising from the use of IT.

Identifying IT applications and other aspects of the IT environment (Ref: Para. 39(b))

Why the auditor identifies risks arising from the use of IT and general IT controls related to identified IT applications and other aspects of the IT environment

A179a. Understanding the risks arising from the use of IT and the general IT controls implemented by the entity to address those risks may affect:

- The auditor's decision about whether to test the operating effectiveness of controls to address risks of material misstatement at the assertion level;

Example:

When general IT controls are not designed effectively or appropriately implemented to address risks arising from the use of IT (e.g., controls do not appropriately prevent or detect unauthorized program changes or unauthorized access to IT applications), this may affect the auditor's decision to rely on automated controls within the affected IT applications.

- The auditor's assessment of control risk at the assertion level;

Example:

The ongoing operating effectiveness of an information processing control may depend on certain general IT controls that prevent or detect unauthorized program changes to the IT information processing control (i.e. program change controls over the related IT application). In such circumstances, the expected operating effectiveness (or lack thereof) of the general IT control may affect the auditor's assessment of control risk (e.g., control risk may be higher when such general IT controls are expected to be ineffective or if the auditor does not plan to test the general IT controls).

- The auditor's strategy for testing information produced by the entity that is produced by or involves information from the entity's IT applications;

Example:

When information produced by the entity to be used as audit evidence is produced by IT applications, the auditor may determine to test controls over system-generated reports, including identification and testing of the general IT controls that address risks of inappropriate or unauthorized program changes or direct data changes to the reports.

- The auditor's assessment of inherent risk at the assertion level; or

Example:

When there are significant or extensive programming changes to an IT application to address new or revised reporting requirements of the applicable financial reporting framework, this may be an indicator of the complexity of the new requirements and their effect on the entity's financial statements. When such extensive programming or data changes occur, the IT application is also likely to be subject to risks arising from the use of IT.

- The design of further audit procedures.

Example:

Information processing controls depend on general IT controls, the auditor may determine to test the operating effectiveness of the general IT controls, which will then require the design of tests of control procedures for those general IT controls. If, in the same circumstances, the auditor determines not to test the operating effectiveness of the general IT controls, or the general IT controls are expected to be ineffective, the related risks arising from the use of IT may need to be addressed through the design of substantive procedures. However, the risks arising from the use of IT may not be able to be addressed when such risks relate to risks for which substantive procedures alone cannot do not provide sufficient appropriate audit evidence. In such circumstances, the auditor may need to consider the implications for the audit opinion.

Identifying IT applications that are subject to risks arising from the use of IT

A180. For the IT applications relevant to the information system, understanding the nature and complexity of the specific IT processes and general IT controls that the entity has in place may assist the auditor in determining which IT applications the entity is relying upon to accurately process and maintain the integrity of information in the entity's information system. Such IT applications may be subject to risks arising from the use of IT.

A180a. Identifying the IT applications that are subject to risks arising from the use of IT involves taking into account controls identified by the auditor ~~in accordance with paragraph 39~~ because such controls may involve the use of IT or rely on IT. The auditor may focus on whether an IT application includes automated controls that management is relying on and that the auditor has identified, including controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. The auditor may also consider how information is stored and processed in the information system relating to significant classes of transactions, account balances and disclosures and whether management is relying on general IT controls to maintain the integrity of that information.

A180b. The ~~automated~~ controls identified by the auditor may ~~include controls related to~~ depend on system-generated reports, in which case the IT applications that produce those reports may be subject to risks arising from the use of IT. In other cases, the auditor may not plan to rely on controls over the system-generated reports and plan to directly test the inputs and outputs of such reports, in which case the auditor may not identify the related IT applications as being subject to risks arising from IT.

Scalability

A180c. The extent of the auditor's understanding of the IT processes, including the extent to which the entity has general IT controls in place, will vary with the nature and the circumstances of the entity and its IT environment, as well as based on the nature and extent of controls identified by the auditor. The number of IT applications that are subject to risks arising from the use of IT also will vary based on these factors.

Examples:

- An entity that uses commercial software and does not have access to the source code to make any program changes is unlikely to have a process for program changes, but may have a process or procedures to configure the software (e.g., the chart of accounts, reporting parameters or thresholds). In addition, the entity may have a process or procedures to manage access to the application (e.g., a designated individual with administrative access to the commercial software). In such circumstances, the entity is unlikely to have or need formalized general IT controls.
- In contrast, a larger entity may rely on IT to a great extent and the IT environment may involve multiple IT applications and the IT processes to manage the IT environment may be complex (e.g., dedicated IT department exists that develops and implements program changes and manages access rights), including that the entity has implemented formalized general IT controls over its IT processes.
- When management is not relying on automated controls or general IT controls to process transactions or maintain the data, and the auditor has not identified any automated controls or other information processing controls (or any that depend on general IT controls), the auditor may plan to directly test any information produced by the entity involving IT and may not identify any IT applications that are subject to risks arising from the use of IT.
- When management relies on an IT application to process or maintain data and the volume of data is significant, and management relies upon the IT application to perform automated controls that the auditor has also identified, the IT application is likely to be subject to risks arising from the use of IT.

A180d. When an entity has greater complexity in its IT environment, identifying the IT applications and other aspects of the IT environment, determining the related risks arising from the use of IT, and identifying general IT controls is likely to require the involvement of team members with specialized skills in IT. Such involvement is likely to be essential, and may need to be extensive, for complex IT environments.

A181. [Moved]

A182. [Moved]

A183. [Moved]

A184. [Moved]

A185. [Moved]

A186. [Moved]

A187. [Moved]

Identifying other aspects of the IT environment that are subject to risks arising from the use of IT

A188. The other aspects of the IT environment that may be subject to risks arising from the use of IT include the network, operating system and databases, and in certain circumstances interfaces between IT applications. Other aspects of the IT environment are also not identified w~~When the auditor does not identify IT applications that are subject to risks arising from the use of IT, other aspects of the IT environment are also not identified.~~ When the auditor has identified IT applications that are subject to risks arising from IT, whether the, other aspects of the IT environment (e.g., database, operating system, network) are likely to be identified varies based on the extent to which~~because~~ such aspects support and interact with the identified IT applications. [Rest moved to Appendix]

Identifying Risks Arising from the Use of IT and General IT Controls (Ref: Para. 39(c))

Appendix 6 sets out considerations for understanding general IT controls.

A188a. In identifying the risks arising from the use of IT, the auditor may consider the nature of the identified IT application or other aspect of the IT environment and the reasons for it being subject to risks arising from the use of IT. For some identified IT applications or other aspects of the IT environment, the auditor may identify applicable specific~~risks~~ arising from the use of IT that relate primarily to unauthorized access or unauthorized program changes. ~~In the case of identified databases or, as well as that address risks related to inappropriate data warehouses, the auditor may be focused on~~exchanges (e.g., the risk of inappropriate changes to the data through direct database access and/or the ability to directly manipulate information).

A189. The extent and nature of the applicable risks arising from the use of IT vary depending on the nature and characteristics of the identified IT applications and other aspects of the IT environment. ~~Specific~~ Applicable IT risks may result when the entity uses external or internal service providers for identified aspects of its IT environment (e.g., outsourcing the hosting of its IT environment to a third party or using a shared service center for central management of IT processes in a group). ~~Specific~~ Applicable ~~IT~~risks arising from the use of IT may also be identified related to cybersecurity. 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. [Deleted as now covered by reference to appendix]

A190. [Moved].

A191. [Moved]

A192. [Moved]

A193. [Moved]

Evaluating the Design, and Determining Implementation of, Identified Controls in the Control Activities Component (Ref: Para 42)~~39(de)~~

A194. Evaluating the design of an identified control involves the auditor's consideration of whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements (i.e., the control objective).

A194a. [Previously part of paragraph A194] The auditor determines the implementation of an identified control by ~~determining~~establishing that the control exists and that the entity is using it. There is little point in the auditor assessing the implementation of a control that is not designed effectively. Therefore, the auditor evaluates the design of a control ~~is considered first~~. An improperly designed control may represent a ~~significant~~ control deficiency.

~~A195. In making risk assessments, the auditor may identify controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to risks of material misstatement in the context of processes and, when applicable, IT applications in which they exist.~~

~~A196. Many identified controls may be direct controls that therefore directly address risks of material misstatement at the assertion level embodied in a particular significant class of transactions or account balance.~~

Example: [Moved to example following paragraph A160a]

A197. [Moved to paragraph A160b]

Example:

[Moved to example paragraph A160b and paragraph A160c]

A198. Risk assessment procedures to obtain audit evidence about the design and implementation of identified controls in the control activities component may include:

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

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

A198a. 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. However, when a control is not designed or implemented effectively, there is no benefit in testing it. 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.

A199. Evaluating the design and determining the implementation of identified controls in the control activities component is not sufficient to test their operating effectiveness, ~~unless a control is an~~. However, for automated control and controls, the auditor has identified and tested may plan to test the operating effectiveness of automated controls by identifying and testing general IT controls that provide for the consistent operation of the automated control an automated control instead of

performing tests of operating effectiveness on the automated controls directly. 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. Tests of the operating effectiveness of controls, including tests of indirect controls, are further described in ISA 330.³³

A200. When the auditor does not plan to test the operating effectiveness of identified controls, the auditor's understanding may still ~~assist~~ assist in the design of the nature, timing and extent of substantive audit procedures that are responsive to the related risks of material misstatement.

Example:

The results of these risk assessment procedures may inform the auditor's consideration of possible deviations in a population when designing audit samples.

Control Deficiencies Within the Entity's System of Internal Control (Ref: Para. 43)

A200a. In performing the evaluations of ~~the relevant aspects of~~ each of the components of the entity's system of internal control,³⁴ the auditor may ~~identify weaknesses or determine that the system of internal control is~~ certain of the entity's policies in a component are not appropriate to the nature and circumstances of the entity. Such a determination may be an indicator that assists the auditor in identifying control deficiencies.

A200b. ~~The auditor also considers whether the control environment supports the operation of controls within the other components of the entity's system of internal control (as explained in paragraph A104a).~~

A200c. If the auditor has identified one or more control deficiencies, ISA 265³⁵ requires the auditor to determine whether, individually or in combination, the deficiencies constitute a significant deficiency. The auditor uses professional judgment in determining whether a deficiency represents a significant control deficiency.³⁶

Examples:

Circumstances that may indicate a significant control deficiency exists include matters such as:

- The identification of fraud of any magnitude that involves senior management;
- Identified internal processes that are inadequate relating to the reporting and communication of deficiencies noted by internal audit;
- Previously communicated deficiencies that are not corrected by management in a timely manner;

³³ ISA 330, paragraphs 8–11

³⁴ Paragraphs 28(b), 30(b), 31A(c), 36(c) and 39(d)

³⁵ ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph 8

³⁶ ~~ISA 265, paragraph 8~~

ISA 265, paragraphs A6–A7 set out indicators of significant deficiencies, and matters to be considered in determining whether a deficiency, or a combination of deficiencies, in internal control constitute a significant deficiency.

- Failure by management to respond to significant risks, for example, by not implementing controls over significant risks; and
- The restatement of previously issued financial statements.

Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 45–54)

Why the Auditor Identifies and Assesses the Risks of Material Misstatement

A201. Risks of material misstatement are identified and assessed by the auditor in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

A201a. Information gathered by performing risk assessment procedures is used as audit evidence to provide the basis for the identification and assessment of the risks of material misstatement. ~~The~~For example, the audit evidence obtained when evaluating the design of identified controls in the control activities component and determining whether those controls have been implemented, is also in the control activities component, is used as audit evidence to support the risk assessment. The basis for the risk assessment also provides evidence for the basis for the auditor to design overall responses to address the assessed risks of material misstatement at the financial statement level, as well as the nature, timing and extent of further audit procedures to be performed in accordance with ISA 330.

A202. *[Deleted]*

A202a. Identifying the risks of material misstatement also provides the basis for the auditor's determination of relevant assertions, which assists the auditor's determination of the significant classes of transactions, account balances and disclosures.

Assertions

Why the Auditor Uses Assertions

A202b. ~~Management makes assertions about the entity's classes of transactions, account balances and disclosures when representing that the financial statements are prepared in accordance with the applicable financial reporting framework.~~ In identifying and assessing the risks of material misstatement, the auditor uses assertions to consider the different types of potential misstatements that may occur. Assertions for which the auditor has identified related risks of material misstatement are relevant assertions.

The Use of Assertions

A203. In identifying and assessing the risks of material misstatement, the auditor may use the assertions as described in paragraph A204(a)–(b) below or may express them differently provided all aspects described below have been covered. The auditor may choose to combine the assertions about classes of transactions and events, and related disclosures, with the assertions about account balances, and related disclosures.

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

- (a) Assertions about classes of transactions and events, and related disclosures, for the period under audit:
 - (i) Occurrence—transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
 - (ii) Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
 - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
 - (iv) Cutoff—transactions and events have been recorded in the correct accounting period.
 - (v) Classification—transactions and events have been recorded in the proper accounts.
 - (vi) Presentation—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

- (b) Assertions about account balances, and related disclosures, at the period end:
 - (i) Existence—assets, liabilities, and equity interests exist.
 - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
 - (iv) Accuracy, valuation and allocation—assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
 - (v) Classification—assets, liabilities and equity interests have been recorded in the proper accounts.
 - (vi) Presentation—assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

A205. The assertions described in paragraph A204(a)–(b) above, adapted as appropriate, may also be used by the auditor in considering the different types of misstatements that may occur in disclosures not directly related to recorded classes of transactions, events, or account balances.

Example:

~~The~~An example of such a disclosure includes where the entity may be required by the applicable financial reporting framework to describe its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks.

Considerations Specific to Public Sector Entities

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

Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 45(a) and Para. 47)

Why the Auditor Identifies and Assesses Risks of Material Misstatement at the Financial Statement ~~and Assertion Levels~~

A206a. The auditor identifies risks of material misstatement at the financial statement level ~~in order to~~ determine whether the risks have a pervasive effect on the financial statements ~~that, and~~ would ~~therefore~~ require an overall response in accordance with ISA 330.³⁷

A206aa. [Previously part of paragraph A206a] In addition, risks of material misstatement at the financial statement level may also affect individual assertions, and identifying these risks may assist the auditor in assessing risks of material misstatement at the assertion level, and in designing further audit procedures to address the identified risks.

A206b. [Moved to paragraph A207]

~~Professional Skepticism~~

A206c. [Moved to paragraph A293c]

Identifying and Assessing Risks of Material Misstatement at the Financial Statement Level

A207. 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 (e.g., risk of management override of controls). Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level. [Previously Paragraph A206b] The auditor's evaluation of whether risks identified relate pervasively to the financial statements supports the auditor's assessment of the risks of material misstatement at the financial statement level. [Previously paragraph A207] In other cases, a number of assertions may be identified as susceptible to the risk, and may therefore affect the auditor's risk identification and assessment of risks of material misstatement at the assertion level.

³⁷ ISA 330, paragraph 5

Example:

The entity faces operating losses and liquidity issues and is reliant on funding that has not yet been secured. In such a circumstance, the auditor may determine that the going concern basis of accounting gives rise to a risk of material misstatement at the financial statement level. In this situation, the accounting framework may need to be applied using a liquidation basis, which would likely affect all assertions pervasively.

A207a. 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, in particular the auditor's understanding of the control environment, the entity's risk assessment process and the entity's process to monitor the system of internal control, ~~and the:~~

- The outcome of the related evaluations required by paragraphs 28(b), 30(b) and 30-31A(c); and any
- Any control deficiencies identified in accordance with paragraph 43.

In particular, risks at the financial statement level may arise from deficiencies in the control environment or from external events or conditions, such as declining economic conditions.

A207b. 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.

Example:

The auditor understands from inquiries of management that the entity's financial statements are to be used in discussions with ~~their bank~~ lenders in order to secure further financing to maintain working capital. The auditor ~~determines~~ may therefore determine that there is a greater ~~potential for misstatement based on susceptibility to management bias or misappropriation of assets~~ misstatement due to other fraud risk factors (i.e., the susceptibility of the financial statements may be materially misstated, as management might engage into material misstatement because of the risk of fraudulent financial reporting, such as overstatement of assets and revenue and under-statement of liabilities and expenses to ensure that financing will be obtained).

A207c. The auditor's understanding ~~and, including the related~~ evaluations, of the control environment and other components of the system of internal control may raise doubts about the ~~auditability~~ ability of the financial statements to be audited, such that it may affect the auditor's expectations about the ability to obtain audit evidence on which to support ~~base~~ the audit opinion or be cause for withdrawal from the engagement.

Examples:

- In evaluating the entity's control environment, the auditor has concerns about the integrity of the entity's management, which 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.
- In evaluating the entity's information system and communication, the auditor determines that significant changes in the IT environment have been poorly managed, with little oversight from management and those charged with governance. The auditor concludes that there are significant concerns about the condition and reliability of ~~at the~~ the entity's accounting records. In such circumstances, the auditor may determine that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

A207d. ISA 705 (Revised)³⁸ 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.

Considerations Specific to Public Sector Entities

A207e. [*Previously paragraph A210*] For public sector entities, the identification of risks at the financial statement level may include consideration of matters related to the political climate, public interest and program sensitivity.

Risks of Material Misstatement at the Assertion Level (Ref: Para. 45(b))

Appendix 2 sets out examples, in the context of the inherent risk factors, of events and conditions that may indicate susceptibility to misstatement that may be material.

A208. Risks of material misstatements that do not relate pervasively to the financial statements are risks of material misstatement at the assertion level.

A208a. [*Previously part of paragraph A208*] The identification of risks of material misstatement at the assertion level is performed before consideration of any related controls, and ~~may be~~ based on a ~~preliminary assessment~~ the auditor's consideration of inherent risk (i.e., the auditor considers those risks for which a misstatement misstatements that could (i.e., have a reasonable possibility to) occur, and be material, and the likelihood that the risk could if they were to occur).³⁹

A209. ~~While obtaining the understanding of the entity and its environment, and how the applicable financial reporting framework is applied, the auditor considers where there are inherent risk factors related to the entity's events and conditions, which may then assist the auditor with identifying where there could be risks of material misstatement related to the classes of transactions, account balances and disclosures.~~

³⁸ ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

³⁹ Proposed ISA 200, paragraph tbc

~~Considerations Specific to Public Sector Entities~~A210. [~~Moved to paragraph 207e~~]~~Relevant Assertions and Significant Classes of Transactions, Account Balances and Disclosures (Ref: Para. 46)~~~~Why Relevant Assertions and Significant Classes of Transactions, Account Balances and Disclosures are Determined~~

~~A211. The assertions to which identified risks of material misstatement relate are relevant assertions, and the classes of transactions, account balances and disclosures to which the relevant assertions relate are significant classes of transactions, account balances and disclosures. Significant classes of transactions, account balances and disclosures are determined to assist the auditor in identifying where to focus further audit procedures in accordance with paragraph 7 of ISA 330. In determining the relevant assertions, the auditor considers the information gathered from the auditor's risk assessment procedures to understand the entity and its environment, the applicable financial reporting framework and the entity's system of internal control (i.e., the information about the identified risks of material misstatement and the assertions that they may affect).~~

A212. [~~Deleted~~]

Automated Tools and Techniques

A213. The auditor may use automated techniques to assist in the identification of significant classes of transactions ~~and~~ account balances and disclosures.**Examples:**

- An entire population of transactions may be analyzed using automated tools and techniques to ~~identify~~ understand their nature, source, size and volume. By applying automated techniques, the auditor may, for example, identify that an account with a zero balance at period end 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 payroll clearing account). This same payroll clearing account may also identify expense reimbursements to management (and other employees), which could be a significant disclosure due to these payments being made to related parties.
- By ~~mapping~~ analyzing the flowflows of an entire population of revenue transactions, the auditor may more easily identify a significant class of ~~transaction in revenue~~ transactions that had not previously been identified ~~by the auditor~~.

~~-Disclosures that May be Significant~~

A214. Significant disclosures include both quantitative and qualitative disclosures for which there is one or more relevant assertions. Examples of disclosures that have qualitative aspects and that may have relevant assertions and may therefore be considered significant by the auditor include disclosures about:

- Liquidity and debt covenants of an entity in financial distress.
- Events or circumstances that have led to the recognition of an impairment loss.

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

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

~~A215. Because risks of material misstatement at the financial statement level have a pervasive effect on the financial statements, it may not be possible to identify the specific assertions that are more susceptible to the risk (e.g., risk of management override of controls). [Moved to paragraph A207] In other cases, a number of assertions may be identified as susceptible to the risk, and which may therefore affect the auditor's risk identification and assessment of risks of material misstatement at the assertion level.~~

A216. [Moved]

A217. [Moved]

A218. [Moved]

A219. [Moved]

A220. [Moved]

Assessing Risks of Material Misstatement at the Assertion Level

Assessing Inherent Risk (Ref: Para. 48–50)

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

Why the Auditor Assesses Likelihood and Magnitude of Risks of Material Misstatement at the Assertion Level

A220a. The auditor assesses the likelihood and magnitude of material misstatement for identified risks of material misstatement because the significance of the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur determines where on the spectrum of inherent risk the identified risk is assessed, which informs the auditor's design of further audit procedures to address the risk.

A220b. [Previously part of paragraph A220a] Assessing the inherent risk of identified risks of material misstatement also assists the auditor in determining significant risks. The auditor determines significant risks because specific responses to significant risks are required in accordance with ISA 330 and other ISAs.

Assessing the Risks of Material Misstatement at the Assertion level

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

Spectrum of Inherent Risk

~~A221a. In assessing the risks of material misstatement, inherent risk, the auditor uses professional judgment in assessing—determining the significance of the combination of the likelihood and magnitude of material a misstatement.~~

~~A221b. For all audit engagements, across the risks of material misstatement at the assertion level, inherent risk varies on a range from lower to higher. The assessed inherent risk relating to a particular risk of material misstatement at the assertion level represents a judgment within ~~that~~ a range, from lower to higher, on the spectrum of inherent risk. The judgment about where in the range the ~~risk of material misstatement is assessed~~ takes into account the assessed likelihood and magnitude of the material misstatement, as well as the inherent risk factors, and is assessed may vary based on the nature, size and complexity of the entity, and takes into account the assessed likelihood and magnitude of the misstatement and the inherent risk factors.~~

~~A222. In assessing the risk of material misstatement at the assertion level, the auditor considers the magnitude and likelihood of a material misstatement separately. In considering the magnitude of a misstatement, the auditor considers the qualitative and quantitative aspects of the possible misstatement (i.e., misstatements in assertions about classes of transactions, account balances or disclosures may be judged to be material due to size, nature or circumstances).~~

~~A222a. The auditor uses the relative degree significance of the combination of the likelihood and magnitude of a possible misstatement ~~determine~~ to assist in determining where on the spectrum of inherent risk (i.e., the range) ~~the inherent risk of misstatement~~ is assessed. The higher the combination of likelihood and magnitude, the higher the assessment of inherent risk; the lower the combination of likelihood and magnitude, the lower the assessment of inherent risk.~~

~~A222b. [Previously part of paragraph A229] For a risk to be assessed as higher on the spectrum of inherent risk, it does not mean that both the magnitude and likelihood need to be assessed as high. Rather, it is the intersection of the magnitude and likelihood of the material misstatement on the spectrum of inherent risk that will determine whether the assessed inherent risk is higher or lower on the spectrum of inherent risk. [Previously part of paragraph A222a] A higher inherent risk assessment may also arise from different combinations of likelihood and magnitude, for example a higher inherent risk assessment could result from a lower likelihood but a very high magnitude.~~

A223. [Moved]

A224. [Deleted]

A225. In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may designate risks of material misstatement within ~~relative~~ categories along the spectrum of inherent risk, based on their assessment of inherent risk. These ~~relative~~ categories may be described in different ways. 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 appropriately responsive to the assessment of inherent risk and the reasons for that assessment.

Pervasive Risks of Material Misstatement at the Assertion Level (Ref: Para 48(a))

A226. In assessing the identified risks of material misstatement at the assertion level, the auditor may conclude that some risks of material misstatement relate more pervasively to the financial statements as a whole and potentially affect many assertions, in which case the auditor may update the identification of risks of material misstatement at the financial statement level.

A227. In circumstances in which risks of material misstatement are identified as financial statement level risks due to their pervasive effect on a number of assertions, and are identifiable with specific assertions, the auditor ~~may consider the effect of~~ is required to take into account those risks when assessing the inherent risk for risks of material misstatement at the assertion level. (~~Ref: Para. 48(b)~~)

Considerations specific to public sector entities

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

Significant Risks (Ref: Para. 49)

Why ~~S~~significant Risks ~~A~~are ~~D~~determined and the ~~I~~implications for the ~~A~~audit

A228a. ~~Significant risks are determined so that~~ 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 responses for the highest risks are appropriate in the circumstances. ISA 330 describes the consequences for further audit procedures of identifying a risk as significant, and the persuasiveness of the audit evidence that will be required to reduce audit risk to an acceptably low level. When a risk is ~~assessed as~~ determined to be a significant risk, ~~the implications for the audit include~~ the design and implementation of an appropriate response to address the assessed risk, ~~which~~ may include, for example, the use of more experienced engagement team members, including those with specialized skills, to perform audit procedures or audit work may involve the use of experts. In addition, the ISAs set out required responses, including:

- Controls that address significant risks are required to be identified in accordance with paragraph 39(a)(i), with a requirement to evaluate whether the control has been designed effectively and implemented in accordance with paragraph ~~42-39~~(d).
- 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.^{40,41}

- ISA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk.⁴²
- ISA 260 (Revised) requires communicating with those charged with governance about the significant risks identified by the auditor.⁴³
- 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.⁴⁴
- 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.⁴⁵
- 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.⁴⁶

Assessing the Magnitude and Likelihood of the Risks of Material Misstatement

~~A229. In determining where on the spectrum of inherent risk an identified risk of material misstatement is assessed, the auditor uses professional judgment to assess both the magnitude and the likelihood of material misstatement. [Moved to paragraph A222b]~~

A229 [new]. Required responses to significant risks may also be appropriate for risks assessed as higher on the spectrum of inherent risk where there is a reasonable possibility that the assessed risks could be significant risks but that the auditor has determined is not a significant risk.

Determining significant risks

A229a. In determining significant risks, the auditor may first identify those assessed risks of material misstatement that have been assessed higher on the spectrum of inherent risk to form the basis for considering which risks may be close to the upper end. Being close to the upper end of the spectrum of inherent risk will differ from entity to entity, and will not necessarily be the same for an entity period on period. It may depend on the nature and circumstances of the entity for which the risk is being assessed.

A229aa. [Previously part of paragraph A229a] The determination of which of the assessed risks of material misstatement 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

⁴⁰—ISA 330, paragraphs 15 and 24

⁴¹—ISA 330, paragraphs 15 and 21

⁴²—ISA 330, paragraph 7(b)

⁴³—ISA 260 (Revised), paragraph 15

⁴⁴—ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraph 9

⁴⁵—ISA 220, paragraphs 17–A19

⁴⁶—ISA 600, paragraphs 30 and 31

significant risk in accordance with the requirements of another ISA. ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.⁴⁷

Example:

- Cash at a supermarket retailer would ordinarily be determined to be a high likelihood of possible misstatement (due to the risk of cash being misappropriated), however the magnitude would typically be very low (due to the low levels of physical cash handled in the stores). The combination of these two factors on the spectrum of inherent risk would be unlikely to result in the existence of cash being ~~assessed as~~ determined to be a significant risk.
- An entity is in negotiations to ~~salesell~~ a ~~falling~~ business segment. The auditor considers the effect on goodwill impairment, and may determine there is a higher likelihood of possible misstatement and a higher magnitude due to the impact of the inherent risk factors of judgment, uncertainty, and susceptibility to management bias or ~~misappropriation of assets~~ other fraud risk factors. This may result in goodwill impairment being ~~assessed as~~ determined to be a significant risk.

A229b. The auditor also takes into the account the relative effects of the inherent risk factors when assessing inherent risk. The lower the effect of the inherent risk factors, the lower the assessed risk is likely to be. However, risks of material misstatement that may be assessed as having higher inherent risk and may therefore be ~~assessed as~~ determined to be a significant ~~risk~~ risk, may arise from matters such as the following:

- Transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved.
- Accounting estimates that have high estimation uncertainty or complex models.
- Complexity in data collection and processing to support account balances.
- Account balances or quantitative disclosures that involve complex calculations.
- Accounting principles that may be subject to differing interpretation.
- Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions.

A230. [Moved]

A231. [Moved]

⁴⁷ ISA 240, paragraphs ~~25–27~~ 26–28

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

Why Risks for Which Substantive Procedures Alone do not Provide Sufficient Appropriate Audit Evidence are Required to be Identified

A231a. Due to the nature of a risk of material misstatement, and the control activities that address that risk, in some circumstances, the only way to obtain sufficient appropriate audit evidence is to test the operating effectiveness of controls. Accordingly, there is a requirement for the auditor to identify any such risks because of the implications for the design and performance of further audit procedures in accordance with ISA 330 to address risks of material misstatement at the assertion level.

A231b. Paragraph 39(a)(iv) also requires the identification of controls that address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence ~~to be relevant to the audit~~ because the auditor is required, in accordance with ISA 330,⁴⁸ to design and perform tests of such controls.

~~Controls that Address Risks for Which Substantive Procedures Alone Cannot Provide Sufficient Appropriate Audit Evidence~~

Determining risks for which substantive procedures alone do not provide sufficient appropriate audit evidence

~~A231c. 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.~~

A231d. Where 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. This ~~to may~~ be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an information system that involves a high-degree of integration across its IT applications. In such cases:

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

Example:

It is typically not possible to obtain sufficient appropriate audit evidence relating to revenue for a telecommunications entity based on substantive procedures alone. This is because the evidence of call or data activity does not exist in a form that is observable. Instead, substantial controls testing is typically performed to determine that the origination and completion of calls, and data activity is correctly captured (e.g., minutes of a call or volume of a download) and recorded correctly in the entity's billing system.

⁴⁸ ISA 330, paragraph 8

A231e. ISA 540 (Revised) provides further guidance related to accounting estimates about risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.⁴⁹ In relation to accounting estimates this may not be limited to automated processing, but may also be applicable to complex models.

A231f. [*Moved*]

Assessing Control Risk (Ref: Para. 5051)

A232. The auditor's ~~intention~~ plans to test the operating effectiveness of controls is based on the expectation that controls are operating effectively, and this will form the basis of the auditor's assessment of control risk. The initial expectation of the operating effectiveness of controls is based on the auditor's evaluation of the design, and the determination of implementation, of the identified controls in the control activities component. Once the auditor has tested the operating effectiveness of the controls in accordance with ISA 330, the auditor will be able to confirm the initial expectation about the operating effectiveness of controls. If the controls are not operating effectively as expected, then the auditor will need to revise the control risk assessment in accordance with paragraph 53. ~~If the auditor does not intend to test the operating effectiveness of controls, the assessment of the risks of material misstatement is based on the auditor's assessment of inherent risk. A233.A233.~~ [Previously part of paragraph A232] The auditor's assessment of control risk may be performed in different ways depending on preferred audit techniques or methodologies, and may be expressed in different ways.

A234. If the auditor ~~intends~~ plans to test the operating effectiveness of controls, ~~the auditor takes into account whether one or a combination of controls will~~ may be necessary to test to address the assessed inherent risk for the risk of material misstatement. The auditor may expect to test both direct and indirect controls, including general IT controls, and, if so, takes into account the combined expected effect of the controls when assessing control risk. If the control to be tested does not fully address the assessed inherent risk of the risk of material misstatement, the auditor determines the implications on the design of further audit procedures to reduce audit risk to an acceptably low level.

A235. ~~The assessment of control risk takes into account the expected results from the auditor's planned tests of the operating effectiveness of controls relevant to the audit, including general IT controls. For controls in the control activities component, and for which the auditor intends to test the operating effectiveness, the auditor may identify related general IT controls.~~

A235a. 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 automated control to address the risks arising from the use of IT, and to provide a basis for the auditor's expectation that the automated control operated effectively throughout the period. When the auditor expects related general IT controls to be ineffective, this determination may affect the auditor's assessment of control risk at the assertion level ~~depending on whether and~~ the auditor is able auditor's further audit procedures may need to perform other tests include substantive procedures to address ~~those~~ the applicable risks arising from the use of IT.

⁴⁹ ISA 540 (Revised), paragraphs A87–A89

Further guidance about the procedures that the auditor may perform in these circumstances is provided in ISA 330.⁵⁰

A236. [Moved]

A237. [Moved]

A238. [Moved]

A239. [Moved]

Evaluating Audit Evidence Obtained from Risk Assessment Procedures (Ref: Para 51A)

Why the Auditor Evaluates Audit Evidence from Risk Assessment Procedures

A239a. Audit evidence obtained from performing risk assessment procedures provides the basis for the identification and assessment of the risk of material misstatement, which provides the basis for the auditor's design of the nature, timing and extent of further audit procedures in accordance with ISA 330. Accordingly, the auditor's consideration of the nature and sufficiency of audit evidence from the risk assessment procedures is important to support the appropriateness of the auditor's risk assessments.

The Evaluation of the Audit Evidence

A239aa. Audit evidence from risk assessment procedures comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.⁵¹ Obtaining audit evidence from risk assessment procedures in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence.

~~A239b. — ISA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of the risk.⁵² Therefore, the consideration of the nature or quantity of the audit evidence from risk assessment procedures may be more important when inherent risks is assessed at the higher end of the spectrum of inherent risk.~~

Professional Skepticism

A239c. [Previously paragraph A206c] In evaluating the audit evidence from the risk assessment procedures, the auditor considers whether sufficient understanding about the entity and its environment, the applicable financial reporting framework and the entity's system of internal control has been obtained to be able to identify the risks of material misstatement, as well as whether there is any evidence that is contradictory that may indicate a risk of material misstatement.

⁵⁰ ISA 330, paragraphs A29–A31

⁵¹ ISA 500, paragraph A1

⁵² ~~ISA 330, paragraphs 7(b) and A19~~

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

A240. As explained in ISA 320,⁵³ 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.⁵⁴ For the purpose of this ISA and paragraph 18 of ISA 330, classes of transactions, account balances or disclosures are material if omitting, misstating or obscuring information about them could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole.

A241. There may be classes of transactions, account balances or disclosures that are material but have not been determined to be significant classes of transactions, account balances or disclosures (i.e., there are no relevant assertions identified).

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 considerations in paragraph A240.

A242. Audit procedures to address classes of transactions, account balances or disclosures that are material but are not determined to be significant are addressed in ISA 330.⁵⁵ When a class of transactions, account balance or disclosure is determined to be significant as required by paragraph 46, the class of transactions, account balance or disclosure₇ is also treated as a material class of transactions, account balance or disclosure for the purposes of paragraph 18 of ISA 330.

Revision of Risk Assessment (Ref: Para. 53)

A243. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based.

Example:

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

⁵³ ISA 320, paragraph A1

⁵⁴ ISA 320, paragraph 4

⁵⁵ ISA 330, paragraph 18

Documentation (Ref: Para. 54)

Scalability

A244. The manner in which the requirements of paragraph 54 are documented is for the auditor to determine using professional judgment.

Example:

~~In audits of less complex entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.⁵⁶ 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.⁵⁷~~

A245. More detailed documentation, that is sufficient to enable an experienced auditor, having no previous experience with the audit, to understand the nature, timing and extent of the audit procedures performed, may be required to support the rationale for difficult judgments made

A246. For the audits of less complex entities, the form and extent of documentation may be simple in form and relatively brief. 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. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements⁵⁸ of understanding documented by the auditor may include those on which the auditor based the assessment of the risks of material misstatement.⁵⁹ However, the auditor is not required to document every inherent risk factor that was taken into account in identifying and assessing the risks of material misstatement at the assertion level.

Example:

In audits of less complex entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.⁵⁹ 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 audit procedures.⁶⁰

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

A248. Paragraph A7 of ISA 230 notes that, although there may be no single way in which the auditor's exercise of professional skepticism is documented, the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism. For example, when the audit evidence obtained from risk assessment procedures includes evidence that both corroborates and contradicts management's assertions, the documentation may include how the auditor evaluated that

⁵⁶ ISA 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9

⁵⁷ ISA 330, paragraph 28

⁵⁸ ISA 230, paragraph 8

⁵⁹ ISA 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9

⁶⁰ ISA 330, paragraph 28

evidence, including the professional judgments made in evaluating whether the audit evidence provides an appropriate basis for the auditor's identification and assessment of the risks of material misstatement. Examples of other requirements in this ISA for which documentation may provide evidence of the exercise of professional skepticism by the auditor include:

- Paragraph 22, which requires a discussion among key engagement team members of the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement;
- Paragraphs 23 (b) and 24, which require the auditor to obtain an understanding of the reasons for any changes to the entity's accounting policies and to evaluate whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework;
- Paragraphs 28 (b), 30 (b), 31 (b), 31A (b), 36 (c), 39 (d) and 43, which require the auditor to evaluate, based on the required understanding obtained, whether the components of the entity's system of internal control are appropriate to the entity's circumstances considering the nature and size of the entity, and to determine whether one or more control deficiencies have been identified;
- Paragraph 51A, which requires the auditor to take into account all audit evidence obtained from risk assessment procedures, whether corroborative or contradictory to assertions made by management, and to evaluate whether the audit evidence obtained from risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement; and
- Paragraph 52, which requires the auditor to evaluate, when applicable, whether the auditor's determination that there are no risks of material misstatement for a material class of transactions, account balance or disclosure.