

Proposed Conforming and Consequential Amendments to ED-315¹

Introduction

1. Changes to the conforming and consequential amendments to address comments received to ED-315 were presented to the Board for discussion on the August 1, 2019 IAASB Teleconference. Appendix 1 sets out the draft minutes from that teleconference and further changes to address Board comments are explained further below.
2. In addition to the proposed conforming and consequential amendments presented in Appendix 2 of this Agenda Item, the Supplement also presents those conforming and consequential amendments that were explained but not presented in Appendix 2 to the Explanatory Memorandum of ED-315 (i.e., those that were considered to be generally straightforward mainly consistently of terminology updates). To respond to comments received to ED-315 that highlighted the need to see the detail of these conforming and consequential amendments, these have been presented in the Supplement to this Agenda Item.

Further Changes to the Consequential and Conforming Amendments

3. Changes to the conforming amendments arising from the revision of ISA 315 (Revised) are presented in Appendix 2 to this agenda Item. The ISA 315 Task Force (the Task Force) considered the changes that had been noted by Board members, and further changes were made from what was presented on the August 1, 2019 Board teleconference as follows:
 - Changes to conform to the way that the inherent risk factors have been described in paragraphs 23(c) and 48 of ISA 315 (Revised)² in ISA 200,³ paragraph A40.
 - Revised paragraph A61 of ISA 200 to more concisely describe the different aspects of presentation and formatting in ISA 315 (Revised).
 - Revised ISA 200, paragraphs A65(a)–A67a for consistency in wording and flow.
 - Within ISA 240,⁴ changes to paragraph A25 and the Appendix for consistency, and to also conform to the way that fraud risk factors have been described within ISA 315 (Revised).
 - Changes to paragraphs 7(a)(i) and A9 of ISA 330⁵ to remove “material” from “material misstatement” to conform to paragraph 48 of ISA 315 (Revised).
 - Changes to ISA 330, paragraph A29b to clarify that it is the ‘applicable’ risks arising from IT rather than the ‘related risks’ to conform to paragraph 39(c) of ISA 315 (Revised).
 - Changes to ISA 330 paragraph A4(b) to be consistent with the description in paragraph 8.

¹ International Standard on Auditing (ISA), 315 (Revised), *Identifying and Assessing Risks of Material Misstatement*

² See Agenda Items 2-A to 2-D for proposed changes to ISA 315 (Revised).

³ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with the International Standards on Auditing*

⁴ ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

⁵ ISA 330, *Auditors Responses to Assessed Risks*

4. The Task Force further considered whether to add more to ISA 200 regarding the ‘spectrum of inherent risk’ as noted by two Board members, however agreed that application material related to the spectrum of inherent risk was better placed within the standards where assessments are required, i.e., ISA 315 (Revised) and ISA 540 (Revised). Accordingly, no further changes have been made in this regard in ISA 200.
5. Changes within ISA 540 (Revised) ⁶ to respond to Board comments from the August 1, 2019 IAASB teleconference include making changes for the term “relevant to the audit” for the way that it is described in paragraph 39(a) of ISA 315 (Revised) (i.e., identifying controls within the control activities component). In addition, further changes have been proposed to conform ISA 540 (Revised) with changes that have been made in ISA 315 (revised), including:⁷
 - Changes for how the assessment of control risk has been described in paragraph 48 of ISA 315 (Revised).
 - Changes for how fraud risk factors have been described within the inherent risk factors,
 - Other changes made in ISA 315 (Revised), such as removal of the term ‘relevant to financial reporting.’
6. In addition, other changes made within Appendix 2 include:
 - Updating footnote and cross references to ISA 315 (Revised) to the paragraphs as presented in **Agenda Item 2-E**.
 - Changes to conform the articulation of the control risk assessment to “plans to test” the operating effectiveness of controls from “intends to rely on” the operating effectiveness of controls where the relevant paragraph is related to the risk assessment process.
 - Other editorials as needed.

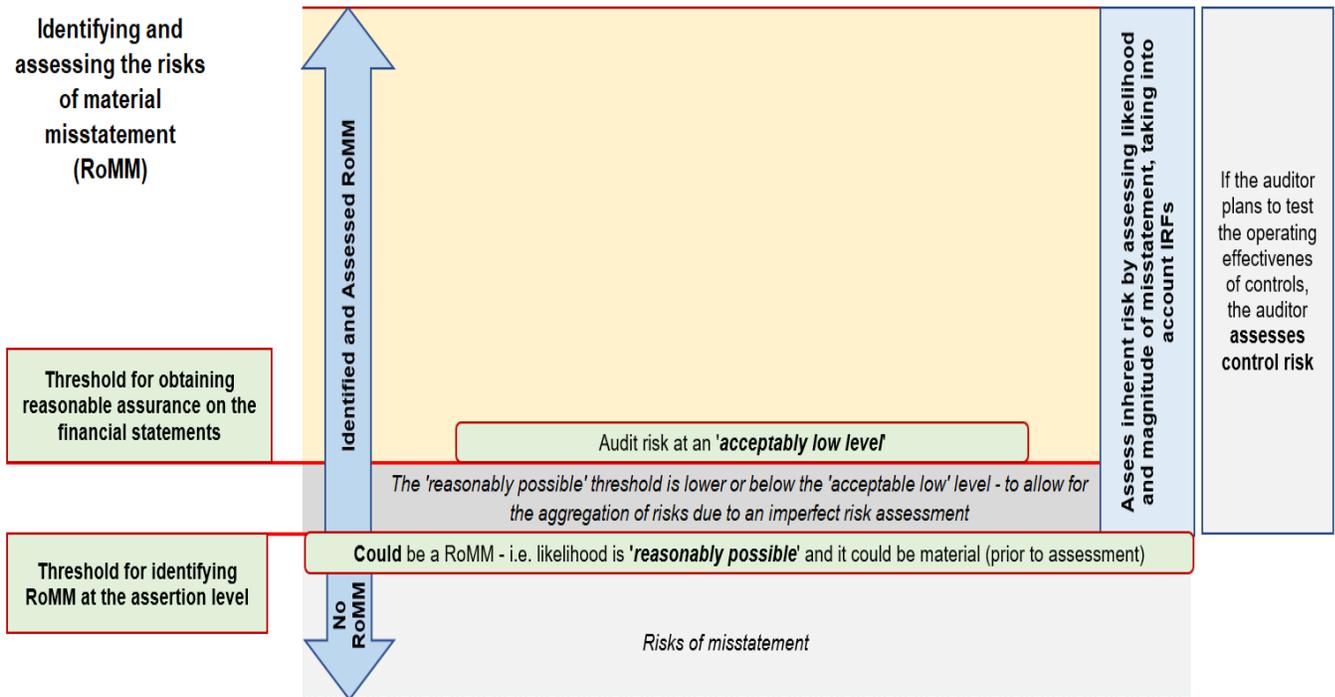
Identifying Risks of Material Misstatement – Threshold for Identifying Risks of Material Misstatement

7. At the June 2019 IAASB meeting the Board discussed various options with regard to how to describe and distinguish the ‘threshold’ for identifying risks of material misstatement within ISA 200. The Task Force continues to be of the view that the ‘acceptably low’ threshold can be linked to a combination of the likelihood threshold of ‘reasonably possible’ and the magnitude threshold of ‘material’ for the purposes of guiding the auditor’s identification of the risks of material misstatement, and has proposed application material in ISA 200 to support the definition of risk of material misstatement (see new application material proposed in ISA 200, paragraph A15a) to make this link.
8. In discussing how to articulate the ‘threshold,’ the Task Force has considered this in terms of the diagram that follows. The threshold for identifying risks of material misstatement at the assertion level is where there is a reasonable possibility that there may be a misstatement, and that it may be material (below this there is no possibility and no further audit procedures are required). This level is slightly lower than the threshold for obtaining reasonable assurance from the further audit procedures

⁶ ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

⁷ The Task Force has reviewed ISA 540 (Revised) and new paragraphs that were not presented for the August 1, 2019 Board call have now been included where relevant to identifying and assessing risks of material misstatement, and changes are needed to conform to ISA 315 (Revised).

performed because there is a need to account for an 'imperfect' risk assessment and aggregation risk. The use of this lower threshold for identification of risks of material misstatement facilitates the auditor's design and performance of further audit procedures that reduce audit risk for the financial statements as a whole to an acceptably low level.



Appendix 1

Draft Minutes from IAASB Teleconference – August 1, 2019⁸

ISA 315 (Revised)⁹ Conforming and Consequential Amendments

Ms. Campbell noted that the focus of the teleconference was to consider changes to the conforming and consequential amendments to address comments received in the responses to ED-315 and on the basis of the proposed revisions to ISA 315 (Revised) presented for the June 2019 Board meeting. Ms. Campbell noted that the conforming amendments based on matters still being discussed would be brought to the September 2019 IAASB meeting for discussion with the Board.

The IAASB Board broadly supported the changes to the conforming and consequential amendments presented in **Agenda 1-A**; however, encouraged the Task Force to further consider:

ISA 200

- In paragraph A42, whether “in most cases” is an appropriate descriptor for “the ISAs refer to the “risks of material misstatement rather than inherent and control risk separately”, because it is only ISA 315 (Revised) and ISA 540 (Revised) that now refer to inherent risk and control risk separately, which is limited.
- Whether more is needed in relation to the spectrum of inherent risk in ISA 200.
- The intent of paragraph A61a, specifically as the ‘why’ relates to a requirement and not a procedure, it was encouraged that further consideration be given to how this explanation has been phrased.
- The appropriateness of “in *some* ISAs” to reference the format of application and other explanatory materials, when the format is used in ISA 315 (Revised) only, such as considerations related to automated tools and techniques.
- The articulation and flow of the paragraphs related to the “Scalability Considerations” (paragraphs A65a to A66a), as there was inconsistency with how these paragraphs were described with the way that other special considerations were described, and it was also not clear exactly to what they related. In addition, it was also queried whether these paragraphs are needed.

ISA 240

The consistency of the revised wording in paragraph A25 in ISA 240 and Appendix 1¹⁰ of ISA 240, with further consideration about consistency of both to the way that fraud has been articulated in ISA 315 (Revised).

ISA 330

- Whether an example should be added to illustrate what is meant by “the effect of that misstatement that would be *most* material” in paragraph A42a of ISA 330, or whether further clarification is needed, as there is confusion about how the paragraph should be applied.

⁸ The draft minutes may change once reviewed by the IAASB.

⁹ International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

¹⁰ Appendix 1 sets out examples of ‘Fraud Risk Factors’

- The use of ‘plans to test’ the operating effectiveness of controls versus ‘intends to rely on’ the operating effectiveness of controls.
- Whether adding ‘magnitude’ to the assessment of the risk of *material* misstatement is logical (in paragraphs 7 and A9), and whether this should rather be of a misstatement (because “magnitude” and “material” are both quantitative measures).
- Whether application material is needed to paragraph 27 of ISA 330 to clarify that the risk of material misstatement for a relevant assertion has been assessed as being acceptably low if the auditor has obtained sufficient appropriate audit evidence in relation to that assertion.
- Aligning the wording of paragraph A4(b) to paragraph 8, as they appear to be inversely written, which may cause confusion and risk misinterpretation.

ISA 540 (Revised)

- Aligning the wording of paragraph A65 in ISA 540 (Revised) to ISA 200, paragraph A42, as both paragraphs relate to the separate assessments of inherent and control risk.
- Whether the explanation in paragraph A39 of ISA 540 about which controls are required to be identified should continue to include reference to a higher inherent risk assessment, as this was helpful but has been deleted.
- The completeness of the conforming amendments presented in **Agenda 1-A** in relation to references to “relevant controls.” The Task Force was encouraged to review the entire standard for references to relevant controls to ensure consistency with ISA 315 (Revised).

While the Board agreed that there are no other conforming or consequential amendments that the Task Force should consider, with the exception of those presented in **Agenda 1-A** for discussion, it was caveated that the view may change upon receiving the final text of the ISA 315 (Revised) standard, and the final proposed conforming and consequential amendments.

PIOB Remarks

Mr. Grund cautioned against changes that may weaken requirements. Ms. Campbell confirmed that no requirements from extant ISA 315 (Revised) were weakened, and that changes are either clarifications to requirements, or additional requirements.

CAG Remarks

Mr. Dalkin questioned whether the changes made to ISA 200 relating to Scalability Considerations,’ and ‘Considerations Specific to Automated Tools and Techniques’ raised more concerns than it purported to resolve. Mr. Dalkin recommended that the Task Force consider simplifying the articulation of those paragraphs.

Way Forward

The Task Force will continue to progress the changes to ISA 315 (Revised), and the full set of conforming and consequential amendments, for expected approval at the September 2019 IAASB meeting. The conforming amendments will form part of the final papers for approval by the IAASB in September 2019.

Next Meeting

The next IAASB meeting is scheduled for August 27, 2019 via Teleconference.

Closing Remarks

Mr. Seidenstein thanked the IAASB members, technical advisors and Staff.

CONFORMING AND CONSEQUENTIAL AMENDMENTS ARISING FROM DRAFT PROPOSED ISA 315 (REVISED)

This Agenda Item presents the proposed conforming amendments arising from changes to ED-315. This Agenda Item (together with the supplement to this Agenda Item) sets out all of the conforming amendments that the Board will be asked to approve.

The changes that are shown in marked (color) are new from the version of the Conforming and Consequential Amendments presented for the Board teleconference. The hard-coded changes are all changes agreed to date – either from the version presented on the August Board teleconference, or from ED-315 where no further changes have been proposed.

Context for these changes is described in the front part of this Agenda Item. The Board discussions will focus on new changes presented since the August 1, 2019 Board teleconference.

Within this Appendix, only those paragraphs that have been affected by conforming amendments are presented, for example, a paragraph in the requirements section of the applicable standard is presented if:

- *There was a conforming amendment in the paragraph itself, or*
- *A footnote, included in the paragraph, has changed; or*
- *Application material, related to the paragraph, has changed.*

In all instances, paragraphs that have no changes but are presented for context have been greyed.

The Supplement to this Agenda Item presents all the conforming amendments to other ISAs that will need to be made. For the purpose of the approval, they have been presented in the Supplement (whereas in ED-315 they were described within a table).

INTERNATIONAL STANDARD ON AUDITING 200

OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH INTERNATIONAL STANDARDS ON AUDITING

Scope of this ISA

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An Audit of Financial Statements

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7. The ISAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The ISAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:
- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control.
 - Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
 - Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

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Effective Date

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Overall Objectives of the Auditor

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Definitions

13. For purposes of the ISAs, the following terms have the meanings attributed below:

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- (n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level: [\(Ref: Para. A15a\)](#)
- (i) Inherent risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

- (ii) Control risk – The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal controls.

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Requirements

Ethical Requirements Relating to an Audit of Financial Statements

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Professional Skepticism

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Professional Judgment

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Sufficient Appropriate Audit Evidence and Audit Risk

- 17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A30–A54)

Conduct of an Audit in Accordance with ISAs

Complying with ISAs Relevant to the Audit

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- 19. The auditor shall have an understanding of the entire text of an ISA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A60–A68)

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Objectives Stated in Individual ISAs

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Complying with Relevant Requirements

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Failure to Achieve an Objective

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Application and Other Explanatory Material

An Audit of Financial Statements

Scope of the Audit (Ref: Para. 3)

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Preparation of the Financial Statements (Ref: Para. 4)

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Considerations Specific to Audits in the Public Sector

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Form of the Auditor's Opinion (Ref: Para. 8)

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Definitions

Financial Statements (Ref: Para. 13(f))

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Risk of Material Misstatement (Ref: Para. 13(n))

A15a. In identifying risks of material misstatement, the auditor considers those misstatements that could (i.e., have a reasonable possibility to):

- (a) Occur (i.e., its likelihood); and
- (b) Be material if they were to occur (i.e., its magnitude).

Ethical Requirements Relating to an Audit of Financial Statements (Ref: Para. 14)

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Professional Skepticism (Ref: Para. 15)

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Professional Judgment (Ref: Para. 16)

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Sufficient Appropriate Audit Evidence and Audit Risk (Ref: Para. 5 and 17)

Sufficiency and Appropriateness of Audit Evidence

A30. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the

current audit¹¹) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

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Audit Risk

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Risks of Material Misstatement

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A40. Inherent risk is influenced by ~~the inherent risk factors. the characteristics of events or conditions that affect the susceptibility to misstatement of an higher for some assertions about a and related classes of transactions, account balances, or and disclosures than for others.~~ Depending on the extent to which the ~~inherent risk factors affect the susceptibility to misstatement of an assertion is subject to, or affected by, such inherent risk factors,~~ the level of inherent risk varies on a scale that is referred to as the spectrum of inherent risk. The auditor determines significant classes of transactions, account balances and disclosures, and their relevant assertions, as part of the process of identifying and assessing the risks of material misstatement. For example, ~~it may be higher for complex calculations or for accounts balances consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty may be identified as significant account balances, and the auditor's assessment of inherent risk for the related risks at the assertion level may be higher because of the high estimation uncertainty.~~

A40a. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

A41. Control risk is a function of the effectiveness of the design, implementation and maintenance of ~~internal controls~~ by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of ~~internal controls~~. These include, for example, the possibility of human errors or mistakes, or of controls being

¹¹ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 219

circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The ISAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.¹²

A42.¹³ The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made. ~~In most cases, the ISAs typically do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement.” rather than to inherent risk and control risk separately.~~ However, ISA 540315 (Revised)¹⁴ requires a ~~separate assessment of inherent risk to be assessed separately from and control risk at the assertion level to~~ provide a basis for designing and performing further audit procedures to respond to the assessed risks of material misstatement at the assertion level, including significant risks, ~~for accounting estimates at the assertion level in accordance with ISA 330.¹⁵ In identifying and assessing risks of material misstatement for significant classes of transactions, account balances or disclosures other than accounting estimates, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.~~

A43a. Risks of material misstatement are assessed at the assertion level in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence.¹⁶

Detection Risk

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Inherent Limitations of an Audit

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The Nature of Financial Reporting

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The Nature of Audit Procedures

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Timeliness of Financial Reporting and the Balance between Benefit and Cost

¹² ISA 330, *The Auditor's Responses to Assessed Risks*, paragraphs 7–17

¹³ Note that paragraph A42 of ISA 200 is marked to the updated paragraph presented separately as a conforming amendment relating to ISA 540 (Revised) and its conforming amendments and presented as a Supplement to ED-315.

¹⁴ ISA 540315 (Revised), *Auditing Accounting Estimates and Disclosures*, paragraph 15 *Identifying and Assessing the Risks of Material Misstatement*

¹⁵ ISA 330, paragraph 7(b)

¹⁶ ISA 330, paragraph 6

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A52. In light of the approaches described in paragraph A51, the ISAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities;¹⁷ and
- Use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population.¹⁸

Other Matters that Affect the Inherent Limitations of an Audit

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Conduct of an Audit in Accordance with ISAs

Nature of the ISAs (Ref: Para. 18)

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Considerations Specific to Audits in the Public Sector

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Contents of the ISAs (Ref: Para. 19)

A60. In addition to objectives and requirements (requirements are expressed in the ISAs using “shall”), an ISA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the ISA, and definitions. The entire text of an ISA, therefore, is relevant to an understanding of the objectives stated in an ISA and the proper application of the requirements of an ISA.

A61. Where necessary, the application and other explanatory material provides further explanation of the requirements of an ISA and guidance for carrying them out. In particular, it may:

- Explain more precisely what a requirement means or is intended to cover. including in some ISAs, such as ISA 315 (Revised), why a procedure is required and presented under specific headings.
- Include examples of procedures that may be appropriate in the circumstances. In some ISAs, such as ISA 315 (Revised), examples are presented in boxes.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an ISA. The application and other explanatory material may also provide background information on matters addressed in an ISA. ~~In some ISAs (such as ISA 315 (Revised)), examples in the application and other explanatory material may be formatted differently from other ISAs (e.g., examples may be presented within boxes). Regardless, these examples form an integral part of the application and other explanatory material.~~

¹⁷ ISA 315 (Revised), paragraphs 175–2249

¹⁸ ISA 330; ISA 500; ISA 520, *Analytical Procedures*; ISA 530, *Audit Sampling*

~~A61a. Some ISAs (e.g., ISA 315 (Revised)) describe why a procedure is required within the application of other explanatory material. These paragraphs assist with understanding the context of the requirement, but do not establish additional requirements within the relevant ISA.~~

Considerations Specific to Smaller Entities Scalability Considerations

~~A65a Scalability considerations have been included in some ISAs (ISA 315 (Revised)), illustrating the application of the requirements to all entities whose-whether their nature and circumstances are less complex, as well as those that are or more complex. Less complex entities are entities for which the majority of the characteristics in paragraph A66 apply.~~

~~A65b67. [Previously paragraph A67] The “considerations specific to smaller entities” included in some the ISAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.~~

A66. For purposes of specifying additional considerations to audits of smaller entities, a “smaller entity” refers to an entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
 - (i) Straightforward or uncomplicated transactions;
 - (ii) Simple record-keeping;
 - (iii) Few lines of business and few products within business lines;
 - (iv) Simpler systems of-Few internal controls;
 - (v) Few levels of management with responsibility for a broad range of controls; or
 - (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

A67 [Moved – now A65b]

~~A66a [Previously A67a] Some ISAs (for example, ISA 315 (Revised)) incorporates considerations specific to audits of smaller less complex entities when such entities are also less complex (i.e., smaller entities for which the majority of the characteristics in paragraph A66(b) apply). Accordingly, in this context, ISA 315 (Revised)these ISAs refers to ‘smaller and less complex entities.’~~

Considerations Specific to Automated Tools and Techniques

A67a. The considerations specific to “automated tools and techniques” included in some ISAs (for example, ISA 315 (Revised)) have been developed to explain how the auditor may apply certain requirements when using automated tools and techniques in performing audit procedures.

Objectives Stated in Individual ISAs (Ref: Para. 21)

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Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 21(a))

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Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: Para. 21(b))

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Complying with Relevant Requirements

Relevant Requirements (Ref: Para. 22)

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Departure from a Requirement (Ref: Para. 23)

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Failure to Achieve an Objective (Ref: Para. 24)

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INTERNATIONAL STANDARD ON AUDITING 240

THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

Introduction

Scope of this ISA

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Characteristics of Fraud

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Responsibility for the Prevention and Detection of Fraud

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Responsibilities of the Auditor

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7. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override controls ~~procedures~~ designed to prevent similar frauds by other employees.

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Effective Date

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Objectives

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Definitions

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Requirements

Professional Skepticism

12. In accordance with ISA 200,¹⁹ the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7–A8)

¹⁹ ISA 200, paragraph 15

13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)
14. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

Discussion among the Engagement Team

15. ISA 315 (Revised) requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion.²⁰ This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10–A11)

Risk Assessment Procedures and Related Activities

16. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control, required by ISA 315 (Revised),²¹ the auditor shall perform the procedures in paragraphs ~~2317–4342~~²⁴ to obtain information for use in identifying the risks of material misstatement due to fraud.

Management and Others within the Entity

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Those Charged with Governance

20. Unless all of those charged with governance are involved in managing the entity,²² the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the ~~internal controls~~ that management has established to mitigate these risks. (Ref: Para. A19–A21)

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Unusual or Unexpected Relationships Identified

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Other Information

²⁰ ISA 315 (Revised), paragraph ~~22–22A~~⁴⁰

²¹ ~~ISA 315 (Revised), paragraphs 5–24~~

²² ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

23. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

Evaluation of Fraud Risk Factors

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23–A27)

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

25. In accordance with ISA 315 (Revised), the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.²³
26. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28–A30)
27. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall ~~obtain an understanding of the entity's related~~ identify the entity's controls, including control activities, relevant to that address such risks as controls relevant to the audit, and evaluate their design and determine whether they have been implemented.²⁴ (Ref: Para. A31–A32)

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

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Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

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Audit Procedures Responsive to Risks Related to Management Override of Controls

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32. Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

²³ ISA 315 (Revised), paragraphs 2-45, 47 and 48

²⁴ ISA 315 (Revised), paragraph 39(a)(i) and 39(d)

- (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:
- (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
 - (ii) Select journal entries and other adjustments made at the end of a reporting period; and
 - (iii) Consider the need to test journal entries and other adjustments throughout the period.
(Ref: Para. A41–A44)

...

Evaluation of Audit Evidence (Ref: Para. A49)

...

Auditor Unable to Continue the Engagement

...

Written Representations

...

Communications to Management and with Those Charged with Governance

...

Communications to Regulatory and Enforcement Authorities

...

Documentation

44. The auditor shall include the following in the audit documentation²⁵ ~~of the auditor's understanding of the entity and its environment and of the identification and the assessment of the risks of material misstatement required by ISA 315 (Revised):~~²⁶
- (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; ~~and~~
 - (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level; ~~and~~
 - (c) ~~Controls identified to be relevant to the audit because they~~ Identified controls that address assessed risks of material misstatement due to fraud.

...

²⁵ ISA 230, *Audit Documentation*, paragraphs 8–11, and paragraph A6

²⁶ ISA 315 (Revised), paragraph 5432

Application and Other Explanatory Material

Characteristics of Fraud (Ref: Para. 3)

...

Professional Skepticism (Ref: Para. 12–14)

A7. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and ~~the identified controls, if any, over its preparation and maintenance, where when such controls are identified to be controls relevant to the audit.~~ Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

...

Discussion Among the Engagement Team (Ref: Para. 15)

...

Risk Assessment Procedures and Related Activities

Inquiries of Management

Management's Assessment of the Risk of Material Misstatement Due to Fraud (Ref: Para. 17(a))

...

Inquiry of Internal Audit (Ref: Para. 19)

A18. ISA 315 (Revised) and ISA 610 (Revised 2013) establish requirements and provide guidance relevant to audits of those entities that have an internal audit function.²⁷ In carrying out the requirements of those ISAs in the context of fraud, the auditor may inquire about specific activities of the function including, for example:

- The procedures performed, if any, by the internal auditor function during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

Obtaining an Understanding of Oversight Exercised by Those Charged with Governance (Ref: Para. 20)

A19. Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and ~~of the relevant internal control—the controls that address such risks.~~ Since the responsibilities of those charged with governance and management may vary by

²⁷ ISA 315 (Revised), paragraphs 186(a) and 31A(a)(ii)-23, and ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

entity and by country, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.²⁸

- A20. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of ~~internal controls~~ that address ~~over~~ risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

Considerations Specific to Smaller Entities

...

Consideration of Other Information (Ref: Para. 23)

- A22. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment, the applicable financial reporting framework and the entity's system of internal control may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

Evaluation of Fraud Risk Factors (Ref: Para. 24)

...

- A25. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:
- An incentive or pressure to commit fraud;
 - A perceived opportunity to commit fraud; and
 - An ability to rationalize the fraudulent action.

Fraud risk factors may relate to incentives, pressures or opportunities that arise from conditions that create susceptibility to misstatement before consideration of controls, which are inherent risk factors and may be due to management bias or fraud (which is an inherent risk factor).²⁹ ~~Alternatively,~~ Fraud risk factors may also relate to conditions within the entity's system of internal control that provide opportunity to commit fraud or that may affect management's attitude or ability to rationalize fraudulent actions. ~~Fraud~~ Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may

²⁸ ISA 260 (Revised), paragraphs A1–A8, discuss with whom the auditor communicates when the entity's governance structure is not well defined.

²⁹ ISA 315 (Revised), paragraph 16(f)

become aware of the existence of such information through, for example, the required understanding of the entity's control environment.³⁰ Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

...

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

Risks of Fraud in Revenue Recognition (Ref: Para. 26)

...

Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls (Ref: Para. 27)

A31. Management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

A32. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. ~~In doing so, In identifying the controls relevant to the audit that address the risks of material misstatement due to fraud,~~ the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from ~~obtaining this understanding identifying these controls, and evaluating their design and determining whether they have been implemented,~~ may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses (Ref: Para. 28)

...

Assignment and Supervision of Personnel (Ref: Para. 29(a))

...

Unpredictability in the Selection of Audit Procedures (Ref: Para. 29(c))

...

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level (Ref: Para. 30)

...

³⁰ ISA 315 (Revised), paragraphs 28

Audit Procedures Responsive to Risks Related to Management Override of Controls

Journal Entries and Other Adjustments (Ref: Para. 32(a))

...

A42. Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries³¹ is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, where IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

A43. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- *The identification and assessment of the risks of material misstatement due to fraud – the presence of fraud risk factors and other information obtained during the auditor's identification and assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.*
- *Controls that have been implemented over journal entries and other adjustments – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.*
- *The entity's financial reporting process and the nature of evidence that can be obtained – for many entities routine processing of transactions involves a combination of manual and automated ~~steps and procedures~~ controls. Similarly, the processing of journal entries and other adjustments may involve both manual and automated ~~procedures and~~ controls. Where information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.*
- *The characteristics of fraudulent journal entries or other adjustments – inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.*
- *The nature and complexity of the accounts – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material*

³¹ ISA 315 (Revised), paragraph 39(a)(iii)

misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.

- *Journal entries or other adjustments processed outside the normal course of business* – non standard journal entries may not be subject to the same ~~level of internal nature and extent of~~ controls as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

...

Accounting Estimates (Ref: Para. 32(b))

...

Business Rationale for Significant Transactions (Ref: Para. 32(c))

...

Evaluation of Audit Evidence (Ref: Para. 34–37)

...

Analytical Procedures Performed Near the End of the Audit in Forming an Overall Conclusion (Ref: Para. 34)

...

Consideration of Identified Misstatements (Ref: Para. 35–37)

...

Auditor Unable to Continue the Engagement (Ref: Para. 38)

...

Written Representations (Ref: Para. 39)

...

Communications to Management and with Those Charged with Governance

Communication to Management (Ref: Para. 40)

...

Communication with Those Charged with Governance (Ref: Para. 41)

...

Other Matters Related to Fraud (Ref: Para. 42)

...

Communications to Regulatory and Enforcement Authorities (Ref: Para. 43)

...

Appendix 1

(Ref: Para. A25)

Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration – that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Fraud risk factors ~~may related~~ to incentives or pressures ~~typically may that~~ arise from conditions that create susceptibility to misstatement before consideration of controls, which are inherent risk factors and may be due to management bias or fraud (which is an inherent risk factor). Fraud risk factors related to opportunities may also arise from other identified inherent risk factors (~~e.g for example~~, complexity or uncertainty may create opportunities that result in susceptibility to misstatement due to fraud). Fraud risk factors related to opportunities may also relate to conditions within the entity's system of internal control, such as limitations or deficiencies in the entity's internal control that create such opportunities. Fraud risk factors related to attitudes or rationalizations may arise, in particular, from limitations or deficiencies in the entity's control environment.

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

...

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

...

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

...

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

...

The monitoring of management is not effective as a result of the following:

...

There is a complex or unstable organizational structure, as evidenced by the following:

...

~~Internal control components are deficient~~ Deficiencies in internal control as a result of the following:

- ~~Inadequate monitoring of controls~~ process to monitor the entity's system of internal control, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of staff in accounting, information technology, or the internal audit function that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

Attitudes/Rationalizations

...

Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

...

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

...

~~Inadequate internal controls~~ over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other re-imbursements.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for ~~internal controls~~ over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures and assertions they may affect.

The following are specific examples of responses:

...

- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of material misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.

...

Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

...

Appendix 3

(Ref: Para. A49)

Examples of Circumstances that Indicate the Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

...

INTERNATIONAL STANDARD ON AUDITING 330 THE AUDITOR'S RESPONSES TO ASSESSED RISKS

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with ISA 315 (Revised)³² in an audit of financial statements.

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:
 - (a) Substantive procedure – An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:
 - (i) Tests of details (of classes of transactions, account balances, and disclosures); and
 - (ii) Substantive analytical procedures.
 - (b) Test of controls – An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Requirements

Overall Responses

5. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1–A3)

³² ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

6. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4–A8; A42–A52)
7. In designing the further audit procedures to be performed, the auditor shall:
 - (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each significant class of transactions, account balance, and disclosure, including:
 - (i) The likelihood and magnitude of ~~material~~ misstatement due to the particular characteristics of the ~~relevant~~ significant class of transactions, account balance, or disclosure (that is, the inherent risk); and
 - (ii) Whether the risk assessment takes account of ~~relevant~~ controls that address the risk of material misstatement (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor ~~intends to rely on~~ plans to test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9–A18)
 - (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

Tests of Controls

8. The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of ~~relevant~~ controls if:
 - (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor ~~intends plans to test to rely on~~ plans to test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
 - (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20–A24)
9. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25)

Nature and Extent of Tests of Controls

10. In designing and performing tests of controls, the auditor shall:
 - (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
 - (i) How the controls were applied at relevant times during the period under audit;
 - (ii) The consistency with which they were applied; and

- (iii) By whom or by what means they were applied. (Ref: Para. A26–A29a)
- (b) To the extent not already addressed, Determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30–A31)

Timing of Tests of Controls

11. The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs 12 and 15 below, in order to provide an appropriate basis for the auditor's intended reliance. (Ref: Para. A32)

Using audit evidence obtained during an interim period

12. If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:
 - (a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and
 - (b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33–A34)

Using audit evidence obtained in previous audits

13. In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:
 - (a) The effectiveness of other ~~elements~~ components of the entity's system of internal control, including the control environment, the entity's process to monitoring of the system of internal controls, and the entity's risk assessment process;
 - (b) The risks arising from the characteristics of the control, including whether it is manual or automated;
 - (c) The effectiveness of general IT controls;
 - (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
 - (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
 - (f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)
14. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance and reliability of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

- (a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36)
- (b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37–A39)

Controls over significant risks

- 15. If the auditor ~~plans-intends~~ to rely ~~test~~ on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

Evaluating the Operating Effectiveness of Controls

- 16. When evaluating the operating effectiveness of ~~relevant~~ controls upon which the auditor intends to rely, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A40)
- 17. If deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether: (Ref: Para. A41)
 - (a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
 - (b) Additional tests of controls are necessary; or
 - (c) The ~~potential~~ risks of material misstatement need to be addressed using substantive procedures.

Substantive Procedures

- 18. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each ~~material~~ class of transactions, account balance, and disclosure that is quantitatively or qualitatively material. (Ref: Para. A42–A47)
- 19. The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48–A51)

Substantive Procedures Related to the Financial Statement Closing Process

- 20. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:
 - (a) Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers; and
 - (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)

Substantive Procedures Responsive to Significant Risks

21. If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)

Timing of Substantive Procedures

22. If substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:
- (a) substantive procedures, combined with tests of controls for the intervening period; or
 - (b) if the auditor determines that it is sufficient, further substantive procedures only,
- that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A54–A57)
23. If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified. (Ref: Para. A58)

Adequacy of Presentation of the Financial Statements

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework. In making this evaluation, the auditor shall consider whether the financial statements are presented in a manner that reflects the appropriate:
- Classification and description of financial information and the underlying transactions, events and conditions; and
 - Presentation, structure and content of the financial statements. (Ref: Para. A59)

Evaluating the Sufficiency and Appropriateness of Audit Evidence

25. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A60–A61)
26. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)
27. If the auditor has not obtained sufficient appropriate audit evidence as to the risk of material misstatement related to an material financial statement relevant assertion about a class of transactions, account balance or disclosure, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

Documentation

28. The auditor shall include in the audit documentation:³³
- (a) The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed;
 - (b) The linkage of those procedures with the assessed risks at the assertion level; and
 - (c) The results of the audit procedures, including the conclusions where these are not otherwise clear. (Ref: Para. A63)
29. If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit.
30. The auditor's documentation shall demonstrate that information in the financial statements agrees or reconciles with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers.

Application and Other Explanatory Material

Overall Responses (Ref: Para. 5)

- A1. Overall responses to address the assessed risks of material misstatement at the financial statement level may include:
- Emphasizing to the engagement team the need to maintain professional skepticism.
 - Assigning more experienced staff or those with special skills or using experts.
 - ~~Providing more supervision~~ Changes to the nature, timing and extent of direction and supervision of members of the engagement team and the review of the work performed.
 - Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
 - Changes to the overall audit strategy as required by ISA 300, or planned audit procedures, and may include changes to:
 - The auditor's determination of performance materiality in accordance with ISA 320.
 - The auditor's plans to test the operating effectiveness of controls, and the persuasiveness of audit evidence needed to support the planned reliance on the operating effectiveness of the controls, particularly when deficiencies in the control environment or the entity's monitoring activities are identified.
 - The nature, timing and extent of substantive procedures. For example, it may be appropriate to perform substantive procedures at or near the date of the financial statements when the risk of material misstatement is assessed as higher.

³³ ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

- ~~Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.~~

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

The Nature, Timing and Extent of Further Audit Procedures (Ref: Para. 6)

A4. The auditor's assessment of the identified risks of material misstatement at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that:

- (a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;
- (b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the ~~relevant risk assessment~~ assessment of the risk of material misstatement. This may be because the ~~auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because~~ auditor is not required to test the operating effectiveness of controls ~~has not identified a risk for which substantive procedures alone cannot provide sufficient appropriate audit evidence and therefore is not required to test the operating effectiveness of controls—considers that testing controls would be inefficient, and~~ therefore, the auditor does may not intend to rely on ~~plan to test~~ the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or
- (c) A combined approach using both tests of controls and substantive procedures is an effective approach.

However, as required by paragraph 18, irrespective of the approach selected, the auditor designs and performs substantive procedures for each ~~material~~ class of transactions, account balance, and disclosure that is quantitatively or qualitatively material.

- A5. The nature of an audit procedure refers to its purpose (that is, test of controls or substantive procedure) and its type (that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks.
- A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.
- A7. Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.
- A8. Designing and performing further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage between the auditor's further audit procedures and the risk assessment.

Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))

Nature

- A9. ISA 315 (Revised) requires that the auditor's assessment of the risks of material misstatement at the assertion level is performed by assessing inherent risk and control risk. The auditor assesses inherent risk by assessing the likelihood and magnitude of a material misstatement taking into account how, and the degree to which the inherent risk factors affect the susceptibility to misstatement of relevant assertions. , identified events or conditions relating to significant classes of transactions, account balances or disclosures are subject to, or affected by, the inherent risk factors.³⁴ The auditor's assessed risks, including the reasons for those assessed risks, may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of material misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of material misstatement of the occurrence assertion.
- A10. The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because ~~of internal~~ the auditor plans intends to test the operating effectiveness of controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

³⁴ ISA 315 paragraph 48

Timing

A11. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from interim date to the period end would not be effective.

A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.

A13. In addition, certain audit procedures can be performed only at or after the period end, for example:

- Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers;
- Examining adjustments made during the course of preparing the financial statements; and
- Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized.

A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.
- The timing of the preparation of the financial statements, particularly for those disclosures that provide further explanation about amounts recorded in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.

Extent

A15. The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample

sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

- A16. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

Considerations specific to public sector entities

- A17. For the audits of public sector entities, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.

Considerations specific to smaller entities

- A18. In the case of very small entities, there may not be many controls ~~activities~~ that could be identified by the auditor, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of controls ~~activities~~ or of other components of the system of internal control may make it impossible to obtain sufficient appropriate audit evidence.

Higher Assessments of Risk (Ref: Para 7(b))

- A19. When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.

Tests of Controls

Designing and Performing Tests of Controls (Ref: Para. 8)

- A20. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an relevant assertion, and the auditor ~~intends to rely upon~~ plans to test those controls. If substantially different controls were used at different times during the period under audit, each is considered separately.
- A21. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.
- A22. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:

- Inquiring about management's use of budgets.
- Observing management's comparison of monthly budgeted and actual expenses.
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts.

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

- A23. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.
- A24. In some cases, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level.³⁵ This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls that address the risk for which substantive procedures alone cannot provide sufficient appropriate audit evidence.

Audit Evidence and Intended Reliance (Ref: Para. 9)

- A25. A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Nature and Extent of Tests of Controls

Other audit procedures in combination with inquiry (Ref: Para. 10(a))

- A26. Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.
- A27. The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of controls ~~activities~~, such as

³⁵ ISA 315 (Revised), paragraph 5130

~~automated controls activities performed by a computer.~~ In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

Extent of tests of controls

A28. When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control. As well as the degree of reliance on controls, matters the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

ISA 530³⁶ contains further guidance on the extent of testing.

A29. Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the ~~program~~ IT application (including the tables, files, or other permanent data used by the ~~program~~ IT application) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests ~~might~~ may include testing the general IT controls related to the IT application, determining that:

- ~~Changes to the program are not made without being subject to the appropriate program change controls;~~
- ~~The authorized version of the program is used for processing transactions; and~~
- ~~Other relevant general controls are effective.~~

~~Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.~~

A29a. Similarly, the auditor may perform tests of controls that address risks of material misstatement related to the integrity of the entity's data, or the completeness and accuracy of the entity's system-generated reports, or to address risks for which substantive procedures alone cannot provide sufficient

³⁶ ISA 530, *Audit Sampling*

appropriate audit evidence. These tests of controls may include tests of general IT controls that address the matters in paragraph 10(a). When this is the case, the auditor may not need to perform any further testing to obtain audit evidence about the matters in paragraph 10(a).

A29b. When the auditor determines that a general IT control is deficient, the auditor may consider the nature of the ~~related-applicable~~ risk(s) arising from the use of IT that were identified in accordance with ISA 315 (Revised)³⁷ to provide the basis for the design of the auditor's additional procedures ~~to determine whether the underlying controls affected by the deficient general IT control functioned throughout the period~~ address the assessed risk of material misstatement. Such procedures may address determining whether:

- The ~~related-applicable~~ risk(s) arising from IT has occurred. For example, if users have unauthorized access to an IT application (but cannot access or modify the system logs that track access), the auditor may inspect the system logs to obtain audit evidence that those users did not access the IT application during the period.
- There are any alternate or redundant general IT controls, or any other controls, that address the ~~related-applicable~~ risk(s) arising from the use of IT. If so, the auditor may ~~determine~~ identify such controls ~~to be relevant to the audit~~ (if not already relevant to the audit-identified) and therefore evaluate their design, determine that they have been implemented and perform tests of their operating effectiveness. For example, if a general IT control related to user access is deficient, the entity may have an alternate control whereby IT management reviews end user access reports on a timely basis. Circumstances when an application control may address a risk arising from the use of IT may include when the information that may be affected by the general IT control deficiency can be reconciled to external sources (~~e.g. for example~~, a bank statement) or internal sources not affected by the general IT control deficiency (~~e.g. for example~~, a separate IT application or data source).

Testing of indirect controls (Ref: Para. 10(b))

A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls (~~e.g. for example~~, general IT controls). As explained in paragraphs A29 to A29b, general IT controls may have been ~~determined to be relevant to the audit~~ identified in accordance with ISA 315 (Revised) because of their support of the operating effectiveness of automated controls or due to their support in maintaining the integrity of information used in the entity's financial reporting, including system-generated reports. The requirement in paragraph 10(b) ~~acknowledges that the auditor may have already tested certain indirect controls to address the matters in paragraph 10(a). For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, general IT controls) are described as "indirect" controls.~~

A31. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.

³⁷ ISA 315 (Revised), paragraph 41

Timing of Tests of Controls

Intended period of reliance (Ref: Para. 11)

A32. Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of controls in the entity's process to monitoring of the system of internal controls.

Using audit evidence obtained during an interim period (Ref: Para. 12(b))

A33. Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel.
- The degree to which audit evidence about the operating effectiveness of those controls was obtained.
- The length of the remaining period.
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.
- The control environment.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the entity's monitoring of controls.

Using audit evidence obtained in previous audits (Ref: Para. 13)

A35. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance and reliability. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

Controls that have changed from previous audits (Ref: Para. 14(a))

A36. Changes may affect the relevance and reliability of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of

audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A37. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

(a) have not changed since they were last tested; and

(b) are not controls that mitigate a significant risk,

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year.

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A deficient control environment.
- ~~A deficiency in the entity's process to monitoring of the system of internal controls.~~
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT controls.

A39. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

Evaluating the Operating Effectiveness of Controls (Ref: Para.16–17)

A40. A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

A41. The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor.

Substantive Procedures (Ref: Para. 6, 18)

A42. Paragraph 18 requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, ~~irrespective of the assessed risks of material misstatement.~~ that is quantitatively or qualitatively material. For significant classes of transactions,

account balances and disclosures, substantive procedures may have already been performed because paragraph 6 requires the auditor to design and perform further audit procedures that are responsive to the assessed risks of material misstatement at the assertion level. Accordingly, substantive procedures are required to be designed and performed in accordance with paragraph 18:

- When the further audit procedures ~~designed and performed in accordance with paragraph 6~~ for significant classes of transactions, account balances or disclosures, ~~designed and performed in accordance with paragraph 6~~, did not include substantive procedures; or
- For each class of transactions, account balance or disclosure that is not a significant class of transactions, account balance or disclosure, but that has been identified as ~~quantitatively or qualitatively~~ material in accordance with ISA 315 (Revised).³⁸

This requirement reflects the facts that: (a) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and (b) there are inherent limitations to ~~internal~~ controls, including management override.

A42a. Not all assertions within a material class of transactions, account balance or disclosure are required to be tested. Rather, ~~in designing the substantive procedures to be performed, the auditor's consideration of the assertion(s) in which a possible misstatement could occur, and if it were to occur, the effect of that misstatement would be most material, may assist in identifying the appropriate nature, timing and extent of the procedures to be performed.~~

Nature and Extent of Substantive Procedures

A43. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

A44. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. ISA 520³⁹ establishes requirements and provides guidance on the application of analytical procedures during an audit.

A45. The ~~nature assessment~~ of the risk ~~and~~ or the nature of the assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

³⁸ ISA 315 (Revised), paragraph 52

³⁹ ISA 520, *Analytical Procedures*

- A46. Because the assessment of the risk of material misstatement takes account of ~~internal controls upon which the auditor intends to rely~~plans to test, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.
- A47. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. See ISA 500.⁴⁰

Considering Whether External Confirmation Procedures Are to Be Performed (Ref: Para. 19)

- A48. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cutoff assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:
- Bank balances and other information relevant to banking relationships.
 - Accounts receivable balances and terms.
 - Inventories held by third parties at bonded warehouses for processing or on consignment.
 - Property title deeds held by lawyers or financiers for safe custody or as security.
 - Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
 - Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
 - Accounts payable balances and terms.
- A49. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.
- A50. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor’s decision about whether to perform external confirmation procedures.
- A51. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

⁴⁰ ISA 500, *Audit Evidence*, paragraph 10

- The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- The ability or willingness of the intended confirming party to respond – for example, the confirming party:
 - May not accept responsibility for responding to a confirmation request;
 - May consider responding too costly or time consuming;
 - May have concerns about the potential legal liability resulting from responding;
 - May account for transactions in different currencies; or
 - May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

- The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

Substantive Procedures Related to the Financial Statement Closing Process (Ref: Para. 20)

A52. The nature, and also the extent, of the auditor's substantive procedures related to the financial statement closing process depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

Substantive Procedures Responsive to Significant Risks (Ref: Para. 21)

A53. Paragraph 21 of this ISA requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

Timing of Substantive Procedures (Ref: Para. 22–23)

A54. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. There are, however, exceptions, for example, a legal opinion obtained in a previous audit related to the structure of a securitization to which no changes have occurred, may be

relevant in the current period. In such cases, it may be appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed, and audit procedures have been performed during the current period to establish its continuing relevance.

Using audit evidence obtained during an interim period (Ref: Para. 22)

A55. In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to:

- (a) Identify amounts that appear unusual;
- (b) Investigate any such amounts; and
- (c) Perform substantive analytical procedures or tests of details to test the intervening period.

A56. Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The control environment and other ~~relevant~~ controls.
- The availability at a later date of information necessary for the auditor's procedures.
- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

A57. Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period end:

- Whether the period-end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.
- Whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.
- Whether the information system ~~relevant to financial reporting~~ will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:
 - (a) Significant unusual transactions or entries (including those at or near the period end);
 - (b) Other causes of significant fluctuations, or expected fluctuations that did not occur; and
 - (c) Changes in the composition of the classes of transactions or account balances.

Misstatements detected at an interim date (Ref: Para. 23)

A58. When the auditor concludes that the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating the procedures performed at the interim date at the period end.

Adequacy of Presentation of the Financial Statements (Ref: Para. 24)

A59. Evaluating the appropriate presentation, arrangement and content of the financial statements includes, for example, consideration of the terminology used as required by the applicable financial reporting framework, the level of detail provided, the aggregation and disaggregation of amounts and the bases of amounts set forth.

Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 25–27)

A60. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example:

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a significant deficiency in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement.

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks of material misstatement for all or some of and the effect on the significant classes of transactions, account balances, or disclosures and ~~related their relevant~~ assertions. ISA 315 (Revised) contains further guidance on revising the auditor's risk assessment.⁴¹

A61. The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

A62. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.

⁴¹ ISA 315 (Revised), paragraph 5334

- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.
- Understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control.

Documentation (Ref: Para. 28)

A63. The form and extent of audit documentation is a matter of professional judgment, and 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 audit.

INTERNATIONAL STANDARD ON AUDITING 540 (REVISED)

AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of financial statements. Specifically, it includes requirements and guidance that refer to, or expand on, how ISA 315 (Revised),⁴² ISA 330,⁴³ ISA 450,⁴⁴ ISA 500⁴⁵ and other relevant ISAs are to be applied in relation to accounting estimates and related disclosures. It also includes requirements and guidance on the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible management bias.

Nature of Accounting Estimates

2. Accounting estimates vary widely in nature and are required to be made by management when the monetary amounts cannot be directly observed. The measurement of these monetary amounts is subject to estimation uncertainty, which reflects inherent limitations in knowledge or data. These limitations give rise to inherent subjectivity and variation in the measurement outcomes. The process of making accounting estimates involves selecting and applying a method using assumptions and data, which requires judgment by management and can give rise to complexity in measurement. The effects of complexity, subjectivity or other inherent risk factors on the measurement of these monetary amounts affects their susceptibility to misstatement. (Ref: Para. A1–A6, Appendix 1)
3. Although this ISA applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing and extent of the risk assessment and further audit procedures required by this ISA will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be very low, based on their nature, and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures required by this ISA would not be expected to be extensive. When estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive. This ISA contains guidance on how the requirements of this ISA can be scaled. (Ref: Para. A7)

⁴² ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

⁴³ ISA 330, *The Auditor's Responses to Assessed Risks*

⁴⁴ ISA 450, *Evaluation of Misstatements Identified during the Audit*

⁴⁵ ISA 500, *Audit Evidence*

Key Concepts of This ISA

4. ~~This ISA 315 (Revised) requires a separate assessment of inherent risk for identified risks of material misstatement at the assertion level.~~⁴⁶ ~~purposes of assessing the risks of material misstatement at the assertion level for accounting estimates.~~ In the context of ISA 540 (Revised), and ~~D~~ depending on the nature of a particular accounting estimate, the susceptibility of an assertion to a misstatement that could be material may be subject to or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, and the interrelationship among them. As explained in ISA 200,⁴⁷ inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale that is referred to ~~in this ISA~~ as the spectrum of inherent risk. (Ref: Para. A8–A9, A65–A66, Appendix 1)
5. This ISA refers to relevant requirements in ISA 315 (Revised) and ISA 330, and provides related guidance, to emphasize the importance of the auditor's decisions about controls relating to accounting estimates, including decisions about whether:
 - There are controls ~~relevant to the audit~~ required to be identified by ISA 315 (Revised), for which the auditor is required to evaluate their design and determine whether they have been implemented.
 - To test the operating effectiveness of ~~relevant~~ controls.
6. ~~This ISA 315 (Revised) also requires a separate assessment of control risk when assessing the risks of material misstatement at the assertion level for accounting estimates.~~ In assessing control risk, the auditor takes into account whether the auditor's further audit procedures contemplate planned reliance on the operating effectiveness of controls. If the auditor does not ~~perform~~ intend plan to tests the operating effectiveness of controls, or does not intend to rely on the operating effectiveness of controls, the auditor's assessment of ~~the risk of material misstatement at the assertion level control risk cannot be reduced for the effective operation of controls with respect to the particular assertion is~~ such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.⁴⁸ (Ref: Para. A10)
7. This ISA emphasizes that the auditor's further audit procedures (including, where appropriate, tests of controls) need to be responsive to the reasons for the assessed risks of material misstatement at the assertion level, taking into account the effect of one or more inherent risk factors and the auditor's assessment of control risk.
8. The exercise of professional skepticism in relation to accounting estimates is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity or other inherent risk factors. Similarly, the exercise of professional

⁴⁶ ED-315, paragraph 48

⁴⁷ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A40

⁴⁸ ISA 530, *Audit Sampling*, Appendix 3

skepticism is important when there is greater susceptibility to misstatement due to management bias or ~~fraud~~ other fraud risk factors insofar as they affect inherent risk. (Ref: Para. A11)

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Objective

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Definitions

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Requirements

Risk Assessment Procedures and Related Activities

13. When obtaining an understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control, as required by ISA 315 (Revised),⁴⁹ the auditor shall obtain an understanding of the following matters related to the entity's accounting estimates. The auditor's procedures to obtain the understanding shall be performed to the extent necessary to obtain sufficient appropriate audit evidence as the that provides an appropriate provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. (Ref: Para. A19–A22)

Obtaining an Understanding of tThe Entity and Its Environment and the Applicable Financial Reporting Framework

- (a) The entity's transactions and other events ~~and~~ conditions that may give rise to the need for, or changes in, accounting estimates to be recognized or disclosed in the financial statements. (Ref: Para. A23)
- (b) The requirements of the applicable financial reporting framework related to accounting estimates (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements); and how they apply in the context of the nature and circumstances of the entity and its environment, including how ~~transactions and other events or conditions are subject to, or affected by, the~~ inherent risk factors affect susceptibility to misstatement of assertions. (Ref: Para. A24–A25)
- (c) Regulatory factors relevant to the entity's accounting estimates, including, when applicable, regulatory frameworks related to prudential supervision. (Ref: Para. A26)
- (d) The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements, based on the auditor's understanding of the matters in 13(a)–(c) above. (Ref: Para. A27)

⁴⁹ ISA 315 (Revised), paragraphs 3, 5–6, 9, 11–12, 15–17, and 20–21 ~~23–434~~

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

- (e) The nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates. (Ref: Para. A28–A30).
 - (f) How management identifies the need for, and applies, specialized skills or knowledge related to accounting estimates, including with respect to the use of a management's expert. (Ref: Para. A31)
 - (g) How the entity's risk assessment process identifies and addresses risks relating to accounting estimates. (Ref: Para. A32–A33)
 - (h) The entity's information system as it relates to accounting estimates, including:
 - (i) How information relating to accounting estimates and related disclosures for significant classes of transactions, account balances or disclosures flows through the entity's information system ~~The classes of transactions, events and conditions, that are significant to the financial statements and that give rise to the need for, or changes in, accounting estimates and related disclosures;~~ and (Ref: Para. A34–A35)
 - (ii) For such accounting estimates and related disclosures, how management:
 - a. Identifies the relevant methods, assumptions or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework, including how management: (Ref: Para. A36–A37)
 - i. Selects or designs, and applies, the methods used, including the use of models; (Ref: Para. A38–A39)
 - ii. Selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions; (Ref: Para. A40–A43); and
 - iii. Selects the data to be used; (Ref: Para. A44)
 - b. Understands the degree of estimation uncertainty, including through considering the range of possible measurement outcomes; and (Ref: Para. A45)
 - c. Addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements. (Ref: Para. A46–A49)
 - (i) Identified controls in the control activities component⁵⁰ ~~activities relevant to the audit~~ over management's process for making accounting estimates as described in paragraph 13(h)(ii). (Ref: Para. A50–A54)
 - (j) How management reviews the outcome(s) of previous accounting estimates and responds to the results of that review.
14. The auditor shall review the outcome of previous accounting estimates, or, where applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor shall take into account the characteristics of the accounting estimates

⁵⁰ ISA 315 (Revised), paragraphs 39(a)–(c)

in determining the nature and extent of that review. The review is not intended to call into question judgments about previous period accounting estimates that were appropriate based on the information available at the time they were made. (Ref: Para. A55–A60)

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Identifying and Assessing the Risks of Material Misstatement

16. In identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the assertion level, including separately assessing inherent risk and control risk at the assertion level, as required by ISA 315 (Revised),⁵¹ the auditor shall ~~separately assess inherent risk and control risk~~. The auditor shall take the following into account in identifying the risks of material misstatement and in assessing inherent risk: (Ref: Para. A64–A71)

(a) The degree to which the accounting estimate is subject to estimation uncertainty; and (Ref: Para. A72–A75)

(b) The degree to which the following are affected by complexity, subjectivity, or other inherent risk factors: (Ref: Para. A76–A79)

(i) The selection and application of the method, assumptions and data in making the accounting estimate; or

(ii) The selection of management's point estimate and related disclosures for inclusion in the financial statements.

17. The auditor shall determine whether any of the risks of material misstatement identified and assessed in accordance with paragraph 16 are, in the auditor's judgment, a significant risk.⁵² If the auditor has determined that a significant risk exists, the auditor shall identify controls that obtain an understanding of the entity's controls, including control activities, relevant to address that risk,⁵³ and evaluate whether such controls have been designed effectively, and determine whether they have been implemented.⁵⁴ (Ref: Para. A80)

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19. As required by ISA 330,⁵⁵ the auditor shall design and perform tests to obtain sufficient appropriate audit evidence as to the operating effectiveness of ~~relevant~~ controls, if:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively; or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

⁵¹ ISA 315 (Revised), paragraph ~~25 and 26~~48 and 51

⁵² ISA 315 (Revised), paragraph ~~49~~27

⁵³ ISA 315 (Revised), paragraph ~~39(a)(i)~~29

⁵⁴ ISA 315 (Revised), Paragraph ~~39(d)~~

⁵⁵ ISA 330, paragraph 8

In relation to accounting estimates, the auditor's tests of such controls shall be responsive to the reasons for the assessment given to the risks of material misstatement. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.⁵⁶ (Ref: Para. A85–A89)

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Other Considerations Relating to Audit Evidence

30. In obtaining audit evidence regarding the risks of material misstatement relating to accounting estimates, irrespective of the sources of information to be used as audit evidence, the auditor shall comply with the relevant requirements in ISA 500.

When using the work of a management's expert, the requirements in paragraphs 21–29 of this ISA may assist the auditor in evaluating the appropriateness of the expert's work as audit evidence for a relevant assertion in accordance with paragraph 8(c) of ISA 500. In evaluating the work of the management's expert, the nature, timing and extent of the further audit procedures are affected by the auditor's evaluation of the expert's competence, capabilities and objectivity, the auditor's understanding of the nature of the work performed by the expert, and the auditor's familiarity with the expert's field of expertise. (Ref: Para. A126–A132)

...

Documentation

39. The auditor shall include in the audit documentation:⁵⁷ (Ref: Para. A149–A152)
- (a) Key elements of the auditor's understanding of the entity and its environment, including the entity's internal control related to the entity's accounting estimates;
 - (b) The linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level,⁵⁸ taking into account the reasons (whether related to inherent risk or control risk) given to the assessment of those risks;
 - (c) The auditor's response(s) when management has not taken appropriate steps to understand and address estimation uncertainty;
 - (d) Indicators of possible management bias related to accounting estimates, if any, and the auditor's evaluation of the implications for the audit, as required by paragraph 32; and
 - (e) Significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

⁵⁶ ISA 330, paragraph 9

⁵⁷ ISA 230, *Audit Documentation*, paragraphs 8–11, A6, A7 and A10

⁵⁸ ISA 330, paragraph 28(b)

Application and Other Explanatory Material

Nature of Accounting Estimates (Ref: Para. 2)

Examples of Accounting Estimates

...

Methods

- A2. A method is a measurement technique used by management to make an accounting estimate in accordance with the required measurement basis. For example, one recognized method used to make accounting estimates relating to share-based payment transactions is to determine a theoretical option call price using the Black Scholes option pricing formula. A method is applied using a computational tool or process, sometimes referred to as a model, and involves applying assumptions and data and taking into account a set of relationships between them.

Assumptions and Data

- A3. Assumptions involve judgments based on available information about matters such as the choice of an interest rate, a discount rate, or judgments about future conditions or events. An assumption may be selected by management from a range of appropriate alternatives. Assumptions that may be made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate.

- A4. For purposes of this ISA, data is information that can be obtained through direct observation or from a party external to the entity. Information obtained by applying analytical or interpretive techniques to data is referred to as derived data when such techniques have a well-established theoretical basis and therefore less need for management judgment. Otherwise, such information is an assumption.

- A5. Examples of data include:

- Prices agreed in market transactions;
- Operating times or quantities of output from a production machine;
- Historical prices or other terms included in contracts, such as a contracted interest rate, a payment schedule, and term included in a loan agreement;
- Forward-looking information such as economic or earnings forecasts obtained from an external information source, or
- A future interest rate determined using interpolation techniques from forward interest rates (derived data).

- A6. Data can come from a wide range of sources. For example, data can be:

- Generated within the organization or externally;
- Obtained from a system that is either within or outside the general or subsidiary ledgers;
- Observable in contracts; or
- Observable in legislative or regulatory pronouncements.

Scalability (Ref: Para. 3)

A7. Examples of paragraphs that include guidance on how the requirements of this ISA can be scaled include paragraphs A20–A22, A63, A67, and A84.

Key Concepts of This ISA

Inherent Risk Factors (Ref: Para. 4)

A8. Inherent risk factors are characteristics of ~~conditions and events~~ and conditions that ~~may~~ affect the susceptibility of an assertion to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosures, before consideration of controls.⁵⁹ Appendix 1 further explains the nature of these inherent risk factors, and their inter-relationships, in the context of making accounting estimates and their presentation in the financial statements.

A9. In addition to the inherent risk factors of estimation uncertainty, complexity or subjectivity, other inherent risk factors included in ISA 315 (Revised) that the auditor ~~may consider~~ takes into account in ~~identifying and~~ assessing the risks of material misstatement at the assertion level⁶⁰ ~~may~~ include the extent to which the accounting estimate is subject to, or affected by:

- Change in the nature or circumstances of the relevant financial statement items, or requirements of the applicable financial reporting framework which may give rise to the need for changes in the method, assumptions or data used to make the accounting estimate.
- Susceptibility to misstatement due to management bias, or other fraud risk factors insofar as they affect inherent risk, in making the accounting estimate.

Control Risk (Ref: Para. 6)

A10. ~~An important consideration for the auditor is~~ in assessing control risk at the assertion level in accordance with ISA 315 (Revised), the auditor takes into account ~~is the effectiveness of the design of the controls that whether~~ the auditor intends plans to rely test on the operating effectiveness of controls, ~~and the extent to which the controls address the assessed inherent risks at the assertion level.~~ When the auditor is considering whether to test the operating effectiveness of controls, ~~the~~ auditor's evaluation that controls are effectively designed and have been implemented supports an expectation about the operating effectiveness of the controls in determining whether establishing their plan to test them.

Professional Skepticism (Ref: Para. 8)

....

Concept of "Reasonable" (Ref: Para. 9, 35)

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⁵⁹ ISA 315 (Revised), paragraph 16(f)

⁶⁰ ISA 315 (Revised), paragraph 48

Risk Assessment Procedures and Related Activities

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control (Ref: Para. 13)

A19. Paragraphs ~~2311–4324~~ of ISA 315 (Revised) require the auditor to obtain an understanding of certain matters about the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control. The requirements in paragraph 13 of this ISA relate more specifically to accounting estimates and build on the broader requirements in ISA 315 (Revised).

Scalability

A20. The nature, timing, and extent of the auditor's procedures to obtain the understanding of the entity and its environment, including the applicable financial reporting framework, and the entity's system of internal control, related to the entity's accounting estimates, may depend, to a greater or lesser degree, on the extent to which the individual matter(s) apply in the circumstances. For example, the entity may have few transactions or other events ~~and or~~ conditions that give rise to the need for accounting estimates, the applicable financial reporting requirements may be simple to apply, and there may be no relevant regulatory factors. Further, the accounting estimates may not require significant judgments, and the process for making the accounting estimates may be less complex. In these circumstances, the accounting estimates may be subject to, or affected by, estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree, and there may be fewer identified controls ~~relevant to the audit~~. If so, the auditor's risk identification and assessment procedures are likely to be less extensive and may be obtained primarily through inquiries of management with appropriate responsibilities for the financial statements, such as ~~and~~ simple walk-throughs of management's process for making the accounting estimate (including when evaluating whether the-identified controls in that process are designed effectively and when determining whether the control has been implemented).

A21. By contrast, the accounting estimates may require significant judgments by management, and the process for making the accounting estimates may be complex and involve the use of complex models. In addition, the entity may have a more sophisticated information system, and more extensive controls over accounting estimates. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, subjectivity, complexity or other inherent risk factors to a greater degree. If so, the nature or timing of the auditor's risk assessment procedures are likely to be different, or be more extensive, than in the circumstances in paragraph A20.

A22. The following considerations may be relevant for entities with only simple businesses, which may include many smaller entities:

- Processes relevant to accounting estimates may be uncomplicated because the business activities are simple or the required estimates may have a lesser degree of estimation uncertainty.
- Accounting estimates may be generated outside of the general and subsidiary ledgers, controls over their development may be limited, and an owner-manager may have significant influence over their determination. The owner-manager's role in making the accounting estimates may

need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering the risk of management bias.

The Entity and Its Environment

The entity's transactions and other events ~~and-or~~ conditions (Ref: Para. 13(a))

A23. Changes in circumstances that may give rise to the need for, or changes in, accounting estimates may include, for example, whether:

- The entity has engaged in new types of transactions;
- Terms of transactions have changed; or
- New events or conditions have occurred.

The requirements of the applicable financial reporting framework (Ref: Para. 13(b))

A24. Obtaining an understanding of the requirements of the applicable financial reporting framework provides the auditor with a basis for discussion with management and, where applicable, those charged with governance about how management has applied ~~these~~ requirements of the applicable financial reporting framework relevant to the accounting estimates, and about the auditor's determination of whether they have been applied appropriately. This understanding also may assist the auditor in communicating with those charged with governance when the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework, not to be the most appropriate in the circumstances of the entity.⁶¹

A25. In obtaining this understanding, the auditor may seek to understand whether:

- The applicable financial reporting framework:
 - Prescribes certain criteria for the recognition, or methods for the measurement of accounting estimates;
 - Specifies certain criteria that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability; or
 - Specifies required or suggested disclosures, including disclosures concerning judgments, assumptions, or other sources of estimation uncertainty relating to accounting estimates; and
- Changes in the applicable financial reporting framework require changes to the entity's accounting policies relating to accounting estimates.

Regulatory factors (Ref: Para. 13(c))

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⁶¹ ISA 260 (Revised), paragraph 16(a)

The nature of the accounting estimates and related disclosures that the auditor expects to be included in the financial statements (Ref: Para. 13(d))

...

The Entity's System of Internal Control ~~Relevant to the Audit~~

The nature and extent of oversight and governance (Ref: Para. 13(e))

A28. In applying ISA 315 (Revised),⁶² the auditor's understanding of the nature and extent of oversight and governance that the entity has in place over management's process for making accounting estimates may be important to the auditor's required evaluation ~~of as it relates to~~ whether:

- Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; ~~and~~
- The ~~strengths in those areas of the entity's~~ control environment ~~elements collectively~~ provides an appropriate foundation for the other components of the system of internal control considering the nature and size of the entity; and ~~whether~~
- ~~those other components are undermined by~~ Control deficiencies identified in the control environment undermine the other components of the system of internal control.⁶³

...

A30. Obtaining an understanding of the oversight by those charged with governance may be important when there are accounting estimates that:

- Require significant judgment by management to address subjectivity;
- Have high estimation uncertainty;
- Are complex to make, for example, because of the extensive use of information technology, large volumes of data or the use of multiple data sources or assumptions with complex interrelationships;
- Had, or ought to have had, a change in the method, assumptions or data compared to previous periods; or
- Involve significant assumptions.

Management's application of specialized skills or knowledge, including the use of management's experts (Ref: Para. 13(f))

...

The entity's risk assessment process (Ref: Para. 13(g))

A32. Understanding how the entity's risk assessment process identifies and addresses risks relating to accounting estimates may assist the auditor in considering changes in:

⁶² ISA 315 (Revised), paragraph 28(a).¹⁴

⁶³ ~~ISA 315 (Revised), paragraph 28~~

- The requirements of the applicable financial reporting framework related to the accounting estimates;
- The availability or nature of data sources that are relevant to making the accounting estimates or that may affect the reliability of the data used;
- The entity's information systems or IT environment; and
- Key personnel.

A33. Matters that the auditor may consider in obtaining an understanding of how management identified and addresses the susceptibility to misstatement due to management bias or fraud in making accounting estimates, include whether, and if so how, management:

- Pays particular attention to selecting or applying the methods, assumptions and data used in making accounting estimates.
- Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors.
- Identifies financial or other incentives that may be a motivation for bias.
- Monitors the need for changes in the methods, significant assumptions or the data used in making accounting estimates.
- Establishes appropriate oversight and review of models used in making accounting estimates.
- Requires documentation of the rationale for, or an independent review of, significant judgments made in making accounting estimates.

The entity's information system relating to accounting estimates (Ref: Para. 13(h)(i))

A34. The significant classes of transactions, events and conditions within the scope of paragraph 13(h) are the same as the significant classes of transactions, events and conditions relating to accounting estimates and related disclosures that are subject to paragraphs ~~356~~18(a) and (d) of ISA 315 (Revised). In obtaining the understanding of the entity's information system as it relates to accounting estimates, the auditor may consider:

- Whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions.
- How the information system addresses the completeness of accounting estimates and related disclosures, in particular for accounting estimates related to liabilities.

A35. During the audit, the auditor may identify classes of transactions, events ~~and or~~ conditions that give rise to the need for accounting estimates and related disclosures that management failed to identify. ISA 315 (Revised) deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including ~~determining whether there is a significant deficiency are one or more control deficiencies in internal control with regard to~~ considering the implications for the auditor's evaluation of the entity's risk assessment process.⁶⁴

⁵⁰ ISA 315 (Revised), paragraph ~~314~~317

Management's Identification of the Relevant Methods, Assumptions and Sources of Data (Ref: Para. 13(h)(ii)(a))

...

Methods (Ref: Para. 13(h)(ii)(a)(i))

...

Models

A39. Management may design and implement specific controls around models used for making accounting estimates, whether management's own model or an external model. When the model itself has an increased level of complexity or subjectivity, such as an expected credit loss model or a fair value model using level 3 inputs, controls that address such complexity or subjectivity may be more likely to be identified controls in accordance with ISA 315 (Revised)⁶⁵as relevant to the auditbecause the assessments of inherent risk may be higher such that the auditor requires more persuasive audit evidence. The auditor's evaluation of the design of such controls and determination of whether such controls have been implemented contributes to the audit evidence related to higher assessed risks. When complexity in relation to models is present, controls over data integrity are also more likely to be identified controls in accordance with ISA 315 (Revised)relevant to the audit. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and of related identified controls activities relevant to the audit include the following:

- How management determines the relevance and accuracy of the model;
- The validation or back testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model may include evaluation of:
 - The model's theoretical soundness;
 - The model's mathematical integrity; and
 - The accuracy and completeness of the data and the appropriateness of data and assumptions used in the model.
- How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model;
- Whether adjustments, also referred to as overlays in certain industries, are made to the output of the model and whether such adjustments are appropriate in the circumstances in accordance with the requirements of the applicable financial reporting framework. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias; and
- Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, the results of any validation performed on it and the nature of, and basis for, any adjustments made to its output.

⁶⁵ ISA 315 (Revised), paragraph 39(a)

Assumptions (Ref: Para. 13(h)(ii)(a)(ii))

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Data (Ref: Para. 13(h)(ii)(a)(iii))

A44. Matters that the auditor may consider in obtaining an understanding of how management selects the data on which the accounting estimates are based include:

- The nature and source of the data, including information obtained from an external information source.
- How management evaluates whether the data is appropriate.
- The accuracy and completeness of the data.
- The consistency of the data used with data used in previous periods.
- The complexity of IT applications or other aspects of the entity's IT environment the information technology systems used to obtain and process the data, including when this involves handling large volumes of data.
- How the data is obtained, transmitted and processed and how its integrity is maintained.

How management understands and addresses estimation uncertainty (Ref: Para. 13(h)(ii)(b)–13(h)(ii)(c))

...

~~Identified Controls Activities Relevant to the Audit~~ Over Management's Process for Making Accounting Estimates (Ref: Para 13(i))

A50. The auditor's judgment in identifying controls ~~relevant to the audit~~ in the controls activities component, and therefore the need to evaluate the design of those controls and determine whether they have been implemented, relates to management's process described in paragraph 13(h)(ii). The auditor may not identify ~~relevant controls relevant to the audit~~ activities in relation to all the elements aspects of paragraph 13(h)(ii), ~~depending on the degree to which complexity affects associated with the accounting estimate.~~

A51. As part of ~~obtaining an understanding of~~ identifying the controls ~~activities relevant to the audit~~, and evaluating their design and determining whether they have been implemented, the auditor may consider:

- How management determines the appropriateness of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers.
- The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those responsible for making the accounting estimates and those committing the entity to the related transactions, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or

services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity's financial products staffed by individuals whose remuneration is not tied to such products.

- The effectiveness of the design of the controls ~~activities~~. Generally, it may be more difficult for management to design controls that address subjectivity and estimation uncertainty in a manner that effectively prevents, or detects and corrects, material misstatements, than it is to design controls that address complexity. Controls that address subjectivity and estimation uncertainty may need to include more manual elements, which may be less reliable than automated controls as they can be more easily bypassed, ignored or overridden by management. The design effectiveness of controls addressing complexity may vary depending on the reason for, and the nature of, the complexity. For example, it may be easier to design more effective controls related to a method that is routinely used or over the integrity of data.

A52. When management makes extensive use of information technology in making an accounting estimate, identified controls ~~relevant to the audit~~ are likely to include general IT controls and application information processing controls. Such controls may address risks related to:

- Whether the IT applications or other aspects of the IT environment ~~information technology system has~~ have the capability and is appropriately configured to process large volumes of data;
- Complex calculations in applying a method. When diverse IT applications systems are required to process complex transactions, regular reconciliations between the IT applications systems are made, in particular when the IT applications systems do not have automated interfaces or may be subject to manual intervention;
- Whether the design and calibration of models is periodically evaluated;
- The complete and accurate extraction of data regarding accounting estimates from the entity's records or from external information sources;
- Data, including the complete and accurate flow of data through the entity's information system, the appropriateness of any modification to the data used in making accounting estimates, the maintenance of the integrity and security of the data. When using external information sources, risks related to processing or recording the data;
- Whether management has controls around access, change and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models; and
- Whether there are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over journal entries.

A53. In some industries, such as banking or insurance, the term governance may be used to describe activities within the control environment, the entity's process to monitor the system of internal control

~~monitoring of controls~~, and other components of the system of internal control, as described in ISA 315 (Revised).⁶⁶

A54. For entities with an internal audit function, its work may be particularly helpful to the auditor in obtaining an understanding of:

- The nature and extent of management's use of accounting estimates;
- The design and implementation of controls ~~activities~~ that address the risks related to the data, assumptions and models used to make the accounting estimates;
- The aspects of the entity's information system that generate the data on which the accounting estimates are based; and
- How new risks relating to accounting estimates are identified, assessed and managed.

Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates (Ref: Para. 14)

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A58. Based on the auditor's previous assessment of the risks of material misstatement, for example, if inherent risk is assessed as higher for one or more risks of material misstatement, the auditor may judge that a more detailed retrospective review is required. As part of the detailed retrospective review, the auditor may pay particular attention, when practicable, to the effect of data and significant assumptions used in making the previous accounting estimates. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A59. The measurement objective for fair value accounting estimates and other accounting estimates, based on current conditions at the measurement date, deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that may be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions that affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant audit evidence. In this case, audit evidence may be obtained by understanding the outcomes of assumptions (such as a cash flow projections) and understanding the effectiveness of management's prior estimation process that supports the identification and assessment of the risks of material misstatement in the current period.

A60. A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. However, such a difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.⁶⁷ Such

⁶⁶ ISA 315 (Revised) paragraph A98(a).⁷⁷

⁶⁷ ISA 560, Subsequent Events, paragraph 14

a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may reassess any plan to test related controls and the related assessment of control risk ~~and-or~~ may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

Specialized Skills or Knowledge (Ref: Para. 15)

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Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 4, 16)

A64. Identifying and assessing risks of material misstatement at the assertion level relating to accounting estimates is important for all accounting estimates, including not only those that are recognized in the financial statements, but also those that are included in the notes to the financial statements.

A65. Paragraph A42 of ISA 200 states that the ISAs ~~do not ordinarily refer to inherent risk and control risk separately~~ typically refer to the "risks of material misstatement" rather than to inherent risk and control risk separately. However, this ISA 315 (Revised) requires a separate assessment of inherent risk and control risk at the assertion level⁶⁸ to provide a basis for designing and performing further audit procedures to respond to the risks of material misstatement at the assertion level⁶⁹, including significant risks, ~~at the assertion level for accounting estimates~~ in accordance with ISA 330.⁷⁰

A66. In identifying the risks of material misstatement and in assessing inherent risk for accounting estimates, in accordance with ISA 315 (Revised),⁷¹ the auditor is required to take into account ~~the degree to which the accounting estimate is subject to, or affected by, the inherent risk factors described in paragraph 16 of this ISA~~ the inherent risk factors that affect susceptibility to misstatement of assertions, and how they do so ~~estimation uncertainty, complexity, subjectivity, or other inherent risk factors~~. The auditor's consideration of the inherent risk factors may also provide information to be used in ~~determining~~:

- Assessing the likelihood and magnitude of material misstatement (i.e., where inherent risk is assessed on the spectrum of inherent risk); and
- Determining ~~the~~ reasons for the assessment given to the risks of material misstatement at the assertion level, and that the auditor's further audit procedures in accordance with paragraph 18 are responsive to those reasons.

The interrelationships between the inherent risk factors are further explained in Appendix 1.

⁶⁸ ISA 315 (Revised), paragraphs 48 and 50

⁶⁹ ISA 315 (Revised), paragraphs 48 and 51

⁷⁰ ISA 330, paragraph 7(b)

⁷¹ ISA 315 (Revised), paragraph 48(a)

- A67. The reasons for the auditor's assessment of inherent risk at the assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity or other inherent risk factors. For example:
- (a) Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgments about future events or conditions. Similar considerations apply to insurance contract liabilities.
 - (b) An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes, but may involve little subjectivity and the degree of estimation uncertainty may be low, depending on the nature of the inventory.
 - (c) Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an accounting estimate that requires a single critical judgment about a liability, the amount of which is contingent on the outcome of the litigation.
- A68. The relevance and significance of inherent risk factors may vary from one estimate to another. Accordingly, the inherent risk factors may, either individually or in combination, affect simple accounting estimates to a lesser degree and the auditor may identify fewer risks or assess inherent risk at close to the lower end of the spectrum of inherent risk.
- A69. Conversely, the inherent risk factors may, either individually or in combination, affect complex accounting estimates to a greater degree, and may lead the auditor to assess inherent risk at the higher end of the spectrum of inherent risk. For these accounting estimates, the auditor's consideration of the effects of the inherent risk factors is likely to directly affect the number and nature of identified risks of material misstatement, the assessment of such risks, and ultimately the persuasiveness of the audit evidence needed in responding to the assessed risks. Also, for these accounting estimates the auditor's application of professional skepticism may be particularly important.
- A70. Events occurring after the date of the financial statements may provide additional information relevant to the auditor's assessment of the risks of material misstatement at the assertion level. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise the assessment of the risks of material misstatement at the assertion level,⁷² regardless of how the inherent risk factors affect susceptibility to misstatement of assertions of degree to which the accounting estimate was subject to, or affected by, estimation uncertainty, complexity, subjectivity or other inherent risk factors. Events occurring after the date of the financial statements also may influence the auditor's selection of the approach to testing the accounting estimate in accordance with paragraph 18. For example, for a simple bonus accrual that is based on a straightforward percentage of compensation for selected employees, the auditor may conclude that

⁷² ISA 315 (Revised), paragraph 5334

there is relatively little complexity or subjectivity in making the accounting estimate, and therefore may assess inherent risk at the assertion level at close to the lower end of the spectrum of inherent risk. The payment of the bonuses subsequent to period end may provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level.

- A71. The auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, minimum) or in terms of the auditor's expectation of how effective the control(s) is in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.

Estimation Uncertainty (Ref: Para. 16(a))

- A72. In taking into account the degree to which the accounting estimate is subject to estimation uncertainty, the auditor may consider:

- Whether the applicable financial reporting framework requires:
 - The use of a method to make the accounting estimate that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of unobservable inputs.
 - The use of assumptions that inherently have a high level of estimation uncertainty, such as assumptions with a long forecast period, assumptions that are based on data that is unobservable and are therefore difficult for management to develop, or the use of various assumptions that are interrelated.
 - Disclosures about estimation uncertainty.
- The business environment. An entity may be active in a market that experiences turmoil or possible disruption (for example, from major currency movements or inactive markets) and the accounting estimate may therefore be dependent on data that is not readily observable.
- Whether it is possible (or practicable, insofar as permitted by the applicable financial reporting framework) for management:
 - To make a precise and reliable prediction about the future realization of a past transaction (for example, the amount that will be paid under a contingent contractual term), or about the incidence and impact of future events or conditions (for example, the amount of a future credit loss or the amount at which an insurance claim will be settled and the timing of its settlement); or
 - To obtain precise and complete information about a present condition (for example, information about valuation attributes that would reflect the perspective of market participants at the date of the financial statements, to develop a fair value estimate).

A73. The size of the amount recognized or disclosed in the financial statements for an accounting estimate is not, in itself, an indicator of its susceptibility to misstatement because, for example, the accounting estimate may be understated.

A74. In some circumstances, the estimation uncertainty may be so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may preclude recognition of an item in the financial statements, or its measurement at fair value. In such cases, there may be risks of material misstatement that relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the reasonableness of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the estimation uncertainty associated with them (see paragraphs A112–A113, A143–A144).

A75. In some cases, the estimation uncertainty relating to an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. ISA 570 (Revised)⁷³ establishes requirements and provides guidance in such circumstances.

Complexity or Subjectivity (Ref: Para. 16(b))

The Degree to Which Complexity Affects the Selection and Application of the Method

A76. In taking into account the degree to which the selection and application of the method used in making the accounting estimate are affected by complexity, the auditor may consider:

- The need for specialized skills or knowledge by management which may indicate that the method used to make an accounting estimate is inherently complex and therefore the accounting estimate may have a greater susceptibility to material misstatement. There may be a greater susceptibility to material misstatement when management has developed a model internally and has relatively little experience in doing so, or uses a model that applies a method that is not established or commonly used in a particular industry or environment.
- The nature of the measurement basis required by the applicable financial reporting framework, which may result in the need for a complex method that requires multiple sources of historical and forward-looking data or assumptions, with multiple interrelationships between them. For example, an expected credit loss provision may require judgments about future credit repayments and other cash flows, based on consideration of historical experience data and the application of forward looking assumptions. Similarly, the valuation of an insurance contract liability may require judgments about future insurance contract payments to be projected based on historical experience and current and assumed future trends.

The Degree to Which Complexity Affects the Selection and Application of the Data

A77. In taking into account the degree to which the selection and application of the data used in making the accounting estimate are affected by complexity, the auditor may consider:

- The complexity of the process to derive the data, taking into account the relevance and reliability of the data source. Data from certain sources may be more reliable than from others. Also, for confidentiality or proprietary reasons, some external information sources will not (or

⁷³ ISA 570, (Revised), *Going Concern*

not fully) disclose information that may be relevant in considering the reliability of the data they provide, such as the sources of the underlying data they used or how it was accumulated and processed.

- The inherent complexity in maintaining the integrity of the data. When there is a high volume of data and multiple sources of data, there may be inherent complexity in maintaining the integrity of data that is used to make an accounting estimate.
- The need to interpret complex contractual terms. For example, the determination of cash inflows or outflows arising from a commercial supplier or customer rebates may depend on very complex contractual terms that require specific experience or competence to understand or interpret.

The Degree to Which Subjectivity Affects the Selection and Application of the Method, Assumptions or Data

A78. In taking into account the degree to which the selection and application of method, assumptions or data are affected by subjectivity, the auditor may consider:

- The degree to which the applicable financial reporting framework does not specify the valuation approaches, concepts, techniques and factors to use in the estimation method.
- The uncertainty regarding the amount or timing, including the length of the forecast period. The amount and timing is a source of inherent estimation uncertainty, and gives rise to the need for management judgment in selecting a point estimate, which in turn creates an opportunity for management bias. For example, an accounting estimate that incorporates forward looking assumptions may have a high degree of subjectivity which may be susceptible to management bias.

Other Inherent Risk Factors (Ref: Para. 16(b))

A79. The degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or fraud. For example, when an accounting estimate is subject to a high degree of subjectivity, the accounting estimate is likely to be more susceptible to misstatement due to management bias or fraud and this may result in a wide range of possible measurement outcomes. Management may select a point estimate from that range that is inappropriate in the circumstances, or that is inappropriately influenced by unintentional or intentional management bias, and that is therefore misstated. For continuing audits, indicators of possible management bias identified during the audit of preceding periods may influence the planning and risk assessment procedures in the current period.

Significant Risks (Ref: Para. 17)

A80. The auditor's assessment of inherent risk, which takes into account the degree to which an accounting estimate is subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, assists the auditor in determining whether any of the risks of material misstatement identified and assessed are a significant risk.

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When the Auditor Intends to Rely on the Operating Effectiveness of ~~Relevant~~ Controls (Ref: Para: 19)

A85. Testing the operating effectiveness of ~~relevant~~ controls may be appropriate when inherent risk is assessed as higher on the spectrum of inherent risk, including for significant risks. This may be the case when the accounting estimate is subject to or affected by a high degree of complexity. When the accounting estimate is affected by a high degree of subjectivity, and therefore requires significant judgment by management, inherent limitations in the effectiveness of the design of controls may lead the auditor to focus more on substantive procedures than on testing the operating effectiveness of controls.

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Overall Evaluation Based on Audit Procedures Performed (Ref: Para. 33)

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Determining Whether the Accounting Estimates are Reasonable or Misstated (Ref: Para. 9, 35)

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