

## Audits of Less Complex Entities – Proposed Revisions to Part 6, *Risk Identification and Assessment* – Clean

This agenda item presents revised drafting of Part 6, *Risk Identification and Assessment*.

### **6. Risk Identification and Assessment**

#### Content of this Part

Part 6 contains the requirements relevant to the auditor's responsibility to perform procedures and related activities to:

- Understand the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control;
- Identify risks of material misstatement at the financial statement and assertion levels, whether due to fraud or error; and
- Assess inherent risk and control risk.

Appendix 2 illustrates the iterative nature of the auditor's risk identification and assessment.

#### Scope of this Part

This Part deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, which provides the basis for the audit procedures undertaken to respond to assessed risks in Part 7. Part 5 sets out the auditor's obligations for planning activities, including the requirements for the engagement team discussion.

#### **6.1. Objectives**

- 6.1.1. The objectives of the auditor are to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

*Understanding the entity and its environment, the applicable financial reporting framework and the entity's system of internal control enables the auditor to identify and assess the risks of material misstatement. The auditor's risk identification and assessment process is iterative and dynamic.*

#### **6.2. Procedures for Identifying and Assessing Risks and Related Activities**

- 6.2.1. The auditor shall design and perform procedures to obtain audit evidence that provides an appropriate basis for:
- (a) The identification and assessment of risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels; and
  - (b) The design of further audit procedures.

*The auditor uses professional judgment to determine the nature and extent of the procedures to be performed, which may vary with the formality of the entity's policies or procedures.*

*Some less complex entities, and particularly owner-managed entities, may not have established structured processes and systems or may have established processes or systems with limited documentation or a lack of consistency in how they are undertaken. When such systems and processes lack formality, the procedures described in paragraph 6.2.2. are still required.*

*Designing and performing procedures to obtain audit evidence in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of evidence.*

6.2.2. The procedures to identify and assess risks of material misstatement shall include:

- (a) Inquiries of management, and other appropriate individuals within the entity;
- (b) Analytical procedures; and
- (c) Observation and inspection.

*The auditor is not required to perform all of these procedures for each aspect of the auditor's understanding required by this Part.*

*Analytical procedures help to identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that indicate matters that may have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud, including those relating to revenue accounts.*

*Analytical procedures performed as a risk assessment procedure may include both financial and non-financial information and the use of data aggregated at a high level. In the audit of an LCE, the auditor may perform a simple comparison of information, such as the change in interim or monthly account balances from balances in prior periods, to identify potential higher risk areas.*

*Observation and inspection may support, corroborate or contradict inquiries of management and others, and may also provide information about the entity and its environment. Where policies or procedures are not documented, or the entity's controls lack formality, the auditor may still be able to obtain some audit evidence to support the identification and assessment of the risks of material misstatement through observation or inspection of the performance of the control.*

#### *Considerations Specific to Public Sector Entities*

*When making inquiries of those who may have information that is likely to assist in identifying risks of material misstatement, auditors of public sector entities may obtain information from additional sources such as from the auditors that are involved in performance or other audits related to the entity. Procedures performed by auditors of public sector entities to identify and assess risks of material misstatement may also include observation and inspection of documents prepared by management for the legislature, for example documents related to mandatory performance reporting.*

### *Automated Tools and Techniques*

*If the auditor uses ATT, the auditor may design and perform procedures to identify and assess risks of material misstatement on relatively large volumes of data (from the general ledger, sub-ledgers or other operational data) including for analysis, observation or inspection.*

6.2.3. In designing and performing procedures to identify and assess risks of material misstatement, the auditor shall consider possible risks of material misstatement arising from:

- (a) Fraud or error;
- (b) Related parties; and
- (c) Events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

### *Fraud*

*Fraudulent financial reporting involves intentional misstatements, including omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively, such as recording fictitious journal entries close to the end of the financial reporting period.*

*Misappropriation of assets involves the theft of the entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.*

*Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.*

*In some LCEs, and particularly owner-managed entities, there may be less segregation of duties and more direct involvement of management or the owner-manager. This may provide a greater opportunity to commit fraud. However, the owner-manager may be able to exercise more effective oversight than in a more complex entity. In addition, owner-managers may have different pressures or incentives to commit fraud than management in more complex entities. Appendix 3 sets out fraud risk factors relevant to less complex entities.*

### *Related Parties*

*In some LCEs, related party transactions between owner-managers and close family members may be common, in particular in closely held entities. These transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.*

### *Going Concern*

*Events or conditions that may cast significant doubt on the entity's ability to continue as a going concern of particular relevance to an LCE include the risk that banks and other lenders may cease to support the entity, as well as the possible loss of a principal supplier, major customer, key employee, or the right to operate under a license, franchise or other legal agreement.*

6.2.4. In obtaining audit evidence to identify and assess risks of material misstatement and design further audit procedures the auditor shall consider information from:

- (a) The acceptance or continuance procedures; and
- (b) When applicable, other engagements performed by the engagement partner for the entity.

6.2.6. If the audit opinion on the prior period's financial statements was modified, the auditor shall evaluate the effect on the current year's financial statements when identifying and assessing risks of material misstatement.

### 6.3. Understanding Relevant Aspects of the Entity

*The auditor's understanding of relevant aspects of the entity establishes a frame of reference in which the auditor identifies and assesses the risks of material misstatement, and also informs how the auditor plans and performs further audit procedures.*

#### *Inquiries of Management and Others within the Entity*

6.3.A. The auditor shall inquire of management and, when applicable, those charged with governance, regarding:

- (a) How the entity identifies risks relevant to the preparation of the financial statements and how they are addressed;
- (b) The risks of fraud in the entity and the controls that management has established to mitigate these risks;
- (c) The nature and extent of management's direct involvement in operations, or other activities that may help to identify controls that are not operating as intended or to prevent or detect misstatements in accounting information.
- (d) The identity of the entity's related parties, including changes from the prior period; the nature of the relationships between the entity and these related parties; and whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions; and
- (e) Non-compliance with law or regulation that may have a material effect on the financial statements.

*Inquiries of management and, when applicable, those charged with governance, assist the auditor to identify and assess risks of material misstatement and respond to those risks.*

*Inquiries about how the entity identifies and assesses its risks may assist the auditor in understanding:*

- *Where there are identified risks;*
- *Whether, and how the entity has responded to those risks;*
- *Whether the risks faced by the entity have been identified, assessed and addressed as appropriate to the nature and circumstances of the entity.*

*Inquiries about the risks of material misstatement due to fraud in the entity may assist the auditor in understanding:*

- *Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;*
- *Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;*
- *Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity;*

*Inquiring about how managements may identify controls that are not operating as intended or to prevent or detect misstatements in accounting information may include understanding the sources of information reviewed by management and the basis upon which management considers the information to be sufficiently reliable, as well as how deficiencies are remediated. These inquiries assist the auditor to understand whether the entity's internal control system is present and functioning as appropriate to the entity's circumstances considering the nature and complexity of the entity.*

6.3.B. The auditor shall make inquiries of management, and, when applicable, those charged with governance, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

#### *Understanding the Entity and Its Environment*

6.3.1. The auditor shall obtain an understanding of:

- (a) The entity's organizational structure, ownership and governance and business model
- (b) The industry and other external factors affecting the entity.
- (c) How the entity's financial performance is measured.
- (d) The legal and regulatory framework applicable to the entity, and how the entity is complying with that framework.
- (e) 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.
- (f) Agreements or relationships that may result in unrecognized liabilities or future commitments.

*Understanding the entity's business model helps the auditor to understand the entity's objectives and strategy, and to understand the business risks the entity takes and faces. Understanding the entity's business risks assists the auditor in identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. When obtaining an understanding of the entity's business model, the auditor may consider how the entity uses IT.*

*Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.*

*When understanding agreements or relationships that may result in unrecognized liabilities or future commitments the auditor may consider inspecting minutes of meetings and correspondence with legal counsel and inspecting legal expense accounts.*

*Considerations Specific to Public Sector Entities*

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

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

*Understanding the Applicable Financial Reporting Framework*

6.3.3. The auditor shall obtain an understanding of:

- (a) The applicable financial reporting framework including, for accounting estimates, the recognition criteria, measurement bases, and the related presentation and disclosure requirements and how these apply in the context of the nature and circumstances of the entity and its environment.
- (b) The entity's accounting policies and reasons for any changes thereto.

6.3.4. The auditor shall evaluate whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework.

*Understanding the Entity's System of Internal Control*

*In less complex entities, and in particular owner-managed entities, the way in which the entity's system of internal control is designed, implemented and maintained will vary with the entity's size and complexity. When there are no formalized processes or documented policies or procedures, the auditor is still required to obtain an understanding how management, or where appropriate, those charged with governance prevent and detect fraud and error, and use professional judgment to determine the nature and extent of the procedures to obtain the required understanding.*

*Considerations Specific to Public Sector Entities*

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

*Understanding the Entity's Control Environment*

6.3.6. The auditor shall:

- (a) Obtain an understanding of the control environment relevant to the preparation of the financial statements; and

- (b) Evaluate whether the control environment provides an appropriate foundation for the entity's system of internal control considering the nature and complexity of the entity.

*The auditor's understanding may include:*

- *How management, and where appropriate, those charged with governance, oversee the entity, demonstrate integrity and ethical values, for example, through communication to employees regarding expectations for business practices and ethical behavior;*
- *The culture of the entity, including whether management supports honesty and ethical behavior;*
- *The entity's assignment of authority and responsibility;*
- *How the entity attracts, develops, and retains competent individuals; and*
- *When applicable, if and how, owner-managers are actively involved in the business and how this may impact the risks arising from management override of controls due to lack of segregation of duties.*

*The control environment provides an overall foundation for the operation of the entity's system of internal control and deficiencies may undermine the rest of the entity's system of internal control. Although it does not directly prevent or detect and correct misstatements, it may influence the effectiveness of other controls in the system of internal control. The control environment includes the governance and management functions and the attitudes, awareness and actions of those charged with governance and management concerning the entity's system of internal control and its importance in the entity.*

*Because the control environment is foundational to the entity's system of internal control, any deficiencies could have pervasive effects on the preparation of the financial statements. Therefore, the auditor's understanding and evaluation of the control environment affects the auditor's identification and assessment of risks of material misstatement at the financial statement level, and may also affect the identification and assessment of risks of material misstatement at the assertion level, as well as the auditor's responses to the assessed risks.*

*Some or all aspects of the control environment for an LCE may not be applicable or may be less formalized. For example, an LCE may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.*

*Some entities may be dominated by a single individual who may exercise a great deal of discretion. The actions and attitudes of that individual may have a pervasive effect on the culture of the entity, which in turn may have a pervasive effect on the control environment. Domination of management by a single individual in an LCE does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential control deficiency since there is an opportunity for management override of controls.*

## Understanding the Entity's Process to Prepare its Financial Statements

6.3.9. The auditor shall obtain an understanding of the entity's process to prepare its financial statements, including:

- (a) The accounting records and other records that support the classes of transactions, account balances and disclosures in the financial statements;
- (b) The entity's resources used in the financial reporting process;
- (c) For significant classes of transactions, account balances and disclosures:
  - (i) How transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
  - (ii) How events and conditions, other than transactions are identified, processed and disclosed.
- (d) The IT environment relevant to (a) to (c) above.

*The auditor's understanding may be obtained in various ways and may include:*

- *Inquiries of relevant personnel about the procedures used to initiate, record, process and report transactions or about the entity's financial reporting process;*
- *Inspection of policy or process manuals or other documentation of the entity's process to prepare the financial statements;*
- *Observation of the performance of the policies or procedures by entity's personnel; or*
- *Selecting transactions and tracing them through the applicable process in the process to prepare the financial statements (i.e., performing a walk-through).*

*Less complex entities with direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies.*

### *Automated Tools and Techniques*

*The auditor may also use ATT to obtain direct access to, or a digital download from, the databases in the entity's information system that store accounting records of transactions. By applying ATT to this information, the auditor may confirm the understanding obtained about how transactions flow through the information system by tracing journal entries, or other digital records related to a particular transaction, or an entire population of transactions, from initiation in the accounting records through to recording in the general ledger. Analysis of complete or large sets of transactions may also result in the identification of variations from the normal, or expected processing procedures for these transactions, which may result in the identification of risks of material misstatement.*

6.3.12. For accounting estimates and related disclosures for significant classes of transactions, account balances or disclosures, the auditor shall obtain an understanding of how management:

- (a) Identifies, selects and applies relevant methods, assumptions and data that are appropriate in the context of the applicable financial reporting framework, including identification of significant assumptions;
- (b) Understands the degree of estimation uncertainty and addresses such uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements; and

- (c) Reviews the outcomes of previous accounting estimates and responds to the results of that review.

6.3.12A. The auditor shall consider whether the entity’s process to prepare its financial statements, including for accounting estimates, appropriately supports the preparation of financial statements in accordance with the applicable financial reporting framework.

#### Understanding the Services Provided by a Service Organization

6.3.12B. If the entity uses the services of a service organization, the auditor shall obtain an understanding of:

- (a) The nature of the services provided by the service organization and the significance of those services to the entity;
- (b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organization;
- (c) The relevant contractual terms for the activities undertaken by the service organization;
- (d) Controls at the service organization relevant to the entity’s transactions; and
- (e) The controls within the entity applied to transactions processed by the service organization.

*The auditors understanding will inform the auditor about the significance of the controls of the service organization relative to those of the entity, which may also be demonstrated by the degree of interaction between its activities and those of the entity. For example, the service organization may process and account for transactions that are still required to be authorized by the entity, alternatively the entity may rely on such controls being affected at the service organization. The nature and extent of work to be performed by the auditor regarding the services provided by a service organization depend on the nature and significance of those services to the entity and the relevance of those services to the audit.*

#### Understanding the Entity’s Control Activities

6.3.14. The auditor shall obtain an understanding of the entity’s control activities by identifying controls that address risks of material misstatement at the assertion level as set out below. For each control identified in (a)—(e) below, the auditor shall perform procedures, beyond inquiry, to evaluate whether the control is designed effectively and has been implemented:

- (a) Controls that address risks determined to be significant risks;
- (b) Controls over journal entries including to record non-recurring, unusual transactions or adjustments;
- (c) Controls, if any, for which the auditor plans to test the operating effectiveness of controls in determining the nature, timing and extent of substantive testing, including those controls that address risks for which substantive procedures alone are not enough to obtain sufficient appropriate audit evidence;
- (d) If applicable, controls that relate to information processed by a service organization; and
- (e) Controls, if any, related to significant transactions and relationships with related parties and significant transactions and arrangements outside the normal course of business.

*The auditor's required understanding of the entity's control activities involves identifying specific controls, as appropriate in the entity's circumstances, and to evaluate the design and determine whether the controls have been implemented. Evaluating the design and implementation of controls includes the evaluation of whether the control is designed effectively to address the risk of material misstatement at the assertion level, or effectively designed to support the operation of other controls, and the determination whether the control has been implemented.*

*This assists the auditor's understanding of management's approach to addressing certain risks, and therefore provides a basis for the design and performance of further audit procedures responsive to these risks even when the auditor does not plan to test the operating effectiveness of identified controls.*

#### *Journal Entries*

*Controls over journal entries are expected to be identified for all audits because the manner in which an entity incorporates information from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or non-standard, or automated or manual. The extent to which other controls are identified may vary based on the nature of the entity and the auditor's planned approach to further audit procedures. For example, in an audit of an LCE, the entity's information system may not be complex and the auditor may not intend to test the operating effectiveness of controls. Further, the auditor may not have identified any significant risks or any other risks of material misstatement for which it is necessary for the auditor to evaluate the design of controls and determine that they have been implemented. In such an audit, the auditor may determine that there are no identified controls other than the entity's controls over journal entries.*

#### *Related Parties*

*Controls in less complex entities are likely to be less formal and such entities may have no documented processes for dealing with related party relationships and transactions. An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of available relevant documentation.*

6.3.15. For the controls identified in paragraph 6.3.14. the auditor shall:

- (a) Identify the IT applications and other aspects of the IT environment that are subject to risks arising from the use of IT and what those related risks are;
- (b) Identify the entity's general IT controls that respond to those identified risks; and
- (c) By performing procedures beyond inquiry, evaluate whether the identified general IT controls are designed effectively and have been implemented.

*The auditor's understanding of the entity's process to prepare the financial statements (which may be done by performing walk-through procedures) includes the IT environment relevant to the flows of transactions and processing of information. This is because the entity's use of IT applications or other aspects of the IT environment may give rise to risks arising from IT (i.e., the susceptibility of*

*information processing controls to ineffective design or operation, or risks to the integrity of information).*

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

#### *Deficiencies Within the Entity’s System of Internal Control*

6.3.18. The auditor shall determine whether one or more deficiencies have been identified in the entity’s system of internal control and if so, if they individually or in combination, constitute significant deficiencies.

*In understanding the entity’s system of internal control, the auditor may determine that certain of the entity’s policies or procedures are not appropriate to the nature and circumstances of the entity. Such a determination may be an indicator that assists the auditor in identifying deficiencies in internal control. If the auditor has identified one or more deficiencies, the auditor may consider the effect of those deficiencies on the identification and assessment of risks of material misstatement and on the design of further audit procedures.*

*The auditor uses professional judgment in determining whether a deficiency represents a significant deficiency in internal control.*

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

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

6.4.1. The auditor shall identify and assess the risks of material misstatement, due to fraud or error, at:

- (a) The financial statement level. For identified financial statement level risks the auditor shall determine whether such risks affect risks at the assertion level, and evaluate the nature and extent of their pervasive effect on the financial statements; and
- (b) The assertion level for classes of transactions, account balances, and disclosures. For identified assertion level risks the auditor shall assess the inherent risk by assessing the likelihood and magnitude of misstatement.

*The identification of risks of material misstatement is performed before consideration of any related controls (i.e., the inherent risk), and is based on the auditor’s consideration of misstatements that have a reasonable possibility of both occurring (i.e., likelihood), and being material if they were to occur (i.e., magnitude).*

*Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance or disclosure level (e.g., risk of management override of controls).*

*In identifying and assessing the risks of material misstatement, the auditor uses assertions to consider the different types of potential misstatements that may occur. Appendix 4 sets out assertions that may be used by the auditor in considering different types of misstatements at the assertion level.*

*In identifying and assessing risks of material misstatement, the results of the engagement team discussion and any inquiries relating to fraud and going concern are relevant.*

#### *Assessing Inherent Risk*

*The assessed inherent risk for a particular risk of material misstatement at the assertion level represents a judgment within a range, from lower to higher, on the spectrum of inherent risk.*

*In assessing inherent risk, the auditor uses professional judgment in determining the significance of the combination of the likelihood and magnitude of a misstatement on the spectrum of inherent risk. The judgment about where in the range inherent risk is assessed may vary based on the nature, size or circumstances of the entity, and takes into account the assessed likelihood and magnitude of the misstatement.*

*In considering the likelihood of a misstatement, the auditor considers the possibility that a misstatement may occur. In considering the magnitude of a misstatement, the auditor considers the qualitative and quantitative aspects of the possible misstatement (i.e., misstatements in assertions about classes of transactions, account balances or disclosures may be judged to be material due to nature, size or circumstances).*

*When assessing inherent risk, factors relating to the preparation of information required by the applicable financial reporting framework that affect the susceptibility of assertions to misstatement may include:*

- Complexity;*
- Subjectivity;*
- Change;*
- Uncertainty (for accounting estimates this is estimation uncertainty); or*
- Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.*

*The presence of these factors may give rise to higher inherent risk and may be an indication that the ISA for LCE is not appropriate for the audit.*

#### *Considerations Specific to Public Sector Entities*

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

6.4.2A. The auditor shall determine the relevant assertions and the related significant classes of transactions, account balances and disclosures.

*Determining relevant assertions and the significant classes of transactions, account balances and disclosures provides a basis for the identification and assessment of risks of material misstatement.*

6.4.2. The auditor shall determine whether there are types of revenue, revenue transactions or assertions that give rise to risks of material misstatement due to fraud.

*When identifying risks of material misstatement due to fraud, the auditor may consider whether unusual or unexpected relationships have been identified in performing analytical procedures, including those related to revenue accounts.*

6.4.3A. In identifying and assessing risks of material misstatement relating to an accounting estimate and related disclosure at the assertion level, the auditor shall take into account the degree to which the accounting estimate is subject to estimation uncertainty, and the degree to which the following are affected by complexity or subjectivity:

- (a) The selection and application of the method, the assumptions and data used; and
- (b) The selection of management's point estimate and related disclosures.

#### *Significant Risks*

6.4.3B. The auditor shall determine whether any of the assessed risks of material misstatement are, in the auditor's professional judgment, a significant risk.

*The determination of which of the assessed risks of material misstatement are close to the upper end of the spectrum of inherent risk, and are therefore significant risks, is a matter of professional judgment, unless the risk is of a type specified to be treated as a significant risk as set out in paragraphs 6.4.3D. Being close to the upper end of the spectrum of inherent risk will differ from entity to entity, and will not necessarily be the same for an entity period on period. It may depend on the nature and circumstances of the entity for which the risk is being assessed.*

6.4.3C. The auditor shall determine whether the assessed risks associated with related party relationships and transactions, and assessed risks relating to accounting estimates are significant risks.

6.4.3D. The auditor shall treat the following as significant risks:

- (a) Identified fraud risks including:
  - (i) Management override of controls. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and therefore a significant risk;
  - (ii) Risks that the auditor identified as risks of material misstatement in accordance with paragraph 6.4.2.; and
- (b) Identified significant related party transactions outside the entity's normal course of business.

#### *Assessing Control Risk*

6.4.3E. The auditor shall assess control risk if:

- (a) The auditor has determined that substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatement at the assertion level; or
- (b) The auditor otherwise plans to test the operating effectiveness of controls,

otherwise, the risk of material misstatement is the same as the assessment of inherent risk.

*The auditor's plans to test the operating effectiveness of controls is based on the expectation that controls are operating effectively, and this will form the basis of the auditor's assessment of control risk.*

*The initial expectation of the operating effectiveness of controls is based on the auditor's evaluation of the design, and the determination of implementation, of the controls identified in paragraphs 6.3.14. and 6.3.15. (b). Once the auditor has tested the operating effectiveness of the controls in accordance with Part 7, the auditor will be able to confirm the initial expectation about the operating effectiveness of controls. If the controls are not operating effectively as expected, then the auditor will need to revise the control risk assessment.*

*The auditor's assessment of control risk may be performed in different ways depending on preferred audit techniques or methodologies, and may be expressed in different ways. 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.*

*Where routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. This may be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form. In such cases:*

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

#### *Evaluation of the Procedures to Identify and Assess Risks of Material Misstatement and Revision of Risk Assessment*

6.4.3F. The auditor shall evaluate whether the audit evidence obtained from procedures to identify and assess the risks of material misstatement provides an appropriate basis for the identification and assessment of the risks of material misstatement. If not, the auditor shall perform additional procedures until audit evidence has been obtained to provide such a basis. In identifying and assessing the risks of material misstatement, the auditor shall take into account all audit evidence obtained from the procedures to identify and assess the risks of material misstatement, whether corroborative or contradictory to assertions made by management.

6.4.3G. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly.

## 6.5. Evaluation of the Appropriateness of Using the ISA for LCE

6.5.A. Based on the procedures performed to identify and assess the risks of material misstatement, the engagement partner shall evaluate whether the ISA for LCE continues to be appropriate for the nature and circumstances of the entity being audited.

*The auditor's original determination to use the ISA for LCE may change as new information or additional audit evidence is obtained when performing procedures to identify and assess risks of material misstatement. In circumstances where audit evidence, or new information, is obtained, which is inconsistent with the auditor's original determination for using the ISA for LCE, the auditor may need to change the original determination to use the ISA for LCE.*

*[Additional EEM still to be proposed by Task Force]*

## 6.7. Specific Communication Requirements

6.7.1. The auditor shall communicate to management, and where appropriate, those charged with governance, the significant risks identified by the auditor.

## 6.8. Specific Documentation Requirements

Grey highlighted paragraphs will not be discussed during the December 2022 Board meeting. As discussed in the [June 2022 Meeting](#), requirements relating to documentation are one of the targeted areas identified to be explored further. Therefore, general and specific requirements related to documentation will be discussed as one topic in a future meeting (currently planned for March 2023).

*The form and extent of documentation for the identification and assessment of the risks of material misstatement may be simple and relatively brief, and is influenced by:*

- *The nature, size and complexity of the entity and its system of internal control.*
- *Availability of information from the entity.*
- *The audit methodology and technology used in the course of the audit.*

*It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it, but rather apply the principles in Part 2.5 and the matters noted below.*

6.8.1. In addition to the general documentation requirements (Part 2.5.) for an audit of an LCE, the auditor shall include the following in the audit documentation:

- (a) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control;

*Key elements of understanding documented by the auditor include those on which the auditor based the assessment of risks of material misstatement.*

- (b) The names of the identified related parties (including changes from prior period) and the nature of the related party relationships;

- (c) The identified and assessed risks of material misstatement, including risks due to fraud, at the financial statement level and at the assertion level, including significant risks and risks for which

substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for the significant judgments made;

- (d) If applicable, the reasons for the conclusion that there is not a risk of material misstatement due to fraud related to revenue recognition;
- (e) The controls set out in paragraphs 6.3.14. and 6.3.16 and the evaluation whether the control is designed effectively and determination whether the control has been implemented; and
- (f) For accounting estimates, key elements of the auditor's understanding of the accounting estimates, including controls as appropriate, the linkage of the assessed risks of material misstatements to the auditor's further procedures, and any indicators of management bias and how those were addressed.

6.8.2. The auditor shall document the evaluation about whether the ISA for LCE continues to be appropriate for the nature and circumstances of the entity being audited.

**APPENDIX 2**

Changes to this diagram are not tracked from Appendix 2 of ED-ISA for LCE.

**Identifying and Assessing the Risks of Material Misstatement (Part 6)**

