

INTOSAI



*Erkennung und
Beurteilung der
Risiken wesentlicher
Falschangaben durch
die Gewinnung eines
ausreichenden
Verständnisses der
Einheit und ihres
Umfelds*

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Praxisleitfaden¹ zur Internationalen Norm für die Rechnungsprüfung [International Standard on Auditing (ISA)] 315 (überarbeiteter Entwurf) – Erkennung und Beurteilung der Risiken wesentlicher Falschangaben durch die Gewinnung eines ausreichenden Verständnisses der Einheit und ihres Umfelds

Hintergrund

Dieser Praxisleitfaden enthält ergänzende Richtlinien zur Internationalen Norm für die Rechnungsprüfung (ISA) 315 (überarbeiteter Entwurf) - Erkennung und Beurteilung der Risiken wesentlicher Falschangaben durch die Gewinnung eines ausreichenden Verständnisses der Einheit und ihres Umfeldes - für Prüfer im öffentlichen Sektor. Dieser Praxisleitfaden ist gemeinsam mit der ISA zu beachten. Er tritt am gleichen Datum wie die ISA in Kraft.

Beschreibung der ISA

Die ISA 315 (überarbeiteter Entwurf) befasst sich mit der Pflicht des Prüfers, die Risiken wesentlicher Falschangaben in Rechnungsabschlüssen zu erkennen und zu beurteilen und sich zu diesem Zweck ein umfassendes Verständnis der geprüften Einheit und ihres Umfeldes, einschließlich ihrer internen Kontrollen, zu verschaffen.

Die ISA 315 (überarbeiteter Entwurf) gilt für die Prüfung von Rechnungsabschlüssen für Zeiträume ab dem 15. Dezember 2008².

Inhalt des Praxisleitfadens

- P1. Der Praxisleitfaden übernimmt die Überschriften der ISA und enthält zusätzliche Richtlinien für Prüfer im öffentlichen Sektor in Bezug auf:
- a. Allgemeine Erwägungen
 - b. Risikobeurteilung und damit verbundene Prüfungshandlungen
 - c. Das erforderliche Verständnis der Einheit und ihres Umfeldes, einschließlich der internen Kontrollstrukturen der Einheit
 - d. Erkennung und Beurteilung der Risiken wesentlicher Falschangaben

¹ Alle Praxisleitfäden gelten in Verbindung mit den Allgemeinen Anmerkungen in den Leitlinien für die Prüfung der Rechnungsführung (Financial Audit Guidelines).

² Dies ist ein vorläufiges Datum des Inkrafttretens, das endgültige Datum wird jedoch nicht vor dem 15. Dezember 2008 liegen.

- e. Erhebliche Schwachstellen der internen Kontrollen
- f. Besondere Erwägungen für Prüfungen in kleinen Einheiten
- g. Besondere Erwägungen für Prüfer in ORKBn, die als Gerichtshof organisiert sind
- h. Weitere Beispiele für Anhang 2 der ISA 315 (überarbeiteter Entwurf) – Bedingungen und Umstände, die auf Risiken wesentlicher Falschangaben hindeuten können.

Anwendbarkeit der ISA bei Prüfungen im öffentlichen Sektor

- P2. Die ISA 315 (überarbeiteter Entwurf) gilt für Prüfer öffentlicher Einrichtungen in ihrer Funktion als Abschlussprüfer.

Zusätzliche Richtlinien zu Themen des öffentlichen Sektors

Allgemeine Erwägungen

- P3. Die Ziele der Finanzkontrolle im öffentlichen Sektor gehen oft über die reine Feststellung, ob die Rechnungsabschlüsse in allen sachlichen Punkten mit dem jeweils geltenden Regelwerk für die Rechnungslegung (d. h. dem Geltungsbereich der ISA) übereinstimmen, hinaus. Aus dem Prüfungsauftrag oder den Pflichten der Einrichtungen des öffentlichen Sektors, die in Gesetzen, Vorschriften, Ministerialverordnungen, Regierungsvorgaben oder Beschlüssen des Gesetzgebers geregelt sind, können sich zusätzliche Prüfungsziele ergeben. Beispiele dafür sind etwa die Prüfung und Berichterstattung, ob der Prüfer Belege für Verstöße gegen geltende Vorschriften, etwa in Haushaltsführung und Rechenschaftspflicht gefunden hat, und/oder die Berichterstattung über die Wirksamkeit der internen Kontrollen. Diese zusätzlichen Ziele können es erfordern, dass Prüfer im öffentlichen Sektor zusätzliche Risiken wesentlicher Falschangaben beurteilen müssen. Aber auch wenn keine zusätzlichen Prüfungsziele formuliert sind, kann die Öffentlichkeit eine Berichterstattung des Prüfers über eventuelle Verstöße gegen geltende Vorschriften oder über die Wirksamkeit der internen Kontrollen erwarten. Prüfer im öffentlichen Sektor müssen auf solche Erwartungen daher Rücksicht nehmen und bei der Planung und Durchführung der Prüfung all jene Punkte besonders aufmerksam prüfen, die auf Risiken eines Verstoßes gegen geltende Vorschriften oder einer eingeschränkten Wirksamkeit der internen Kontrollen hinweisen können.
- P4. Die ISA 315 (überarbeiteter Entwurf) enthält in Absatz A19, A31, A61, A106 und A126 Anwendungshinweise und weitere Erläuterungen mit besonderer Berücksichtigung der Prüfung in öffentlichen Einrichtungen.

Risikobeurteilung und damit verbundene Prüfungshandlungen

- P5. Bei der Risikobeurteilung und den damit verbundenen Prüfungshandlungen laut Absatz 5 bis 10 der ISA 315 (überarbeiteter Entwurf) müssen Prüfer im

öffentlichen Sektor die weiter gefassten Ziele des Prüfungsauftrags berücksichtigen, die in Absatz 3 weiter oben erläutert sind.

- P6. Neben der Befragung von Geschäftsleitung und anderen Stellen innerhalb der geprüften Einheit im Rahmen der Risikobeurteilung nach Absatz 6(a) und A6 der ISA 315 (überarbeiteter Entwurf) können Prüfer im öffentlichen Sektor auch Informationen aus weiteren Quellen einholen, wie beispielsweise:
- Prüfer, die Wirtschaftlichkeitsprüfungen und andere Prüfungen in dieser Einheit ausgeführt haben
 - Mitarbeiter staatlicher Organe
 - Sammlungen und Protokolle der Legislative.
- P7. Bei der Durchführung analytischer Prüfungshandlungen im Rahmen der Risikobeurteilung laut Absatz 6(b) und A7 bis A8 der ISA 315 (überarbeiteter Entwurf) können Prüfer im öffentlichen Sektor auch weitere Vergleichswerte berücksichtigen wie beispielsweise:
- Ausgaben im Vergleich zu den bewilligten Mitteln
 - Leistungsgewährung, z.B. Kindergeld und Pensionen, im Vergleich zu den demografischen Daten
 - Zinsaufkommen prozentual zur Staatsverschuldung im Vergleich zur Kreditaufnahme der Regierung.
- P8. Bei der Durchführung von Einsichtnahmen und Beobachtungen im Rahmen der Risikobeurteilung laut Absatz 6(c) und A9 der ISA 315 (überarbeiteter Entwurf) können Prüfer im öffentlichen Sektor auch Einsicht in andere Unterlagen nehmen, z. B.:
- von der Geschäftsleitung für die gesetzgebenden Organe erstellte Unterlagen wie Tätigkeitsberichte oder Anträge auf die Gewährung von Finanzmitteln
 - (eidliche) Aussagen von Behördenmitarbeitern
 - Ministerialverordnungen und Verfügungen anderer Organe
 - amtliche Protokolle der Legislative.
- P9. Die Bestimmungen in Absatz 7 der ISA 315 (überarbeiteter Entwurf) über die Annahme und Pflege von Mandanten sind im öffentlichen Sektor oft nicht anwendbar. Prüfer im öffentlichen Sektor haben oft keine Möglichkeit, einen Prüfungsauftrag abzulehnen oder abzubrechen. Sie können sich jedoch auf Informationen, die sie aus diesen oder ähnlichen Handlungen gewinnen, für die Erkennung und Beurteilung der Risiken wesentlicher Falschangaben stützen.
- P10. Bei der Nutzung von Informationen aus früheren Erfahrungen mit der geprüften Einheit und früheren Prüfungen laut Absatz 9 der ISA 315 (überarbeiteter Entwurf) können Prüfer im öffentlichen Sektor auch Berichte über frühere Wirtschaftlichkeitsprüfungen und andere Prüfungsberichte, die die Einheit betreffen, heranziehen.

- P11. Nach Absatz 10 der ISA 315 (überarbeiteter Entwurf) müssen der Auftragsverantwortliche und weitere Kernmitglieder des Auftragssteams die Gefahr wesentlicher Falschangaben in den Rechnungsabschlüssen der Einheit und die Anwendbarkeit der geltenden Regeln der Rechnungslegung auf die Situation und die Gegebenheiten der Einheit untersuchen. Im öffentlichen Sektor kann diese Untersuchung auch die zusätzlichen Ziele und die damit verbundenen Risiken wesentlicher Falschangaben, wie in Absatz 3 weiter oben erläutert, umfassen. In diese Untersuchung können auch Prüfer, die mit der Durchführung von Wirtschaftlichkeitsprüfungen und anderen Prüfungshandlungen in der betroffenen Einheit beauftragt sind, einbezogen werden.

Das erforderliche Verständnis der Einheit und ihres Umfelds, einschließlich der internen Kontrollstrukturen der Einheit

- P12. Um sich das in Absatz 11 der ISA 315 (überarbeiteter Entwurf) geforderte Verständnis der Einheit und ihres Umfeldes zu verschaffen, müssen Prüfer im öffentlichen Sektor die folgenden Besonderheiten berücksichtigen:
- a. Es können außerhalb der geprüften Einheit Entscheidungen im Rahmen politischer Prozesse fallen, die die Tätigkeit der Geschäftsführung beeinflussen. Solche Entscheidungen sind beispielsweise:
 - neue geografische Standorte oder Schließung von Standorten
 - Umstrukturierungen, einschließlich der Verlagerung von Geschäftsfeldern auf andere Einheiten
 - neue Programmbereiche
 - Haushaltskürzungen oder -einschnitte
 - b. Einschlägige regulatorische Faktoren schließen spezifische Gesetze und Vorschriften ein, an die die Einheit möglicherweise gebunden ist, so dass die Auswirkungen eines Verstoßes gegen diese Vorschriften zu berücksichtigen sind.
 - c. Andere externe Faktoren, z. B. das geltende Regelwerk für die Rechnungslegung, können bestimmte Ziele der Berichterstattung beeinflussen.
 - d. Das Verständnis der Geschäftsvorgänge setzt möglicherweise die Kenntnis der von der öffentlichen Einrichtung durchgeführten Aktivitäten, einschließlich einschlägiger Programme, voraus.
 - e. Programmziele und -ausrichtung können politische Faktoren mit enthalten und daher Auswirkungen auf die Risikobeurteilung haben.
 - f. Der Begriff des Inhabers wie in privaten Wirtschaftseinheiten ist meist nicht auf den öffentlichen Sektor übertragbar. Im öffentlichen Sektor stehen dafür die für die Führung / Überwachung verantwortlichen Personen in ihrer Rolle als Vertreter der Bürger im Mittelpunkt.
 - g. Die Führungs- und Leitungsstrukturen werden durch die rechtliche Struktur der Einheit beeinflusst, zum Beispiel davon, ob es sich um ein Ministerium, eine Dienststelle, eine Behörde oder ein anderes Organ handelt.
 - h. Die Annahme der Geschäftsleitung über die Fortführung der Betriebstätigkeit ist hier möglicherweise nicht von Belang.

- P13. Absatz 11 der ISA 315 (überarbeiteter Entwurf) bezieht sich auf die Bewertung und Prüfung der Wirtschaftlichkeit. Prüfer im öffentlichen Sektor können in diese Prüfung auch rechnungsunabhängige Informationen wie etwa die Erreichung von Zielen einbeziehen (zum Beispiel die Zahl der Personen, denen mit einem Programm geholfen werden konnte). Ferner gibt es im öffentlichen Sektor auch externe Parteien, die die Wirtschaftlichkeit bewerten und prüfen können. Dies sind beispielsweise die gesetzgebenden Organe, andere öffentliche Einrichtungen und die Medien.
- P14. Um sich das in Absatz 12 der ISA 315 (überarbeiteter Entwurf) geforderte Verständnis der internen Kontrollstrukturen der Einheit zu verschaffen, müssen Prüfer im öffentlichen Sektor folgende Besonderheiten berücksichtigen:
- a. Eventuelle zusätzliche Berichtspflichten über die internen Kontrollen
 - b. Kontrollmechanismen, die die Einhaltung der geltenden Vorschriften sicherstellen sollen
 - c. Kontrollen zur Überwachung der wirtschaftlichen Haushaltsführung
 - d. Kontrollen der Übertragung von Haushaltsmitteln an andere Einheiten
 - e. Kontrollen geheimer Daten zur nationalen Sicherheit und sensible Personendaten, zum Beispiel steuer- und gesundheitsbezogene Daten
 - f. Organe außerhalb der Einheit können Aufsichts- und andere Kontrollaufgaben ausüben, beispielsweise in folgenden Bereichen:
 - Beachtung der Beschaffungsgrundsätze
 - Erfüllung des Haushalts
 - andere Bereiche, die in Gesetzen oder im Prüfungsauftrag festgelegt sind
 - Rechenschaftspflicht der Geschäftsleitung.
- P15. Um sich das laut Absatz 15 der ISA 315 (überarbeiteter Entwurf) verlangte Verständnis der Verfahren zur Risikobeurteilung der Einheit zu verschaffen, müssen Prüfer im öffentlichen Sektor berücksichtigen, dass diese Verfahren möglicherweise in Gesetzen oder Richtlinien festgelegt oder von anderen öffentlichen Einrichtungen durchgeführt werden können.

Erkennung und Beurteilung der Risiken wesentlicher Falschangaben

- P16. Bei der Erkennung und Beurteilung von Risiken wesentlicher Falschangaben laut Absatz 24 und 25 der ISA 315 (überarbeiteter Entwurf) müssen Prüfer im öffentlichen Sektor u.U. weitere Faktoren berücksichtigen, wie beispielsweise:
- die Tatsache, dass für die Erkennung und Beurteilung von Risiken in den Rechnungsabschlüssen und Aussagen auch Themen wie das politische Klima, das öffentliche Interesse und die Sensibilität von Programmen beachtet werden müssen;
 - die Tatsache, dass bloße Aussagen über Geschäftsvorgänge, Kontosalde und die Offenlegung laut Absatz A106 der ISA 315 (überarbeiteter Entwurf) dahingehend erweitert werden können, dass auch Aussagen zu

der Frage eingeholt werden, ob Geschäfte und Vorgänge unter Einhaltung der geltenden Gesetze und Vorschriften ausgeführt wurden.

P17. Bei der Beurteilung, welche Risiken in den Rechnungsabschlüssen oder Aussagen als signifikant laut Absatz 27 der ISA 315 (überarbeiteter Entwurf) einzustufen sind, müssen Prüfer im öffentlichen Sektor u.U. auch folgende Elemente bewerten:

- a. Komplexität und Inkonsistenz bestehender Vorschriften und Richtlinien
- b. Verstöße gegen geltende Vorschriften
- c. Haushaltskontrollen und Haushaltserfüllung.

Der Haushalt ist im öffentlichen Sektor ein wichtiges Regulierungsinstrument, das vom Gesetzgeber vorgeschrieben wird. Für Prüfer im öffentlichen Sektor ist daher der gesamte Haushaltsprozess meist eine wichtige Grundlage zum Verständnis der geprüften Einheit und ihres Umfelds ebenso wie zur Risikobeurteilung, also viel mehr als ein reines Geschäftsführungsinstrument.

Erhebliche Schwachstellen der internen Kontrollen

P18. Bei der Mitteilung erheblicher Schwächen der internen Kontrollstrukturen, die laut Absatz 32 der ISA 315 (überarbeiteter Entwurf) verlangt wird, müssen Prüfer im öffentlichen Sektor berücksichtigen, dass Prüfungsberichte über bestimmte öffentliche Einrichtungen auch Dritten, beispielsweise der Öffentlichkeit, zugänglich gemacht werden können.

Besondere Erwägungen für Prüfungen in kleineren Einheiten

P19. Die Richtlinien in Absatz A72 bis A74 und A89 bis A90 der ISA 315 (überarbeiteter Entwurf) sind für kleine Einheiten im öffentlichen Sektor u.U. nicht von Belang. Zwar kann das Kontrollumfeld in kleineren öffentlichen Einrichtungen anders als in einer größeren öffentlichen Einrichtung aufgebaut sein, dennoch können beide in eine übergreifende staatliche Kontrollstruktur eingebunden sein. Somit können auch Kontrollen außerhalb der geprüften Einheit stattfinden.

Besondere Erwägungen für Prüfer in ORKBn, die als Gerichtshof organisiert sind

P20. Für Prüfer einer als Gerichtshof organisierten ORKB kann die enge Zusammenarbeit mit Strafverfolgern und Polizei bei der Ahndung betrügerischer Handlungen erforderlich sein. Daher können sie bei Bedarf auch Informationen von Strafverfolgungsbehörden und der Polizei erhalten, die zum Verständnis der Einheit und ihres Umfeldes sowie für die Risikobeurteilung wesentlich sind.

Anhang 1

Weitere Beispiele für Anhang 2 der ISA 315 (überarbeiteter Entwurf) „Bedingungen und Umstände, die auf Risiken wesentlicher Falschangaben hinweisen können“ (Conditions and Events that may Indicate Risks of Material Misstatement)

Die folgenden Beispiele stehen für Bedingungen und Umstände, die auf Risiken wesentlicher Falschangaben in Einheiten des öffentlichen Sektors hinweisen können:

- Überziehung des Haushalts auf Grund schwacher Kontrollen
- Privatisierungen
- Neue Programme
- Größere Änderungen an vorhandenen Programmen
- Neue Finanzierungsquellen
- Neue Gesetze und Vorschriften oder Richtlinien
- Politische Entscheidungen, beispielsweise über die Verlegung von Geschäftsfeldern
- Programme ohne ausreichende Mittelzuwendung und -bereitstellung
- Erhöhte öffentliche Ausgaben
- Beschaffung von Gütern und Dienstleistungen in bestimmten Branchen, zum Beispiel in der Rüstung
- Outsourcing staatlicher Aufgaben
- Tätigkeiten, zu denen besondere Ermittlungen stattfinden
- Änderungen in der politischen Führung
- Anzeichen für Verschwendung oder Missbrauch
- Unnatürlich hohe Erwartungen an die Erfüllung des Haushalts
- Partnerschaften zwischen öffentlichen und privaten Trägern

Redrafted International Standard on Auditing

ISA 315, Identifying and Assessing
the Risks of Material Misstatement
Through Understanding the Entity
and Its Environment



**International Federation
of Accountants**

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**INTERNATIONAL STANDARD ON AUDITING 315
(REDRAFTED)**

**IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT
THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT**

(Effective for audits of financial statements for periods beginning on or after December 15, 2008)*

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International Standard on Auditing (ISA) 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of ISAs.

* See footnote 1.

Introduction

Scope of this ISA

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

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2008.¹

Objective

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

Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:
 - (a) Assertions – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.
 - (b) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
 - (c) Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.
 - (d) Risk assessment procedures – The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
 - (e) Significant risk – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Requirements

Risk Assessment Procedures and Related Activities

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk

¹ This effective date is provisional but it will not be earlier than December 15, 2008.

assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1-A5)

6. The risk assessment procedures shall include the following:
 - (a) Inquiries of management, and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6)
 - (b) Analytical procedures. (Ref: Para. A7-A8)
 - (c) Observation and inspection. (Ref: Para. A9)
7. The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.
8. Where the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.
9. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A10-A11)
10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A12-A14)

The Required Understanding of the Entity and its Environment, Including the Entity's Internal Control

The Entity and Its Environment

11. The auditor shall obtain an understanding of the following:
 - (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A15-A20)
 - (b) The nature of the entity, including:
 - (i) Its operations;
 - (ii) Its ownership and governance structures;
 - (iii) The types of investments that the entity is making and plans to make; and
 - (iv) The way that the entity is structured and how it is financed,
 to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A21-A23)
 - (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A24)

- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A25-A31)
- (e) The measurement and review of the entity's financial performance. (Ref: Para. A32-A37)

The Entity's Internal Control

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A38-A61)

Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A62-A64)

Components of Internal Control

Control environment

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
 - (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by control environment weaknesses. (Ref: Para. A65-A74)

The entity's risk assessment process

15. The auditor shall obtain an understanding of whether the entity has a process for:
- (a) Identifying business risks relevant to financial reporting objectives;
 - (b) Estimating the significance of the risks;
 - (c) Assessing the likelihood of their occurrence; and
 - (d) Deciding about actions to address those risks. (Ref: Para. A75)
16. If the entity has established such a process (referred to hereafter as the 'entity's risk assessment process'), the auditor shall obtain an understanding of it, and the results thereof. Where the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or if there is a material weakness in the entity's risk assessment process.
17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a

documented risk assessment process is appropriate in the circumstances, or represents a material weakness in the entity's internal control. (Ref: Para. A76)

The information system, including the related business processes, relevant to financial reporting, and communication

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:
 - (a) The classes of transactions in the entity's operations that are significant to the financial statements;
 - (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
 - (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
 - (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
 - (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and
 - (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A77-A81)
19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:
 - (a) Communications between management and those charged with governance; and
 - (b) External communications, such as those with regulatory authorities. (Ref: Para. A82-A83)

Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A84-A90)
21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A91-A93)

Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates corrective actions to its controls. (Ref: Para. A94-A96)

23. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A97)

Identifying and Assessing the Risks of Material Misstatement

24. The auditor shall identify and assess the risks of material misstatement at:
- (a) The financial statement level; and (Ref: Para. A98-A101)
 - (b) The assertion level for classes of transactions, account balances, and disclosures, (Ref: Para. A102-A106)
- to provide a basis for designing and performing further audit procedures.
25. For this purpose, the auditor shall:
- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; Ref: Para. A107-A108)
 - (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
 - (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A109-A111)
 - (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risks that Require Special Audit Consideration

26. As part of the risk assessment as described in paragraph 24, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.
27. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:
- (a) Whether the risk is a risk of fraud;
 - (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
 - (c) The complexity of transactions;
 - (d) Whether the risk involves significant transactions with related parties;
 - (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
 - (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A112-A116)
28. When the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A117-A119)

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

29. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A120-A122)

Revision of Risk Assessment

30. 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. (Ref: Para. A123)

Material Weakness in Internal Control

31. The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the design, implementation or maintenance of internal control. (Ref: Para. A124-A125)
32. The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility, and, as required by ISA 260 (Revised), "Communication with Those Charged with Governance,"¹ with those charged with governance (unless all of those charged with governance are involved in managing the entity). (Ref: Para. A126)

Documentation

33. The auditor shall document:
- (a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;
 - (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14-23; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
 - (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 24; and
 - (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 26-29. (Ref: Para. A127-A130)

* * *

Application and Other Explanatory Material

¹ Close off document approved May 2006.

Risk Assessment Procedures and Related Activities (Ref: Para. 5)

- A1. Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:
- Assessing risks of material misstatement of the financial statements;
 - Establishing materiality and evaluating whether the judgment about materiality remains appropriate as the audit progresses;
 - Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
 - Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
 - Developing expectations for use when performing analytical procedures;
 - Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
 - Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.
- A2. Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.
- A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this ISA. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.
- A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this ISA. However, the significance of fraud is such that further requirements and guidance are included in ISA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.
- A5. Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11-23), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include:
- Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.

- Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.

Inquiries of Management and Others Within the Entity (Ref: Para. 6(a))

- A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:
- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
 - Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
 - Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
 - Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
 - Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

Analytical Procedures (Ref: Para. 6(b))

- A7. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- A8. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures. ISA 520, "Analytical Procedures," establishes requirements and provides guidance on the use of analytical procedures.

Observation and Inspection (Ref: Para. 6(c))

- A9. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:
- The entity's operations.
 - Documents (such as business plans and strategies), records, and internal control manuals.

- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- The entity's premises and plant facilities.

Information Obtained in Prior Periods (Ref: Para. 9)

- A10. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:
- Past misstatements and whether they were corrected on a timely basis.
 - The nature of the entity and its environment, and the entity's internal control.
 - Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.
- A11. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

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

- A12. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:
- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
 - Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
 - Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures.
 - Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

ISA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.

- A13. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, specialists and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered

necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Considerations Specific to Smaller Entities

A14. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

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

Industry Factors

A15. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include:

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

A16. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience, as required by ISA 220, "Quality Control for Audits of Historical Financial Information."

Regulatory Factors

A17. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include:

- Accounting principles and industry specific practices.
- Regulatory framework for a regulated industry.
- Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

- A18. ISA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements,” includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry.

Considerations specific to public sector entities

A19. For the audits of public sector entities, in addition to legislation or regulations, there may be ministerial directives, government policy requirements and resolutions of the legislature that affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

Other External Factors

A20. Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

Nature of the Entity (Ref. Para.11(b))

A21. An understanding of the nature of an entity enables the auditor to understand such matters as:

- Whether the entity has a complex structure, for example with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately.
- The ownership, and relations between owners and other people or entities. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately. ISA 550, "Related Parties," establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

A22. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- *Business operations* – such as:
 - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
 - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
 - Alliances, joint ventures, and outsourcing activities.
 - Geographic dispersion and industry segmentation.
 - Location of production facilities, warehouses, and offices, and location and quantities of inventories.
 - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
 - Research and development activities and expenditures.
 - Transactions with related parties.
- *Investments and investment activities* – such as:
 - Planned or recently executed acquisitions or divestitures.
 - Investments and dispositions of securities and loans.

- Capital investment activities.
- Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
- *Financing and financing activities* – such as:
 - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.
 - Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
 - Beneficial owners (local, foreign, business reputation and experience) and related parties.
 - Use of derivative financial instruments.
- *Financial reporting* – such as:
 - Accounting principles and industry specific practices, including industry-specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).
 - Revenue recognition practices.
 - Accounting for fair values.
 - Foreign currency assets, liabilities and transactions.
 - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A23. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

The Entity's Selection and Application of Accounting Policies (Ref: Para.11(c))

- A24. An understanding of the entity's selection and application of accounting policies may encompass such matters as:
- The methods the entity uses to account for significant and unusual transactions.
 - The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
 - Changes in the entity's accounting policies.
 - Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.

Objectives and Strategies and Related Business Risks (Ref: Para.11(d))

- A25. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.
- A26. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognize

the need for change may also give rise to business risk. Business risk may arise, for example, from:

- The development of new products or services that may fail;
- A market which, even if successfully developed, is inadequate to support a product or service; or
- Flaws in a product or service that may result in liabilities and reputational risk.

A27. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

A28. Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A29. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in Appendix 2.

A30. Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A75-A76.

Considerations Specific to Public Sector Entities

A31. For the audits of public sector entities, “management objectives” may be influenced by concerns regarding public accountability and may include objectives which have their source in legislation, regulations, government ordinances, and ministerial directives.

Measurement and Review of the Entity’s Financial Performance (Ref: Para.11(e))

A32. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity’s performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud – See ISA 240 for requirements and guidance in relation to the risks of fraud.

A33. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A94-A97), though their purposes may overlap:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.

A34. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- Period-on-period financial performance analyses.
- Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.
- Employee performance measures and incentive compensation policies.
- Comparisons of an entity’s performance with that of competitors.

A35. External parties may also measure and review the entity’s financial performance. For example, external information such as analysts’ reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.

A36. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example,

performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations Specific to Smaller Entities

A37. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

The Entity's Internal Control

A38. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing, and extent of further audit procedures.

A39. The following application material on internal control is presented in four sections, as follows:

- General Nature and Characteristics of Internal Control.
- Controls Relevant to the Audit.
- Nature and Extent of the Understanding of Relevant Controls.
- Components of Internal Control.

General Nature and Characteristics of Internal Control (Ref: Para. 12)

Purpose of Internal Control

A40. Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

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

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Considerations specific to smaller entities

A41. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

Limitations of Internal Control

A42. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

A43. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

A44. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

Considerations specific to smaller entities

A45. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager¹ may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

¹ Owner-manager refers to the proprietor of an entity who is involved in running the entity on a day-to-day basis.

- A46. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Division of Internal Control into Components

- A47. The division of internal control into the following five components, for purposes of the ISAs, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

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

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

- A48. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A65-A97 below. Appendix 1 provides further explanation of these components of internal control.

Characteristics of Manual and Automated Elements of Internal Control Relevant to the Auditor's Risk Assessment

- A49. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.
- A50. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

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

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

- A51. Generally, IT benefits an entity's internal control by enabling an entity to:
- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
 - Enhance the timeliness, availability, and accuracy of information;
 - Facilitate the additional analysis of information;
 - Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
 - Reduce the risk that controls will be circumvented; and
 - Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.
- A52. IT also poses specific risks to an entity's internal control, including, for example:
- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
 - Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
 - The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
 - Unauthorized changes to data in master files.
 - Unauthorized changes to systems or programs.
 - Failure to make necessary changes to systems or programs.
 - Inappropriate manual intervention.
 - Potential loss of data or inability to access data as required.
- A53. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:
- Large, unusual or non-recurring transactions.
 - Circumstances where errors are difficult to define, anticipate or predict.
 - In changing circumstances that require a control response outside the scope of an existing automated control.
 - In monitoring the effectiveness of automated controls.
- A54. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:
- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.

- Control activities where the specific ways to perform the control can be adequately designed and automated.

A55. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Controls Relevant to the Audit

A56. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

A57. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business, including its organization and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

A58. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

A59. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting.

A60. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

Considerations Specific to Public Sector Entities

A61. Public sector auditors often have additional responsibilities with respect to internal control, for example to report on compliance with an established Code of Practice. Public sector auditors can also have responsibilities to report on the compliance with legislative authorities. As a result, their review of internal control may be broader and more detailed.

Nature and Extent of the Understanding of Relevant Controls (Ref: Para. 13)

A62. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a material weakness in the entity's internal control.

A63. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

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

A64. Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A51), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in ISA 330, "The Auditor's Responses to Assessed Risks."

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

A65. 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 internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A66. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- (a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- (b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

- (c) *Participation by those charged with governance* – Attributes of those charged with governance such as:
- Their independence from management.
 - Their experience and stature.
 - The extent of their involvement and the information they receive, and the scrutiny of activities.
 - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- (d) *Management’s philosophy and operating style* – Characteristics such as management’s:
- Approach to taking and managing business risks.
 - Attitudes and actions toward financial reporting.
 - Attitudes toward information processing and accounting functions and personnel.
- (e) *Organizational structure* – The framework within which an entity’s activities for achieving its objectives are planned, executed, controlled, and reviewed.
- (f) *Assignment of authority and responsibility* – Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
- (g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counseling, promotion, compensation, and remedial actions.

Audit Evidence for Elements of the Control Environment

A67. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

Effect of the Control Environment on the Assessment of the Risks of Material Misstatement

A68. Some elements of an entity’s control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity’s control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

- Their independence from management and their ability to evaluate the actions of management.
- Whether they understand the entity’s business transactions.

- The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework.
- A69. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.
- A70. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, weaknesses in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in ISA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.
- A71. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

Considerations Specific to Smaller Entities

- A72. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small business; it may, however, increase other risks, for example, the risk of override of controls.
- A73. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.
- A74. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

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

- A75. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

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

A76. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

Components of Internal Control—The Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

The Information System, Including Related Business Processes, Relevant to Financial Reporting (Ref: Para. 18)

A77. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

- Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;
- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

Journal entries

A78. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A79. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

Related business processes

A80. An entity's business processes are the activities designed to:

- Develop, purchase, produce, sell and distribute an entity's products and services;

- Ensure compliance with laws and regulations; and
- Record information, including accounting and financial reporting information.

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

Considerations specific to smaller entities

A81. Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's systems and processes may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

Communication (Ref: Para. 19)

A82. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A83. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

Components of Internal Control—Control Activities (Ref: Para. 20)

A84. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:

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

A85. Control activities that are relevant to the audit are:

- Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 28 and 29, respectively; or
 - Those that are considered to be relevant in the judgment of the auditor.
- A86. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.
- A87. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.
- A88. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

Considerations Specific to Smaller Entities

- A89. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.
- A90. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Risks Arising From IT (Ref: Para. 21)

- A91. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT-controls and application controls.
- A92. General IT-controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:
- Data center and network operations.
 - System software acquisition, change and maintenance.
 - Program change.
 - Access security.
 - Application system acquisition, development, and maintenance.

They are generally implemented to deal with the risks referred to in paragraph A52 above.

A93. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

Components of Internal Control—Monitoring of Controls (Ref: Para. 22)

A94. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary corrective actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A95. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. ISA 610, "Considering the Work of Internal Audit" establishes requirements and provides guidance on the auditor's consideration of the work of internal auditing. Management's monitoring activities may also include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations Specific to Smaller Entities

A96. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the control.

Sources of Information (Ref: Para. 23)

A97. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

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

is required as part of the auditor's understanding of the entity's monitoring activities as a component of internal control.

Identifying and Assessing the Risks of Material Misstatement

Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 24 (a))

A98. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may

increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

- A99. Risks at the financial statement level may derive in particular from a weak control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, weaknesses such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.
- A100. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:
- Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
 - Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.
- A101. ISA 705, "Modifications to the Opinion in the Independent Auditor's Report" establishes requirements and provides guidance in determining whether there is a need for the auditor to consider a qualification or disclaimer of opinion or, as may be required in some cases, to withdraw from the engagement where this is legally possible.

Assessment of Risks of Material Misstatement at the Assertion Level (Ref: Para. 24(b))

- A102. Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The Use of Assertions

- A103. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.
- A104. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:
- (a) Assertions about classes of transactions and events for the period under audit:
 - (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
 - (ii) Completeness—all transactions and events that should have been recorded have been recorded.
 - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
 - (iv) Cutoff—transactions and events have been recorded in the correct accounting period.

- (v) Classification—transactions and events have been recorded in the proper accounts.
- (b) Assertions about account balances at the period end:
 - (i) Existence—assets, liabilities, and equity interests exist.
 - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.
 - (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
- (c) Assertions about presentation and disclosure:
 - (i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
 - (ii) Completeness—all disclosures that should have been included in the financial statements have been included.
 - (iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
 - (iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

A105. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

Considerations specific to public sector entities

A106. When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A104, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

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

A107. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

A108. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement.

Relating Controls to Assertions (Ref: Para. 25(c))

A109. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A110. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

A111. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks

Identifying Significant Risks (Ref: Para. 27)

A112. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A113. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.

- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

A114. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

A115. ISA 330 describes the consequences for further audit procedures of identifying a risk as significant.

Significant risks relating to the risks of material misstatement due to fraud

A116. ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.

Understanding Controls Related to Significant Risks (Ref: Para. 28)

A117. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

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

A118. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A119. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. This may indicate a material weakness in the entity's internal control.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para. 29)

A120. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A121. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation

to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

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

A122. The consequences for further audit procedures of identifying such risks are described in ISA 330.

Revision of Risk Assessment (Ref: Para. 30)

A123. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. See ISA 330 for further guidance.

Material Weakness in Internal Control (Ref: Para. 31)

A124. The types of material weaknesses in internal control that the auditor may identify when obtaining an understanding of the entity and its internal controls may include:

- Risks of material misstatement that the auditor identifies and which the entity has not controlled, or for which the relevant control is inadequate.
- A weakness in the entity's risk assessment process that the auditor identifies as material, or the absence of a risk assessment process in those cases where it would be appropriate for one to have been established.

A125. Material weaknesses may also be identified in controls that prevent, or detect and correct, error, or those to prevent and detect fraud.

Considerations Specific to Public Sector Entities (Ref: Para. 32)

A126. In the audit of public sector entities, there may be additional communication or reporting requirements for public sector auditors. For example, internal control weaknesses may have to be reported to the legislature or other governing body.

Documentation (Ref: Para. 33)

A127. The manner in which the requirements of paragraph 33 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan that is required by ISA 300, "Planning an Audit of Financial Statements." Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures (see ISA 330). The form and extent of the documentation is influenced by the nature, size and complexity of the entity and

its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

- A128. For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.
- A129. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of ISA 230, "Audit Documentation," are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.
- A130. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

Appendix 1

(Ref: Paras. 4(c), 14-23 and A65-A97)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14-23 and A65-A97, as they relate to a financial statement audit.

Control Environment

2. The control environment encompasses the following elements:
 - (a) *Communication and enforcement of integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
 - (b) *Commitment to competence.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.
 - (c) *Participation by those charged with governance.* An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.
 - (d) *Management's philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
 - (e) *Organizational structure.* Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.
 - (f) *Assignment of authority and responsibility.* The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.
 - (g) *Human resource policies and practices.* Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on

educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity’s commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity’s commitment to the advancement of qualified personnel to higher levels of responsibility.

Entity’s Risk Assessment Process

3. For financial reporting purposes, the entity’s risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity’s applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity’s risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.
4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity’s ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:
 - *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
 - *New personnel.* New personnel may have a different focus on or understanding of internal control.
 - *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
 - *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
 - *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
 - *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
 - *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
 - *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
 - *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Information System, Including the Related Business Processes, Relevant To Financial Reporting, And Communication

5. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).
6. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:
 - Identify and record all valid transactions.
 - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
 - Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
 - Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
 - Present properly the transactions and related disclosures in the financial statements.
7. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Control Activities

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:
 - *Performance reviews.* These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
 - *Information processing.* The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
 - *Physical controls.* Controls that encompass:

- The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
- The authorization for access to computer programs and data files.
- The periodic counting and comparison with amounts shown on control records (for example comparing the results of cash, security and inventory counts with accounting records).

The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.

- *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.
10. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, non-routine transactions such as major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

Monitoring of Controls

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.
12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and weaknesses and recommendations for improving internal control.
13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Appendix 2

(Ref: Para. A29 and A108)

Conditions and Events that May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.
- Use of off-balance-sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Weaknesses in internal control, especially those not addressed by management.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.

- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including accounting estimates.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.



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