

REDRAFTED ISA 315
UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT
AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT
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Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's assessment of the risks of material misstatement in the financial statements. It sets out the objective to be achieved by the auditor, and the requirements that are to be complied with in achieving that objective. The requirements are to be understood and applied in the context of the application material that provides guidance on their application.

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 200x.

Objective to Be Achieved

3. The objective of the auditor in following the requirements of this ISA is to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error.

The purpose of making such an assessment is to enable the auditor to design and perform further audit procedures to reduce audit risk to an acceptably low level, as required by ISA 200, "Objective and General Principles Governing an Audit of Financial Statements."

Definitions

4. The following terms and related meanings are introduced in this ISA:
 - (a) 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.
 - (b) Internal control – The process designed and effected 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. Internal control consists of the following components: (i) the control environment; (ii) the entity's risk assessment process; (iii) the information system, including the related business processes, relevant to financial reporting, and communication; (iv) control activities; and (v) monitoring controls. The term "controls" refers to one or more of the components, or any aspect thereof.
 - (c) Material weakness – A weakness in internal control that could have a material effect on the financial statements. A material weakness includes risks of material misstatement that the auditor identifies and which the entity has either not controlled, or for which the relevant control is inadequate, and a weakness in the entity's risk assessment process that the auditor identifies as material.
 - (d) Owner-manager – The proprietor of an entity who is involved in the running of the entity on a day-to-day basis.

- (e) Risk assessment procedures – The audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement whether due to fraud or error at the financial statement and assertion levels.
- (f) Significant risk – An identified risk of material misstatement that is determined to be, in the auditor's judgment, a risk that requires special audit consideration.

Requirements

Risk Assessment Procedures and Activities

5. The objective of the following risk assessment procedures and activities is to obtain a satisfactory basis, supported by audit evidence, for making a reliable assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures and activities by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1-A6)
6. The auditor should perform risk assessment procedures and activities that include the following:
 - (a) Inquiries of management and others within the entity who may have information that helps in identifying risks of material misstatement due to fraud or error. (Ref: Para. A7)
 - (b) Analytical procedures, including the consideration of the results of such analytical procedures along with other information gathered in identifying the risks of material misstatements due to fraud or error. (Ref: Para. A8-A9)
 - (c) Observation and inspection, including tracing transactions through the information systems relevant to financial reporting as considered appropriate. (Ref: Para. A10)
 - (d) Discussion with members of the engagement team about the susceptibility of the entity's financial statements to material misstatements due to fraud or error (with a particular emphasis on fraud), and application of the applicable financial reporting framework to the entity's facts and circumstances.

The discussion should involve at least the key members of the engagement team but not all of the members of the engagement team necessarily need to be informed of all of the decisions reached in the discussion. However, the engagement partner should consider which matters are to be communicated to members of the engagement team not involved in the discussion.

Throughout the audit, engagement team members should continue to communicate and share information obtained that may affect the assessment of risks of material misstatement due to fraud or error or the audit procedures performed to address these risks. (Ref: Para. A11-A14, and A114)

7. The auditor should consider whether information obtained from the auditor's client acceptance or continuance process or from the performance of other audit procedures, or experience gained on other engagements performed for the entity, may be helpful in identifying risks of material misstatement. (Ref: Para. A15)

8. For continuing engagements, some of the information used to gain an understanding of the entity may be obtained from the auditor's previous experience with the entity and audit procedures performed in previous audits. When the auditor intends to use such information, the auditor should determine whether changes have occurred that may affect its relevance in the current audit. (Ref: Para. A16-A17)

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

9. The objective of the following requirements is to obtain an understanding of those aspects of the entity and its environment, including its internal control, that are generally relevant to the identification and assessment of risks of material misstatement.

THE ENTITY AND ITS ENVIRONMENT

10. The auditor should obtain an understanding of the following:

- (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework and any local regulations that specify certain financial reporting requirements for the industry in which the entity operates. (Ref: Para. A18-A23)
- (b) The nature of the entity, for example:
 - The entity's operations.
 - The entity's ownership and governance.
 - The types of investments that the entity is making and plans to make.
 - The way that the entity is structured and how it is financed.

An understanding of the nature of an entity enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A24-A26)

- (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should consider 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. A27)
- (d) The entity's objectives and strategies, and the related business risks that may result in a material misstatement of the financial statements. An understanding of business risks 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 as not all business risks give rise to risks of material misstatement. (Ref: Para. A28-A32, and A115)
- (e) How management and others measure and review the entity's financial performance, in order to understand business performance. An understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance

targets result in management actions that may have increased the risks of material misstatement, and in particular those due to fraud. (Ref: Para. A33-A37, and A116)

THE ENTITY'S INTERNAL CONTROL

11. The auditor should obtain an understanding of internal control relevant to the audit. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement due to fraud or error, and in designing the nature, timing, and extent of further audit procedures. (Ref: Para. A38-A60, and A117 – A119)
12. In order to understand a control, the auditor should evaluate its design and determine whether it has been implemented. 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. The auditor should do so by performing procedures in addition to inquiry of the entity's personnel, as inquiry alone is not sufficient for such purposes.
13. In understanding the entity's internal control relevant to the audit, the auditor should obtain an understanding of the following components of internal control, which are those relevant to the audit:
 - (a) The control environment, which sets the tone of an organization and is the foundation for effective internal control, providing discipline and structure. The understanding should include how management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior, and whether the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and are not undermined by control environment weaknesses.

For this purpose, the auditor should understand the following elements of the control environment and how they have been incorporated into the entity's processes:

- (i) Communication and enforcement of integrity and ethical values.
 - (ii) Commitment to competence.
 - (iii) Participation by those charged with governance.
 - (iv) Management's philosophy and operating style.
 - (v) Organizational structure.
 - (vi) Assignment of authority and responsibility.
 - (vii) Human resource policies and practices. (Ref: Para. A61-A74, and A120-A121)
- (b) The entity's process, whether formal or informal, for:
 - identifying business risks relevant to financial reporting objectives, including risks of fraud in the entity;

- estimating the significance of the risks;
- assessing the likelihood of their occurrence; and
- deciding about actions to address those risks;

and the results thereof. This process is described as the “entity’s risk assessment process” and forms the basis for how management determines the risks to be managed. If the entity’s risk assessment process is appropriate to the circumstances, it assists the auditor in identifying risks of material misstatement.

In obtaining this understanding, the auditor should inquire about business risks that management has identified and consider whether they may result in material misstatement. Even if the entity has no formal process, it does not mean that management has not identified and considered the implication of business risks; accordingly, inquiry about identified risks is still relevant in such circumstances. (Ref: Para. A75-A77, and A122)

- (c) The information system, including the related business processes, relevant to financial reporting. The auditor’s understanding should include the following areas:
- The classes of transactions in the entity’s operations that are significant to the financial statements.
 - The procedures, within both 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.
 - The related accounting records supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing, correcting as necessary, transferring to the general ledger and reporting transactions.
 - How the information system captures events and conditions, other than classes of transactions, that are significant to the financial statements.
 - The financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures.

The auditor should consider risks of material misstatement associated with inappropriate override of controls over journal entries and the controls surrounding non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A78-A83, and A123)

- (d) How the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including communications between management and those charged with governance as well as external communications such as those with regulatory authorities. (Ref: Para. A84 and A124)
- (e) Control activities relevant to the audit, i.e., those the auditor considers it necessary to understand in order to assess the risks of material misstatement due to fraud or error at the assertion level and to design further audit procedures responsive to assessed risks.

In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from information technology (IT) or manual systems. (Ref: Para. A85-A91, and A125-A126)

- (f) The major types of 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. In doing so, the auditor should obtain 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. (Ref: Para. A92-A95, and A127)

Assessing the Risks of Material Misstatement

14. The auditor should identify and assess the risks of material misstatement due to fraud or error at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures. The objective of this requirement is to identify, and make an assessment of, risks at appropriate levels sufficient for the purpose of designing and perform further audit procedures. (Ref: Para. A96-A102)
15. For this purpose, the auditor should:
- Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and consider the classes of transactions, account balances, and disclosures in the financial statements;
 - Relate the identified risks to what can go wrong at the assertion level;
 - Consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements, including the possibility that the risks might give rise to multiple misstatements; and
 - Consider the likelihood that the risks could result in a material misstatement of the financial statements.

RISKS THAT REQUIRE SPECIAL AUDIT CONSIDERATION

16. As part of the risk assessment as described in paragraph 14, the auditor should determine which of the risks identified are, in the auditor's judgment, significant risks. In any case, the auditor should treat those assessed risks that could result in a material misstatement due to fraud as significant risks.

The objective of this requirement is to ensure that appropriate attention is given to the more significant risks, and in particular to the risks due to fraud. (Ref: Para. A103-A107)

17. The determination of significant risks, which arise on most audits, is a matter for the auditor's professional judgment. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk to determine whether:
- the nature of the risk;
 - the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements; and

- the likelihood of the risk occurring
- are such that they require special audit consideration.

18. In determining which risks are significant risks, the auditor should consider the following:

- Whether the risk is a risk of fraud.
- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.
- The complexity of transactions.
- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risk especially those involving a wide range of measurement uncertainty.
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

19. For significant risks, the auditor should understand the internal controls relevant to such risks.

The objective of this requirement is to provide the auditor with adequate information to develop an effective audit approach. Management ought to be aware of significant risks; however, those risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, although management may have other responses intended to deal with such risks. (Ref: Para. A108-A109)

RISKS FOR WHICH SUBSTANTIVE PROCEDURES ALONE DO NOT PROVIDE SUFFICIENT APPROPRIATE AUDIT EVIDENCE

20. In respect of some risks, the auditor may judge that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, such as an entity's revenue, purchases, and cash receipts or cash payments. In such cases, as part of the risk assessment described in paragraph 14, the auditor should evaluate the design and determine the implementation of the entity's controls, including relevant control activities, over those risks. (Ref: Para. A110-A111)

REVISION OF RISK ASSESSMENT

21. The auditor's assessment of the risks of material misstatement at the assertion level is based on available audit evidence and 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 that tends to contradict the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A112)

Communicating With Those Charged With Governance

22. The auditor should make those charged with governance aware, as soon as practicable, of material weaknesses in the design or implementation of internal control, including in particular

those to prevent and detect fraud, which have come to the auditor's attention. [The objective of this requirement is to provide those charged with governance with information directly arising from the audit that is relevant to their governance roles.]

Documentation

23. To meet the documentation requirements of ISA 230, Audit Documentation, in the context of the auditor's assessment of the risks of material misstatements, the auditor should document:
- (a) The discussion among the engagement team required by paragraph 6(d), and the significant decisions reached;
 - (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment identified in paragraph 10 and each of the internal control components identified in paragraph 13; the sources of information from which the understanding was obtained; and the risk assessment procedures;
 - (c) The identified and assessed risks of material misstatement due to fraud or error at the financial statement level and at the assertion level as required by paragraph 14; and
 - (d) The risks identified and related controls evaluated as a result of the requirements in paragraphs 19 and 20. (Ref: Para. A113)

Application Material

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

- A1. Risk assessment procedures and activities are performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement whether due to fraud or error at the financial statement and assertion levels.
- A2. Obtaining an understanding of the entity and its environment, including its 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 about assessing risks of material misstatement of the financial statements whether due to fraud or error (referred to hereafter as "risks of material misstatement") and responding to those risks throughout the audit, for example when:
- 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;

- Designing and performing further audit procedures to reduce audit risk to an acceptably low level; and
 - Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.
- A3. Information obtained by performing risk assessment procedures and 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.
- A4. 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 stated objective of 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.
- A5. 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 Responsibility to Consider Fraud in an Audit of Financial Statements" in relation to risk assessment procedures and activities to obtain information that is used to identify the risks of material misstatement due to fraud.
- A6. The auditor is required to perform all the risk assessment procedures and activities described in paragraph 6 in the course of obtaining the required understanding. However, the auditor is not required to perform all the risk assessment procedures and activities for each aspect of the understanding described in paragraphs 10 - 13.

INQUIRIES OF MANAGEMENT AND OTHERS WITHIN THE ENTITY (Ref: Para.6(a))

- A7. Much of the information needed by the auditor can be obtained by inquiries of management and those responsible for financial reporting. However, the auditor may also obtain information 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 relate to their activities concerning the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to any findings from these activities.
 - Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor in evaluating the appropriateness of the selection and application of certain accounting policies.
 - Inquiries directed toward in-house legal counsel may relate to 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 relate to changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

ANALYTICAL PROCEDURES (Ref: Para.6(b))

- A8. 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.
- A9. However, when such analytical procedures use data aggregated at a high level (which is often the situation), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. This is why paragraph 6(b) requires the auditor to consider the results of such analytical procedures along with other information gathered in identifying the risks of material misstatement. See ISA 520, "Analytical Procedures" for requirements on the use of analytical procedures.

OBSERVATION AND INSPECTION (Ref: Para.6(c))

- A10. Observation and inspection may support inquiries of management and others, and also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:
- Entity activities and 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.

DISCUSSION AMONG THE ENGAGEMENT TEAM (Ref: Para.6(d))

- A11. The objective of the discussion among the engagement team is for members of the engagement team to gain a better understanding of the potential for material misstatements of the financial statements resulting from fraud or error 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.
- A12. The discussion provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity. It also allows the 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.

- A13. Due to the characteristics of fraud, particular emphasis is given to discussion about the susceptibility of the entity's financial statements to material misstatement due to fraud, and the need to maintain professional skepticism throughout the engagement and to be rigorous in following up on information or other conditions that indicate that a material misstatement due to fraud or error may have occurred. The discussion occurs with a questioning mind setting aside any beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. ISA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.
- A14. It is not always necessary or practical for the discussion among the audit team to include all members in a single discussion. The engagement partner may discuss matters with key members of the team, including 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 team. A communications plan, agreed by the engagement partner, may be useful.

OTHER AUDIT PROCEDURES (Ref: Para.7)

- A15. Other audit procedures may be useful in obtaining information about the entity and in identifying risks of material misstatements. Examples of such procedures include:
- Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.
 - Reviewing information obtained from external sources such as reports by analysts, banks, or rating agencies; trade and economic journals; or regulatory or financial publications.

INFORMATION OBTAINED IN PRIOR PERIODS (Ref: Para.8)

- A16. 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, as well as with information about the nature of the entity's and its controls. Identifying significant changes in any of the aspects of the entity from prior periods assists in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.
- A17. Paragraph 8 requires the auditor to determine whether information obtained in prior periods remains valid, if the auditor intends to use that information for purposes of the current audit. 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 systems.

Understanding the Entity and Its Environment

INDUSTRY, REGULATORY AND OTHER EXTERNAL FACTORS (Ref: Para.10(a))

Industry factors

A18. 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

Changes in the operating environment can result in changes in competitive pressures and significantly different risks.

A19. 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 costs that give rise to risks of material misstatement. In such cases, it is important that the engagement team includes members with sufficient relevant knowledge and experience, as required by ISA 220 (Revised), "Quality Control for Audits of Historical Financial Information".

Regulatory factors

A20. 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, such as regulatory requirements and 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.

A21. Local regulations may specify certain financial reporting requirements for the industry in which the entity operates. The financial statements may be materially misstated in the context of the applicable financial reporting framework if management fails to prepare the financial statements in accordance with such regulations.

A22. 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.

Other external factors

A23. 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.10(b))

A24. In addition to the classes of transactions, account balances, and disclosures to be expected in the financial statements, an understanding of the nature of an entity enables the auditor to understand:

- 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, investments, or special-purpose entities are accounted for appropriately.
- The ownership, and relations between owners and other people or entities. This understanding is important in determining whether related party transactions have been identified and accounted for appropriately. ISA 550, “Related Parties” provides additional requirements on the auditor’s considerations relevant to related parties.

A25. Examples of matters that auditor may consider when obtaining an understanding of the nature of the entity include:

- *Business operations* – such as:
 - nature of revenue sources, and 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)
 - 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).

A26. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement. For example, significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.

THE ENTITY'S SELECTION AND APPLICATION OF ACCOUNTING POLICIES (Ref: Para.10(c))

A27. An understanding of the entity's selection and application of accounting policies encompasses 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 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.10(d))

A28. 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 operational approaches by which management intends to achieve its objectives. The entity's strategies and objectives may change over time.

- A29. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk particularly may arise from change or complexity, though a failure to recognize the need for change may also give rise to risk. Change may arise, for example, from the development of new products that may fail; from an inadequate market, even if successfully developed; or from flaws that may result in liabilities and reputational risk. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks.
- A30. Examples of matters that auditor may consider 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)
 - 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)
- A31. A business risk may have an immediate consequence for the risk of misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statements as a whole. For example, the business risk arising from a contracting customer base may increase the risk of 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 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 paragraph A97.
- A32. 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 13(b) and paragraphs A75 to A77.

HOW MANAGEMENT AND OTHERS MEASURE AND REVIEW THE ENTITY'S FINANCIAL PERFORMANCE (Ref: Para.10(e))

- A33. 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. Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.
- A34. 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 A92-A95), though their purposes may overlap. Monitoring of controls is specifically concerned with the effective operation of internal control through consideration of information about the control. The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties). In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.
- A35. Examples of internally-generated information used by management for this purpose, and which the may auditor consider, include:
- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics
 - Period-on-period financial performance analysis
 - Budgets, forecasts, variance analysis, 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.
- A36. 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 provide useful information. Such reports may often be obtained from the entity being audited.
- A37. 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 a risk of misstatement of related financial statement information. 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.

Understanding the Entity's Internal Control (Ref: Para. 11-13)

- A38. The following application material on internal control is presented in three sections, as follows:
- General Nature and Characteristics of Internal Control

- Extent of Understanding of Internal Control
- The Components of Internal Control

General Nature and Characteristics of Internal Control

PURPOSE OF INTERNAL CONTROL

A39. Internal control is the process designed and put in place by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to:

- reliability of financial reporting;
- effectiveness and efficiency of operations; and
- compliance with applicable laws and regulations.

Internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives. The way in which internal control is designed and implemented varies with an entity's size and complexity.

LIMITATIONS OF INTERNAL CONTROL

A40. Internal control, no matter how well designed and operated, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of 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, or there may be a information produced by an internal control (for example, an exception report) on where the individual responsible for reviewing the information does not understand the purpose of the information or fails to take appropriate action.

A41. 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.

A42. Further, in designing and implementing controls, management may make informed 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.

DIVISION OF INTERNAL CONTROL INTO COMPONENTS

A43. The division of internal control into the five components, as described in paragraph 13, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. The division does not necessarily reflect how an entity considers and implements internal control. The auditor's primary consideration is whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures,

and their related assertions, rather than its classification into 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.

CHARACTERISTICS OF MANUAL AND AUTOMATED ELEMENTS OF INTERNAL CONTROL RELEVANT TO THE AUDITOR'S RISK ASSESSMENT

A44. An entity's system of internal control is likely to contain manual and automated elements, the characteristics of which are relevant to the auditor's risk assessment and further audit procedures based thereon.

A45. 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 activities, 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 controls varies with the nature and complexity of the entity's use of IT.

A46. 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.

A47. IT also poses specific risks to an entity's internal control, including the following:

- 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.

A48. Manual aspects of systems 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.

A49. Manual controls pose specific risks to the entity's internal control. Manual controls may be less reliable than automated controls 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 systems may be less suitable for the following:

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented or detected by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

A50. 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 manual systems by establishing effective controls in light of the characteristics of the entity's information system.

Extent of Understanding of Internal Control

CONTROLS RELEVANT TO THE AUDIT

A51. 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.

- A52. Ordinarily, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements for external purposes and the management of risk that may give rise to a material misstatement in those financial statements. Controls relevant to the audit may exist in any of the components of internal control.
- A53. It is a matter of the auditor's professional judgment whether a control is relevant to the audit. Factors relevant to that judgment include the following:
- The circumstances and the applicable component of internal control.
 - The auditor's judgment about materiality.
 - 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 nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.
- A54. 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 pertain to data the auditor evaluates or uses in applying audit procedures.
- A55. 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 safeguarding controls is generally limited to those relevant to the reliability of financial reporting.
- A56. 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.

DEPTH OF UNDERSTANDING OF INTERNAL CONTROL

- A57. Paragraph 12 requires that an understanding of internal control involve evaluating the design of a control and determining whether it has been implemented. There is little point in assessing the implementation of an ineffective control, 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.

A58. 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.

A59. In obtaining this understanding, the auditor may learn for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

A60. Obtaining an understanding of an entity's controls is not sufficient to serve as testing the operating effectiveness of controls, unless there is some automation that provides for the consistent application of the operation of the control. 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 A46), 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 Components of Internal Control

CONTROL ENVIRONMENT (Ref: Para. 13(a))

A61. 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.

A62. Because of the importance of the entity's control environment to the effectiveness of internal controls, paragraph 13(a) requires the auditor to obtain an understanding of the following elements of the control environment:

Communication and enforcement of integrity and ethical values

A63. Integrity and ethical values are essential elements of the control environment which influence the effectiveness of the design, administration, and monitoring of other components of internal control. Integrity and ethical behavior include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity values and behavioral standards to personnel through policy statements and codes of conduct and by example.

Commitment to competence

A64. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

Participation by those charged with governance

A65. An entity's control consciousness is influenced significantly by those charged with governance. One role of those charged with governance, for example, 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 influenced by such matters as their independence from management and their ability to evaluate the actions of management, and whether there is an audit committee that understands the entity's business transactions and evaluates whether the financial statements are prepared in accordance with the applicable financial reporting framework.

A66. Additional attributes of those charged with governance include:

- 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.
- Their oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.

Management's philosophy and operating style

A67. Management's philosophy and operating style encompass a broad range of characteristics, including management's:

- Approach to taking and monitoring business risks.
- Attitudes and actions toward financial reporting (conservative or aggressive selection from available alternative accounting principles, and conscientiousness and conservatism with which accounting estimates are developed).
- Attitudes toward information processing and accounting functions and personnel.

Organizational structure

A68. An entity's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and reviewed. The establishment of a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting.

Assignment of authority and responsibility

A69. This factor includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established. It includes 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.

Human resource policies and practices

A70. Human resource policies and practices relate to recruitment, orientation, training, evaluation, counseling, promotion, compensation, and remedial actions. For example, standards for recruiting or promotion of 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.

Audit evidence for elements of the control environment

A71. 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 established a formal 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

A72. Some elements of an entity’s control environment have a pervasive effect on assessing the risks of material misstatement. For example, owner-manager controls may mitigate a lack of segregation of duties in a small business, or an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities. 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.

A73. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. In particular, it may help reduce the risk of fraud, although 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 by allowing unauthorized transactions to be processed. As explained in paragraph 5 of ISA 330, the control environment also influences the nature, timing, and extent of the auditor’s further procedures.

A74. The control environment in itself does not prevent, or detect and correct, a material misstatement; the effect of other components (for example, the monitoring of controls and the operation of specific control activities) along with the control environment affects the risks of material misstatement.

THE ENTITY’S RISK ASSESSMENT PROCESS (Ref: Para. 13(b))

A75. An entity’s risk assessment process is its process for identifying and responding to business risks, including risks of fraud in the entity, 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. Risks relevant to reliable financial reporting also relate to specific events or transactions.

A76. Risks relevant to financial reporting include external and internal events and 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.

A77. During the audit, the auditor may identify risks of material misstatement that management failed to identify. If there was an underlying risk of a kind that should have been identified by the entity's risk assessment process, it may indicate that the process is not appropriate to its circumstances and possibly, a material weakness in the entity's risk assessment process. Paragraph 22 requires the auditor to communicate a material weakness to those charged with governance.

INFORMATION SYSTEM, INCLUDING THE RELATED BUSINESS PROCESSES, RELEVANT TO FINANCIAL REPORTING (Ref: Para. 13(c))

The information system relevant to financial reporting

A78. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records 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 general ledger or financial reporting systems;
- 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
- present properly the transactions and related disclosures in the financial statements.

A79. Significant and rapid changes in information systems, including the incorporation of new technologies into such systems, can change the risk relating to internal control.

Journal entries

A80. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions such as 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.

A81. 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.

- A82. Paragraph 13(c) requires the auditor to consider risks of material misstatement associated with inappropriate override of controls over journal entries and the controls surrounding non-standard journal entries. This consideration is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

Related business processes

- A83. 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. These business processes result in the transaction that are recorded, processed and reported by the information system. It is therefore important for the auditor to obtain an understanding of the entity's related business processes, including how transactions originate therein, in order to obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

COMMUNICATION (Ref: Para. 13(d))

- A84. 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 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.

CONTROL ACTIVITIES (Ref: Para. 13(e))

- A85. 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* - Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, non-routine transactions such as major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

- *Performance reviews* – Controls such as reviews and analyses of actual operating and financial performance versus budgets, forecasts, and prior period performance; comparing internal data with external sources of information; and review of functional or activity performance.
- *Information processing* – Controls performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are application controls and general IT-controls (see A96-A98 for further discussion of application and general IT-controls relevant to the audit).
- *Physical controls* – Controls that encompass the physical security of assets, including adequate safeguards such as secured facilities over access to assets and records; authorization for access to computer programs and data files; and 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.

Control activities relevant to the audit

- A86. An audit does not require an understanding of all the control activities related to each assertion. The auditor's emphasis is on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that material misstatements are more likely to occur. Accordingly, a control activity may be relevant to the audit if it, individually or in combination with others, prevents, or detects and corrects, material misstatements. When multiple control activities achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.
- A87. 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.
- A88. Control activities are relevant to the audit if the auditor is required to evaluate them as discussed in paragraphs 19 and 20.

RISKS ARISING FROM IT

- A89. 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.

A90. 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 A55 above.

A91. 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 preventative 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.

MONITORING OF CONTROLS (Ref: Para. 13(f))

A92. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the design and operation 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.

A93. 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.

A94. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. See ISA 610, "Considering the Work of Internal Auditing" for additional guidance. 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.

A95. 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 may exist in the information, potentially leading 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 important to the auditor's evaluation of the design of the entity's monitoring activities as a component of internal control

Assessing the Risks of Material Misstatement (Ref: Para. 14-15)

A96. 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.

A97. Examples of conditions and events that may indicate the existence of risks of material misstatement include the following:

- 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.
- 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.
- 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.

CONTROLS AND THE ASSESSMENT OF RISKS OF MATERIAL MISSTATEMENT AT THE ASSERTION LEVEL

- A98. 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, the auditor gains an understanding of controls and relates them to assertions in the context of processes and systems in which they exist. Doing so is useful because individual control activities often do not in themselves address a risk. Often only multiple control activities, together with other elements of internal control, will be sufficient to address a risk.
- A99. 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.
- A100. 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.

ASSESSMENT OF RISKS OF MATERIAL MISSTATEMENT AT THE FINANCIAL STATEMENT LEVEL

- A101. 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 latter risks (risks at the financial statement level) may derive in particular from a weak control environment. 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.

A102. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. 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. Also, 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. See [extant] ISA 701 for requirements and 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.

RISKS THAT REQUIRE SPECIAL AUDIT CONSIDERATION (Ref: Para.16-19)

Identifying risks that require special audit consideration

A103. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because they have lower inherent risks. On the other hand, significant risks are often derived from business risks that may result in a material misstatement.

A104. Significant risks often relate to significant non-routine transactions and judgmental matters. Non-routine transactions are transactions that are unusual, either due to size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.

A105. Risks of material misstatement may be greater for risks relating to 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.

A106. Risks of material misstatement may be greater for risks relating to 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, complex or require assumptions about the effects of future events, for example, judgment about fair value.

ISA 330, paragraphs 44 and 51 describe the consequences for further audit procedures of identifying a risk as significant.

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

A107. ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.

Understanding internal controls related to significant risks

A108. 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;
- formal processes for estimations, or
- approval by those charged with governance.

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.

A109. In some cases, management may not have appropriately responded by implementing controls over 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. 20)

A110. The characteristics of routine business transactions often permit highly automated processing with little or no manual intervention. In such circumstances, 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 electronically 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. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed or reported only in electronic form and appropriate controls are not operating effectively.

A111. The consequences for further audit procedures of identifying such risks are described in paragraph 25 of ISA 330.

REVISION OF RISK ASSESSMENT (Ref: Para. 21)

A112. 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 misstatement. See paragraphs 66 and 70 of ISA 330 for further guidance.

Documentation (Ref: Para.23)

A113. The manner in which the requirements of paragraph 23 are documented is for the auditor to determine using professional judgment. In particular, 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 paragraph 73 of ISA 330 for additional guidance). 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. Ordinarily, the more complex the entity and the more extensive the audit procedures performed by the auditor, the more extensive the auditor's documentation will be.

Considerations Specific to Smaller Entities

RISK ASSESSMENT PROCEDURES AND ACTIVITIES

Discussion Among the Engagement Team (Ref: Para.6(d) and A11-A14)

A114. 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.

UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

Objectives and Strategies and Related Business Risks (Ref: Para.10(d) and A28-A32)

A115. Smaller entities often do not set their objectives and strategies, or manage the related business risks, through formal plans or processes. In many cases there may be no documentation of such matters. In such entities, the auditor's understanding is ordinarily obtained through inquiries of management and observation of how the entity responds to such matters.

How Management and Others Measure and Review the Entity's Financial Performance (Ref: Para.10(e) and A33-37)

A116. Smaller entities often do not have formal processes to measure and review the entity's financial performance. Management nevertheless may rely on certain key indicators which their knowledge and experience of the business suggest are reliable bases for evaluating financial performance and taking appropriate action.

INTERNAL CONTROL (Ref: Para. 11-12, and A39-A60)

General Nature and Characteristics of Internal Control

A117. The way in which internal control is designed and implemented varies with an entity's size and complexity. Smaller entities may use less formal means and simpler processes and procedures to achieve their objectives. For example, smaller entities with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures or detailed written policies. In addition, the owner-manager may

perform functions which in a larger entity would be regarded as belonging to several of the components of internal control. Therefore, the components of internal control may not be clearly distinguished within smaller entities, but their underlying purposes are equally valid.

- A118. As explained in paragraph A42, management may make informed 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. The auditor may learn for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties; this may often be the case in small entities where the owner provides day-to-day supervision of operations. Information from obtaining this understanding may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

Limitations of Internal Control

- A119. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, for key areas, even in a very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. For example, in a small owner-managed entity, the owner-manager 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. On the other hand, the owner-manager may be more able to override controls because of the informal system of internal control. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud. The potential for override of controls by the owner-manager depends to a great extent on the control environment and the owner-manager's attitudes about the importance of internal control.

Components of Internal Control

CONTROL ENVIRONMENT (Ref: Para. 13(a), and A61- A74)

- A120. Small entities may implement the control environment elements differently than larger entities. 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. Similarly, those charged with governance in small entities may not include an independent or outside member, or the role of governance is may be undertaken by the owner-manager where there are no other owners.
- A121. Consequently, management's attitudes, awareness and actions are of particular importance in the design of a smaller entity's control environment.

THE ENTITY'S RISK ASSESSMENT PROCESS (Ref: Para. 13(b) and A75-A77)

- A122. The basic concepts of the entity's risk assessment process are relevant to every entity, regardless of size. However, the risk assessment process is likely to be less formal and less structured in small entities than in larger ones. In a smaller entity, management may not have a formal risk assessment process as identified in paragraph 13(b). Management nevertheless may

be aware of risks related to these objectives without the use of a formal process but through direct personal involvement with employees and outside parties.

INFORMATION SYSTEM, INCLUDING THE RELATED BUSINESS PROCESSES, RELEVANT TO FINANCIAL REPORTING (Ref: Para. 13(c) and A78-A83)

A123. Information systems and related business processes relevant to financial reporting in small entities are likely to be less formal 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.

COMMUNICATION (Ref: Para. 13(d) and A84)

A124. Communication may be less formal and easier to achieve in a small entity than in a larger entity due to the small entity's size and fewer levels as well as management's greater visibility and availability.

CONTROL ACTIVITIES (Ref: Para. 13(e) and A85-A91)

A125. 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 varies. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's retention of authority for approving credit sales, significant purchases, and draw-downs on lines of credit can provide strong control over those activities, lessening or removing the need for more detailed control activities.

A126. An appropriate segregation of duties often appears to present difficulties in small entities. Even companies that have only a few employees, however, may be able to assign their responsibilities to achieve appropriate segregation. Alternatively, if that is not possible, management oversight of the incompatible activities may achieve control objectives.

MONITORING OF CONTROLS (Ref: Para. 13(f) and A92-A95)

A127. Management's monitoring of control is often accomplished by 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.

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