

## Auditing Disclosures – Revised Proposed Changes to Full ISA Standards (ISA 315, ISA 330, ISA 450 and ISA 700(Revised))

### (FOR REFERENCE ONLY)

The following includes selective ISAs with mark-up for proposed revisions (including changes arising from the Disclosures ED and those proposed for December 2014 discussion). This document will not be discussed and is for reference only, and has been presented to assist with considering the extent of change arising from the proposed changes relating to this project in these selective ISAs.

*The footnote numbering in this document does not necessarily correlate with the footnotes as currently included in the extant ISAs.*

### INTERNATIONAL STANDARD ON AUDITING 315 (REVISED)

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

(Effective for audits of financial statements for periods  
ending on or after December 15, 2013)

### [Marked for Changes to the Extant Standard]

## CONTENTS

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	Paragraph
Introduction	
Scope of this ISA .....	1
Effective Date .....	2
Objective .....	3
Definitions .....	4

## Requirements

Risk Assessment Procedures and Related Activities .....	5–10
The Required Understanding of the Entity and Its Environment, Including the Entity’s Internal Control .....	11–24
Identifying and Assessing the Risks of Material Misstatement .....	25–31
Documentation .....	32

## Application and Other Explanatory Material

Risk Assessment Procedures and Related Activities .....	A1–A23
The Required Understanding of the Entity and Its Environment, Including the Entity’s Internal Control .....	A24–A117
Identifying and Assessing the Risks of Material Misstatement .....	A118–A143
Documentation .....	A144–A147

## Appendix 1: Internal Control Components

## Appendix 2: Conditions and Events That May Indicate 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 responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity’s internal control.

### Effective Date

2. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2013.

### Objective

3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and

its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

## Definitions

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

## Requirements

### Risk Assessment Procedures and Related Activities

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1–A5)
6. The risk assessment procedures shall include the following:
  - (a) Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor’s judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6–A13)
  - (b) Analytical procedures. (Ref: Para. A14–A17)
  - (c) Observation and inspection. (Ref: Para. A18)
7. The auditor shall consider whether information obtained from the auditor’s client acceptance or continuance process is relevant to identifying risks of material misstatement.
8. If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.
9. Where the auditor intends to use information obtained from the auditor’s previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A19–A20)
10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity’s financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity’s facts and circumstances. The engagement partner shall determine which matters are to be

communicated to engagement team members not involved in the discussion. (Ref: Para. A21–A23)

## **The Required Understanding of the Entity and Its Environment, Including the Entity’s Internal Control**

### *The Entity and Its Environment*

11. The auditor shall obtain an understanding of the following:
  - (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A24–A29)
  - (b) The nature of the entity, including:
    - (i) its operations;
    - (ii) its ownership and governance structures;
    - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
    - (iv) the way that the entity is structured and how it is financed, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A30–A34)
  - (c) The entity’s selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity’s accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A35)
  - (d) The entity’s objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A36–A42)
  - (e) The measurement and review of the entity’s financial performance. (Ref: Para. A43–A48)

### *The Entity's Internal Control*

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A49–A72)

### Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A73–A75)

### Components of Internal Control

#### Control environment

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
  - (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
  - (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A76–A86)

#### The entity's risk assessment process

15. The auditor shall obtain an understanding of whether the entity has a process for:

- (a) Identifying business risks relevant to financial reporting objectives;
  - (b) Estimating the significance of the risks;
  - (c) Assessing the likelihood of their occurrence; and
  - (d) Deciding about actions to address those risks. (Ref: Para. A87)
16. If the entity has established such a process (referred to hereafter as the “entity’s risk assessment process”), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity’s risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity’s risk assessment process.
17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. A88)

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

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:
- (a) The classes of transactions in the entity’s operations that are significant to the financial statements;
  - (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated,

recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

- (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
- (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures. This includes information from accounting records that are outside the general and subsidiary ledgers; and
- (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. This includes information from accounting records that are outside the general and subsidiary ledgers. (Ref: Para. A89–A93)

19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including: (Ref: Para. A94–A95)

- (a) Communications between management and those charged with governance; and
- (b) External communications, such as those with regulatory authorities.

#### Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion

level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A96–A102)

21. In understanding the entity’s control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A103–A105)

#### Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control relevant to financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A106–A108)
23. If the entity has an internal audit function,<sup>1</sup> the auditor shall obtain an understanding of the nature of the internal audit function’s responsibilities, its organizational status, and the activities performed, or to be performed. (Ref: Para. A109–A116)
24. The auditor shall obtain an understanding of the sources of the information used in the entity’s monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A117)

#### Identifying and Assessing the Risks of Material Misstatement

25. The auditor shall identify and assess the risks of material misstatement at:
  - (a) the financial statement level; and (Ref: Para. A118–A121)
  - (b) the assertion level for classes of transactions, account balances, and disclosures, (Ref: Para. A122–A126)

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<sup>1</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 14(a), defines the term “internal audit function” for purposes of the ISAs.

to provide a basis for designing and performing further audit procedures.

26. For this purpose, the auditor shall:
- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A127–A128**b**)
  - (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
  - (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A129–A131)
  - (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

*Risks that Require Special Audit Consideration*

27. As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.
28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:
- (a) Whether the risk is a risk of fraud;
  - (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
  - (c) The complexity of transactions;

- (d) Whether the risk involves significant transactions with related parties;
  - (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
  - (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A132–A136)
29. If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity’s controls, including control activities, relevant to that risk. (Ref: Para. A137–A139)

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

30. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity’s controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A140–A142)

*Revision of Risk Assessment*

31. The auditor’s assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A143)

## Documentation

32. The auditor shall include in the audit documentation:<sup>2</sup>
- (a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;
  - (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14–24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
  - (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and
  - (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27–30. (Ref: Para. A144–A147)

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## Application and Other Explanatory Material

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

- A1. Obtaining an understanding of the entity and its environment, including the entity’s internal control (referred to hereafter as an “understanding of the entity”), is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:
- Assessing risks of material misstatement of the financial statements;
  - Determining materiality in accordance with ISA 320;<sup>3</sup>

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<sup>2</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

<sup>3</sup> ISA 320, *Materiality in Planning and Performing an Audit*

- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
  - Identifying areas of the financial statements where special audit consideration may be necessary, for example: related party transactions, or the appropriateness of management's use of the going concern assumption, including related disclosures; or when considering the business purpose of transactions;
  - Developing expectations for use when performing analytical procedures;
  - Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
  - Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.
- A2. Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures, and related assertions, and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.
- A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this ISA. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

- A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this ISA. However, the significance of fraud is such that further requirements and guidance are included in ISA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.<sup>4</sup>
- A5. Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11–24), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include:
- Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.
  - Making inquiries of the entity’s external legal counsel or of valuation experts that the entity has used.

*Inquiries of Management, the Internal Audit Function and Others within the Entity* (Ref: Para. 6(a))

- A6. Much of the information obtained by the auditor’s inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity.
- A7. The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:

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<sup>4</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 12–24

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. ISA 260<sup>5</sup> identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
  - Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
  - Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
  - Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
  - Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
  - Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.
- A8. As obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's inquiries may occur throughout the audit engagement.

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<sup>5</sup> ISA 260, *Communication with Those Charged with Governance*, paragraph 4(b)

## Inquiries of the Internal Audit Function

- A9. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.<sup>6</sup> Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.
- A10. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.
- A11. In addition, in accordance with ISA 240,<sup>7</sup> if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.
- A12. Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief

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<sup>6</sup> The relevant requirements are contained in ISA 610 (Revised 2013).

<sup>7</sup> ISA 240, paragraph 19

internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

Considerations specific to public sector entities (Ref: Para 6(a))

A13. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of deficiencies in internal control over financial reporting.

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

A14. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

A15. 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.

A16. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results

of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

### Considerations Specific to Smaller Entities

A17. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

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

A18. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- The entity's operations.
- Documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- The entity's premises and plant facilities.

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

A19. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.

- The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.
- Those particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example due to their complexity.

A20. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

*Discussion among the Engagement Team* (Ref: Para. 10)

- A21. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:
- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
  - Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
  - Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them,

and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures.

- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

ISA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.<sup>8</sup>

A21a. As part of the discussion among the engagement team required by paragraph 10, consideration of the disclosure requirements of the applicable financial reporting framework assists in identifying early in the audit where there may be risks of material misstatement in relation to disclosures. Examples of matters the engagement team may discuss include:

- Changes in reporting requirements that may result in significant new or revised disclosures;
- Changes in the entity's environment, financial condition or activities that may result in significant new or revised disclosures, for example, a significant business combination in the period under audit; and
- Disclosures for which obtaining sufficient appropriate audit evidence may have been difficult in the past.
- Complex disclosures where there is a risk that users may not understand the potential impact of the information provided.\*

A22. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location

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<sup>8</sup> ISA 240, paragraph 15

\* When the final standard is issued, this paragraph will become paragraph A22 and all subsequent paragraphs will be renumbered accordingly.

audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

#### Considerations Specific to Smaller Entities

A23. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

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

#### **The Entity and Its Environment**

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

##### Industry Factors

A24. 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.

A25. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience.<sup>9</sup>

### Regulatory Factors

A26. 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, including requirements for disclosures.
- Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

A27. ISA 250 includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.<sup>10</sup>

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<sup>9</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14

<sup>10</sup> ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 12

## Considerations specific to public sector entities

A28. For the audits of public sector entities, law, regulation or other authority may affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

## Other External Factors

A29. Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

## *Nature of the Entity* (Ref: Para. 11(b))

A30. An understanding of the nature of an entity enables the auditor to understand such matters as:

- Whether the entity has a complex structure, for example, with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately, and whether adequate disclosure of such issues in the financial statements has been made.
- The ownership, and relationships between owners and other people or entities. This understanding assists in determining whether related party transactions have been appropriately identified, and accounted for, appropriately and adequately disclosed in the financial statements. ISA 550<sup>11</sup> establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

A31. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- Business operations such as:

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<sup>11</sup> ISA 550, *Related Parties*

- Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
- Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
- Alliances, joint ventures, and outsourcing activities.
- Geographic dispersion and industry segmentation.
- Location of production facilities, warehouses, and offices, and location and quantities of inventories.
- Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post-employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
- Research and development activities and expenditures.
- Transactions with related parties.
- Investments and investment activities such as:
  - Planned or recently executed acquisitions or divestitures.
  - Investments and dispositions of securities and loans.
  - Capital investment activities.
  - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
- Financing and financing activities such as:
  - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.
  - Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.

- Beneficial owners (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.
- Financial reporting practices such as:
  - Accounting principles and industry-specific practices, including for industry-specific significant categories classes of transactions, account balances and related disclosures in the financial statements (for example, loans and investments for banks, or research and development for pharmaceuticals).
  - Revenue recognition 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).

A32. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

#### Nature of Special-Purpose Entities

A33. A special-purpose entity (sometimes referred to as a special-purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitization of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As ISA 550

indicates, in some circumstances, a special-purpose entity may be a related party of the entity.<sup>12</sup>

A34. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special-purpose entity.

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

A35. An understanding of the entity's selection and application of accounting policies may encompass such matters as:

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

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

A36. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

A37. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may

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<sup>12</sup> ISA 550, paragraph A7

arise from change or complexity. A failure to recognize the need for change may also give rise to business risk. Business risk may arise, for example, from:

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

A38. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

A39. Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).

- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A40. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in Appendix 2.

A41. Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A87–A88.

#### Considerations Specific to Public Sector Entities

A42. For the audits of public sector entities, “management objectives” may be influenced by concerns regarding public accountability and may include objectives which have their source in law, regulation or other authority.

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

A43. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. See ISA 240 for requirements and guidance in relation to the risks of fraud.

A44. 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 A106–A117), though their purposes may overlap:

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

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

A45. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- Period-on-period financial performance analyses.
- Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.

- Employee performance measures and incentive compensation policies.
  - Comparisons of an entity's performance with that of competitors.
- A46. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.
- A47. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

#### Considerations Specific to Smaller Entities

- A48. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

#### **The Entity's Internal Control** (Ref: Para. 12)

- A49. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.

A50. The following application material on internal control is presented in four sections, as follows:

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

### *General Nature and Characteristics of Internal Control*

#### Purpose of Internal Control

A51. Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

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

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

#### Considerations specific to smaller entities

A52. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

#### Limitations of Internal Control

A53. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for

example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

- A54. 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.
- A55. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

#### Considerations specific to smaller entities

- A56. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-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.
- A57. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

#### Division of Internal Control into Components

- A58. The division of internal control into the following five components, for purposes of the ISAs, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:
- (a) The control environment;

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

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

A59. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A76–A117 below. Appendix 1 provides further explanation of these components of internal control.

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

A60. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A61. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

- Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
- Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer

programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

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

A62. 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.

A63. IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate

recording of transactions. Particular risks may arise where multiple users access a common database.

- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

A64. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

A65. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.

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

A66. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

#### *Controls Relevant to the Audit*

A67. 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.

A68. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business, including its organization and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.

- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.
- A69. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.
- A70. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting.
- A71. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

#### Considerations Specific to Public Sector Entities

- A72. Public sector auditors often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice. Public sector auditors can also have responsibilities to report on compliance with law, regulation or other authority. As a result, their review of internal control may be broader and more detailed.

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

- A73. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.
- A74. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:
- Inquiring of entity personnel.
  - Observing the application of specific controls.
  - Inspecting documents and reports.
  - Tracing transactions through the information system relevant to financial reporting.

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

- A75. Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A62), 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.<sup>13</sup>

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<sup>13</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

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

- A76. 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.
- A77. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:
- (a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
  - (b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
  - (c) *Participation by those charged with governance* – Attributes of those charged with governance such as:
    - Their independence from management.
    - Their experience and stature.
    - The extent of their involvement and the information they receive, and the scrutiny of activities.
    - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
  - (d) *Management's philosophy and operating style* – Characteristics such as management's:
    - Approach to taking and managing business risks.
    - Attitudes and actions toward financial reporting.

- Attitudes toward information processing and accounting functions and personnel.
- (e) *Organizational structure* – The framework within which an entity’s activities for achieving its objectives are planned, executed, controlled, and reviewed.
- (f) *Assignment of authority and responsibility* – Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
- (g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

#### Audit Evidence for Elements of the Control Environment

- A78. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.
- A79. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

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

- A80. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:
- Their independence from management and their ability to evaluate the actions of management.
  - Whether they understand the entity's business transactions.
  - The extent to which they evaluate whether the financial statements, including classes of transactions, account balances and disclosures, are prepared in accordance with the applicable financial reporting framework.
- A81. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.
- A82. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or

unauthorized transactions to be processed. As explained in ISA 330, the control environment also influences the nature, timing and extent of the auditor's further procedures.<sup>14</sup>

- A83. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

#### Considerations Specific to Smaller Entities

- A84. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small entity; it may, however, increase other risks, for example, the risk of override of controls.
- A85. 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.
- A86. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

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<sup>14</sup> ISA 330, paragraphs A2–A3

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

A87. The entity’s risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity’s risk assessment process is appropriate to the circumstances is a matter of judgment.

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

A88. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

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

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

A89. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

- Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;

- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

A89a. Financial statements may contain information from accounting records<sup>15</sup> that are outside the general and subsidiary ledgers. Examples of such accounting records include:

- Relevant information produced by an entity's risk management system.
- Valuation information produced by management's experts relating to, for example, the disclosure of the fair value of an amount that is recorded on the balance sheet at cost.
- Models or other calculations used to develop estimates recognized or disclosed in the financial statements, including the underlying data and assumptions used in those models, for example, assumptions developed internally that may affect an asset's useful life, or that may be affected by factors outside the control of the entity, such as interest rate data.
- Sensitivity analyses derived from financial models to demonstrate that management has considered alternative assumptions.
- An entity's underlying tax records and returns.
- Analysis to support management's use of the going concern basis of accounting or management's assessment of the entity's ability to continue as a going concern.

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<sup>15</sup> Paragraph 5(a) of ISA 500, *Audit Evidence*, defines accounting records.

## Journal entries

- A90. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.
- A91. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

## Related business processes

- A92. An entity's business processes are the activities designed to:
- Develop, purchase, produce, sell and distribute an entity's products and services;
  - Ensure compliance with laws and regulations; and
  - Record information, including accounting and financial reporting information.

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

### Considerations specific to smaller entities

A93. Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's systems and processes may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

### Communication (Ref: Para. 19)

A94. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

### Considerations specific to smaller entities

A95. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

### *Components of Internal Control—Control Activities Relevant to the Audit* (Ref: Para. 20)

A96. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied

at various organizational and functional levels. Examples of specific control activities include those relating to the following:

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

A97. Control activities that are relevant to the audit are:

- Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30, respectively; or
- Those that are considered to be relevant in the judgment of the auditor.

A98. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

A99. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A99a. Control activities relevant to the audit may include controls established by management that address risks of material misstatement from disclosures not being prepared in accordance with the applicable financial reporting framework, in addition to controls that address risks related to account balances and transactions. This also includes those control activities that address risks of material misstatement relating to

account balances, transactions and disclosures from the entity's accounting records that are outside the general and subsidiary ledgers

A100. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

#### Considerations Specific to Smaller Entities

A101. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A102. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

#### Risks Arising from IT (Ref: Para. 21)

A103. 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.

A104. 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 A63 above.

A105. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

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

A106. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial 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.

A107. Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

## Considerations Specific to Smaller Entities

A108. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

### The Entity's Internal Audit Function (Ref: Para. 23)

A109. If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control, in particular the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor's inquiries in paragraph 6(a) of this ISA, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.

A110. The objectives and scope of an internal audit function, the nature of its responsibilities and its status within the organization, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. These matters may be set out in an internal audit charter or terms of reference.

A111. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control and governance processes. If so, the internal audit function may play an important role in the entity's monitoring of internal control over financial reporting. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting.

A112. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6(a) of this ISA help the

auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function.

- A113. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.
- A114. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, ISA 610 (Revised 2013) applies.
- A115. As is further discussed in ISA 610 (Revised 2013), the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.
- A116. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. ISA 200 discusses the importance of the

auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

#### Sources of Information (Ref: Para. 24)

A117. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

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

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

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

#### *Assessment of Risks of Material Misstatement at the Financial Statement Level* (Ref: Para. 25(a))

A118. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be

especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A119. Risks at the financial statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as a management's lack of management competence or lack of oversight over the preparation of the financial statements (including disclosures) may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A120. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
- Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

A121. ISA 705<sup>16</sup> establishes requirements and provides guidance in determining whether there is a need for the auditor to express a qualified opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement where withdrawal is possible under applicable law or regulation.

*Assessment of Risks of Material Misstatement at the Assertion Level* (Ref: Para. 25(b))

A122. Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level

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<sup>16</sup> ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*

necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

## The Use of Assertions

A123. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding ~~the~~ recognition, measurement, and presentation of classes of transactions and events, account balances and disclosures. ~~of the various elements of financial statements and related disclosures.~~

A123a. The auditor may use the assertions as described in paragraph A124(a)-(b) above-below or may express them differently provided all aspects described above-below have been covered. For example, the auditor may choose to combine the assertions about transactions and events, and related disclosures, with the assertions about account balances, and related disclosures. [Moved from paragraph A125]

### Assertions about classes of transactions, account balances, and related disclosures

A124. Assertions used by the auditor ~~to~~in considering the different types of potential misstatements that may ~~occur~~ fall into the following ~~three~~ categories and may take the following forms:

- (a) Assertions about classes of transactions and events, and related disclosures, for the period under audit:
  - (i) Occurrence—transactions and events that have been recorded, or disclosed, have occurred, and such transactions and events pertain to the entity.
  - (ii) Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

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

understandable in the context of the requirements of the applicable financial reporting framework.

~~(iv)(vi) Classification—assets, liabilities and equity interests have been recorded in the proper accounts.~~

~~(e) Assertions about presentation and disclosure:~~

~~(i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.~~

~~(ii) Completeness—all disclosures that should have been included in the financial statements have been included.~~

~~(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.~~

~~(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.~~

#### Assertions about other disclosures

A124a. The assertions described in paragraph A124(a)–(b) above, adapted as appropriate, may also be used by the auditor in considering the different types of potential misstatements that may occur in disclosures not directly related to recorded classes of transactions, events, or account balances. As an example of such a disclosure, the entity may be required to describe its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks.

A125. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

## Considerations specific to public sector entities

A126. When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A124, management may often assert that transactions and events have been carried out in accordance with law, regulation or other authority. Such assertions may fall within the scope of the financial statement audit.

### *Process of Identifying Risks of Material Misstatement (Ref: Para. 26(a))*

A127. 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. In identifying the risks of material misstatement in the financial statements, the auditor exercises professional skepticism.

A128. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement, including risks of material misstatement relating to disclosure.

A128a. As explained in ISA 320,<sup>17</sup> materiality and audit risk are considered when identifying and assessing the risks of material misstatement in classes of transactions, account balances and disclosures. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial reporting needs of users of the financial statements.<sup>18</sup>

A128b. The auditor's consideration of disclosures in the financial statements when identifying risks includes qualitative disclosures, the misstatement of which could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole. Depending on the circumstances of the entity and the engagement, examples of such disclosures that may be

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<sup>17</sup> ISA 320, *Materiality in Planning and Performing an Audit*, paragraph A1

<sup>18</sup> ISA 320, paragraph 4

relevant when assessing the risks of material misstatement include disclosures about:

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

*Relating Controls to Assertions* (Ref: Para. 26(c))

A129. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A130. 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.

A131. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

### *Significant Risks*

Identifying Significant Risks (Ref: Para. 28)

A132. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A133. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

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

A134. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

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

A135. ISA 330 describes the consequences for further audit procedures of identifying a risk as significant.<sup>19</sup>

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

A136. ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.<sup>20</sup>

Understanding Controls Related to Significant Risks (Ref: Para. 29)

A137. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

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

A138. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response

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<sup>19</sup> ISA 330, paragraphs 15 and 21

<sup>20</sup> ISA 240, paragraphs 25–27

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.

A139. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant deficiency in internal control.<sup>21</sup>

*Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para. 30)*

A140. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A141. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

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

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<sup>21</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph A7

A142. The consequences for further audit procedures of identifying such risks are described in ISA 330.<sup>22</sup>

*Revision of Risk Assessment* (Ref: Para. 31)

A143. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. See ISA 330 for further guidance.

**Documentation** (Ref: Para. 32)

A144. The manner in which the requirements of paragraph 32 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.<sup>23</sup> Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures.<sup>24</sup> 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.

A145. For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple in

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<sup>22</sup> ISA 330, paragraph 8

<sup>23</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9

<sup>24</sup> ISA 330, paragraph 28

form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

A146. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of ISA 230 are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

A147. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

## Appendix 1

(Ref: Para. 4(c), 14–24, A76–A117)

### Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14–24 and A76–A117, as they relate to a financial statement audit.

### Control Environment

2. The control environment encompasses the following elements:
  - (a) *Communication and enforcement of integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
  - (b) *Commitment to competence.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.
  - (c) *Participation by those charged with governance.* An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower

procedures and the process for reviewing the effectiveness of the entity's internal control.

- (d) *Management's philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
- (e) *Organizational structure.* Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.
- (f) *Assignment of authority and responsibility.* The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.
- (g) *Human resource policies and practices.* Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to

the advancement of qualified personnel to higher levels of responsibility.

### **Entity's Risk Assessment Process**

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.
4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:
  - *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
  - *New personnel.* New personnel may have a different focus on or understanding of internal control.
  - *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
  - *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
  - *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.

- *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

### **Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication**

5. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).
6. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:
  - Identify and record all valid transactions.
  - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
  - Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
  - Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.

- Present properly the transactions and related disclosures in the financial statements.
7. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

### **Control Activities**

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:
- *Performance reviews.* These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
  - *Information processing.* The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT controls are program change controls, controls that restrict

access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

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

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

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

## Monitoring of Controls

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

## Appendix 2

(Ref: Para. A40, A128)

### Conditions and Events That May Indicate Risks of Material Misstatement

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

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.
- Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.

- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Deficiencies in internal control, especially those not addressed by management.
- Incentives for management and employees to engage in fraudulent financial reporting.
- 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 and related disclosures.
- Omission, or obscuring, of significant information in disclosures.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

# INTERNATIONAL STANDARD ON AUDITING 330

## THE AUDITOR’S RESPONSES TO ASSESSED RISKS

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

**[Marked for Changes to the Extant Standard]**

### CONTENTS

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	Paragraph
<b>Introduction</b>	
Scope of this ISA .....	1
Effective Date .....	2
<b>Objective</b> .....	3
<b>Definitions</b> .....	4
<b>Requirements</b>	
Overall Responses .....	5
Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level .....	6–23
Adequacy of Presentation and Disclosure .....	24
Evaluating the Sufficiency and Appropriateness of Audit Evidence .	25–27
Documentation .....	28–30
<b>Application and Other Explanatory Material</b>	
Overall Responses .....	A1–A3
Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level .....	A4–A58
Adequacy of Presentation and Disclosure .....	A59
Evaluating the Sufficiency and Appropriateness of Audit Evidence .	A60–A62
Documentation .....	A63

## Introduction

### Scope of this ISA

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

### Effective Date

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

### Objective

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

### Definitions

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

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<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

## Requirements

### Overall Responses

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

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

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

### *Tests of Controls*

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

### *Nature and Extent of Tests of Controls*

10. In designing and performing tests of controls, the auditor shall:
  - (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
    - (i) How the controls were applied at relevant times during the period under audit;
    - (ii) The consistency with which they were applied; and
    - (iii) By whom or by what means they were applied. (Ref: Para. A26–A29)
  - (b) Determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30–A31)

### Timing of Tests of Controls

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

### Using audit evidence obtained during an interim period

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

### Using audit evidence obtained in previous audits

13. In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:
  - (a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
  - (b) The risks arising from the characteristics of the control, including whether it is manual or automated;
  - (c) The effectiveness of general IT controls;
  - (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
  - (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and

- (f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)
14. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:
- (a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36)
  - (b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37–A39)

#### Controls over significant risks

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

#### Evaluating the Operating Effectiveness of Controls

16. When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A40)
17. If deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these

matters and their potential consequences, and shall determine whether: (Ref: Para. A41)

- (a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
- (b) Additional tests of controls are necessary; or
- (c) The potential risks of misstatement need to be addressed using substantive procedures.

### *Substantive Procedures*

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

### *Substantive Procedures Related to the Financial Statement Closing Process*

- 20. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:
  - (a) Agreeing or reconciling information, including classes of transactions, account balances and disclosures in the financial statements with the underlying accounting records, including those relevant accounting records that are outside the general and subsidiary ledgers; and
  - (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)

### *Substantive Procedures Responsive to Significant Risks*

- 21. If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that

risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)

#### Timing of Substantive Procedures

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

#### Adequacy of Presentation and Disclosure

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. This includes whether the financial statements are presented in a manner that reflects the appropriate:
- (a) Classification and description of financial information, and the underlying transactions and events, including in disclosures; and
  - (b) Form, arrangement, and content of the financial statements.
- (Ref: Para. A59)

#### Evaluating the Sufficiency and Appropriateness of Audit Evidence

25. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit

whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A60–A61)

26. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)
27. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

### Documentation

28. The auditor shall include in the audit documentation:<sup>2</sup>
  - (a) The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed;
  - (b) The linkage of those procedures with the assessed risks at the assertion level; and
  - (c) The results of the audit procedures, including the conclusions where these are not otherwise clear. (Ref: Para. A63)
29. If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit.
30. The auditor's documentation shall demonstrate that information, including classes of transactions, account balances and disclosures in the financial statements agree<sub>s</sub> or reconcile<sub>s</sub> with the underlying accounting records, including those relevant accounting records that are outside the general and subsidiary ledgers.

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<sup>2</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

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## Application and Other Explanatory Material

### Overall Responses (Ref: Para. 5)

A1. Overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- Emphasizing to the engagement team the need to maintain professional skepticism.
- Assigning more experienced staff or those with special skills or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

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

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.

- Increasing the number of locations to be included in the audit scope.
- A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

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

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

- A4. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that:
- (a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;
  - (b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or
  - (c) A combined approach using both tests of controls and substantive procedures is an effective approach.

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

- A5. The nature of an audit procedure refers to its purpose (that is, test of controls or substantive procedure) and its type (that is, inspection,

observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks.

- A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.
- A7. Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.
- A8. Designing and performing further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage between the auditor's further audit procedures and the risk assessment.

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

##### Nature

- A9. The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.
- A10. The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls, and the auditor intends to base the substantive procedures on that low assessment,

then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

## Timing

- A11. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from interim date to the period end would not be effective.
- A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.
- A13. In addition, certain audit procedures can be performed only at or after the period end, for example:
- Agreeing the financial statements to the accounting records;
  - Examining adjustments made during the course of preparing the financial statements; and
  - Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized.
- A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

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

## Extent

- A15. The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.
- A16. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

### Considerations specific to public sector entities

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

### Considerations specific to smaller entities

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

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

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

### *Tests of Controls*

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

A20. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

A21. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit

procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

A22. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:

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

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

A23. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

A24. In some cases, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level.<sup>3</sup> This may occur

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<sup>3</sup> ISA 315 (Revised), paragraph 30

when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls.

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

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

#### Nature and Extent of Tests of Controls

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

A26. Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

A27. The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

## Extent of tests of controls

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

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

ISA 530<sup>4</sup> contains further guidance on the extent of testing.

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

- Changes to the program are not made without being subject to the appropriate program change controls;

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<sup>4</sup> ISA 530, *Audit Sampling*

- The authorized version of the program is used for processing transactions; and
- Other relevant general controls are effective.

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

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

- A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls. For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, the general IT controls) are described as “indirect” controls.
- A31. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity’s general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.

#### Timing of Tests of Controls

##### Intended period of reliance (Ref: Para. 11)

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

times during that period are appropriate. Such tests may include tests of the entity's monitoring of controls.

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

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

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

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

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

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

evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

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

A36. Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

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

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

- (a) have not changed since they were last tested; and
- (b) are not controls that mitigate a significant risk,

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

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

- A deficient control environment.
- Deficient monitoring of controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.

- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT controls.

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

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

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

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

#### *Substantive Procedures* (Ref: Para. 18)

A42. Paragraph 18 requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. This requirement reflects the facts that: (a) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and (b) there are inherent limitations to internal control, including management override.

#### Nature and Extent of Substantive Procedures

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

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor’s assessment of risk is supported by audit evidence from tests of controls.
  - Only tests of details are appropriate.
  - A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.
- A44. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. ISA 520<sup>5</sup> establishes requirements and provides guidance on the application of analytical procedures during an audit.
- A45. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.
- A46. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.
- A47. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. See ISA 500.<sup>6</sup>

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<sup>5</sup> ISA 520, *Analytical Procedures*

<sup>6</sup> ISA 500, *Audit Evidence*, paragraph 10

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

A48. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cutoff assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms.

A49. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.

A50. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor's decision about whether to perform external confirmation procedures.

A51. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**Adequacy of Presentation and Disclosure** (Ref: Para. 24)

A59. Evaluating the appropriate form, arrangement and content of the financial statements ~~overall presentation of the financial statements, including the related disclosures, relates to whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information, and the form, arrangement, and~~

~~content of the financial statements and their appended notes. This includes, for example, consideration of the terminology used as required by the applicable financial reporting framework, the level of detail provided, the aggregation and disaggregation of amounts, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.~~

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

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

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

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. ISA 315 (Revised) contains further guidance on revising the auditor's risk assessment.<sup>7</sup>

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

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<sup>7</sup> ISA 315 (Revised), paragraph 31

is important in determining whether the assessment remains appropriate.

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

- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.
- Understanding of the entity and its environment, including the entity's internal control.

**Documentation** (Ref: Para. 28)

A63. The form and extent of audit documentation is a matter of professional judgment, and is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the audit.

# INTERNATIONAL STANDARD ON AUDITING 450

## EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

**[Marked for Changes to the Extant Standard]**

### CONTENTS

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	Paragraph
<b>Introduction</b>	
Scope of this ISA .....	1
Effective Date .....	2
<b>Objective</b> .....	3
<b>Definitions</b> .....	4
<b>Requirements</b>	
Accumulation of Identified Misstatements .....	5
Consideration of Identified Misstatements as the Audit Progresses .....	6–7
Communication and Correction of Misstatements .....	8–9
Evaluating the Effect of Uncorrected Misstatements .....	10–13
Written Representations .....	14
Documentation .....	15
<b>Application and Other Explanatory Material</b>	
Definition of Misstatement .....	A1
Accumulation of Identified Misstatements .....	A2–A3
Consideration of Identified Misstatements as the Audit Progresses .....	A4–A6
Communication and Correction of Misstatements .....	A7–A10
Evaluating the Effect of Uncorrected Misstatements .....	A11–A23
Written Representations .....	A24
Documentation .....	A25

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. ISA 700 deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by ISA 700 takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this ISA.<sup>32</sup> ISA 320<sup>33</sup> deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

### Effective Date

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

### Objective

3. The objective of the auditor is to evaluate:
  - (a) The effect of identified misstatements on the audit; and
  - (b) The effect of uncorrected misstatements, if any, on the financial statements.

### Definitions

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

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<sup>32</sup> ISA 700, *Forming an Opinion and Reporting on Financial Statements*, paragraphs 10–11

<sup>33</sup> ISA 320, *Materiality in Planning and Performing an Audit*

- (a) Misstatement – A difference between the reported amount, classification, presentation, or disclosure of a ~~reported~~ financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

- (b) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

## Requirements

### Accumulation of Identified Misstatements

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2–A3)

### Consideration of Identified Misstatements as the Audit Progresses

6. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:
- (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A4)
- (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with ISA 320. (Ref: Para. A5)
7. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected

misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)

### **Communication and Correction of Misstatements**

8. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation.<sup>34</sup> The auditor shall request management to correct those misstatements. (Ref: Para. A7–A9)
9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management’s reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A10)

### **Evaluating the Effect of Uncorrected Misstatements**

10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with ISA 320 to confirm whether it remains appropriate in the context of the entity’s actual financial results. (Ref: Para. A11–A12)
11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:
  - (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A13–A17, A19–A20)
  - (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or

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<sup>34</sup> ISA 260, *Communication with Those Charged with Governance*, paragraph 7

disclosures, and the financial statements as a whole. (Ref: Para. A18)

### *Communication with Those Charged with Governance*

12. The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.<sup>35</sup> The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21–A23)
13. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

### **Written Representations**

14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A24)

### **Documentation**

15. The auditor shall include in the audit documentation:<sup>36</sup> (Ref: Para. A25)
  - (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);
  - (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5, 8 and 12); and

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<sup>35</sup> See footnote 3.

<sup>36</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

- (c) The auditor’s conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion (paragraph 11).

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## Application and Other Explanatory Material

### Definition of Misstatement (Ref: Para. 4(a))

#### A1. Misstatements may result from:

- (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;
- (b) An omission of an amount or disclosure, including inadequate or incomplete qualitative disclosures, and those disclosures required to meet disclosure objectives of certain financial reporting frameworks as applicable;<sup>37</sup>
- (c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts; and
- (d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.
- (e) An inappropriate classification, aggregation or disaggregation, of information; and
- (f) For financial statements prepared in accordance with a fair presentation framework, the omission of a disclosure beyond what is specifically required by the framework that is necessary for fair presentation.<sup>38</sup>

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<sup>37</sup> For example, International Financial Reporting Standard (IFRS) 7, *Financial Instruments: Disclosures*, paragraph 42H states that “an entity shall disclose any additional information that it considers necessary to meet the disclosure objectives in paragraph...”

<sup>38</sup> For example, IFRS requires an entity to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial

Examples of misstatements arising from fraud are provided in ISA 240.<sup>39</sup>

### Accumulation of Identified Misstatements (Ref: Para. 5)

A2. The auditor may designate an amount below which quantitative misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that ~~the accumulation of~~ such amounts clearly would not have a material effect, individually or in aggregate, on the financial statements. “Clearly trivial” is not another expression for “not material.” ~~Matters—Quantitative and qualitative misstatements~~ that are clearly trivial will be of a wholly different (smaller) order of magnitude or significance, as applicable, than materiality determined in accordance with ISA 320, and ~~will would~~ be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances as applicable. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

A2a. Paragraph 5 of this ISA requires the auditor to accumulate misstatements identified during the audit, whether quantitative or qualitative, other than those that are clearly trivial. Misstatements in disclosures are therefore also accumulated to assist the auditor in evaluating the effect of such misstatements on the disclosures and the financial statements as a whole. Although misstatements in qualitative disclosures cannot be added together as is possible in the case of misstatements of amounts, they are still evaluated individually and in aggregate (i.e., collectively with other misstatements) as required by paragraph 11 of this ISA. Paragraph A13a of this ISA provides

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position and financial performance (International Accounting Standard 1, *Presentation of Financial Statements*, paragraph 17(c)).

<sup>39</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs A1–A6

considerations about when misstatements in qualitative disclosures may be material.\*

- A3. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.
- Factual misstatements are misstatements about which there is no doubt.
  - Judgmental misstatements are differences arising from the judgments of management including those concerning recognition, measurement, presentation and disclosure in the financial statements (including accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies) that the auditor considers unreasonable or inappropriate.
  - Projected misstatements are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in ISA 530.<sup>40</sup>

**Consideration of Identified Misstatements as the Audit Progresses** (Ref: Para. 6–7)

- A4. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

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\* When the final standard is issued, this paragraph will become paragraph A3 and all subsequent paragraphs will be renumbered accordingly.

<sup>40</sup> ISA 530, *Audit Sampling*, paragraphs 14–15

- A5. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with ISA 320, there may be a greater than acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.<sup>41</sup>
- A6. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

**Communication and Correction of Misstatements** (Ref: Para. 8–9)

- A7. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.
- A8. Law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.

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<sup>41</sup> ISA 530, paragraph 5(c)–(d)

- A9. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.
- A10. ISA 700 requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments,<sup>42</sup> which may be affected by the auditor's understanding of management's reasons for not making the corrections.

#### **Evaluating the Effect of Uncorrected Misstatements** (Ref: Para. 10–11)

- A11. The auditor's determination of materiality in accordance with ISA 320 is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with ISA 320 based on the actual financial results.
- A12. ISA 320 explains that, as the audit progresses, materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.<sup>43</sup> Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with ISA 320 (see paragraph 10 of this ISA) gives rise to a lower amount (or

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<sup>42</sup> ISA 700, paragraph 12

<sup>43</sup> ISA 320, paragraph 12

amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.

A13. Each individual misstatement of an amount is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

A13a. Each individual misstatement of a qualitative disclosure is also considered to evaluate its effect on the relevant disclosure(s), as well as its overall effect on the financial statements as a whole. The auditor exercises professional judgment in determining whether a misstatement(s) in a qualitative disclosure is material, in the context of the applicable financial reporting framework and the specific circumstances of the entity. Examples where such misstatements could be material include:

- Inaccurate or incomplete descriptions of information about the objectives, policies and processes for managing capital for entities with insurance and banking activities.
- The omission of information about the events or circumstances that have led to an impairment loss (e.g., a significant long-term decline in the demand for a metal or commodity) in an entity with mining operations.
- The incorrect description of an accounting policy relating to a significant item in the statement of financial position, statement of financial performance or the statement of cash flows.
- The inadequate description of the sensitivity of an exchange rate in an entity that undertakes international trading activities.

A13b. The circumstances related to some misstatements in qualitative disclosures may also cause the auditor to evaluate them as material when considered together with qualitative misstatements accumulated during the audit. For example, the auditor may consider whether

clerical errors in narrative disclosures could be persistent or pervasive where the misstatements of a number of qualitative disclosures are each related to the same matter, the auditor may consider whether collectively their impact would result in a material misstatement in the financial statements as a whole. This aggregation of misstatements in disclosures is also helpful when evaluating the financial statements in accordance with paragraph 13(d) of ISA 700,<sup>44</sup> which requires the auditor to consider whether the disclosures undermine the overall presentation of the financial statements by including information that is not relevant or that is presented in a manner that may obscure a proper understanding of the matters disclosed.

- A14. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.<sup>45</sup>
- A15. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to

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<sup>44</sup> ISA 700(Revised), *Forming an Opinion and Reporting on Financial Statements*

<sup>45</sup> The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to reassess the risk of material misstatement for that account balance or class of transactions.

the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

A16. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the materiality level for the financial statements as a whole or are not of the nature of a qualitative misstatement in disclosures that the auditor has determined could be material. Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example, in relation to forecast earnings;

- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. ISA 720<sup>46</sup> deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

- A17. ISA 240<sup>47</sup> explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements. The auditor exercises professional skepticism when considering indicators of fraud. Examples of misstatements in disclosures that could be indicative of fraud may include:
- Misleading disclosures that have resulted from bias in management's judgments; or

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<sup>46</sup> ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*

<sup>47</sup> ISA 240, paragraph 35

- Extensive duplicative or uninformative disclosures that are intended to obscure a proper understanding of matters in the financial statements.

A18. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

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

A19. In the case of an audit of a public sector entity, the evaluation whether a misstatement is material may also be affected by the auditor's responsibilities established by law, regulation or other authority to report specific matters, including, for example, fraud.

A20. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with law, regulation or other authority.

#### *Communication with Those Charged with Governance (Ref: Para. 12)*

A21. If uncorrected misstatements have been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.<sup>48</sup>

A22. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

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<sup>48</sup> ISA 260, paragraph 13

A23. ISA 260 requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this ISA).<sup>49</sup> The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

**Written Representations** (Ref: Para. 14)

A24. Because the preparation of the financial statements requires management and, where appropriate, those charged with governance to adjust the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: “We do not agree that items ... and ... constitute misstatements because [description of reasons].” Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

**Documentation** (Ref: Para. 15)

A25. The auditor’s documentation of uncorrected misstatements may take into account:

- (a) The consideration of the aggregate effect of uncorrected misstatements;
- (b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and

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<sup>49</sup> ISA 260, paragraph 16(c)(ii)

- (c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

# INTERNATIONAL STANDARD ON AUDITING 700 (REVISED) FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

(Effective for audits of financial statements for periods ending on or after  
December 15, 2016)

**[Marked for Changes to ISA 700 (Revised for Auditor Reporting  
Changes)]**

Paragraph

## **Introduction**

Scope of this ISA .....

Effective Date .....

**Objectives** .....

**Definitions** .....

## **Requirements**

Forming an Opinion on the Financial Statements .....

Form of Opinion .....

Auditor's Report .....

Supplementary Information Presented with the Financial Statements .....

## **Application and Other Explanatory Material**

Qualitative Aspects of the Entity's Accounting Practices .....

Disclosure of the Effect of Material Transactions and Events on the  
Information Conveyed  
in the Financial Statements .....

Description of the Applicable Financial Reporting Framework .....

Form of Opinion .....

Auditor's Report .....

Supplementary Information Presented with the Financial Statements .....

Appendix: Illustrations of Independent Auditor's Reports on Financial  
Statements

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## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.
2. ISA 701<sup>50</sup> deals with the auditor's responsibility to communicate key audit matters in the auditor's report. ISA 705<sup>51</sup> (Revised) and ISA 706<sup>52</sup> (Revised) deal with how the form and content of the auditor's report are affected when the auditor expresses a modified opinion or includes an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor's report. Other ISAs also contain reporting requirements that are applicable when issuing an auditor's report.
3. This ISA applies to an audit of a complete set of general purpose financial statements and is written in that context. ISA 800<sup>53</sup> deals with special considerations when financial statements are prepared in accordance with a special purpose framework. ISA 805<sup>54</sup> deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement. This ISA also applies to audits for which ISA 800 or ISA 805 apply.
4. The requirements of this ISA are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report

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<sup>50</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

<sup>51</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

<sup>52</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

<sup>53</sup> ISA 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*

<sup>54</sup> ISA 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*

more relevant to users. This ISA promotes consistency in the auditor's report, but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with ISAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

### **Effective Date**

5. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2016.

### **Objectives**

6. The objectives of the auditor are:
  - (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
  - (b) To express clearly that opinion through a written report.

### **Definitions**

7. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) General purpose financial statements – Financial statements prepared in accordance with a general purpose framework.
  - (b) General purpose framework – A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.<sup>55</sup>

- (c) Unmodified opinion – The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.<sup>56</sup>

- 8. Reference to “financial statements” in this ISA means “a complete set of general purpose financial statements, including the related notes.” The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The requirements of the applicable financial reporting framework determine the form and content of the financial statements, and what constitutes a complete set of financial statements.
- 9. Reference to “International Financial Reporting Standards” in this ISA means the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board, and reference to “International Public Sector Accounting Standards” means the International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board.

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<sup>55</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(a)

<sup>56</sup> Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

## Requirements

### Forming an Opinion on the Financial Statements

10. The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.<sup>57,58</sup>
11. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:
  - (a) The auditor's conclusion, in accordance with ISA 330, whether sufficient appropriate audit evidence has been obtained;<sup>59</sup>
  - (b) The auditor's conclusion, in accordance with ISA 450, whether uncorrected misstatements are material, individually or in aggregate;<sup>60</sup> and
  - (c) The evaluations required by paragraphs 12–15.
12. The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. (Ref: Para. A1–A3)
13. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:
  - (a) The financial statements adequately disclose the significant accounting policies selected and applied. This includes

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<sup>57</sup> ISA 200, paragraph 11

<sup>58</sup> Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

<sup>59</sup> ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 26

<sup>60</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

- consideration of the relevance to the entity, and the understandability of, these disclosures;
- (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- (c) The accounting estimates made by management are reasonable;
- (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable. This includes consideration of whether:
- Information in the financial statements is appropriately classified, aggregated or disaggregated, and characterized, disclosed in an understandable manner, and does not omit information that is relevant in view of the requirements of the applicable financial reporting framework.
  - The disclosures undermine the overall presentation of the financial statements by including information that is not relevant or that is presented in a manner that may obscure a proper understanding of the matters disclosed.(Ref: Para. A3b)
- (e). The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A4)
- (f). The terminology used in the financial statements, including the title of each financial statement, is appropriate.
14. When the financial statements are prepared in accordance with a fair presentation framework, the evaluation required by paragraphs 12–13 shall also include whether the financial statements achieve fair presentation. The auditor’s evaluation as to whether the financial statements achieve fair presentation shall include consideration of:
- (a) The overall presentation, structure and content of the financial statements; and

- (b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.
15. The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. (Ref: Para. A5–A10)

### **Form of Opinion**

16. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
17. If the auditor:
- (a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
  - (b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,
- the auditor shall modify the opinion in the auditor's report in accordance with ISA 705 (Revised).
18. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with ISA 705 (Revised). (Ref: Para. A11)
19. When the financial statements are prepared in accordance with a compliance framework, the auditor is not required to evaluate whether the financial statements achieve fair presentation. However, if in extremely rare circumstances the auditor concludes that such financial statements are misleading, the auditor shall discuss the matter with

management and, depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor's report. (Ref: Para. A12)

### **Auditor's Report**

20. The auditor's report shall be in writing. (Ref: Para. A13–A14)

#### *Auditor's Report for Audits Conducted in Accordance with International Standards on Auditing*

##### Title

21. The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor. (Ref: Para. A15)

##### Addressee

22. The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. (Ref: Para. A16)

##### Auditor's Opinion

23. The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

24. The Opinion section of the auditor's report shall also:

- (a) Identify the entity whose financial statements have been audited;
- (b) State that the financial statements have been audited;
- (c) Identify the title of each statement comprising the financial statements;
- (d) Refer to the notes, including the summary of significant accounting policies; and
- (e) Specify the date of, or period covered by, each financial statement comprising the financial statements. (Ref: Para. A17–A18)

25. When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion

shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

- (a) In our opinion, the accompanying financial statements present fairly, in all material respects, [...] in accordance with [the applicable financial reporting framework]; or
- (b) In our opinion, the accompanying financial statements give a true and fair view of [...] in accordance with [the applicable financial reporting framework]. (Ref: Para. A19–A26)

26. When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the accompanying financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework]. (Ref: Para. A21–A26)
27. If the reference to the applicable financial reporting framework in the auditor's opinion is not to IFRSs issued by the International Accounting Standards Board or IPSASs issued by the International Public Sector Accounting Standards Board, the auditor's opinion shall identify the jurisdiction of origin of the framework.

#### Basis for Opinion

28. The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that: (Ref: Para. A27)
- (a) States that the audit was conducted in accordance with International Standards on Auditing; (Ref: Para. A28)
  - (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the ISAs;
  - (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the International Ethics

Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code); and (Ref: Para. A29–A34)

- (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

#### Going Concern

- 29. Where applicable, the auditor shall report in accordance with ISA 570 (Revised).<sup>61</sup>

#### Key Audit Matters

- 30. For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with ISA 701.
- 31. When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with ISA 701. (Ref: Para. A35–A38)

#### Responsibilities for the Financial Statements

- 32. The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." The auditor's report shall use the term that is appropriate in the context of the legal framework in the particular jurisdiction and need not refer specifically to "management". In some jurisdictions, the appropriate reference may be to those charged with governance. (Ref: Para. A39)
- 33. This section of the auditor's report shall describe management's responsibility for: (Ref: Para. A40–A43)
  - (a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the

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<sup>61</sup> ISA 570 (Revised), *Going Concern*, paragraphs 21–23

preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

- (b) Assessing the entity's ability to continue as a going concern<sup>62</sup> and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate. (Ref: Para. A43)
34. This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfill the responsibilities described in paragraph 33 above. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework in the particular jurisdiction. (Ref: Para. A44)
35. When the financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

#### Auditor's Responsibilities for the Audit of the Financial Statements

36. The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."
37. This section of the auditor's report shall: (Ref: Para. A45)
- (a) State that the objectives of the auditor are to:

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<sup>62</sup> ISA 570 (Revised), paragraph 2

- (i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
    - (ii) Issue an auditor's report that includes the auditor's opinion. (Ref: Para. A46)
  - (b) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists; and
  - (c) State that misstatements can arise from fraud or error, and either:
    - (i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or <sup>63</sup>
    - (ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework. (Ref: Para. A47)
38. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further: (Ref: Para. A45)
- (a) State that, as part of an audit in accordance with ISAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and
  - (b) Describe an audit by stating that the auditor's responsibilities are:
    - (i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement

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<sup>63</sup> ISA 320, *Materiality in Planning and Performing an Audit*, paragraph 2

resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- (ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.
- (iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- (iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.
- (v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial

statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- (c) When ISA 600<sup>64</sup> applies, further describe the auditor's responsibilities in a group audit engagement by stating that:
- (i) The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the group financial statements;
  - (ii) The auditor is responsible for the direction, supervision and performance of the group audit; and
  - (iii) The auditor remains solely responsible for the auditor's opinion.

39. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall: (Ref: Para. A45)

- (a) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;
- (b) For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and
- (c) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in

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<sup>64</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

accordance with ISA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. (Ref: Para. A48)

#### Location of the description of the auditor's responsibilities for the audit of the financial statements

40. The description of the auditor's responsibilities for the audit of the financial statements required by paragraphs 38–39 shall be included: (Ref: Paras. A49)
  - (a) Within the body of the auditor's report;
  - (b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or (Ref: Para. A49–A50)
  - (c) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so. (Ref: Para. A49, A51–A52)
41. When the auditor refers to a description of the auditor's responsibilities on a website of an appropriate authority, the auditor shall determine that such description addresses, and is not inconsistent with, the requirements in paragraphs 38–39 of this ISA. (Ref: Para. A51)

#### Other Reporting Responsibilities

42. If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's

responsibilities under the ISAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the ISAs. (Ref: Para. A53–A55)

43. If other reporting responsibilities are presented in the same section as the related report elements required by the ISAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the ISAs. (Ref: Para. A55)
44. If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements of paragraphs 20–39 of this ISA shall be included under a section with a heading "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements." (Ref: Para. A55)

#### Name of the Engagement Partner

45. The name of the engagement partner shall be included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat. In the rare circumstances that the auditor intends not to include the name of the engagement partner in the auditor's report, the auditor shall discuss this intention with those charged with governance to inform the auditor's assessment of the likelihood and severity of a significant personal security threat. (Ref: Para. A56–A58)

#### Signature of the Auditor

46. The auditor's report shall be signed. (Ref: Para. A59–A60)

### Auditor's Address

47. The auditor's report shall name the location in the jurisdiction where the auditor practices.

### Date of the Auditor's Report

48. The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that: (Ref: Para. A61–A64)

- (a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
- (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

### *Auditor's Report Prescribed by Law or Regulation*

49. If the auditor is required by law or regulation of a specific jurisdiction to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to International Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements: (Ref: Para. A65–A66)

- (a) A title.
- (b) An addressee, as required by the circumstances of the engagement.
- (c) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the jurisdiction of origin of the financial reporting framework that is not International Financial Reporting Standards or International Public Sector Accounting Standards, see paragraph 26).
- (d) An identification of the entity's financial statements that have been audited.

- (e) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the IESBA Code.
- (f) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements in paragraph 22 of ISA 570 (Revised).
- (g) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements in paragraph 23 of ISA 570 (Revised).
- (h) Where applicable, a section that includes the information required by ISA 701, or additional information about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that ISA.<sup>65</sup> (Ref: Para. A66–A67).
- (i) A description of management's responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements in paragraphs 32–35.
- (j) A reference to International Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements in paragraphs 36–39. (Ref: Paras. A49–A50)
- (k) For audits of complete sets of general purpose financial statements of listed entities, the name of the engagement partner unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat.

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<sup>65</sup> ISA 701, paragraphs 11-16

- (l) The auditor's signature.
- (m) The auditor's address.
- (n) The date of the auditor's report.

*Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards of a Specific Jurisdiction and International Standards on Auditing*

50. An auditor may be required to conduct an audit in accordance with the auditing standards of a specific jurisdiction (the "national auditing standards"), and has additionally complied with the ISAs in the conduct of the audit. If this is the case, the auditor's report may refer to International Standards on Auditing in addition to the national auditing standards, but the auditor shall do so only if: (Ref: Para. A71–A72)
- (a) There is no conflict between the requirements in the national auditing standards and those in ISAs that would lead the auditor (i) to form a different opinion, or (ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by ISAs; and
  - (b) The auditor's report includes, at a minimum, each of the elements set out in paragraphs 49(a)–(n) above when the auditor uses the layout or wording specified by the national auditing standards. However, reference to "law or regulation" in paragraph 49(j) shall be read as reference to the national auditing standards. The auditor's report shall thereby identify such national auditing standards.
51. When the auditor's report refers to both the national auditing standards and International Standards on Auditing, the auditor's report shall identify the jurisdiction of origin of the national auditing standards.

**Supplementary Information Presented with the Financial Statements**

(Ref: Para. A73–A79)

52. If supplementary information that is not required by the applicable financial reporting framework is presented with the audited financial statements, the auditor shall evaluate whether, in the auditor's professional judgment,

supplementary information is nevertheless an integral part of the financial statements due to its nature or how it is presented. When it is an integral part of the financial statements, the supplementary information shall be covered by the auditor's opinion.

53. If supplementary information that is not required by the applicable financial reporting framework is not considered an integral part of the audited financial statements, the auditor shall evaluate whether such supplementary information is presented in a way that sufficiently and clearly differentiates it from the audited financial statements. If this is not the case, then the auditor shall ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall identify the unaudited supplementary information and explain in the auditor's report that such supplementary information has not been audited.

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## Application and Other Explanatory Material

### Qualitative Aspects of the Entity's Accounting Practices (Ref: Para. 12)

- A1. Management makes a number of judgments about the amounts and disclosures in the financial statements
- A2. ISA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.<sup>66</sup> In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor's evaluation of whether the financial statements as a whole are materially misstated include the following:
- The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings,

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<sup>66</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, Appendix 2

but not correcting misstatements that have the effect of decreasing reported earnings).

- Possible management bias in ~~the~~ making ~~of~~ accounting estimates.

A3. ISA 540 addresses possible management bias in making accounting estimates.<sup>67</sup> Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

**Information Presented in the Financial Statements Is Relevant, Reliable, Comparable and Understandable (Ref: Para. 13(d))**

**A3a. Evaluating the understandability of the financial statements includes consideration of matters such as whether:**

- The information in the financial statements is presented in a clear and concise manner.
- The placement of significant disclosures gives appropriate prominence to them (for example, when there is perceived value of entity-specific information to users), and whether the disclosures are appropriately internally cross-referenced in a manner that would not give rise to significant challenges for users in identifying necessary information.\*

**Disclosures of the Effect of Material Transactions and Events on the Information Conveyed in the Financial Statements (Ref: Para. 13(e))**

A4. It is common for financial statements prepared in accordance with a general purpose framework to present an entity's financial position, financial performance and cash flows. Evaluating whether, in view of

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<sup>67</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 21

\* When the final standard is issued, this paragraph will become paragraph A4 and all subsequent paragraphs will be renumbered accordingly.

the applicable financial reporting framework, ~~in such circumstances, the auditor evaluates whether~~ the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the entity's financial position, financial performance and cash flows includes consideration of such matters as:

- The extent to which the information in the financial statements is relevant and specific to the circumstances of the entity; and
- Whether the disclosures are adequate to assist the intended users to understand:
  - The nature and extent of the entity's potential assets and liabilities arising from transactions or events that do not meet the criteria for recognition (or the criteria for derecognition) established by the applicable financial reporting framework.
  - The nature and extent of risks of material misstatement arising from transactions and events.
  - The methods used and the assumptions and judgments made, and changes to them, that affect amounts presented or otherwise disclosed, including relevant sensitivity analyses.

### **Evaluating Whether the Financial Statements Achieve Fair Presentation**

(Ref: Para. 14)

A4a. Some financial reporting frameworks acknowledge explicitly or implicitly the concept of fair presentation.<sup>68</sup> As noted in paragraph 7(b) of this ISA, a fair presentation<sup>69</sup> financial reporting framework not only requires compliance with the requirements of the framework, but also acknowledges explicitly or implicitly that it may be necessary for

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<sup>68</sup> For example, International Financial Reporting Standards (IFRSs) note that fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses.

<sup>69</sup> See ISA 200, paragraph 13(a).

management to provide disclosures beyond those specifically required by the framework.<sup>70</sup>

A4b. The auditor's evaluation about whether the financial statements achieve fair presentation, both in respect of presentation and disclosure, is a matter of professional judgment. This evaluation takes into account such matters as the facts and circumstances of the entity, including changes thereto, based on the auditor's understanding of the entity and the audit evidence obtained during the audit. The evaluation also includes consideration, for example, of the disclosures needed to achieve a fair presentation arising from matters that may be relevant to the economic decisions of the users of the financial statements, such as evolving financial reporting requirements or the changing economic environment.

A4c. Evaluating whether the financial statements achieve fair presentation includes, for example and as appropriate, discussions with management and those charged with governance about their views on why a particular presentation was chosen, as well as alternatives that may have been considered. The discussions may include, for example:

- The degree to which the amounts in the financial statements are aggregated or disaggregated, and whether the presentation of amounts or disclosures obscures useful information, or results in misleading information.
- Consistency with appropriate industry practice, or whether any departures are relevant to the entity's circumstances and therefore warranted.

## **Description of the Applicable Financial Reporting Framework (Ref: Para. 15)**

A5. As explained in ISA 200, the preparation of the financial statements by

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<sup>70</sup> For example, IFRS requires an entity to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (International Accounting Standard 1, *Presentation of Financial Statements*, paragraph 17(c)).

management and, where appropriate, those charged with governance requires the inclusion of an adequate description of the applicable financial reporting framework in the financial statements.<sup>71</sup> That description advises users of the financial statements of the framework on which the financial statements are based.

- A6. A description that the financial statements are prepared in accordance with a particular applicable financial reporting framework is appropriate only if the financial statements comply with all the requirements of that framework that are effective during the period covered by the financial statements.
- A7. A description of the applicable financial reporting framework that contains imprecise qualifying or limiting language (e.g., “the financial statements are in substantial compliance with International Financial Reporting Standards”) is not an adequate description of that framework as it may mislead users of the financial statements.

*Reference to More than One Financial Reporting Framework*

- A8. In some cases, the financial statements may represent that they are prepared in accordance with two financial reporting frameworks (e.g., the national framework and IFRSs). This may be because management is required, or has chosen, to prepare the financial statements in accordance with both frameworks, in which case both are applicable financial reporting frameworks. Such description is appropriate only if the financial statements comply with each of the frameworks individually. To be regarded as being prepared in accordance with both frameworks, the financial statements need to comply with both frameworks simultaneously and without any need for reconciling statements. In practice, simultaneous compliance is unlikely unless the jurisdiction has adopted the other framework (e.g., IFRSs) as its own national framework, or has eliminated all barriers to compliance with it.
- A9. Financial statements that are prepared in accordance with one financial reporting framework and that contain a note or supplementary

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<sup>71</sup> ISA 200, paragraphs A2–A3

statement reconciling the results to those that would be shown under another framework are not prepared in accordance with that other framework. This is because the financial statements do not include all the information in the manner required by that other framework.

- A10. The financial statements may, however, be prepared in accordance with one applicable financial reporting framework and, in addition, describe in the notes to the financial statements the extent to which the financial statements comply with another framework (e.g., financial statements prepared in accordance with the national framework that also describe the extent to which they comply with IFRSs). Such description may constitute supplementary financial information as discussed in paragraph 53 and is covered by the auditor's opinion if it cannot be clearly differentiated from the financial statements.

#### **Form of Opinion** (Ref: Para. 18–19)

- A11. There may be cases where the financial statements, although prepared in accordance with the requirements of a fair presentation framework, do not achieve fair presentation. Where this is the case, it may be possible for management to include additional disclosures in the financial statements beyond those specifically required by the framework or, in extremely rare circumstances, to depart from a requirement in the framework in order to achieve fair presentation of the financial statements.
- A12. It will be extremely rare for the auditor to consider financial statements that are prepared in accordance with a compliance framework to be misleading if, in accordance with ISA 210, the auditor determined that the framework is acceptable.<sup>72</sup>

#### **Auditor's Report** (Ref: Para. 20)

- A13. A written report encompasses reports issued in hard copy and those using an electronic medium.

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<sup>72</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

A14. The Appendix to this ISA contains illustrations of auditor’s reports on financial statements, incorporating the elements set out in paragraphs 20–48. With the exception of the Opinion and Basis for Opinion sections, this ISA does not establish requirements for ordering the elements of the auditor’s report. However, this ISA requires the use of specific headings, which are intended to assist in making auditor’s reports that refer to audits that have been conducted in accordance with ISAs more recognizable, particularly in situations where the elements of the auditor’s report are presented in an order that differs from the illustrative auditor’s reports in the Appendix to this ISA.

*Auditor’s Report for Audits Conducted in Accordance with International Standards on Auditing*

Title (Ref: Para. 21)

A15. A title indicating the report is the report of an independent auditor, for example, “Independent Auditor’s Report,” distinguishes the independent auditor’s report from reports issued by others.

Addressee (Ref: Para. 22)

A16. Law, regulation or the terms of the engagement may specify to whom the auditor’s report is to be addressed in that particular jurisdiction. The auditor’s report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

Auditor’s Opinion (Ref. Para. 24–26)

Reference to the financial statements that have been audited

A17. The auditor’s report states, for example, that the auditor has audited the financial statements of the entity, which comprise [state the title of each financial statement comprising the complete set of financial statements required by the applicable financial reporting framework, specifying the date or period covered by each financial statement] and notes to the financial statements, including a summary of significant accounting policies.

A18. When the auditor is aware that the audited financial statements will be included in a document that contains other information, such as an annual report, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the audited financial statements are presented. This helps users to identify the financial statements to which the auditor's report relates.

“Present fairly, in all material respects” or “give a true and fair view”

A19. The phrases “present fairly, in all material respects,” and “give a true and fair view” are regarded as being equivalent. Whether the phrase “present fairly, in all material respects,” or the phrase “give a true and fair view” is used in any particular jurisdiction is determined by the law or regulation governing the audit of financial statements in that jurisdiction, or by generally accepted practice in that jurisdiction. Where law or regulation requires the use of different wording, this does not affect the requirement in paragraph 14 of this ISA for the auditor to evaluate the fair presentation of financial statements prepared in accordance with a fair presentation framework.

A20. When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as “with the foregoing explanation” or “subject to” in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

Description of the financial statements and the matters they present

A21. The auditor's opinion covers the complete set of financial statements as defined by the applicable financial reporting framework. For example, in the case of many general purpose frameworks, the financial statements may include: a statement of financial position, a statement of comprehensive income, a statement of changes in equity, a statement of cash flows, and related notes, which ordinarily comprise a summary of significant accounting policies and other explanatory information. In some jurisdictions, additional information may also be considered to be an integral part of the financial statements.

A22. In the case of financial statements prepared in accordance with a fair presentation framework, the auditor's opinion states that the financial

statements present fairly, in all material respects, or give a true and fair view of, the matters that the financial statements are designed to present. For example, in the case of financial statements prepared in accordance with IFRSs, these matters are *the financial position of the entity as at the end of the period and the entity's financial performance and cash flows for the period then ended*. Consequently, the [...] in paragraph 25 and elsewhere in this ISA is intended to be replaced by the words in italics in the preceding sentence when the applicable financial reporting framework is IFRSs or, in the case of other applicable financial reporting frameworks, be replaced with words that describe the matters that the financial statements are designed to present.

Description of the applicable financial reporting framework and how it may affect the auditor's opinion

- A23. The identification of the applicable financial reporting framework in the auditor's opinion is intended to advise users of the auditor's report of the context in which the auditor's opinion is expressed; it is not intended to limit the evaluation required in paragraph 14. The applicable financial reporting framework is identified in such terms as:
- “... in accordance with International Financial Reporting Standards” or
- “... in accordance with accounting principles generally accepted in Jurisdiction X ...”
- A24. When the applicable financial reporting framework encompasses financial reporting standards and legal or regulatory requirements, the framework is identified in such terms as “... in accordance with International Financial Reporting Standards and the requirements of Jurisdiction X Corporations Act.” ISA 210 deals with circumstances where there are conflicts between the financial reporting standards and the legislative or regulatory requirements.<sup>73</sup>
- A25. As indicated in paragraph A8, the financial statements may be prepared in accordance with two financial reporting frameworks, which are therefore both applicable financial reporting frameworks.

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<sup>73</sup> ISA 210, paragraph 18

Accordingly, each framework is considered separately when forming the auditor's opinion on the financial statements, and the auditor's opinion in accordance with paragraphs 25–27 refers to both frameworks as follows:

- (a) If the financial statements comply with each of the frameworks individually, two opinions are expressed: that is, that the financial statements are prepared in accordance with one of the applicable financial reporting frameworks (e.g., the national framework) and an opinion that the financial statements are prepared in accordance with the other applicable financial reporting framework (e.g., IFRSs). These opinions may be expressed separately or in a single sentence (e.g., the financial statements are presented fairly, in all material respects [...], in accordance with accounting principles generally accepted in Jurisdiction X and with IFRSs).
- (b) If the financial statements comply with one of the frameworks but fail to comply with the other framework, an unmodified opinion can be given that the financial statements are prepared in accordance with the one framework (e.g., the national framework) but a modified opinion given with regard to the other framework (e.g., IFRSs) in accordance with ISA 705 (Revised).

A26. As indicated in paragraph A10, the financial statements may represent compliance with the applicable financial reporting framework and, in addition, disclose the extent of compliance with another financial reporting framework. Such supplementary information is covered by the auditor's opinion if it cannot be clearly differentiated from the financial statements (see paragraphs 52–53 and related application material in paragraphs A73–A79). Accordingly,

- (a) If the disclosure as to the compliance with the other framework is misleading, a modified opinion is expressed in accordance with ISA 705 (Revised).
- (b) If the disclosure is not misleading, but the auditor judges it to be of such importance that it is fundamental to the users' understanding of the financial statements, an Emphasis of

Matter paragraph is added in accordance with ISA 706 (Revised), drawing attention to the disclosure.

#### Basis for Opinion (Ref: Para. 28)

- A27. The Basis for Opinion section provides important context about the auditor's opinion. Accordingly, this ISA requires the Basis for Opinion section to directly follow the Opinion section in the auditor's report.
- A28. The reference to the standards used conveys to the users of the auditor's report that the audit has been conducted in accordance with established standards.

#### Relevant ethical requirements

- A29. The identification of the jurisdiction of origin of relevant ethical requirements increases transparency about those requirements relating to the particular audit engagement. ISA 200 explains that relevant ethical requirements ordinarily comprise Parts A and B of the IESBA Code related to an audit of financial statements together with national requirements that are more restrictive.<sup>74</sup> When the relevant ethical requirements include those of the IESBA Code, the statement may also make reference to the IESBA Code. If the IESBA Code constitutes all of the ethical requirements relevant to the audit, the statement need not identify a jurisdiction of origin.
- A30. In some jurisdictions, relevant ethical requirements may exist in several different sources, such as the ethical code(s) and additional rules and requirements within law and regulation. When the independence and other relevant ethical requirements are contained in a limited number of sources, the auditor may choose to name the relevant source(s) (e.g., the name of the code, rule or regulation applicable in the jurisdiction), or may refer to a term that is commonly understood and that appropriately summarizes those sources (e.g., independence requirements for audits of private entities in Jurisdiction X).

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<sup>74</sup> ISA 200, paragraph A14

- A31. Law or regulation, national auditing standards or the terms of an audit engagement may require the auditor to provide in the auditor's report more specific information about the sources of the relevant ethical requirements, including those pertaining to independence, that applied to the audit of the financial statements.
- A32. In determining the appropriate amount of information to include in the auditor's report when there are multiple sources of relevant ethical requirements relating to the audit of the financial statements, an important consideration is balancing transparency against the risk of obscuring other useful information in the auditor's report.

#### Considerations specific to group audits

- A33. In group audits when there are multiple sources of relevant ethical requirements, including those pertaining to independence, the reference in the auditor's report to the jurisdiction ordinarily relates to the relevant ethical requirements that are applicable to the group engagement team. This is because, in a group audit, component auditors are also subject to ethical requirements that are relevant to the group audit.<sup>75</sup>
- A34. The ISAs do not establish specific independence or ethical requirements for auditors, including component auditors, and thus do not extend, or otherwise override, the independence requirements of the IESBA Code or other ethical requirements to which the group engagement team is subject, nor do the ISAs require that the component auditor in all cases to be subject to the same specific independence requirements that are applicable to the group engagement team. As a result, relevant ethical requirements, including those pertaining to independence, in a group audit situation may be complex. ISA 600<sup>76</sup> provides guidance for auditors in performing work on the financial information of a component for a group audit, including those situations where the component auditor does not meet the independence requirements that are relevant to the group audit.

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<sup>75</sup> ISA 600, paragraph A37

<sup>76</sup> ISA 600, paragraphs 19–20

### Key Audit Matters (Ref: Para. 30)

- A35. Law or regulation may require communication of key audit matters for audits of entities other than listed entities, for example, entities characterized in such law or regulation as public interest entities.
- A36. The auditor may also decide to communicate key audit matters for other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities.
- A37. ISA 210 requires the auditor to agree the terms of the audit engagement with management and those charged with governance, as appropriate, and explains that the roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance arrangements of the entity and relevant law or regulation.<sup>77</sup> ISA 210 also requires the audit engagement letter or other suitable form of written agreement to include reference to the expected form and content of any reports to be issued by the auditor.<sup>78</sup> When the auditor is not otherwise required to communicate key audit matters, ISA 210<sup>79</sup> explains that it may be helpful for the auditor to make reference in the terms of the audit engagement to the possibility of communicating key audit matters in the auditor's report and, in certain jurisdictions, it may be necessary for the auditor to include a reference to such possibility in order to retain the ability to do so.

### Considerations specific to public sector entities

- A38. Listed entities are not common in the public sector. However, public sector entities may be significant due to size, complexity or public interest aspects. In such cases, an auditor of a public sector entity may

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<sup>77</sup> ISA 210, paragraphs 9 and A21

<sup>78</sup> ISA 210, paragraph 10

<sup>79</sup> ISA 210, paragraph A23a

be required by law or regulation or may otherwise decide to communicate key audit matters in the auditor's report.

#### Responsibilities for the Financial Statements (Ref: Para. 32–33)

- A39. ISA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with ISAs is conducted.<sup>80</sup> Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted. ISA 260 (Revised) uses the term those charged with governance to describe the person(s) or organization(s) with responsibility for overseeing the entity, and provides a discussion about the diversity of governance structures across jurisdictions and by entity.
- A40. There may be circumstances when it is appropriate for the auditor to add to the descriptions of the responsibilities of management and those charged with governance in paragraphs 33–34 to reflect additional responsibilities that are relevant to the preparation of the financial statements in the context of the particular jurisdiction or the nature of the entity.
- A41. ISA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.<sup>81</sup> ISA 210 provides some flexibility in doing so, by explaining that, if law or regulation prescribes the responsibilities of management and, where appropriate, those charged with governance in relation to financial

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<sup>80</sup> ISA 200, paragraph 13(j)

<sup>81</sup> ISA 210, paragraph 6(b)(i)–(ii)

reporting, the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in ISA 210. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the engagement letter or other suitable form of written agreement. In such cases, this wording may also be used in the auditor's report to describe the responsibilities as required by paragraph 33(a) of this ISA. In other circumstances, including where the auditor decides not to use the wording of law or regulation as incorporated in the engagement letter, the wording in paragraph 33(a) of this ISA is used. In addition to including the description of management's responsibilities in the auditor's report as required by paragraph 33, the auditor may refer to a more detailed description of these responsibilities by including a reference to where such information may be obtained (e.g., in the annual report of the entity or a website of an appropriate authority).

- A42. In some jurisdictions, law or regulation prescribing management's responsibilities may specifically refer to a responsibility for the adequacy of accounting books and records, or accounting system. As books, records and systems are an integral part of internal control (as defined in ISA 315 (Revised)<sup>82</sup>), the descriptions in ISA 210 and in paragraph 33 do not make specific reference to them.
- A43. The Appendix to this ISA provides illustrations of how the requirement in paragraph 33(b) would be applied when IFRSs is the applicable financial reporting framework. If an applicable financial reporting framework other than IFRSs is used, the illustrative statements featured in the Appendix to this ISA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

#### Oversight of the financial reporting process (Ref: Para. 34)

- A44. When some, but not all, of the individuals involved in the oversight of the financial reporting process are also involved in preparing the

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<sup>82</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 4(c)

financial statements, the description as required by paragraph 34 of this ISA may need to be modified to appropriately reflect the particular circumstances of the entity. When individuals responsible for the oversight of the financial reporting process are the same as those responsible for the preparation of the financial statements, no reference to oversight responsibilities is required.

Auditor's Responsibilities for the Audit of the Financial Statements (Ref: Para. 36–39)

A45. The description of the auditor's responsibilities as required by paragraphs 36–39 of this ISA may be tailored to reflect the specific nature of the entity, for example, when the auditor's report addresses consolidated financial statements. Illustration 2 in the Appendix to this ISA includes an example of how this may be done.

Objectives of the auditor (Ref: Para. 37(a))

A46. The auditor's report explains that the objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes the auditor's opinion. These are in contrast to management's responsibilities for the preparation for the financial statements.

Description of materiality (Ref: Para. 37(c))

A47. The Appendix to this ISA provides illustrations of how the requirement in paragraph 37(c), to provide a description of materiality, would be applied when IFRSs is the applicable financial reporting framework. If an applicable financial reporting framework other than IFRSs is used, the illustrative statements presented in the Appendix to this ISA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

Auditor's responsibilities relating to ISA 701 (Ref: Para. 39(c))

A48. The auditor may also consider it useful to provide additional information in the description of the auditor's responsibilities beyond

what is required by paragraph 39(c). For example, the auditor may make reference to the requirement in paragraph 9 of ISA 701 to determine the matters that required significant auditor attention in performing the audit, taking into account areas of higher assessed risk of material misstatement or significant risks identified in accordance with ISA 315 (Revised); significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and the effects on the audit of significant events or transactions that occurred during the period.

Location of the description of the auditor's responsibilities for the audit of the financial statements (Ref: Para. 40, 49(j))

A49. Including the information required by paragraphs 38–39 of this ISA in an appendix to the auditor's report or, when law, regulation or national auditing standards expressly permit, referring to a website of an appropriate authority containing such information may be a useful way of streamlining the content of the auditor's report. However, because the description of the auditor's responsibilities contains information that is necessary to inform users' expectations of an audit conducted in accordance with ISAs, a reference is required to be included in the auditor's report indicating where such information can be accessed.

Location in an appendix (Ref: Para. 40(b), 49(j))

A50. Paragraph 40 permits the auditor to include the statements required by paragraphs 38–39 describing the auditor's responsibilities for the audit of the financial statements in an appendix to the auditor's report, provided that appropriate reference is made within the body of the auditor's report to the location of the appendix. The following is an illustration of how such a reference to an appendix could be made in the auditor's report:

## **Auditor’s Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor’s report. This description, which is located at [*indicate page number or other specific reference to the location of the description*], forms part of our auditor’s report.

Reference to a website of an appropriate authority (Ref: Para. 40(c), 41)

A51. Paragraph 40 explains that the auditor may refer to a description of the auditor’s responsibilities located on a website of an appropriate authority, only if expressly permitted by law, regulation or national auditing standards. The information on the website that is incorporated in the auditor’s report by way of a specific reference to the website location where such information can be found may describe the auditor’s work, or the audit in accordance with ISAs more broadly, but it cannot be inconsistent with the description required in paragraphs 38–39 of this ISA. This means that the wording of the description of the auditor’s responsibilities on the website may be more detailed, or may address other matters relating to an audit of financial statements, provided that such wording reflects and does not contradict the matters addressed in paragraphs 38–39.

- A52. An appropriate authority could be a national auditing standard setter, regulator, or an audit oversight body. Such organizations are well-placed to ensure the accuracy, completeness and continued availability of the standardized information. It would not be appropriate for the auditor to maintain such a website. The following is an illustration of how such a reference to a website could be made in the auditor's report:

**Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located at [Organization's] website at: [website address]. This description forms part of our auditor's report.

Other Reporting Responsibilities (Ref: Para. 42–44)

- A53. In some jurisdictions, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibilities under the ISAs. For example, the auditor may be asked to report certain matters if they come to the auditor's attention during the course of the audit of the financial statements. Alternatively, the auditor may be asked to perform and report on additional specified procedures, or to express an opinion on specific matters, such as the adequacy of accounting books and records, internal control over financial reporting or other information. Auditing standards in the

specific jurisdiction often provide guidance on the auditor's responsibilities with respect to specific additional reporting responsibilities in that jurisdiction.

- A54. In some cases, the relevant law or regulation may require or permit the auditor to report on these other responsibilities as part of their auditor's report on the financial statements. In other cases, the auditor may be required or permitted to report on them in a separate report.
- A55. Paragraphs 42–44 of this ISA permit combined presentation of other reporting responsibilities and the auditor's responsibilities under the ISAs only when they address the same topics and the wording of the auditor's report clearly differentiates the other reporting responsibilities from those under the ISAs. Such clear differentiation may make it necessary for the auditor's report to refer to the source of the other reporting responsibilities and to state that such responsibilities are beyond those required under the ISAs. Otherwise, other reporting responsibilities are required to be addressed in a separate section in the auditor's report with a heading "Report on Other Legal and Regulatory Requirements," or otherwise as appropriate to the content of the section. In such cases, paragraph 44 requires the auditor to include reporting responsibilities under the ISAs under a heading titled "Report on the Audit of the Financial Statements."

Name of the Engagement Partner (Ref: Para. 45)

- A56. ISQC 1<sup>83</sup> requires that the firm establish policies and procedures to provide reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements. Notwithstanding these ISQC 1 requirements, naming the engagement partner in the auditor's report is intended to provide further transparency to the users of the auditor's report of a complete set of general purpose financial statements of a listed entity.
- A57. Law, regulation or national auditing standards may require that the auditor's report include the name of the engagement partner

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<sup>83</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraph 32

responsible for audits other than those of complete sets of general purpose financial statements of listed entities. The auditor may also be required by law, regulation or national auditing standards, or may decide to include additional information beyond the engagement partner's name in the auditor's report to further identify the engagement partner, for example, the engagement partner's professional license number that is relevant to the jurisdiction where the auditor practices.

- A58. In rare circumstances, the auditor may identify information or be subject to experiences that indicate the likelihood of a personal security threat that, if the identity of the engagement partner is made public, may result in physical harm to the engagement partner, other engagement team members or other closely related individuals. However, such a threat does not include, for example, threats of legal liability or legal, regulatory or professional sanctions. Discussions with those charged with governance about circumstances that may result in physical harm may provide additional information about the likelihood or severity of the significant personal security threat. Law, regulation or national auditing standards may establish further requirements that are relevant to determining whether the disclosure of the name of the engagement partner may be omitted.

Signature of the Auditor (Ref: Para. 46)

- A59. The auditor's signature is either in the name of the audit firm, the personal name of the auditor or both, as appropriate for the particular jurisdiction. In addition to the auditor's signature, in certain jurisdictions, the auditor may be required to declare in the auditor's report the auditor's professional accountancy designation or the fact that the auditor or firm, as appropriate, has been recognized by the appropriate licensing authority in that jurisdiction.
- A60. In some cases, law or regulation may allow for the use of electronic signatures in the auditor's report.

Date of the Auditor's Report (Ref: Para. 48)

- A61. The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in ISA 560.<sup>84</sup>
- A62. Since the auditor's opinion is provided on the financial statements and the financial statements are the responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until evidence is obtained that all the statements that comprise the financial statements, including the related notes, have been prepared and management has accepted responsibility for them.
- A63. In some jurisdictions, law or regulation identifies the individuals or bodies (e.g., the directors) that are responsible for concluding that all the statements that comprise the financial statements, including the related notes, have been prepared, and specifies the necessary approval process. In such cases, evidence is obtained of that approval before dating the report on the financial statements. In other jurisdictions, however, the approval process is not prescribed in law or regulation. In such cases, the procedures the entity follows in preparing and finalizing its financial statements in view of its management and governance structures are considered in order to identify the individuals or body with the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared. In some cases, law or regulation identifies the point in the financial statement reporting process at which the audit is expected to be complete.
- A64. In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial

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<sup>84</sup> ISA 560, *Subsequent Events*, paragraphs 10–17

statements for purposes of ISAs is the earlier date on which those with the recognized authority determine that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

*Auditor's Report Prescribed by Law or Regulation (Ref: Para. 49)*

- A65. ISA 200 explains that the auditor may be required to comply with legal or regulatory requirements in addition to ISAs.<sup>85</sup> When the differences between the legal or regulatory requirements and ISAs relate only to the layout and wording of the auditor's report, the requirements in paragraph 49(a)–(n) set out the minimum elements to be included in the auditor's report to enable a reference to the International Standards on Auditing. In those circumstances, the requirements in paragraphs 21–48 that are not included in paragraph 49(a)–(n) do not need to be applied including, for example, the required ordering of the Opinion and Basis for Opinion sections.
- A66. Where specific requirements in a particular jurisdiction do not conflict with ISAs, the layout and wording required by paragraphs 21–48 of this ISA assist users of the auditor's report in more readily recognizing the auditor's report as a report of an audit conducted in accordance with ISAs.

*Information Required by ISA 701 (Ref: Para. 49(h))*

- A67. Law or regulation may require the auditor to provide additional information about the audit that was performed, which may include information that is consistent with the objectives of ISA 701, or may prescribe the nature and extent of communication about such matters.
- A68. The ISAs do not override law or regulation that governs an audit of financial statements. When ISA 701 is applicable, reference can only be made to ISAs in the auditor's report if, in applying the law or regulation, the section required by paragraph 49(h) of this ISA is not inconsistent with the reporting requirements in ISA 701. In such

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<sup>85</sup> ISA 200, paragraph A55

circumstances, the auditor may need to tailor certain aspects of the communication of key audit matters in the auditor's report required by ISA 701, for example by:

- Modifying the heading "Key Audit Matters", if law or regulation prescribes a specific heading;
- Explaining why the information required by law or regulation is being provided in the auditor's report, for example by making a reference to the relevant law or regulation and describing how that information relates to the key audit matters;
- Where law or regulation prescribes the nature and extent of the description, supplementing the prescribed information to achieve an overall description of each key audit matter that is consistent with the requirement in paragraph 13 of ISA 701.

A69. ISA 210 deals with circumstances where law or regulation of the relevant jurisdiction prescribes the layout or wording of the auditor's report in terms that are significantly different from the requirements of ISAs, which in particular includes the auditor's opinion. In these circumstances, ISA 210 requires the auditor to evaluate:

- (a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,
- (b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding.

If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, ISA 210 requires the auditor not to accept the audit engagement, unless required by law or regulation to do so. In accordance with ISA 210, an audit conducted in accordance with such law or regulation does not comply with ISAs. Accordingly, the auditor does not include any reference in the auditor's report to the audit having been conducted in accordance with International Standards on Auditing.<sup>86</sup>

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<sup>86</sup> ISA 210, paragraph 21

## Considerations specific to public sector entities

A70. Auditors of public sector entities may also have the ability pursuant to law or regulation to report publicly on certain matters, either in the auditor's report or in a supplementary report, which may include information that is consistent with the objectives of ISA 701. In such circumstances, the auditor may need to tailor certain aspects of the communication of key audit matters in the auditor's report required by ISA 701 or include a reference in the auditor's report to a description of the matter in the supplementary report.

### *Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards of a Specific Jurisdiction and International Standards on Auditing* (Ref: Para. 50)

A71. The auditor may refer in the auditor's report to the audit having been conducted in accordance with both International Standards on Auditing as well as the national auditing standards when, in addition to complying with the relevant national auditing standards, the auditor complies with each of the ISAs relevant to the audit.<sup>87</sup>

A72. A reference to both International Standards on Auditing and the national auditing standards is not appropriate if there is a conflict between the requirements in ISAs and those in the national auditing standards that would lead the auditor to form a different opinion or not to include an Emphasis of Matter or Other Matter paragraph that, in the particular circumstances, is required by ISAs. In such a case, the auditor's report refers only to the auditing standards (either International Standards on Auditing or the national auditing standards) in accordance with which the auditor's report has been prepared.

### **Supplementary Information Presented with the Financial Statements** (Ref: Para. 52–53)

A73. In some circumstances, the entity may be required by law, regulation or standards, or may voluntarily choose, to present together with the financial statements supplementary information that is not required by

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<sup>87</sup> ISA 200, paragraph A56

the applicable financial reporting framework. For example, supplementary information might be presented to enhance a user's understanding of the applicable financial reporting framework or to provide further explanation of specific financial statement items. Such information is normally presented in either supplementary schedules or as additional notes.

A74. Paragraph 52 of this ISA explains that the auditor's opinion covers supplementary information that is an integral part of the financial statements because of its nature or how it is presented. This evaluation is a matter of professional judgment. To illustrate:

- When the notes to the financial statements include an explanation or the reconciliation of the extent to which the financial statements comply with another financial reporting framework, the auditor may consider this to be supplementary information that cannot be clearly differentiated from the financial statements. The auditor's opinion would also cover notes or supplementary schedules that are cross-referenced from the financial statements.
- When an additional profit and loss account that discloses specific items of expenditure is disclosed as a separate schedule included as an Appendix to the financial statements, the auditor may consider this to be supplementary information that can be clearly differentiated from the financial statements.

A75. Supplementary information that is covered by the auditor's opinion does not need to be specifically referred to in the auditor's report when the reference to the notes in the description of the statements that comprise the financial statements in the auditor's report is sufficient.

A7. Law or regulation may not require that the supplementary information be audited, and management may decide to ask the auditor not to include the supplementary information within the scope of the audit of the financial statements.

A77. The auditor's evaluation whether unaudited supplementary information is presented in a manner that could be construed as being covered by

the auditor's opinion includes, for example, where that information is presented in relation to the financial statements and any audited supplementary information, and whether it is clearly labeled as "unaudited."

A78. Management could change the presentation of unaudited supplementary information that could be construed as being covered by the auditor's opinion, for example, by:

- Removing any cross-references from the financial statements to unaudited supplementary schedules or unaudited notes so that the demarcation between the audited and unaudited information is sufficiently clear.
- Placing the unaudited supplementary information outside of the financial statements or, if that is not possible in the circumstances, at a minimum placing the unaudited notes together at the end of the required notes to the financial statements and clearly labeling them as unaudited. Unaudited notes that are intermingled with the audited notes can be misinterpreted as being audited.

A79. The fact that supplementary information is unaudited does not relieve the auditor of the responsibilities described in ISA 720.

**[Note:** *The Appendix with the Illustrative Reports has not been presented here.*]